

# Management Implication Report: Some States Failed to Conduct Required Financial Audits of Their State Revolving Funds

September 12, 2024 | Report No. 24-N-0060





**OFFICE OF INSPECTOR GENERAL**  
U.S. ENVIRONMENTAL PROTECTION AGENCY

September 12, 2024

**MEMORANDUM**

**SUBJECT:** Management Implication Report: Some States Failed to Conduct Required Financial Audits of Their State Revolving Funds

**FROM:** Sean W. O'Donnell, Inspector General 

**TO:** Bruno Pigott, Acting Assistant Administrator  
Office of Water

**Purpose:** We are alerting the U.S. Environmental Protection Agency to issues that the Office of Inspector General has encountered regarding mandatory audits of state revolving funds, or SRFs. The statutes creating the SRFs require states to conduct financial and compliance audits of their SRFs. The EPA's implementing regulations expressly or implicitly require, among other things, that the states send these audits to the OIG and that the OIG review the audits. The need for the OIG to review these SRF audits is particularly important in light of the approximately \$43.4 billion that the Infrastructure Investment and Jobs Act appropriates to the SRFs. Until our April 2023 request, the states have not submitted their audits to the OIG so that the OIG can determine whether those audits meet regulatory requirements. Based on the response to our request for those audits and on subsequent audit work, at least nine states did not provide audit reports for their Clean Water State Revolving Fund, or CWSRF, and Drinking Water State Revolving Fund, or DWSRF, Programs that, at a minimum, specifically identified the state's CWSRF and DWSRF financial information.<sup>1</sup> This represents what the OIG estimates to be approximately \$13 billion in total assets at greater risk for fraud, waste, and abuse because of the failure to conduct and report the mandated audit. Furthermore, the EPA has announced that it will award nearly \$4.7 billion of IJIA funds to these nine states.<sup>2</sup>

**Background:** The SRFs provide low-interest loans and other low-cost financing to support local water systems. Previously, the EPA funded infrastructure projects directly through its Construction Grants Program. The EPA devolved this funding to the states with the CWSRFs, established in 1987 through amendments to the Clean Water Act, and the DWSRFs, established in 1997 through amendments to the Safe Drinking Water Act. Every year, the EPA provides each SRF with a capitalization grant. The states

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<sup>1</sup> We did not review SRF compliance audits for this report.

<sup>2</sup> We conducted this work in accordance with the *Quality Standards for Federal Offices of Inspector General* published in August 2012 by the Council of the Inspectors General on Integrity and Efficiency, as well as our own internal standards.

then contribute an amount, typically equal to at least 20 percent of the grant, into the SRF. With the EPA and state funds, the SRFs make low-interest loans to eligible recipients and recycle, or revolve, loan repayments into the SRFs to fund additional water projects.<sup>3</sup> Since their inception, the SRF programs have provided more than \$200 billion in low-cost financing for water-related infrastructure projects. The Infrastructure Investment and Jobs Act will add an additional \$43.4 billion to the SRFs, significantly increasing the size of each SRF.

Both the Clean Water Act and the Safe Drinking Water Act impose periodic reporting requirements regarding the SRFs. For example, section 606(b) of the Clean Water Act requires that, “at least on an annual basis,” the EPA must “conduct or require each State to have independently conducted reviews and audits as may be deemed necessary or appropriate by the Administrator.”<sup>4</sup> Similarly, section 1452(g)(4) of the Safe Drinking Water Act requires that there be a periodic “audit [of] all State loan funds” and that the DWSRF submit periodic reporting, including “the findings of the most recent audit of the fund and the entire State allotment.”<sup>5</sup>

To implement these reporting requirements, the EPA promulgated regulations setting forth what the SRFs should report and how they should report. These regulatory requirements generally require that there be independently conducted financial and compliance audits of the SRFs. With respect to the CWSRFs, EPA regulations require that “[a]t least once a year the [regional administrator] (through the Office of the Inspector General) will conduct, or require the State to have independently conducted, a financial and compliance audit of the SRF and the operations of the SRF.”<sup>6</sup> Furthermore, “[t]he audit report must be completed within one year of the end of the appropriate accounting period and submitted to the Office of the Inspector General within 30 days of completion.”<sup>7</sup> This audit “may be done in *conjunction* with the Single Audit Act”;<sup>8</sup> however, as the EPA recognizes in its *SRF Fund Management Handbook*, single audits may not show SRF-specific information and, therefore, may not have the necessary information to meet the requirement that “the audit report required under section 606(b) must contain an opinion on the financial statements of the SRF and its internal controls, and a report on compliance with title VI.”<sup>9</sup>

The DWSRF regulations require similar audit requirements. A state may “voluntarily agree to conduct annual independent audits which provide an auditor’s opinion on the DWSRF program financial statements, reports on internal controls, and reports on compliance with section 1452 of the Act, applicable regulations, and general grant requirements.”<sup>10</sup> According to these regulations, those states

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<sup>3</sup> In addition to issuing low-interest loans, states may subsidize projects through SRF grants and principal forgiveness. States can also charge fees to recipients when providing SRF assistance. These fees can include loan origination, annual loan-servicing, and application or processing fees.

<sup>4</sup> 31 U.S.C. § 1386(b).

<sup>5</sup> 42 U.S.C. § 300j–12(g)(4).

<sup>6</sup> 40 C.F.R. § 35.3165(d)(1).

<sup>7</sup> 40 C.F.R. § 35.3165(d)(4).

<sup>8</sup> 40 C.F.R. § 35.3165(d)(4) (emphasis added).

<sup>9</sup> 40 C.F.R. § 35.3165(d)(3).

<sup>10</sup> 40 C.F.R. § 35.3570(b)(2).

that do not conduct independent audits “will be subject to periodic audits by the EPA Office of Inspector General.”<sup>11</sup>

The audit requirements remain one of the most important tools for determining the financial and operational health of an SRF and for detecting potential fraud. This is particularly true now that the EPA can no longer rely on the systemic subrecipient monitoring requirements in the Uniform Guidance found in 2 C.F.R. § 200.331 through § 200.333. In 2022, nearly a year after the enactment of the Infrastructure Investment and Jobs Act, the EPA finalized a rule that relieved the SRFs from engaging in regulatorily required monitoring of the water systems that receive SRF loans or other assistance.<sup>12</sup>

The OIG is entitled to an SRF’s audits or other related documents. The Inspector General Act of 1978, as amended, authorizes the OIG to have timely access to all documents or other material available to the EPA, including those related to the SRFs.<sup>13</sup> The Uniform Guidance further authorizes the OIG to “access any documents, papers, or other records of the” SRF.<sup>14</sup> The EPA has reaffirmed the OIG’s right to a recipient’s or subrecipient’s records in the terms and conditions of its grants.<sup>15</sup>

The audit requirements are also important tools for the EPA’s oversight of a state’s operation of its SRF. The SRFs are subject to annual reviews, the purpose of which are “to assess the success of the State’s performance of activities identified in the [Intended Use Plan] and [the statutorily required periodic report], and to determine compliance with the terms of the capitalization grant agreement” and applicable laws and regulations.<sup>16</sup> According to the *SRF Reviewer’s Guide (FY2018-22)*, the annual review combines a “prescriptive, checklist-based portion” with a “framework for regions to develop risk-based protocol for the interview portion of the review.” To prepare for completing the annual review checklist, the Agency reviews and analyzes several program documents, including a state’s SRF audit reports. The EPA views these annual reviews as critical pieces of its SRF oversight.

**Concerns Identified:** Since the early 1990s, states have been expressly or implicitly required to send their SRF audits to the OIG.<sup>17</sup> Over the last decade or more, however, the states have not been sending their SRF audits to the OIG so that the OIG could determine whether the states have been conducting the required independent audits.

On April 18, 2023, the OIG sent a letter requesting each SRF’s most recent regulatorily required audits to the SRF points of contact obtained from the EPA.<sup>18</sup> All the SRFs responded; however, not all of them

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<sup>11</sup> 40 C.F.R. § 35.3570(b)(3).

<sup>12</sup> 2 C.F.R. § 1500.3(b).

<sup>13</sup> 5 U.S.C. § 406(a)(1)(A).

<sup>14</sup> 2 C.F.R. § 200.337(a).

<sup>15</sup> See EPA, [General Terms and Conditions Effective October 1, 2023](#) (2023).

<sup>16</sup> 40 C.F.R. § 35.3165(e)(1); see also 40 C.F.R. § 35.3570(c)(1).

<sup>17</sup> See EPA *State Revolving Fund Program Implementation Regulations*, 55 Fed. Reg. 10178, 10184 (Mar. 19, 1990) (publishing interim rule with request for comments, to include requirements for the CWSRF annual audit).

<sup>18</sup> The EPA’s list of points of contact required some refinement because of state-level changes such as retirements, reassignments, or changes of duty.

provided the regulatorily required audit. For example, one state submitted its statewide comprehensive audit, which did not include the required compliance reports, among other things. Another state submitted an unaudited financial statement and the state's single audit, which did not separately identify the CWSRF or the DWSRF. Some states did not provide the information that the OIG requested, despite their statutory and regulatory obligation to respond to an OIG request. For example, one state sent an agreed-upon procedures report, which does not provide the same level of assurance as an audit.

On September 20, 2023, the OIG announced an audit of the states' and the Commonwealth of Puerto Rico's compliance with the CWSRF and DWSRF annual financial statement audit requirements. As part of its audit work, the OIG reviewed what each state provided as its SRF financial statement audits for fiscal year 2022. Based on the April 18, 2023 letter and the OIG's audit analysis, we determined that at least nine states did not provide audit reports for their CWSRF and DWSRF Programs that, at a minimum, specifically identified the state's CWSRF and DWSRF financial information.

The failure to conduct the regulatorily required audits has several significant consequences. As discussed above, the EPA relies on these SRF audits as part of its annual review of the SRFs. Without the benefit of the regulatorily required SRF audits, the EPA's annual reviews could fail to be complete or sufficient. More importantly, from the OIG's perspective, these audits serve as an important tool in detecting and preventing fraud, waste, and abuse in the SRFs. Without the benefit of these SRF audits, the various stakeholders lack clarity into the state of the funds. This represents what the OIG estimates to be approximately \$13 billion in total assets at greater risk for fraud, waste, and abuse because of the failure to conduct and report the mandated audit. Furthermore, the EPA has announced that it has, or will, award nearly \$4.7 billion of IJA funds to these nine states.

We raise these concerns so that the Agency may take whatever steps it deems appropriate to address state compliance with the regulations requiring SRF audits. If you decide it is appropriate for your office to take or plan to take action to address these matters, we would appreciate notification of that action. Should you have any questions regarding this report, please contact me at [REDACTED] or Jee Kim, senior advisor to the inspector general, at [REDACTED] or [kim.jee@epa.gov](mailto:kim.jee@epa.gov).



## Whistleblower Protection

U.S. Environmental Protection Agency

*The whistleblower protection coordinator's role is to educate Agency employees about prohibitions against retaliation for protected disclosures and the rights and remedies against retaliation. For more information, please visit the OIG's whistleblower protection [webpage](#).*

### Contact us:



**Congressional Inquiries:** [OIG.CongressionalAffairs@epa.gov](mailto:OIG.CongressionalAffairs@epa.gov)



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