A Report
to the
Montana
Legislature

Financial-Compliance Audit

Department of Environmental Quality

For the Two Fiscal Years Ended June 30, 2018

November 2018

Legislative Audit
Division

18-16

Financial-Compliance Audits

Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States Government Accountability Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

The Single Audit Act Amendments of 1996 and the Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards require the auditor to issue certain financial, internal control, and compliance reports in addition to those reports required by *Government Auditing Standards*. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2017, was issued March 23, 2018. The Single Audit Report for the two fiscal years ended June 30, 2019, will be issued by March 31, 2020.

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November 2018

The Legislative Audit Committee
of the Montana State Legislature:

The enclosed report documents the results of our financial-compliance audit of the Department of Environmental Quality for the two fiscal years ended June 30, 2018. Included in this report are three recommendations related to the following: internal control deficiencies over the recording of financial transactions; unallowed expenditures charged to the department's internal service fund; and noncompliance with state laws, policies, and other regulations. Also included are three disclosure issues for the legislature's consideration.

The department's written response to the audit recommendations is included in the audit report on page C-1. We thank the director and his staff for their cooperation and assistance throughout the audit.

Respectfully submitted,

/s/ Angus Maciver

Angus Maciver
Legislative Auditor

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Appointed and Administrative Officials

Department of Environmental Quality	Tom Livers, Director (through September 2018)		
	George Mathieus, Acting Interim Director (effective September 2018)		
	Peggy MacEwen, Centralized Services Division Administrator		
	Christopher Dorrington, Air, Energy & Mining Division Administrator		
	Jenny Chambers, Waste Management & Remediation Division Administrator		
	Tim Davis, Water Quality Division Administrator		

			Term Expires
Board of Environmental Review	Christine (Chris) Deveny, Chair	Helena	January 1, 2021
	John Felton	Billings	January 1, 2019
	Dexter Busby	Great Falls	January 1, 2021
	Hillary Hanson	Kalispell	January 1, 2019
	Tim Warner	Bozeman	January 1, 2019
	John DeArment	Missoula	January 1, 2021
	Chris Tweeten	Missoula	January 1, 2021
Petroleum Tank Release Compensation Board	Jerry Breen, Presiding Officer	Choteau	July 1, 2019
	Keith Schnider, Vice-Presiding Officer	Great Falls	July 1, 2019
	Jim Corson	Billings	July 1, 2018
	Heather Smith	Bozeman	July 1, 2020
	Ed Thamke	Helena	July 1, 2020
	Mark Johnson	Bozeman	July 1, 2019
	Jason Rorabaugh	Belgrade	July 1, 2021

For additional information concerning the Department of Environmental Quality, contact:

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Montana Legislative Audit Division

Financial-Compliance Audit
Department of Environmental Quality
For the Two Fiscal Years Ended June 30, 2018

November 2018 | 18-16 | Report Summary

The Department of Environmental Quality expends over $100 million each year for environmental protection and enforcement activities within the state of Montana. During the audit period, decisions made by department management jeopardized the health of the department's internal service fund, and also put state funds at risk of having to cover unfunded federal program costs. In addition, an internal control deficiency over the recording of financial transactions resulted in several multimillion-dollar misstatements on the department's accounting records in fiscal years 2017 and 2018.

Context

The Department of Environmental Quality (department) supports a clean and healthy environment through the administration of programs aimed at protecting, sustaining, and improving Montana's air, land, and water. The department is funded primarily from license and permit revenue and federal grants. These revenues are mainly used for personal services expenditures, contracted services, and transfers to the Department of Natural Resources and Conservation in their joint administration of the State Revolving Loan Programs.

We focused our audit effort on testing transactions related to the revenues and expenditures discussed above. In addition, we reviewed the completeness and accuracy of the department's investment transactions. We also reviewed the department's control systems and determined compliance with selected state and federal laws and regulations.

Results

Our prior audit report for the two fiscal years ended June 30, 2016, contained no audit recommendations. In our current audit, we recognized a significant control deficiency over the recording of financial transactions after identifying several misstatements in the accounting records. We identified costs related to the development of an information system that were inappropriately charged to the department's internal service fund. We also discovered several instances of noncompliance with state laws and policies, as well as the Administrative Rules of Montana.

In addition to the three recommendations resulting from the issues discussed above, we identified several matters the legislature should have knowledge of in order to fulfill its legislative responsibilities. As such, we have included three disclosure issues in the report relating to employee settlement payments charged to the department's internal service fund, the transferring of an employee to a management position without competitive recruitment, and the incurrence of $1.5 million in federal expenditures prior to receiving a federal grant award.

(continued on back)

Recommendation Concurrence	
Concur	3
Partially Concur	0
Do Not Concur	0
Source: Agency audit response included in final report.	

For a complete copy of the report (18-16) or for further information, contact the
Legislative Audit Division at 406-444-3122; e-mail to **lad@mt.gov**; or check the web site at
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Chapter I – Introduction

Introduction

We performed a financial-compliance audit of the Department of Environmental Quality (department) for the two fiscal years ended June 30, 2018. The objectives of the audit were to:

1. Obtain an understanding of the department's internal controls to the extent necessary to support our audit of the department's financial schedules and, if appropriate, make recommendations for improvements in internal and management controls of the department.
2. Determine whether the department's financial schedules for each of the two fiscal years ended June 30, 2018, fairly present the results of operations and changes in fund equity, in accordance with state accounting policy.
3. Determine whether the department complied with selected state laws and federal regulations.

We addressed these objectives by focusing our audit efforts primarily on revenues received from federal grant awards and those generated from licensing and permitting activities. We also reviewed expenditures related to personal services, other services, and transfers-out. This included examining the department's internal control procedures, performing analytical procedures, and reviewing accounting transactions. We also reviewed and tested the department's compliance with selected state laws and policies and federal regulations.

In accordance with §17-8-101(6), MCA, we reviewed the fees, charges, and fund equity of the department's internal service fund, which is used to account for the indirect costs charged in the Central Management Program. The Central Management Program bills other department programs for its centralized services, including financial-related services and information system support services, through the use of an approved indirect cost rate. While we determined the fees and charges are commensurate with costs and the fund equity balance is reasonable in fiscal years 2017 and 2018, we have concerns regarding certain charges to the internal service fund. Additional information is provided in Recommendation #2 and the Internal Service Fund disclosure issue beginning on pages 7 and 13, respectively.

Background

The department is charged with helping protect the environment as guaranteed to the citizens of Montana by the state's constitution. The department's various divisions each have their own part in helping fulfill this responsibility. The department is currently organized according to the following programs: Centralized Management; Air, Energy, and Mining; Water Quality; Waste Management and Remediation; Libby Asbestos Superfund Team; and Petroleum Tank Release Compensation Board. The following paragraphs contain a brief description of each of these programs, including the full-time equivalent (FTE) positions. These FTE numbers include House Bill 2, proprietary, and modified FTE. At the end of the audit period, the department had approximately 75 vacant positions, which are not included in the FTE numbers shown below.

Centralized Management Division (Program 10) (82.66 FTE) consists of the Director's Office and the Centralized Services Division. In fiscal year 2018, the department completed a minor reorganization and the Enforcement Division was incorporated into the Centralized Management Division as well. The Centralized Services Division provides department-wide support relating to human resources, safety, information technology, financial services, operations project management, and records and information management. The Director's Office includes the director's staff, the public policy director, centralized legal pool, and the functions of the Montana Environmental Policy Act and the Montana Facility Siting Act. The Director's Office includes the Board of Environmental Review (BER) established by §2-15-3502, MCA. The BER reviews administrative decisions made by the department that are appealed to it by affected parties as provided by statute.

Air, Energy & Mining Division (Program 50) (111.03 FTE) consists of four bureaus. In order to ensure conformity with the Montana Environmental Policy Act, the Air Quality Bureau regulates air emissions through permitting, education, and compliance activities. The Energy Bureau promotes renewable and alternative energy production, encourages energy conservation across the state, and provides information regarding Montana's energy forecasts. The Coal and Opencut Mining Bureau regulates opencut mines that extract materials such as bentonite, clay, scoria, sand and gravel and issues permits for all activities relating to coal mining and exploration. The Hard Rock Mining Bureau regulates mining of all metallic and industrial minerals other than bentonite, clay, coal, sand, gravel, peat, and uranium.

Water Quality Division (Program 20) (141.84 FTE) protects water quality through implementing measures that conserve the state's water resources. The division consists of the Public Water & Subdivision Bureau, Water Quality Planning Bureau, Water Protection Bureau, and the Technical and Financial Assistance Bureau.

Waste Management & Remediation Division (Program 40) (122.70 FTE) is responsible for overseeing environmental protection related to underground tanks, solid waste, and remediation of contaminated sites. The division consists of the Federal Superfund and Construction Bureau, the Abandoned Mine Lands section, Contaminated Site Clean-up Bureau, and Waste and Underground Tank Management Bureau.

Libby Asbestos Superfund Advisory Team (Program 80) (.67 FTE) was established in Chapter 317, Laws of 2017 Legislative Regular Session. The team is attached to the department for administrative purposes only. The duties of the team are to advise the department regarding the administration of the Libby asbestos cleanup trust fund, the administration of the cleanup operation and maintenance account, and to recommend task and work priorities for the Libby asbestos superfund liaison.

Petroleum Tank Release Compensation Board (Program 90) (5.75 FTE) oversees the Petroleum Tank Release Cleanup Fund, established by §75-11-313, MCA, which reimburses eligible owners and operators for costs of petroleum release cleanup. Fund administration is a joint responsibility of the board and the department.

Chapter II – Findings and Recommendations

Financial Misstatements

The department's internal controls were not effective in preventing misstatements on the state's accounting records.

State accounting policy charges management with the responsibility for establishing and maintaining department internal controls. A control structure is a process designed to provide management with reasonable assurance it will achieve its objectives related to financial accountability and compliance with laws and regulations. The components of a control structure work together to help an organization operate as management intends. Deficiencies in internal control increase the risk the department may not identify inappropriate or fraudulent transactions in a timely manner or be able to ensure the financial schedules are free from material misstatement. During the audit, we identified several instances where internal controls failed to identify errors such as misclassifications between funds, accounts, and fiscal years, as well as errors in expenditure recognition. We discuss these errors in more detail below.

Trust Transactions

During fiscal year 2017, the Department of Environmental Quality (department) was the beneficiary of a settlement related to the bankruptcy of a mining corporation. The purpose of the settlement agreement was to form a trust, of which the department is the sole beneficiary, to ensure the mine site is fully reclaimed. The source of the trust's funds was monies submitted by the mining corporation to the department in 2001 to help complete the required reclamation at the mine site. The department originally held these monies in a private purpose trust fund (PPTF) account, but per the settlement agreement, was required to move the funds to a state special revenue fund (SSRF) account for the department's use. State accounting policy requires agencies to use transfer accounts to move money between two funds within the state's Treasury Fund structure. When the department moved the funds, however, it incorrectly recorded the activity as a benefits and claims expenditure in the PPTF and a fines and forfeiture revenue in the SSRF. This resulted in benefits and claims expenditures in the PPTF and fines and forfeitures revenues in the SSRF to be overstated, and transfers-out and transfers-in to be understated, by $2,347,909 in fiscal year 2017.

In addition, as part of the settlement agreement, the department advances funds to the trustee to pay the trust's operating expenses. Monthly, the trustee submits an invoice to the department outlining the trust's expenditures. Per state accounting policy, the department should have recorded the advances as an asset at the time the advance occurred, and expenditures as the trustee submitted invoices. Instead, the department recorded expenditures at the time of the advance, resulting in expenditures being overstated by $57,124 and advances being understated by the same amount, in fiscal year 2017. Continued accounting errors related to these transactions resulted in a $200,000 understatement in advances and a $142,876 overstatement of expenditures in fiscal year 2018.

Department personnel stated when the trust was first established, the employee responsible for recording the trust-related transactions was not provided proper guidance as to how these transactions should be recorded, resulting in the errors discussed above.

Abandoned Mine Land Grant

The department receives federal funds for the Abandoned Mine Land Reclamation grant program (AML) annually. Grant awards may span several fiscal years, resulting in multiple awards being available in any given fiscal year, but each award is tracked separately in its own account on the state's accounting records. In fiscal year 2017, the department drew $2,482,562 from its 2016 AML grant, but recorded the revenue in the 2015 AML grant account. In fiscal year 2018, the department drew another $2.5 million, this time from its 2015 AML grant, but recorded the revenue in the 2016 AML account. This resulted in revenues being recorded in the wrong account in both fiscal years 2017 and 2018. In addition, because the department recorded the revenue in the wrong account each fiscal year, when the department recorded subsequent activity to transfer the underlying cash to another account, the transfers were also incorrect because they existed in the incorrect account.

Department personnel stated the errors were identified through their federal reporting process, but based on our review of the transactions, we found the department netted the errors with improperly coded subsequent transactions and did not complete correcting entries. While these misstatements do not affect the face of the financial schedules, the revenues and expenditures in the underlying accounting records are misstated in fiscal years 2017 and 2018 from these errors. The department's controls failed to ensure grant transactions were coded to the correct account associated with each grant award or ensure correcting entries were completed.

Summary

Because of the errors discussed above, we determined a significant deficiency in controls over the recording of accounting transactions existed in the department. This is reflected in the report on internal control over financial reporting on page B-1.

Recommendation #1

We recommend the Department of Environmental Quality implement internal controls to prevent, or identify and correct, misstatements in its accounting records.

TREADS Expenditures

The department recorded expenditures in its Internal Service Fund that were not incurred from centrally-provided services.

State accounting policy defines an internal service fund (ISF) as a fund used to account for the financing of goods and services provided by one department or agency to other departments, agencies, or other governmental entities on a cost reimbursement basis. The department operates an ISF for the purpose of funding the department's indirect costs, which are incurred from centrally-provided services that benefit more than one program and are not readily assignable to a specific program. Costs incurred in the department's ISF are financed by charging a federally-approved indirect cost rate to all other department funds.

As reported in the *System Development and Project Management for the Tracking Remedial Environmental Actions Data System* (TREADS) (17DP-01) information system audit (audit), the department is in the process of developing TREADS to help manage its processes related to the responsibilities of the Waste Management and Remediation Division. The audit also reported the department terminated its contract in June 2016 with the vendor originally hired to develop the system and brought the project in-house to finish its development. The work completed in-house over TREADS is project specific and the system will not be utilized by the entire department once it is operational. As such, the costs associated with developing the system are not consistent with costs that should be recorded in the department's ISF. However, in fiscal years 2017 and 2018, we identified $28,467 and $264,319, respectively, in personal services expenditures charged inappropriately to the department's ISF for the development of TREADS. While the salaries of the personnel who charged time to the ISF for TREADS development are normally paid from the ISF fund, the development of TREADS is primarily for the benefit of one department program. Therefore, the related expenditures should not be considered indirect costs allocated to all department programs through the ISF.

Department management stated they believe the information contained in TREADS will be available to the entire department, will aid them in decision-making processes, and provide for more efficiency by eliminating duplication of work. As such, they believed it was appropriate to record the expenditures in the ISF. While we do not dispute transparency of information benefits management's decision-making process, the development of the system does not fall into the realm of ISF activity and the costs should be charged directly to funding specifically appropriated for the project.

Recommendation #2

We recommend the Department of Environmental Quality comply with state policy and only record expenditures in the department's internal service fund that are incurred from centrally-provided services.

Department Noncompliance

The department did not comply with various state laws and policies in fiscal years 2017 and 2018.

The department, as a state agency, is governed by many state laws and policies. In addition, the department participates in a collective bargaining agreement. During the audit, we tested the department's compliance with 42 state laws, as well as numerous state accounting policies, administrative rules, federal regulations, and its collective bargaining agreement. Through this work, we identified several instances of noncompliance. The following sections discuss several of the issues identified during the audit.

Collective Bargaining Agreement

The department entered into a two-year collective bargaining agreement on July 1, 2017, for the purpose of ensuring sound and mutually beneficial working relationships with its employees. The collective bargaining agreement states the department shall make a good faith effort to equalize the offer of scheduled overtime and compensatory time among employees in the same work unit and classification where training and ability are sufficient to perform the work. In fiscal year 2017, a collective bargaining grievance was filed with the department claiming inequity in earned overtime/compensatory time for an employee. The department settled the grievance because, per department personnel, inequities may have existed. The department paid approximately $13,500 from state sources as part of the settlement. To ensure future settlements are not necessary, the department should adhere to its collective bargaining agreement and ensure employees are given equal opportunity to earn overtime/compensatory time.

Excess Cash

The department maintains the Leaking Underground Storage Tank (LUST) Cost Recovery account in the state special revenue fund. The account is used to record cost recoveries the department receives related to clean-up costs the department has incurred for leaking underground storage tanks. State law limits the cash balance in state special revenue funds whose sole source of revenue is charges for services income, which is the case with the LUST Cost Recovery account, to twice the account's annual appropriation for that year or to no greater than the account's biennial appropriation. State law also allows for agencies to retain the excess balance if, by following procedures outlined in state law, they request permission to retain it. In both fiscal years 2017 and 2018, the department retained excess cash in its LUST fund without requesting permission to do so.

Department personnel stated recoveries do not happen often, but in fiscal year 2017, the department recovered approximately $700,000 from one entity. Subsequently, at fiscal year-end 2017, the department loaned $980,000 from the LUST account to its federal Performance Partnership Grant fund which was experiencing cash flow issues, as discussed in more detail in the third disclosure issue beginning on page 15 of the audit report. The loan was paid back in fiscal year 2018, but in our determination of the excess cash, we included the amount of the inter-entity loan. As a result, in fiscal years 2017 and 2018, the department maintained excess cash in its LUST account in the amounts of $22,900 and $83,700, respectively.

Per department personnel, they did not include the cash used for the inter-entity loan in their determination of excess cash because those funds were no longer available in their cash balance, and thus, they did not request permission to retain it. We maintain if the department had enough extra cash to make a loan, which would be repaid to the LUST account, the loaned amount should have been included in the calculation and the department should have requested permission to retain it.

Bad Actor Law

Per state law, a person may not engage in metal mine exploration in the state without an exploration license issued by the department. In addition, the department may not issue a metal mine exploration license to a person if the person, or an entity where the person was a controlling member, can be associated with past violations of the laws pertaining to metal mines. During the audit, the department renewed an exploratory license for a company whose Chief Executive Officer was a former controlling member of a mining company that did not fulfill its legal responsibilities for reclaiming its mine sites.

State accounting policy holds agency managers responsible for ensuring controls exist to carry out government programs, including associated compliance requirements. The department was unaware of its noncompliance until a nongovernmental entity provided the department with notification of its violation of state law. As such, we determined the department did not have controls in place to identify situations such as the one discussed in the previous paragraph. The department acknowledges this internal control deficiency and is in the process of establishing procedures to help prevent future violations of this law.

Student Interns

During fiscal year 2018, the department employed 15 student interns. Per state law, interns are not allowed leave and holiday benefits. However, in fiscal year 2018, the department paid approximately $5,585, primarily from the Internal Service Fund, to 11 of their interns for these benefits. Out of the remaining four, three interns terminated employment prior to management's decision to offer these benefits, and one intern was hired at the end of fiscal year 2018, and had not yet been paid these benefits prior to the end of our audit period.

Department management stated they were informed by the State Human Resources Division at the Department of Administration that providing leave benefits to interns was up to individual agencies, but were unable to provide support for this statement. In addition, department management stated many of the interns work in a similar manner to temporary employees, who qualify for these benefits, and management believes providing interns with holiday and leave benefits increases the department's potential applicant pools and provides recognition to the interns' contributions in meeting program objectives. Nonetheless, the department is in direct violation of state law.

Summary

State accounting policy emphasizes that accountability is intrinsic to the governing process and internal controls are key to ensuring accountability and achieving the objectives for which departments were authorized and funded. By not complying with the various rules and regulations discussed above, the department is at risk of not fulfilling its responsibilities to the citizens of Montana.

<u>Recommendation #3</u>

We recommend the Department of Environmental Quality implement controls to ensure compliance with the various laws and regulations governing its operations.

Disclosure Issues

The Montana Legislature is tasked with authorizing the expenditure of public money, designating the sources from which money may be collected, shaping the administration to perform the work of state government, and is held accountable for fiscal policy. As such, it is vital we disclose relevant information discovered during our audits of state agencies, even if recommendations do not result from the work, in order to enable the legislature to fulfill its responsibilities. The following sections outline several matters we observed during the audit we believe warrant the attention of the legislature.

Internal Service Fund

As discussed in Recommendation #2 beginning on page 7, the Department of Environmental Quality (department) operates an internal service fund (ISF) for the purpose of funding the department's centrally-provided services, or indirect costs. These costs are funded through a federally-approved indirect cost rate charged against all other departmental funds on a biweekly basis. During the audit, we identified other costs recorded in the ISF that, in addition to the Tracking Remedial Environmental Actions Data System (TREADS) expenditures discussed in Recommendation #2, we do not believe were appropriate for the department to charge to the ISF.

In fiscal year 2018, three employees received lump sum payments from the department as part of confidential separation agreements. Through these agreements, the department purchased one year of retirement for each of the employees totaling \$130,292. In addition, two of the employees were paid three months of administrative leave of approximately \$50,500. The entire \$180,792 was paid from the ISF. While these employees' regular salaries and benefits were normally paid from the department's ISF, the payments made per the settlement agreements were not for centrally-provided services performed by the employees. As such, we question whether the payments should have been recorded in the department's internal service fund.

Department management stated the settlements were a cost of doing business, as the department's strategic vision had changed which required changes in the skill sets of its employees. Department management elaborated further stating factors such as the current skill sets of its employees, ability of employees to learn new skill sets, the cost of retraining employees, and the cost of laying off employees were considered and the settlements were determined to be the most cost-effective solution. However, as a result of these payments, as well as the TREADS expenditures discussed previously, the department depleted its working capital in the ISF in fiscal year 2018 and was not able to recover enough revenue through its cost allocation process to finance all expenditures in the fund. Consequently, the fund had to obtain a \$100,000 inter-entity loan in order to continue to operate in fiscal year 2018. The department paid back the inter-entity loan at fiscal year-end, but was left with only three days of working capital.

While we question management's decisions related to the internal service fund, fees were technically commensurate with costs, so we make no recommendation at this time. However, if the department continues to charge costs to the ISF that are not for centrally-provided services, there is risk the department will be unable to fully recover the charged costs, resulting in the ISF fees not being commensurate with costs as required by state law.

We also briefly considered the legality of the settlement payments, but because our performance audit division is currently engaged in a settlement-specific audit, we determined it was more efficient and effective to provide our information to that audit for their consideration.

Competitive Recruitment

Administrative Rules of Montana (ARM) require agency managers to use a competitive process when recruiting to fill permanent positions. The competitive process ensures an equal opportunity is provided to all qualified employees who are interested in applying for the available position.

During the audit, we identified a situation in which a permanent management position was filled internally, without the use of a competitive hiring process. Instead of completing a competitive process, department management transferred an employee from their existing position to the position being filled. This new position was in a higher pay band, and came with a significantly higher salary and more responsibilities, than the employee's prior position. Based on the nature of the position being filled, as well as department staff education and experience, it is highly likely other department employees were qualified for the position, but were not afforded the opportunity to be considered for the position.

Department management stated they were not required to use the competitive recruitment process established in ARMs because the employee who was transferred to the management position was going to be subjected to a reduction in force (RIF) due to the elimination of their position during a minor department reorganization. Under guidelines published by the State of Montana Human Resources Division, a RIF is a management decision resulting in the layoff of a permanent employee, also referred to as downsizing. A Montana Operations Manual (MOM) policy outlines procedures and guidelines for state agencies to follow in the event of a RIF. The policy references guidelines that discuss alternatives to a RIF, including identifying positions for elimination and transferring the employees from those positions to other vacant agency positions for which the employee is also qualified. Because this is an established alternative to a RIF, department management believe they were justified in moving the employee from their prior position to the management position they filled.

While policy guidelines allow for this approach, we question whether transferring an employee to a higher paying position without a competitive recruitment process meets the intent of ARMs and MOM policy. We believe other alternatives existed for the department that would have complied with the intent of both ARMs and policy. For instance, the department could have opened the management position up to all qualified employees through a competitive process as required by ARMs and either the same employee would have been selected based on qualifications, or another position may have been vacated to which the employee could have been transferred.

While we appreciate the department's decision to not displace a valued employee, we disagree with the department's decision to transfer the employee to a higher paying position without a competitive recruitment, and not affording other employees an equal opportunity for advancement. However, because policy guidelines do not specifically disallow the approach taken by the department, we make no recommendation at this time.

Performance Partnership Grant

The Environmental Protection Agency provides financial assistance to states to help them develop and implement environmental programs. A state may receive these funds in individual environmental program categorical grants or choose to combine up to 19 grants into a Performance Partnership Grant (PPG). PPGs streamline administrative requirements, give states greater flexibility to direct resources to their most pressing environmental problems, and make it easier to fund efforts that cross program boundaries.

The department was awarded a five-year PPG in state fiscal year 2015. Each year, the department receives notice of its annual award, but there is no guarantee the department will continue to receive funding or if it does receive funds, how much will actually be awarded. In January 2017, the department received a $2,049,977 incremental increase to its PPG, bringing the total grant award to $15,516,023. By May of 2017, the department had expended the full amount of the award, but continued to incur expenditures under the grant. Because the department did not have funds to cover the expenditures incurred, it had to obtain an inter-entity loan to cover its costs. By fiscal year-end 2017, the department had incurred approximately $1.5 million in expenditures in excess of the amount awarded to date, with no guarantee the state would receive another award, or an increment large enough to cover the costs already incurred.

Federal regulations for this award allow the department to incur pre-award costs, but the regulations warn recipients there is no guarantee pre-award costs will be reimbursed and the recipient incurs them at their own risk. Because federal regulations technically allow the department to incur costs up to 90 days prior to their next award, we acknowledge the department did not violate federal regulations and do not take exception to the $1.5 million in excess expenditures from a federal compliance perspective. However, we do question the department's practice of incurring costs prior to receiving a federal award. Given the volatile nature of the federal government, we believe the department is putting the state at risk of having to pay unanticipated costs.

Department management stated that in the past, cash flows closely equated to expenditures, meaning funding was received before, or soon after, excess expenditures were incurred, so there was little risk to the state. Regarding the $1.5 million in excess expenditures the department incurred discussed above, another award was received, but not until July 2017. Even though delays in receiving the award were perceived by the department as more of a cash flow issue than a risk of not receiving funds, department management stated they plan to change their policies to reduce the risk to the state if federal funds are not received. While we have concerns about the department's practice of incurring pre-award costs, because federal regulations allow it, we make no recommendation at this time.

Independent Auditor's Report and Department Financial Schedules

LEGISLATIVE AUDIT DIVISION

Angus Maciver, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Joe Murray

Independent Auditor's Report

The Legislative Audit Committee
of the Montana State Legislature:

Introduction
We have audited the accompanying Schedules of Changes in Fund Equity, Schedules of Total Revenues & Transfers-In, and Schedules of Total Expenditures & Transfers-Out of the Department of Environmental Quality for each of the fiscal years ended June 30, 2018, and 2017, and the related notes to the financial schedules.

Management's Responsibility for the Financial Schedules
Management is responsible for the preparation and fair presentation of these financial schedules in accordance with the regulatory format prescribed by the Legislative Audit Committee, based on the transactions posted to the state's accounting system without adjustment; this responsibility includes recording transactions in accordance with state accounting policy; and designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of the financial schedules that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility
Our responsibility is to express opinions on these financial schedules based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial schedules are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial schedules. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial schedules, whether due to fraud or error. In making those risk assessments, the auditor considers internal controls relevant to the department's preparation and fair presentation of the financial schedules in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the department's internal control, and accordingly, we express no such opinion. An

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audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as the overall presentation of the financial schedules.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Basis for Adverse Opinions on U.S. Generally Accepted Accounting Principles
As described in Note 1, the financial schedules are prepared from the transactions posted to the state's primary accounting system without adjustment, in the regulatory format prescribed by the Legislative Audit Committee. This is a basis of accounting other than accounting principles generally accepted in the United States of America. The financial schedules are not intended to, and do not, report assets, deferred outflows of resources, liabilities, deferred inflows of resources, and cash flows.

The effects on the financial schedules of the variances between the regulatory basis of accounting described in Note 1 and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

Adverse Opinions on U.S. Generally Accepted Accounting Principles
In our opinion, because of the significance of the matter discussed in the "Basis for Adverse Opinions on U.S. Generally Accepted Accounting Principles" paragraph, the financial schedules referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of the department as of June 30, 2018, and June 30, 2017, or changes in financial position for the years then ended.

Unmodified Opinions on Regulatory Basis of Accounting
In our opinion, the Schedules of Changes in Fund Equity, Schedules of Total Revenues & Transfers-In, and Schedules of Total Expenditures & Transfers-Out, presents fairly, in all material respects, the results of operations and changes in fund equity of the Department of Environmental Quality for each of the fiscal years ended June 30, 2018, and 2017, in conformity with the basis of accounting described in Note 1.

Other Reporting Required by Government Auditing Standards
In accordance with *Government Auditing Standards*, we have also issued our report dated October 11, 2018, on our consideration of the Department of Environmental Quality's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That

report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the department's internal control over financial reporting and compliance.

Respectfully submitted,

/s/ Cindy Jorgenson

Cindy Jorgenson, CPA
Deputy Legislative Auditor
Helena MT

October 11, 2018

DEPARTMENT OF ENVIRONMENTAL QUALITY
SCHEDULE OF CHANGES IN FUND EQUITY
FOR THE FISCAL YEAR ENDED JUNE 30, 2018

	General Fund	State Special Revenue Fund	Federal Special Revenue Fund	Debt Service Fund	Capital Projects Fund	Internal Service Fund	Private Purpose Trust Fund	Permanent Fund
FUND EQUITY: July 1, 2017	$ (714,486)	$ 213,056,608	$ 27,177,384	$ 1,768,410	$ 5,909,702	$ (4,231,632)	$ 26,324,347	$ 18,476,196
ADDITIONS								
Budgeted Revenues & Transfers-In	13,400	18,113,920	24,801,935			7,386,144		1,764
Nonbudgeted Revenues & Transfers-In	79,490	6,671,346	15,330,789	343,958	253	86,664	1,018,605	1,152,796
Prior Year Revenues & Transfers-In Adjustments	52	(160,105)	(1,068)	(23)	(397)	(323)	(3,047)	(296)
Direct Entries to Fund Equity	4,574,690	14,883,526	(357,493)	1,194,227	(1,260,460)	709,791		
Total Additions	4,667,633	39,508,687	39,774,163	1,538,161	(1,260,604)	8,182,276	1,015,558	1,154,265
REDUCTIONS								
Budgeted Expenditures & Transfers-Out	4,541,226	34,575,816	20,480,584		476,609	7,899,028		
Nonbudgeted Expenditures & Transfers-Out		15,278,383	15,401,605	1,788,452	450,000	259,394	360,337	
Prior Year Expenditures & Transfers-Out Adjustments	(82,417)	446,658	(120,349)			6,940		
Total Reductions	4,458,809	50,300,857	35,761,840	1,788,452	926,609	8,165,361	360,337	0
FUND EQUITY: June 30, 2018	$ (505,662)	$ 202,264,438	$ 31,189,706	$ 1,518,120	$ 3,722,489	$ (4,214,717)	$ 26,979,569	$ 19,630,461

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment.
Additional information is provided in the notes to the financial schedules beginning on page A-11.

DEPARTMENT OF ENVIRONMENTAL QUALITY
SCHEDULE OF CHANGES IN FUND EQUITY
FOR THE FISCAL YEAR ENDED JUNE 30, 2017

	General Fund	State Special Revenue Fund	Federal Special Revenue Fund	Debt Service Fund	Capital Projects Fund	Internal Service Fund	Private Purpose Trust Fund	Permanent Fund
FUND EQUITY: July 1, 2016	$ (562,412)	$ 228,552,289	$ 23,785,204	$ 2,141,224	$ 4,782,682	$ (4,070,637)	$ 28,908,979	$ 17,156,556
ADDITIONS								
Budgeted Revenues & Transfers-In	9,400	20,145,870	25,586,149			7,722,449		
Nonbudgeted Revenues & Transfers-In	355,863	9,914,094	13,021,898	348,882	2,793,764	80,473	546,293	1,319,640
Prior Year Revenues & Transfers-In Adjustments	125	(335,432)	2,155	(35,160)		(432)	3,000	
Direct Entries to Fund Equity	5,126,081	18,695,397	(323,002)	989,775	(1,461,636)			
Total Additions	5,491,469	48,419,929	38,287,200	1,303,496	1,332,128	7,802,491	549,293	1,319,640
REDUCTIONS								
Budgeted Expenditures & Transfers-Out	5,647,292	36,318,717	21,822,789		180,109	7,747,386		
Nonbudgeted Expenditures & Transfers-Out		27,643,935	13,057,623	1,676,310	25,000	215,992	3,016,925	
Prior Year Expenditures & Transfers-Out Adjustments	(3,749)	(47,041)	14,608			107	117,000	
Total Reductions	5,643,542	63,915,611	34,895,020	1,676,310	205,109	7,963,485	3,133,925	0
FUND EQUITY: June 30, 2017	$ (714,486)	$ 213,056,608	$ 27,177,384	$ 1,768,410	$ 5,909,702	$ (4,231,632)	$ 26,324,347	$ 18,476,196

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DEPARTMENT OF ENVIRONMENTAL QUALITY
SCHEDULE OF TOTAL REVENUES & TRANSFERS-IN
FOR THE FISCAL YEAR ENDED JUNE 30, 2018

	General Fund	State Special Revenue Fund	Federal Special Revenue Fund	Debt Service Fund	Capital Projects Fund	Internal Service Fund	Private Purpose Trust Fund	Permanent Fund	Total
TOTAL REVENUES & TRANSFERS-IN BY CLASS									
Licenses and Permits	$ 9,500	$ 10,836,262							$ 10,845,762
Taxes	52		$ 2,845						2,897
Charges for Services		2,534,669				$ 4,999,427			7,534,096
Investment Earnings	2,400	1,615,512	419,405	$ 2,272	$ (144)		$ 273,542	$ 284,265	2,597,252
Fines and Forfeits	76,208	439,141							515,349
Monetary Settlements		2,723,458							2,723,458
Rentals, Leases and Royalties		1,250	45,552						46,802
Grants, Contracts, and Donations		1,024,000				69,342	742,016		1,835,358
Transfers-in		3,031,963	2,709,347	222,295				870,000	6,833,605
Capital Asset Sale Proceeds	4,155	22,000	7,000						33,155
Loan Proceeds		1,589,186							1,589,186
Federal Indirect Cost Recoveries						2,386,709			2,386,709
Miscellaneous	627	807,720		119,368		17,008			944,723
Federal			36,947,508						36,947,508
Total Revenues & Transfers-In	92,943	24,625,162	40,131,656	343,935	(144)	7,472,485	1,015,558	1,154,265	74,835,859
Less: Nonbudgeted Revenues & Transfers-In	79,490	6,671,346	15,330,789	343,958	253	86,664	1,018,605	1,152,796	24,683,902
Prior Year Revenues & Transfers-In Adjustments	52	(160,105)	(1,068)	(23)	(397)	(323)	(3,047)	(296)	(165,206)
Actual Budgeted Revenues & Transfers-In	13,400	18,113,920	24,801,935	0	0	7,386,144	0	1,764	50,317,163
Estimated Revenues & Transfers-In	13,525	17,865,576	23,081,720			7,386,311		2,000	48,349,132
Budgeted Revenues & Transfers-In Over (Under) Estimated	$ (125)	$ 248,344	$ 1,720,214	$ 0	$ 0	$ (167)	$ 0	$ (236)	$ 1,968,031
BUDGETED REVENUES & TRANSFERS-IN OVER (UNDER) ESTIMATED BY CLASS									
Licenses and Permits		$ (6,322)							$ (6,322)
Taxes			$ (339)						(339)
Charges for Services		(1,843)				$ (73)			(1,916)
Investment Earnings		(5,390)	(131)					$ (236)	(5,757)
Fines and Forfeits	$ (125)	(2,150)							(2,275)
Monetary Settlements		(500)							(500)
Sale of Documents, Merchandise and Property		(50)	(50)						(100)
Rentals, Leases and Royalties		(50)	(50)						(100)
Contributions and Premiums						(50)			(50)
Grants, Contracts, and Donations		(1,155)	480			(2)			(678)
Transfers-in		(716)				(1)			(717)
Capital Asset Sale Proceeds			(50)						(50)
Loan Proceeds		(4)							(4)
Federal Indirect Cost Recoveries						(41)			(41)
Miscellaneous		266,530							266,530
Federal		(5)	1,720,355						1,720,350
Budgeted Revenues & Transfers-In Over (Under) Estimated	$ (125)	$ 248,344	$ 1,720,214	$ 0	$ 0	$ (167)	$ 0	$ (236)	$ 1,968,031

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DEPARTMENT OF ENVIRONMENTAL QUALITY
SCHEDULE OF TOTAL REVENUES & TRANSFERS-IN
FOR THE FISCAL YEAR ENDED JUNE 30, 2017

	General Fund	State Special Revenue Fund	Federal Special Revenue Fund	Debt Service Fund	Capital Projects Fund	Internal Service Fund	Private Purpose Trust Fund	Permanent Fund	Total
TOTAL REVENUES & TRANSFERS-IN BY CLASS									
Licenses and Permits	$ 2,500	$ 10,855,071							$ 10,857,571
Taxes	770		$ 1,788						2,558
Charges for Services		3,191,365				$ 5,163,403			8,354,769
Investment Earnings	2,400	1,749,975	216,134	$ 1,430	$ (386)		$ 141,305	$ 119,640	2,230,498
Fines and Forfeits	359,652	3,470,322							3,829,973
Monetary Settlements		3,428,027							3,428,027
Sale of Documents, Merchandise and Property		9,778	1,300						11,078
Rentals, Leases and Royalties		1,250	21,048						22,298
Grants, Contracts, and Donations		1,160,458	37,800			70,233	407,989		1,676,480
Transfers-in		3,670,255	2,500,000	239,795	2,794,150			1,200,000	10,404,200
Loan Proceeds		1,769,711							1,769,711
Federal Indirect Cost Recoveries						2,558,518			2,558,518
Miscellaneous	66	418,322		72,496		10,336			501,221
Federal			35,832,131						35,832,131
Total Revenues & Transfers-In	365,388	29,724,532	38,610,202	313,721	2,793,764	7,802,491	549,293	1,319,640	81,479,031
Less: Nonbudgeted Revenues & Transfers-In	355,863	9,914,094	13,021,898	348,882	2,793,764	80,473	546,293	1,319,640	28,380,907
Prior Year Revenues & Transfers-In Adjustments	125	(335,432)	2,155	(35,160)		(432)	3,000		(365,744)
Actual Budgeted Revenues & Transfers-In	9,400	20,145,870	25,586,149	0	0	7,722,449	0	0	53,463,868
Estimated Revenues & Transfers-In	9,411	20,068,366	25,902,842			7,722,458			53,703,077
Budgeted Revenues & Transfers-In Over (Under) Estimated	$ (11)	$ 77,504	$ (316,693)	$ 0	$ 0	$ (9)	$ 0	$ 0	$ (239,209)
BUDGETED REVENUES & TRANSFERS-IN OVER (UNDER) ESTIMATED BY CLASS									
Licenses and Permits	$ (5)	$ (4,110)							$ (4,115)
Taxes			$ (104)						(104)
Charges for Services		(155)				$ (2)			(156)
Investment Earnings	(1)	(1,433)	(7)						(1,441)
Fines and Forfeits	(5)	(1,888)							(1,893)
Monetary Settlements		(1)							(1)
Sale of Documents, Merchandise and Property		(5)	(5)						(10)
Rentals, Leases and Royalties		(5)	(4)						(9)
Contributions and Premiums						(1)			(1)
Grants, Contracts, and Donations		(125)	(11)			(1)			(137)
Transfers-in		(141)							(141)
Loan Proceeds		85,379							85,379
Federal Indirect Cost Recoveries						(5)			(5)
Miscellaneous		(6)							(6)
Federal		(5)	(316,562)						(316,567)
Budgeted Revenues & Transfers-In Over (Under) Estimated	$ (11)	$ 77,504	$ (316,693)	$ 0	$ 0	$ (9)	$ 0	$ 0	$ (239,209)

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment.
Additional information is provided in the notes to the financial schedules beginning on page A-11.

DEPARTMENT OF ENVIRONMENTAL QUALITY
SCHEDULE OF TOTAL EXPENDITURES & TRANSFERS-OUT
FOR THE FISCAL YEAR ENDED JUNE 30, 2018

	Air, Energy, & Mining Division	Central Management Program	Libby Asbestos Superfund Advisory Team	Petroleum Tank Release Compensation Board	Enforcement Division	Waste Management & Remediation Division	Water Quality Division	Total
PROGRAM (ORG) EXPENDITURES & TRANSFERS-OUT								
Personal Services								
Salaries	$ 6,111,413	$ 4,994,729		$ 266,716		$ 6,004,627	$ 7,754,825	$ 25,132,310
Employee Benefits	2,016,956	1,364,353		107,186		2,063,736	2,605,620	8,157,851
Personal Services-Other		(97,272)						(97,272)
Total	8,128,368	6,261,810		373,902		8,068,363	10,360,445	33,192,889
Operating Expenses								
Other Services	4,806,996	2,146,301		28,966		15,441,726	1,412,619	23,836,608
Supplies & Materials	240,433	139,373		3,078	$ 57	247,077	263,459	893,477
Communications	131,542	223,176	$ 607	5,536		115,601	150,420	626,882
Travel	166,458	39,108	101	3,596		139,624	182,238	531,124
Rent	218,675	1,583,344				91,609	134,675	2,028,303
Utilities	16,612	4,072				38,238		58,922
Repair & Maintenance	3,701	23,052				10,908	3,089	40,751
Other Expenses	2,119,536	726,522	28	89,303	(2)	2,437,501	2,642,685	8,015,572
Total	7,703,953	4,884,949	736	130,479	54	18,522,284	4,789,185	36,031,639
Equipment & Intangible Assets								
Equipment							17,914	17,914
Total							17,914	17,914
Grants								
From State Sources						1,566,597	201,701	1,768,298
Total						1,566,597	201,701	1,768,298
Benefits & Claims								
From State Sources				5,519,705				5,519,705
Total				5,519,705				5,519,705
From Other Sources								
Distrib from Priv Purp Trusts	360,337							360,337
Total	360,337							360,337
Transfers-out								
Fund transfers	3,327,117	873		1,018,534		4,036,019	15,227,491	23,610,035
Total	3,327,117	873		1,018,534		4,036,019	15,227,491	23,610,035
Debt Service								
Bonds	534,900					148,025		682,925
Total	534,900					148,025		682,925
Post Employment Benefits								
Other Post Employment Benefits		16,458						16,458
Employer Pension Expense		562,067						562,067
Total		578,525						578,525
Total Expenditures & Transfers-Out	$ 20,054,674	$ 11,726,156	$ 736	$ 7,042,620	$ 54	$ 32,341,288	$ 30,596,736	$ 101,762,265
EXPENDITURES & TRANSFERS-OUT BY FUND								
General Fund	$ 1,346,102	$ 619,984				$ 249,394	$ 2,243,329	$ 4,458,809
State Special Revenue Fund	11,067,164	2,214,282	$ 736	$ 7,042,620	$ 54	23,456,510	6,519,490	50,300,857
Federal Special Revenue Fund	5,190,645	731,676				8,005,603	21,833,917	35,761,840
Debt Service Fund	1,640,427					148,025		1,788,452
Capital Projects Fund	450,000					476,609		926,609
Internal Service Fund		8,160,214				5,147		8,165,361
Private Purpose Trust Fund	360,337							360,337
Total Expenditures & Transfers-Out	20,054,674	11,726,156	736	7,042,620	54	32,341,288	30,596,736	101,762,265
Less: Nonbudgeted Expenditures & Transfers-Out	4,775,357	254,246		1,000,000		12,316,309	15,192,259	33,538,171
Prior Year Expenditures & Transfers-Out Adjustments	(31,762)	(3,495)		(10,812)	54	389,584	(92,737)	250,833
Actual Budgeted Expenditures & Transfers-Out	15,311,080	11,475,405	736	6,053,432	0	19,635,396	15,497,214	67,973,261
Budget Authority	24,809,262	18,114,882	600,000	7,138,639		28,132,055	19,801,863	98,596,701
Unspent Budget Authority	$ 9,498,182	$ 6,639,477	$ 599,264	$ 1,085,207	$ 0	$ 8,496,660	$ 4,304,649	$ 30,623,440
UNSPENT BUDGET AUTHORITY BY FUND								
General Fund	$ 2,454	$ 6,291				$ 13,370	$ 2,784	$ 24,899
State Special Revenue Fund	4,283,919	4,311,129	$ 479,264	$ 1,085,207		4,244,011	352,526	14,756,056
Federal Special Revenue Fund	3,411,810	1,447,651				4,195,996	3,949,340	13,004,797
Capital Projects Fund	1,800,000					43,282		1,843,282
Internal Service Fund		874,407						874,407
Permanent Fund			120,000		$			120,000
Unspent Budget Authority	$ 9,498,182	$ 6,639,477	$ 599,264	$ 1,085,207	$ 0	$ 8,496,660	$ 4,304,649	$ 30,623,440

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DEPARTMENT OF ENVIRONMENTAL QUALITY
SCHEDULE OF TOTAL EXPENDITURES & TRANSFERS-OUT
FOR THE FISCAL YEAR ENDED JUNE 30, 2017

	Air, Energy, & Mining Division	Centralized Services Division	Enforcement Division	Petroleum Tank Release Compensation Board	Waste Management & Remediation Division	Water Quality Division	Total
PROGRAM (ORG) EXPENDITURES & TRANSFERS-OUT							
Personal Services							
Salaries	$ 6,409,767	$ 3,989,779	$ 795,414	$ 252,509	$ 6,023,897	$ 7,582,990	$ 25,054,356
Employee Benefits	2,292,979	1,142,536	293,637	114,748	2,254,406	2,796,956	8,895,262
Personal Services-Other		(18)					(18)
Total	8,702,745	5,132,297	1,089,051	367,258	8,278,303	10,379,946	33,949,601
Operating Expenses							
Other Services	4,133,963	2,112,526	23,933	40,022	29,152,793	1,737,128	37,200,366
Supplies & Materials	260,545	309,286	16,691	3,818	212,336	259,230	1,061,906
Communications	125,020	202,461	12,618	4,579	116,793	133,835	595,307
Travel	194,257	46,824	10,207	4,898	200,843	200,083	657,113
Rent	218,846	1,509,301	10,106		84,906	152,975	1,976,133
Utilities	14,776	3,889			28,801		47,466
Repair & Maintenance	49,124	87,615	756		34,692	25,728	197,915
Other Expenses	2,312,576	525,858	256,759	86,653	2,722,516	2,803,617	8,707,977
Total	7,309,106	4,797,761	331,068	139,971	32,553,680	5,312,596	50,444,182
Equipment & Intangible Assets							
Equipment	55,650				30,656	72,226	158,532
Total	55,650				30,656	72,226	158,532
Capital Outlay							
Land & Interest In Land					16,483		16,483
Total					16,483		16,483
Grants							
From State Sources					1,155,821	167,919	1,323,740
Total					1,155,821	167,919	1,323,740
Benefits & Claims							
From State Sources				4,160,807			4,160,807
Total				4,160,807			4,160,807
From Other Sources							
Distrib from Priv Purp Trusts	3,048,324						3,048,324
Total	3,048,324						3,048,324
Transfers-out							
Fund transfers	3,870,554	1,207		27,918	6,094,401	13,060,945	23,055,025
Total	3,870,554	1,207		27,918	6,094,401	13,060,945	23,055,025
Debt Service							
Bonds	532,065				269,925		801,990
Total	532,065				269,925		801,990
Post Employment Benefits							
Other Post Employment Benefits		143,926					143,926
Employer Pension Expense		330,393					330,393
Total		474,319					474,319
Total Expenditures & Transfers-Out	$ 23,518,445	$ 10,405,584	$ 1,420,120	$ 4,695,954	$ 48,399,269	$ 28,993,631	$ 117,433,002
EXPENDITURES & TRANSFERS-OUT BY FUND							
General Fund	$ 1,736,179	$ 367,587	$ 576,512		$ 347,080	$ 2,616,185	$ 5,643,542
State Special Revenue Fund	11,976,743	1,559,662	480,708	$ 4,695,954	38,779,581	6,422,963	63,915,611
Federal Special Revenue Fund	5,328,192	519,617	362,900		8,729,827	19,954,483	34,895,020
Debt Service Fund	1,404,385				271,925		1,676,310
Capital Projects Fund	25,000				180,109		205,109
Internal Service Fund	(379)	7,958,717			5,147		7,963,485
Private Purpose Trust Fund	3,048,324				85,601		3,133,925
Total Expenditures & Transfers-Out	23,518,445	10,405,584	1,420,120	4,695,954	48,399,269	28,993,631	117,433,002
Less: Nonbudgeted Expenditures & Transfers-Out	7,650,228	211,224			24,591,709	13,182,623	45,635,785
Prior Year Expenditures & Transfers-Out Adjustments	143,458	(2,744)		(47,845)	13,027	(24,971)	80,925
Actual Budgeted Expenditures & Transfers-Out	15,724,758	10,197,104	1,420,120	4,743,799	23,794,533	15,835,979	71,716,293
Budget Authority	28,234,893	18,067,227	1,483,166	6,646,236	34,023,078	18,692,003	107,146,603
Unspent Budget Authority	$ 12,510,135	$ 7,870,123	$ 63,046	$ 1,902,437	$ 10,228,545	$ 2,856,024	$ 35,430,310
UNSPENT BUDGET AUTHORITY BY FUND							
General Fund	$ 19,210	$ 9,407	$ 5,109		$ 2,865	$ 19,886	$ 56,478
State Special Revenue Fund	5,220,130	5,009,828	27,163	$ 1,902,437	5,064,539	348,101	17,572,199
Federal Special Revenue Fund	3,570,795	2,567,764	30,774		4,641,249	2,488,038	13,298,620
Capital Projects Fund	3,700,000				519,891		4,219,891
Internal Service Fund		283,124					283,124
Unspent Budget Authority	$ 12,510,135	$ 7,870,123	$ 63,046	$ 1,902,437	$ 10,228,545	$ 2,856,024	$ 35,430,310

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

1. Summary of Significant Accounting Policies

Basis of Accounting

The department uses the modified accrual basis of accounting, as defined by state accounting policy, for its Governmental fund category (General, State Special Revenue, Federal Special Revenue, Capital Projects, Debt Service, and Permanent). In applying the modified accrual basis, the department records:

- Revenues when it receives cash or when receipts are realizable, measurable, earned, and available to pay current period liabilities.
- Expenditures for valid obligations when the department incurs the related liability and it is measurable, with the exception of the cost of employees' annual and sick leave. State accounting policy requires the department to record the cost of employees' annual and sick leave when used or paid.

The department uses accrual basis accounting for its Proprietary (Internal Service) and Fiduciary (Private-Purpose Trust) fund categories. Under the accrual basis, as defined by state accounting policy, the department records revenues in the accounting period when realizable, measurable, and earned, and records expenses in the period incurred when measurable.

Expenditures and expenses may include: entire budgeted service contracts even though the department receives the services in a subsequent fiscal year; goods ordered with a purchase order before fiscal year-end, but not received as of fiscal year-end; and equipment ordered with a purchase order before fiscal year-end.

Basis of Presentation

The financial schedule format was adopted by the Legislative Audit Committee. The financial schedules are prepared from the transactions posted to the state's accounting system without adjustment.

The department uses the following funds:

Governmental Fund Category

- **General Fund** – to account for all financial resources except those required to be accounted for in another fund.

- **State Special Revenue Fund** – to account for proceeds of specific revenue sources (other than private-purpose trusts or major capital projects) that are legally restricted to expenditures for specific state program purposes. Department State Special Revenue Funds include permitting and compliance activity for Air Quality Permits, Public Water Supply, Water and Waste Water Operator Certification, Subdivision Review, Montana Pollutant Discharge Elimination System (MPDES), Hard Rock, Coal, Uranium and Opencut Mining, Major Facility Siting, Asbestos Control, Hazardous Waste Management, Junk Vehicle Disposal, Septic Tank Pumper Certification and disposal site inspections, Solid Waste Management and Underground Storage Tanks. In addition to the permitting and compliance activities, the State Special Revenue Fund includes the Department's Alternate Energy Loan Program and State Building Energy Conservation Program, Orphan Share, Petroleum Tank Release Cleanup, Hard Rock Mining Reclamation, Environmental Quality Protection Fund (State Superfund), and various reclamation bond forfeiture and settlement accounts including Upper Blackfoot Mining Complex, Streamside Tailings, Montana Post and Pole, and Clark Fork remedial action accounts.
- **Federal Special Revenue Fund** – to account for activities funded from federal revenue sources. Department Federal Special Revenue Funds include federal assistance programs such as the Water Pollution Control and Drinking Water State Revolving Funds, Performance Partnership Grants, Abandoned Mine Lands Reclamation Grant, as well as other federal grants and agreements.
- **Debt Service Fund** – to account for accumulated resources for the payment of general long-term debt principal and interest. The department uses this fund for recording debt service principal and interest payments for state Hard Rock Mining Reclamation Bonds, Energy Conservation Bonds, and Comprehensive Environmental Response, Compensation and Liability Bonds.
- **Capital Projects Fund** – to account for financial resources used for the acquisition or construction of major capital facilities, other than those financed by proprietary funds or trust funds. The department uses this fund for accounting for resources recovered from state agencies and component units for repayment of State Buildings Energy Conservation Program projects that are legally committed for construction of future State Building Energy Conservation projects.
- **Permanent Fund** – to account for financial resources that are permanently restricted to the extent that only earnings, and not principal, may be used for purposes that support the department's programs. The legislature created a trust fund in fiscal year 2005-06 to cover the long-term costs of water treatment in the area of the Zortman-Landusky mines. The trust was financed from an annual transfer of $1.2 million from the orphan share fund. The final transfer was done for $750,000 in fiscal year 2018 when the balance reached $19.3 million. The department uses this fund for accounting for this trust.

Proprietary Fund Category

- **Internal Service Fund** – to account for the financing of goods or services provided by one department or agency to other departments or agencies of state government or to other governmental entities on a cost-reimbursement basis. Department Internal Service Funds include indirect charges assessed against all units of the department by the Central Management Program for providing department-wide support functions and services.

Fiduciary Fund Category

- **Private-Purpose Trust Fund** – to account for activity of any trust arrangement not properly reported in a pension fund or an investment trust fund where the principal and income benefit individuals, private organizations, or other governments. Department private-purpose trust funds include financial resources held in trust related to permitting activities.

2. Fund Equity Balance

- **General Fund** - The negative fund equity balance in the General Fund does not indicate overspent appropriation authority. The department has authority to pay obligations from the statewide General Fund within its appropriation limits. The department expends cash or other assets from the statewide fund when it pays General Fund obligations. The department's outstanding liabilities exceed the assets it has placed in the fund, resulting in negative ending General Fund equity balances for each of the fiscal years ended June 30, 2017 and June 30, 2018.
- **Internal Service Fund** – The negative fund equity balance in the Internal Service Fund does not indicate overspent appropriation authority. The department has authority to pay obligations from this fund within its appropriation limits. Due to generally accepted accounting principles for post-employment benefits and pension liabilities, the department's outstanding liabilities exceed the assets it has placed in the fund, resulting in negative ending Internal Service Fund equity balances for each of the fiscal years ended June 30, 2017 and June 30, 2018.

3. Direct Entries to Fund Equity

Direct entries to fund equity in the General, State Special Revenue, Federal Special Revenue, Debt Service, and Capital Projects include entries generated by SABHRS to reflect the flow of resources within individual funds shared by separate agencies.

4. Nonbudgeted Revenues & Transfers-In

In the Schedule of Total Revenues and Transfers-In for nonbudgeted revenues and transfers-in, there are several points of clarification, including:

General Fund non-budgeted revenue activity is primarily revenue collected for fines and penalties received for Enforcement activities that are unknown from year-to-year.

Federal Special Revenue Fund increased $2.3 million from fiscal year 2017 to 2018. This is attributable to:

- Drinking Water SRF loan draws increasing by $1.8 million.
- Water Pollution Control draws increasing approximately $300 thousand.
- Belt Water Treatment account received $209 thousand transfer of funds from OSM Trust Fund.

State Special Revenue Fund decreased by approximately $3.2 million from fiscal year 2017 to 2018. The change is primarily attributed to:

- Availability of other funding streams, making a marked reduction in use of Reclamation and Development Grant funding and cost recovery efforts.
- A decline in collection of financial assurance funding which subsequently impacted investment earnings.

Capital Projects Fund decreased approximately $2.8 million. The change is attributed to:

- The standard 2nd year biennial sweep from the Energy Conservation Repayment Account to the Energy Conservation Capital Projects Account in accordance with §§90-4-615 and 617, MCA.

Private Purpose Trust Fund increased approximately $500,000. The change is primarily attributed to:

- Increased property held in trust for financial assurance and the associated increased investment earnings.

5. Nonbudgeted Expenses & Transfers-Out

Waste Management and Remediation division decreased $12.2 million from fiscal year 2017 to 2018. The change is primarily attributed to:

- Nonbudgeted settlement reclamation expenditures decreased $10.2 million including Clark Fork River & Upper Blackfoot Mining Complex and Iron Mountain Custodial.
- $2 million transfer from Junk Vehicle in 2017 for HB648 to assist Natural Resource Operations fund 02576.

Water Quality division increased approximately $2 million. The change is primarily attributed to:

- An increase in the Federal Drinking and Clean Water State Revolving Fund programs. The transfers were made to the Department of Natural Resources and Conservation for disbursement to local governments for construction of water and wastewater system improvements. These grants from EPA are multi-year grants and therefore an analysis of the amount expensed within any twelve-month period is not indicative of any problems or issues with these programs.

Changes attributed to compliance with HB6 of the 2017 Special Session:

- Air, Energy, and Mining Division
  State Special funds and Capital projects increased $2.1 million.
- Petroleum Tank Release Compensation Board
  State Special funds increased $1 million.

In addition to the HB6 transfers, the 2017 transfer-outs include a $2.7 million transfer for the biennium from the Energy Conservation Repayment Account to the Energy Conservation Capital Projects Account in accordance with §§90-4-615 and 617, MCA.

6. Unspent Budget Authority

The unspent budget authority is primarily in the following areas:

- State Special Revenue Fund is attributed to the decrease in revenue. Spending is limited to cash balance or authority, whichever is less. If revenue collected decreases spending is also reduced, leaving unspent authority.
- Federal Special Revenue Fund reflects the unspent multi-year grant authority.
- Capital Projects Fund for fiscal years 2017 and 2018 is authority earmarked for State Building Loan Program projects.

7. Related Parties

The Montana Petroleum Tank Release Compensation Board is an independent board that is attached to DEQ for administrative purposes, ARM 17.58.101. Board members are required to follow Montana's code of ethics, that includes recusing oneself in matters related to a conflict of interest. In compliance with GASB 62, paragraphs 54-57, the following is to disclose the related relationships identified with Board members:

- Member, Chuck Thompson – works for CHS, a company that had a release and is receiving funding.
- Member, Keith Schnider, is the insurance agent for the station owner that had a release and is receiving funding. Associated company is Payne West Insurance.
- Member, Jim Corson, owns stock in 1st Interstate Bank that is receiving funding.
- Member, Edward Thamke, is an employee of the regulatory agency that provides oversight of the cleanup at the facility.

- Member, Mark Johnson, is a contractor for the regulatory agency that provides oversight of the cleanup at the facility. He also owns stock in the company that is receiving funding. Associated companies are to JW Roylance Construction and Resource Technologies, Inc.
    - ◊ Mr. Johnson is under contract with DEQ to complete remediation work and the following contract payments were made to Resource Technologies, Inc: $193,204 in FY2017, and $61,034.53 in FY2018. In addition, only $8,986 was matched with Petroleum Tank Release Compensation fund 02058.

Financial transactions include:

Our records show Direct payments of:

Payee:	FY 17 & FY18
Resource Technologies Inc	$ 1,207,513.45
Payne West Insurance	$ 0.00
First Interstate Bank	$ 0.00

Our records show indirect payments (where Petro Fund paid their contractor) of:

Facility Owner	Consultant	FY17 & FY18
Payne West Insurance		$ 0.00
First Interstate Bank	Several	$ 120,242.96

Our records show indirect payments (where Petro Fund paid their client) of:

Facility	Insurance Co	FY17 & FY18
B & C OIL	Payne West	$ 15,887.61
National Laundry Co	Payne Financial Group	$0.00

To ensure we are following state law, all contracts are required to go through a competitive bidding process.

8. Agency Reorganization

During fiscal year 2018 DEQ went through a minor reorganization by transferring the Enforcement Division (program 30) into a program within Centralized Services (program 10). There were 2 FTE from the Enforcement Division (Enforcement Administrator and Financial Manager) permanently transitioned to program positions in Program 40. The funding for the Enforcement Division was transferred to Program 10.

Report on Internal Control and Compliance

LEGISLATIVE AUDIT DIVISION

Angus Maciver, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Joe Murray

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Schedules Performed in Accordance with *Government Auditing Standards*

The Legislative Audit Committee
of the Montana State Legislature:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the Schedules of Changes in Fund Equity, Schedules of Total Revenues & Transfers-In, and Schedules of Total Expenditures & Transfers-Out of the Department of Environmental Quality (department) for each of the fiscal years ended June 30, 2018, and 2017, and the related notes to the financial schedules, and have issued our report thereon dated October 11, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial schedules, we considered the department's internal control over financial reporting to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial schedules, but not for the purpose of expressing an opinion on the effectiveness of the department's internal control. Accordingly, we do not express an opinion on the effectiveness of the department's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial schedules will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal controls was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies

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may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify certain deficiencies in internal control, described below, that we consider to be a significant deficiency.

The department's internal controls were not effective in ensuring transactions recorded on the primary accounting system are complete, accurate, and in accordance with state policy. See the finding and recommendation beginning on page 5 for a description of this significant deficiency.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the department's financial schedules are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination on financial schedule amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

The Department of Environmental Quality's Response to Findings

The Department of Environmental Quality's response to the findings identified in our audit are described on page C-1 of this report. The department's response was not subjected to the auditing procedures applied in the audit of the financial schedules and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the department's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the department's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Respectfully submitted,

/s/ Cindy Jorgenson

Cindy Jorgenson, CPA
Deputy Legislative Auditor
Helena, MT

October 11, 2018

Department of Environmental Quality

Department Response

DEQ
Montana Department
of Environmental Quality

November 14, 2018

Mr. Angus Maciver
Legislative Auditor
Legislative Audit Division
PO Box 201705
Helena, MT 59620-1705

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LEGISLATIVE AUDIT DIV.

RE: Financial Compliance Audit #18-16

Dear Mr. Maciver,

Thank you for the opportunity to respond to the FY17/18 Financial Compliance Audit for the Department of Environmental Quality. We have reviewed the recommendations contained in the report and provided our responses below.

Recommendation #1

We recommend the Department of Environment Quality implement internal controls to prevent, or identify and correct, misstatements in its accounting records.

Response: Concur.

DEQ will revise its internal control plan to correct weaknesses identified in the audit. In addition, DEQ will review its internal control plan to identify other opportunities to strengthen controls. DEQ will complete its review by July 1, 2019. Opportunities identified to strengthen the plan will be implemented and DEQ will train appropriate staff on the changes. Brenda Thomas, CFO, is responsible for completing the review by July 1, 2019 and implementing any changes identified.

Recommendation #2

We recommend the Department of Environment Quality comply with state policy and only record expenditures in the department's internal service fund that are incurred from centrally-provided services.

Response: Concur.

The TREADS project is scheduled to conclude December 18, 2018. DEQ will review existing and future technology projects that include staff from the internal services fund to ensure compliance with state policy. Stephen Forrest, CIO, is responsible for completing the review by June 1, 2019.

Recommendation #3

We recommend the Department of Environmental Quality implement controls to ensure compliance with the various laws and regulations governing its operations.

Response: Concur.

DEQ will revise its controls to correct weaknesses identified in the audit by June 1, 2019. In addition, DEQ will continue its efforts to review and improve processes both from a compliance and performance improvement perspective. George Mathieus, Deputy Director, is responsible for completing the review by June 1, 2019.

I want to thank you and your staff for the professionalism and fairness during the audit fieldwork and conferences. We appreciate the willingness of the auditors to discuss recommendations and respond to our questions. We always look upon the audit process as an opportunity to improve the department's operations and performance.

Sincerely,

George Mathieus
Interim Director
Department of Environmental Quality