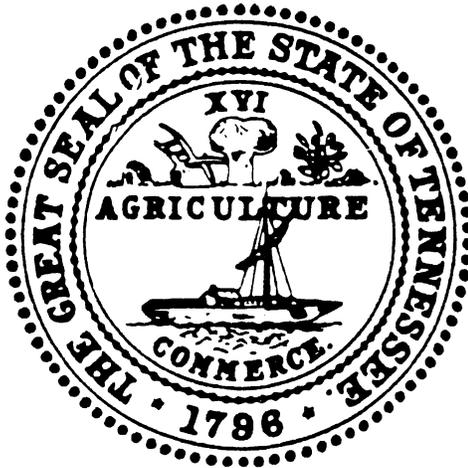


# AUDIT REPORT

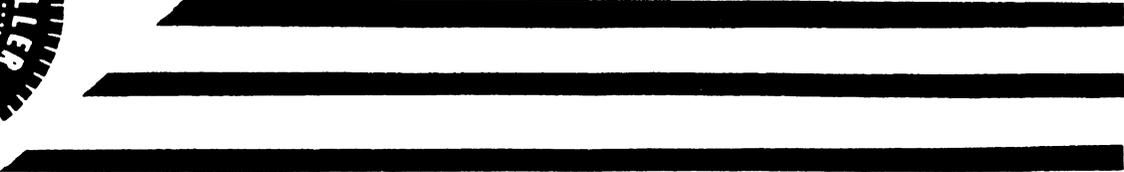
Clean Water State Revolving Fund

For the Year Ended  
June 30, 2005



STATE OF TENNESSEE  
COMPTROLLER OF THE TREASURY

Department of Audit  
Division of State Audit



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**STATE OF TENNESSEE**  
**COMPTROLLER OF THE TREASURY**

State Capitol  
Nashville, Tennessee 37243-0260  
(615) 741-2501

John G. Morgan  
Comptroller

March 9, 2006

The Honorable Phil Bredesen, Governor  
and  
Members of the General Assembly  
State Capitol  
Nashville, Tennessee 37243  
and  
Members of the Water and Wastewater Financing Board  
Department of Environment and Conservation  
401 Church Street, 21<sup>st</sup> Floor  
Nashville, TN 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Clean Water State Revolving Fund for the year ended June 30, 2005. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance resulted in no audit findings.

Sincerely,

John G. Morgan  
Comptroller of the Treasury

JGM/rrp  
06/015

State of Tennessee

# **A u d i t   H i g h l i g h t s**

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit  
**Clean Water State Revolving Fund**  
For the Year Ended June 30, 2005

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## **AUDIT OBJECTIVES**

The objectives of the audit were to consider the fund's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, contracts, and grant agreements; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

## **AUDIT FINDINGS**

The audit report contains no findings.

## **OPINION ON THE FINANCIAL STATEMENTS**

The opinion on the financial statements is unqualified.

**Audit Report**  
**Clean Water State Revolving Fund**  
**For the Year Ended June 30, 2005**

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# Clean Water State Revolving Fund For the Year Ended June 30, 2005

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## INTRODUCTION

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### POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Clean Water State Revolving Fund. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

### BACKGROUND

The Clean Water State Revolving Fund was created in 1987 by an act of the General Assembly, codified as Section 68-221-1004, *Tennessee Code Annotated*. The fund is intended, in coordination with state and federal assistance programs, to provide local governments and utility districts with low-cost financial assistance to improve and protect water quality and public health. The fund was established as a revolving loan fund under Title VI of the Clean Water Act, administered by the United States Environmental Protection Agency. The fund’s loans are provided to local governments, at or below market interest rates, to construct facilities whose purposes may include collection, treatment, and disposal of wastewater. Local governments pledge to repay the loan principal and interest through a variety of methods including assessing, levying, and collecting ad valorem taxes on all taxable property within their jurisdiction; pledging their full faith and credit and unlimited taxing power; fixing, levying, and collecting fees and other charges for the use of the wastewater facility; and pledging any other security deemed necessary as determined by the Tennessee Local Development Authority.

### ORGANIZATION

The Clean Water State Revolving Fund is governed by the Tennessee Local Development Authority (TLDA), the Department of Environment and Conservation’s Division of Water Supply (the department), and the Water and Wastewater Financing Board (the board). The TLDA administers the fund, adopts the rules and regulations for the fund’s administration, and deposits

all receipts from repayments of loans into the fund. The department conducts engineering and environmental studies on the planning and design of the facilities, approves applications for facility construction, and recommends to TLDA an appropriate financing method for each facility. In the event of missed payments, the board is empowered to effect reasonable user rate increases or to effect system efficiencies through the negotiated consolidation of certain wastewater facilities. The board is composed of the Commissioner of Environment and Conservation; the Comptroller of the Treasury; and five members appointed by the Governor representing municipalities, utility districts, environmental interests, manufacturing interests, and minority citizens of the state. The Director of the Division of Water Supply serves as technical secretary to the board.

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## AUDIT SCOPE

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The audit was limited to the period July 1, 2004, through June 30, 2005, and was conducted 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. Financial statements are presented for the year ended June 30, 2005, and for comparative purposes, the year ended June 30, 2004. The Clean Water State Revolving Fund forms an integral part of state government and as such has been included as an enterprise fund in the *Tennessee Comprehensive Annual Financial Report*.

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## OBJECTIVES OF THE AUDIT

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The objectives of the audit were

1. to consider the fund's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, contracts, and grant agreements;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

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## **PRIOR AUDIT FINDINGS**

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There were no findings in the prior audit report.

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## **OBSERVATIONS AND COMMENTS**

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### **MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT**

Auditors and management are required to assess the risk of fraud in the operations of the entity. The risk assessment is based on a critical review of operations considering what frauds could be perpetrated in the absence of adequate controls. The auditors' risk assessment is limited to the period during which the audit is conducted and is limited to the transactions that the auditors are able to test during that period. The risk assessment by management is the primary method by which the entity is protected from fraud, waste, and abuse. Since new programs may be established at any time by management or older programs may be discontinued, that assessment is ongoing as part of the daily operations of the entity.

Risks of fraud, waste, and abuse are mitigated by effective internal controls. It is management's responsibility to design, implement, and monitor effective controls in the entity. Although auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the ongoing monitoring required of management. After all, the auditor testing is limited and is usually targeted to test the effectiveness of particular controls. Even if controls appear to be operating effectively during the time of the auditor testing, they may be rendered ineffective the next day by management override or by other circumventions that, if left up to the auditor to detect, will not be noted until the next audit engagement and then only if the auditor tests the same transactions and controls. Furthermore, since staff may be seeking to avoid auditor criticisms, they may comply with the controls during the period that the auditors are on site and revert to ignoring or disregarding the control after the auditors have left the field.

The assessment and the controls should be reviewed and approved by the commissioner or agency head. The risk assessments and the actions of management in designing, implementing, and monitoring the controls should be adequately documented to provide an audit trail both for auditors and for management, in the event that there is a change in management or staff and to maintain a record of areas that are particularly problematic.

## **FRAUD CONSIDERATIONS**

Statement on Auditing Standards No. 99 promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.

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## **RESULTS OF THE AUDIT**

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### **AUDIT CONCLUSIONS**

#### Internal Control

As part of the audit of the Clean Water State Revolving Fund's financial statements for the year ended June 30, 2005, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by 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. Consideration of internal control over financial reporting disclosed no material weaknesses.

#### Compliance and Other Matters

The results of our audit tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

#### Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the Clean Water State Revolving Fund's financial statements.



STATE OF TENNESSEE  
**COMPTROLLER OF THE TREASURY**  
DEPARTMENT OF AUDIT  
DIVISION OF STATE AUDIT  
SUITE 1500  
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NASHVILLE, TENNESSEE 37243-0264  
PHONE (615) 401-7897  
FAX (615) 532-2765

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

November 18, 2005

The Honorable John G. Morgan  
Comptroller of the Treasury  
State Capitol  
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the Clean Water State Revolving Fund, as of and for the year ended June 30, 2005, and have issued our report thereon dated November 18, 2005. 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the fund's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

The Honorable John G. Morgan  
November 18, 2005  
Page Two

We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the fund's financial statements are free of material misstatement, we performed tests of the fund's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement 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*.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee and management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

A handwritten signature in black ink that reads "Arthur A. Hayes, Jr." with a stylized flourish at the end.

Arthur A. Hayes, Jr., CPA  
Director

AAH/rrp



STATE OF TENNESSEE  
**COMPTROLLER OF THE TREASURY**  
DEPARTMENT OF AUDIT  
DIVISION OF STATE AUDIT  
SUITE 1500  
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NASHVILLE, TENNESSEE 37243-0264  
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**Independent Auditor's Report**

November 18, 2005

The Honorable John G. Morgan  
Comptroller of the Treasury  
State Capitol  
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the accompanying statements of net assets of the Clean Water State Revolving Fund, an enterprise fund of the State of Tennessee, as of June 30, 2005, and June 30, 2004, and the related statements of revenues, expenses, and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the fund's management. Our responsibility is to express an opinion on these financial statements, based on our audits.

We conducted our audits 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 statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include serving as a member of the board of directors of the Tennessee Local Development Authority and the Water and Wastewater Financing Board; approving accounting policies of the state as prepared by the state's Department of Finance and Administration; maintaining the accounting records for the Clean Water State Revolving Fund and the Tennessee Local Development Authority; and providing support staff to the Authority.

The Honorable John G. Morgan  
November 18, 2005  
Page Two

As discussed in Note 1, the financial statements present only the Clean Water State Revolving Fund, an enterprise fund, and do not purport to, and do not, present fairly the financial position of the State of Tennessee, as of June 30, 2005, and June 30, 2004, and the changes in its financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Clean Water State Revolving Fund of the State of Tennessee, as of June 30, 2005, and June 30, 2004, and the changes in its financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 18, 2005, on our consideration of the Clean Water State Revolving Fund'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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

A handwritten signature in black ink that reads "Arthur A. Hayes, Jr." with a stylized, cursive script.

Arthur A. Hayes, Jr., CPA  
Director

AAH/rtp

CLEAN WATER STATE REVOLVING FUND  
STATEMENTS OF NET ASSETS  
JUNE 30, 2005, AND JUNE 30, 2004

(Expressed in Thousands)		
	June 30, 2005	June 30, 2004
<b>ASSETS</b>		
Current assets:		
Cash (Note 2)	\$ 212,108	\$ 177,872
Receivables		
Loans receivable	19,464	18,209
Interest receivable on loans	33	21
Total current assets	231,605	196,102
Noncurrent assets:		
Loans receivable	318,124	315,101
Total noncurrent assets	318,124	315,101
Total assets	549,729	511,203
<b>LIABILITIES</b>		
Current liabilities:		
Accounts Payable	316	-
Payable to borrowers (Note 3)	23	10
Total current liabilities	339	10
Total liabilities	339	10
<b>NET ASSETS</b>		
Restricted	549,390	511,193
Total net assets	\$ 549,390	\$ 511,193

The Notes to the Financial Statements are an integral part of this statement.

CLEAN WATER STATE REVOLVING FUND  
 STATEMENTS OF REVENUES, EXPENSES, AND  
 CHANGES IN NET ASSETS  
 FOR THE YEARS ENDED JUNE 30, 2005, AND JUNE 30, 2004

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(Expressed in Thousands)

	<u>Year Ended June 30, 2005</u>	<u>Year Ended June 30, 2004</u>
<b>OPERATING REVENUES</b>		
Revenue from loans	\$ 11,542	\$ 11,525
Interest income	<u>4,101</u>	<u>1,717</u>
Total operating revenues	<u>15,643</u>	<u>13,242</u>
<b>OPERATING EXPENSES</b>		
Administrative expense	<u>941</u>	<u>794</u>
Total operating expenses	<u>941</u>	<u>794</u>
Operating income	<u>14,702</u>	<u>12,448</u>
<b>NONOPERATING REVENUE</b>		
Operating grant	<u>19,966</u>	<u>24,701</u>
Total nonoperating revenue	<u>19,966</u>	<u>24,701</u>
Income before transfers	34,668	37,149
Transfers in (Note 4)	<u>3,529</u>	<u>3,470</u>
Change in net assets	38,197	40,619
Net assets, July 1	<u>511,193</u>	<u>470,574</u>
Net assets, June 30	<u>\$ 549,390</u>	<u>\$ 511,193</u>

The Notes to the Financial Statements are an integral part of this statement.

CLEAN WATER STATE REVOLVING FUND  
STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED JUNE 30, 2005, AND JUNE 30, 2004

(Expressed in Thousands)

	<u>Year Ended June 30, 2005</u>	<u>Year Ended June 30, 2004</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Payments for interfund services	\$ (936)	\$ (783)
Payments to service providers	<u>(5)</u>	<u>(11)</u>
Net cash used by operating activities	<u>(941)</u>	<u>(794)</u>
<b>CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES</b>		
Operating grants received	19,966	24,701
Transfers in	<u>3,529</u>	<u>3,470</u>
Net cash provided by noncapital financing activities	<u>23,495</u>	<u>28,171</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Loans issued	(22,721)	(31,660)
Collections of loan principal	18,769	24,223
Interest received on loans	11,533	11,528
Interest received on investments	<u>4,101</u>	<u>1,717</u>
Net cash provided by investing activities	<u>11,682</u>	<u>5,808</u>
Net increase in cash	34,236	33,185
Cash, July 1	<u>177,872</u>	<u>144,687</u>
Cash, June 30	<u>\$ 212,108</u>	<u>\$ 177,872</u>
<b>Reconciliation of operating income to net cash used by operating activities:</b>		
Operating income	\$ <u>14,702</u>	\$ <u>12,448</u>
Adjustments to reconcile operating income to net cash used by operating activities:		
Revenue from loans	(11,542)	(11,525)
Interest income	<u>(4,101)</u>	<u>(1,717)</u>
Total adjustments	<u>(15,643)</u>	<u>(13,242)</u>
Net cash used by operating activities	<u>\$ (941)</u>	<u>\$ (794)</u>

The Notes to the Financial Statements are an integral part of this statement.

**Clean Water State Revolving Fund  
Notes to the Financial Statements  
June 30, 2005, and June 30, 2004**

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**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Reporting Entity**

The Clean Water State Revolving Fund was created to provide local governments and utility districts with low-cost financial assistance to improve and protect water quality and public health.

Pursuant to the Governmental Accounting Standards Board's *Codification of Governmental Accounting and Financial Reporting Standards*, Section 2100, the Clean Water State Revolving Fund forms an integral part of state government and as such has been included in the *Tennessee Comprehensive Annual Financial Report* as an enterprise fund (Sewer Treatment Loan Fund).

**Basis of Presentation**

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB). The Clean Water State Revolving Fund follows all applicable GASB pronouncements as well as applicable private-sector pronouncements issued on or before November 30, 1989. The fund has chosen not to follow subsequent private-sector guidance.

**Measurement Focus and Basis of Accounting**

The accompanying financial statements have been prepared using the accrual basis of accounting and the flow of economic resources measurement focus. Under this method, revenues are recorded when earned, and expenses are recorded at the time liabilities are incurred.

Operating revenues and expenses are distinguished from nonoperating items in the Clean Water State Revolving Fund. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with principal ongoing operations. The principal operation of the fund is to provide loans to local governments through a revolving loan fund established under Title VI of the Clean Water Act. Therefore, the principal operating revenues of the fund are from interest on loans made to borrowers. The fund also recognizes interest income as operating revenue. The fund's operating expenses are its administrative expenses. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

**Clean Water State Revolving Fund**  
**Notes to the Financial Statements (Cont.)**  
**June 30, 2005, and June 30, 2004**

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**Cash**

This classification includes cash on hand and deposits in the pooled investment fund administered by the State Treasurer.

**NOTE 2. DEPOSITS**

The fund had \$212,107,852 in the State Treasurer's pooled investment fund at June 30, 2005, and \$177,871,642 at June 30, 2004. The pooled investment fund administered by the State Treasurer is authorized by statute to invest funds in accordance with policy guidelines approved by the State Funding Board. The pooled investment fund is not rated by a nationally recognized statistical rating organization. The pooled investment fund's investment policy and required risk disclosures are presented in the *Tennessee Comprehensive Annual Financial Report*. That report may be obtained by writing to the Tennessee Department of Finance and Administration, Division of Accounts, 14<sup>th</sup> Floor William R. Snodgrass Tennessee Tower, 312 Eighth Avenue North, Nashville, Tennessee 37243-0298, or by calling (615) 741-2140.

**NOTE 3. PAYABLE TO BORROWERS**

This account represents loan principal overpayments that will be refunded to borrowers.

**NOTE 4. INTERFUND TRANSFER**

The Clean Water State Revolving Fund received an interfund transfer from the general fund of the state to provide the state match of a federal grant to operate the program of \$3,529,088 during fiscal year 2005 and \$3,469,899 during fiscal year 2004.