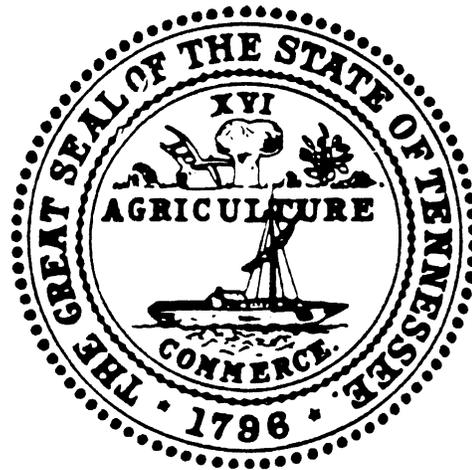


AUDIT REPORT

Clean Water State Revolving Fund

For the Year Ended
June 30, 2006



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

May 22, 2007

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, 8th 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, 2006. 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 disclosed a deficiency, which is detailed in the Results of the Audit section of this report. The Department of Environment and Conservation's management has responded to the audit finding; the response is included following the finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit finding.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/wg
07/017

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Clean Water State Revolving Fund
For the Year Ended June 30, 2006

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.

INTERNAL CONTROL AND COMPLIANCE FINDING

Staff of the Department of Environment and Conservation Did Not Properly Prepare the Clean Water State Revolving Fund Annual Report for the Year Ended June 30, 2006, Which Resulted in the U.S. Environmental Protection Agency Not Having Reliable Information to Use in Its Review of the Fund

Staff of the Department of Environment and Conservation made numerous errors in the preparation of its annual report required by the U.S. Environmental Protection Agency (EPA). A revised report was submitted to the EPA after the conclusion of the audit.

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, 2006

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Clean Water State Revolving Fund For the Year Ended June 30, 2006

INTRODUCTION

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.

AUDIT SCOPE

The audit was limited to the period July 1, 2005, through June 30, 2006, 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, 2006. 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*.

OBJECTIVES OF THE AUDIT

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.

Although this audit was not intended to serve as an organization-wide audit as described in the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, it included tests of compliance with applicable

federal laws and regulations and consideration of internal control used in administering federal financial assistance programs. This audit is a segment of the organization-wide audit of the State of Tennessee, which is conducted in accordance with the Single Audit Act.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

OBSERVATIONS AND COMMENTS

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 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. The assessment and the controls should be reviewed and approved by the head of the entity.

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*, 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.

RESULTS OF THE AUDIT

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, 2006, 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. A reportable condition, along with the recommendation and management's response, is detailed in the Finding and Recommendation section of this report. 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*. An immaterial instance of noncompliance, along with the recommendation and management's response, is included in the Finding and Recommendation section.

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
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**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***

December 19, 2006

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, 2006, and have issued our report thereon dated December 19, 2006. 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. However, we noted a matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the fund's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

The following reportable condition was noted:

- Staff of the Department of Environment and Conservation did not properly prepare the Clean Water State Revolving Fund Annual Report for the year ended June 30, 2006, which resulted in the U.S. Environmental Protection Agency not having reliable information to use in its review of the fund.

This condition is described in the Finding and Recommendation section of this report.

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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness.

We also noted certain matters involving the internal control over financial reporting, which we have reported to the fund's management in a separate letter.

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*.

We did, however, note an immaterial instance of noncompliance that we have included in the Finding and Recommendation section of this report. We also noted certain other less significant matters, which we have reported to the fund's management in a separate letter.

The Honorable John G. Morgan
December 19, 2006
Page Three

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." The signature is written in a cursive style with a prominent initial "A" and a trailing flourish.

Arthur A. Hayes, Jr., CPA
Director

AAH/wg

FINDING AND RECOMMENDATION

Staff of the Department of Environment and Conservation did not properly prepare the Clean Water State Revolving Fund Annual Report for the year ended June 30, 2006, which resulted in the U.S. Environmental Protection Agency not having reliable information to use in its review of the fund

Finding

The State Revolving Fund Loan Program Division of the Department of Environment and Conservation made numerous errors in the preparation of its annual report required by the U.S. Environmental Protection Agency. The U.S. Environmental Protection Agency awards grants to states to create and maintain Clean Water State Revolving Funds to: (1) enable states to encourage construction of wastewater treatment facilities to meet the requirements of the Clean Water Act; (2) increase the emphasis on pollution control and protection of estuaries; and (3) establish permanent financing institutions in each state to provide continuing sources of financing to maintain water quality. Tennessee's Clean Water State Revolving Fund provides loans to local governments and utility districts (subrecipients).

The Tennessee Local Development Authority (TLDA) administers the Clean Water State Revolving Fund, but the Department of Environment and Conservation (the department) oversees the detailed functions including the approval of payments to subrecipients, the drawdown of grants funds, the preparation of the annual report, and other responsibilities. The *Code of Federal Regulations*, Section 40, Part 35.3165(a), requires the submission of an annual report to the U.S. Environmental Protection Agency.

We found the following errors during our testwork on the annual report prepared by the department for the year ended June 30, 2006:

Description of Misstated Amount	Reported Amount	Correct Amount	Overstated / (Understated)
Total capitalization grants awarded for the year ended June 30, 2006	\$15,653,781	\$15,766,858	\$(113,077)
State funds deposited in the Clean Water State Revolving Fund for the year ended June 30, 2006	\$3,153,496	\$3,089,874	\$63,622
Total state funds appropriated for the Clean Water State Revolving Fund as of June 30, 2006	\$81,809,480	\$81,288,662	\$520,818

Total interest and loan repayments received for the year ended June 30, 2006	\$48,182,877	\$44,182,877	\$4,000,000
Total federal and state-match disbursements for the year ended June 30, 2006	\$44,214,777	\$44,391,171	\$(176,394)
Total disbursements to loan recipients for the year ended June 30, 2006	\$43,540,346	\$43,653,346	\$(113,000)
Total state appropriations used to match administrative costs as of June 30, 2006	\$956,188	\$1,846,052	\$(889,864)
Total state funds provided as of June 30, 2006	\$81,809,480	\$83,134,714	\$(1,325,234)
Actual binding commitment total as of June 30, 2006	\$759,415,791	\$777,638,862	\$(18,223,071)

These errors resulted in total misstatements of \$25,425,080 in the annual report for the year ended June 30, 2006. A revised report was submitted to the U.S. Environmental Protection Agency after the conclusion of the audit. We reviewed the revised report and concluded that the department made the appropriate revisions.

These misstatements were discussed with the department's Environmental Program Manager. The Environmental Program Manager stated that there had been recent turnover in his section which led to different staff working on the annual report for the first time. Also, we noted no evidence of a supervisor's review of the annual report. A review by a supervisor might have led to the detection of the errors in the annual report. In addition, the department has not completely documented the process used to prepare the annual report. It is important that the annual report preparation process be formalized to provide:

- a working plan for staff in future years as personnel changes such as turnover or retirements result in new staff preparing the annual report,
- a guide—to serve as a checklist—to ensure that all appropriate information is gathered and accurately presented,
- documentation of sources of data presented in the annual report, and
- year-to-year consistency.

When the annual report is not accurately prepared in a consistent manner, staff with the U.S. Environmental Protection Agency do not have reliable information to use in their review of the fund's performance and its compliance with applicable federal regulations.

Recommendation

The Commissioner of Environment and Conservation and the Environmental Program Manager should ensure that future annual reports are properly prepared. The Environmental Program Manager should also ensure that written procedures are developed for the preparation of the annual report in order to provide accurate and complete information to the U.S. Environmental Protection Agency. These procedures should include a supervisor's review of the annual report before submission, a description of the sources of data, the method for compilation of amounts, and any necessary reconciliations to other accounting reports to ensure consistency of amounts reported.

The Commissioner should ensure that other risks of improper accountability, noncompliance, fraud, waste, or abuse are adequately identified and assessed in management's documented risk assessment. Management should implement effective controls to ensure compliance with applicable requirements, assign staff to be responsible for ongoing monitoring of the risks and mitigating controls, and take action if deficiencies occur.

Management's Comment

We concur with the finding. By way of a response, we offer the following comments:

- The basis of the audit, the FY2006 CWSRF Annual Report for program activities occurring from July 1, 2005, through June 30, 2006, was required to be sent to the Environmental Protection Agency (EPA) by September 30, 2006, i.e., within 90 days after the close of the state's fiscal year. The FY2006 CWSRF Annual Report was mailed to EPA on September 25, 2006.

The CWSRF Annual Report is prepared using data and input from multiple outside sources in addition to the CWSRF Loan Program staff—the Tennessee Department of Environment and Conservation's Division of Fiscal Services, the Office of the Tennessee Comptroller of the Treasury, the Tennessee Treasury Department, the Tennessee Department of Finance and Administration, etc., each with their own timetable for finalizing annual and quarterly data. Therefore, based on past experience with the gathering of information from these other departments/divisions/offices, the CWSRF Loan Program acknowledges that some of the information contained in the September 30 report is preliminary. We failed to note the preliminary information as preliminary. Steps have been taken to insure that all preliminary information in future reports is labeled as preliminary until final figures are provided. The CWSRF Loan Program has always provided updated information to the EPA as it became available.

- The CWSRF Loan Program has implemented corrective actions to ensure that the errors noted in the draft audit report do not happen again by formalizing a standard operating procedure identifying source documents, responsible parties for supply data, and electronic reports for use in preparation of the CWSRF Annual Report. The report will be reviewed by the supervisor to insure that the information is correct.
- We would like to point out that some of the errors noted in the audit report were the result of the audit staff using more current data than that available for the September 25, 2006, CWSRF Annual Report.
- EPA completed its annual review of the total CWSRF Loan Program including administrative, financial, and technical processes, procedures, and documents in December 2006 with no comments.



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COMPTROLLER OF THE TREASURY
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Independent Auditor's Report

December 19, 2006

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

Dear Mr. Morgan:

We have audited the accompanying statement of net assets of the Clean Water State Revolving Fund, an enterprise fund of the State of Tennessee, as of June 30, 2006, and the related statements of revenues, expenses, and changes in net assets and cash flows for the year 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 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 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 audit provides 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; approving certain state contracts; participating in the negotiation and procurement of services for

The Honorable John G. Morgan

December 19, 2006

Page Two

the state; maintaining the accounting records for the Clean Water State Revolving Fund and the Tennessee Local Development Authority; and providing support staff to the Authority.

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, 2006, and the changes in its financial position and cash flows for the year 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, 2006, and the changes in its financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The Clean Water State Revolving Fund has not presented the Management's Discussion and Analysis that accounting principles generally accepted in the United States of America have determined is necessary to supplement, although not required to be part of, the basic financial statements.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 19, 2006, 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, appearing to read "Arthur A. Hayes, Jr.", written in a cursive style.

Arthur A. Hayes, Jr., CPA
Director

AAH/wg

CLEAN WATER STATE REVOLVING FUND
STATEMENT OF NET ASSETS
JUNE 30, 2006

(Expressed in Thousands)

ASSETS

Current assets:		
Cash (Note 2)	\$	252,454
Receivables		
Loans receivable		19,467
Interest receivable on loans		<u>15</u>
Total current assets		<u>271,936</u>
Noncurrent assets:		
Loans receivable		<u>338,457</u>
Total noncurrent assets		<u>338,457</u>
Total assets		<u>610,393</u>

LIABILITIES

Current liabilities:		
Accounts payable		-
Payable to borrowers (Note 3)		<u>37</u>
Total current liabilities		<u>37</u>
Noncurrent liabilities:		
Customer deposits payable		<u>421</u>
Total noncurrent liabilities		<u>421</u>
Total liabilities		<u>458</u>
NET ASSETS		
Unrestricted		<u>609,935</u>
Total net assets	\$	<u><u>609,935</u></u>

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

CLEAN WATER STATE REVOLVING FUND
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2006

(Expressed in Thousands)

OPERATING REVENUES

Revenue from loans	\$ 11,633
Interest income	<u>9,446</u>
Total operating revenues	<u>21,079</u>

OPERATING EXPENSES

Administrative expenses	<u>740</u>
Total operating expenses	<u>740</u>
Operating income	<u>20,339</u>

NONOPERATING REVENUE

Operating grant	<u>36,994</u>
Total nonoperating revenue	<u>36,994</u>
Income before transfers	57,333
Transfers in (Note 4)	<u>3,212</u>
Change in net assets	60,545
Net assets, July 1	<u>549,390</u>
Net assets, June 30	<u>\$ 609,935</u>

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

CLEAN WATER STATE REVOLVING FUND
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2006

(Expressed in Thousands)

CASH FLOWS FROM OPERATING ACTIVITIES

Payments for interfund services	\$ (731)
Payments to service providers	<u>(9)</u>

Net cash used by operating activities	<u>(740)</u>
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CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

Operating grants received	36,994
Transfers in	<u>3,212</u>

Net cash provided by noncapital financing activities	<u>40,206</u>
--	---------------

CASH FLOWS FROM INVESTING ACTIVITIES

Loans issued	(43,969)
Collections of loan principal	23,266
Interest received on loans	11,732
Interest received on investments	<u>9,446</u>

Net cash provided by investing activities	<u>475</u>
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Net increase in cash	<u>39,941</u>
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Cash, July 1	212,108
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Prior-year reclassification (Note 5)	<u>405</u>
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Reclassified cash, July 1	<u>212,513</u>
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Cash, June 30	<u><u>\$ 252,454</u></u>
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Reconciliation of operating income to net cash used by operating activities:

Operating income	<u>\$ 20,339</u>
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Adjustments to reconcile operating income to net cash used by operating activities:

Revenue from loans	(11,633)
Interest income	<u>(9,446)</u>

Total adjustments	<u>(21,079)</u>
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Net cash used by operating activities	<u><u>\$ (740)</u></u>
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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, 2006

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.

Cash

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

Clean Water State Revolving Fund
Notes to the Financial Statements (Cont.)
June 30, 2006

NOTE 2. DEPOSITS

At June 30, 2006, the Clean Water State Revolving fund had \$252,032,560 in the State Treasurer's pooled investment fund for operating cash purposes, and \$421,145 in customer security deposits in the Local Government Investment Pool which is also part of the pooled investment fund administered by the State Treasurer. The pooled investment fund 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, 14th 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 \$3,211,717 during fiscal year 2006.

NOTE 5. PRIOR YEAR RECLASSIFICATION

Certain activity for the preceding year has been reclassified affecting the beginning cash balance in the current year Statement of Cash Flows. During fiscal year 2005, the Clean Water State Revolving Fund received \$405,243 in security deposits from customers. The cash and corresponding liability were eliminated from the financial statements. In fiscal year 2006, the security deposits are reported on the Statement of Net Assets as cash and customer deposits payable.