AUDIT REPORT

Clean Water State Revolving Fund

For the Year Ended
June 30, 2008

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

TENNESSEE COMPTROLLER OF THE TREASURY

Arthur A. Hayes, Jr., CPA, JD, CFE
Director

Edward Burr, CPA
Assistant Director

Derek D. Martin, CPA, CFE
Audit Manager

Wendi Goodwin
In-Charge Auditor

Thad Sanders, CPA
Staff Auditor

Gerry C. Boaz, CPA
Technical Manager

Amy Brack
Editor

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-1402
(615) 401-7897

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-1402
PHONE (615) 401-7897
FAX (615) 532-2765

February 24, 2009

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Jim Fyke, Commissioner
Department of Environment and Conservation
401 Church Street, 1st Floor
Nashville, Tennessee 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, 2008. 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,

Arthur A. Hayes, Jr., CPA
Director

AAH/wg
09/019

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, 2008

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, 2008

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Clean Water State Revolving Fund
For the Year Ended June 30, 2008

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) and the Department of Environment and Conservation (the department). 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 Waste and Wastewater Financing Board or the Utilities Management Review Board is empowered to effect reasonable user rate increases or to effect system efficiencies through the negotiated consolidation of certain wastewater facilities.

AUDIT SCOPE

The audit was limited to the period July 1, 2007, through June 30, 2008, 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 generally accepted government auditing standards. Financial statements are presented for the year ended June 30, 2008, and for comparative purposes, the year ended June 30, 2007. 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 as a basis for designing 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.

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 internal and external 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 Resolving Fund's financial statements for the year ended June 30, 2008, we considered internal control over financial reporting as a basis for designing 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 generally accepted government auditing standards. 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 generally accepted 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.

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DIVISION OF STATE AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-1402
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*

December 12, 2008

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Jim Fyke, Commissioner
Department of Environment and Conservation
401 Church Street, 1st Floor
Nashville, Tennessee 37243

Ladies and Gentlemen:

We have audited the financial statements of the Clean Water State Revolving Fund, as of and for the year ended June 30, 2008, and have issued our report thereon dated December 12, 2008. 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 generally accepted government auditing standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the fund's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the fund's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the fund's internal control over financial reporting.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with accounting principles generally accepted in the United States of America such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

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 generally accepted government auditing standards.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee, management, and others within the entity 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,

Arthur A. Hayes, Jr., CPA
Director

AAH/wg

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Independent Auditor's Report

December 12, 2008

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Jim Fyke, Commissioner
Department of Environment and Conservation
401 Church Street, 1st Floor
Nashville, Tennessee 37243

Ladies and Gentlemen:

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, 2008, and June 30, 2007, 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 generally accepted government auditing standards. 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.

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, 2008, and June 30, 2007, 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, 2008, and June 30, 2007, 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 generally accepted government auditing standards, we have also issued our report dated December 12, 2008, 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 generally accepted government auditing standards and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/wg

Exhibit A

Clean Water State Revolving Fund
Statements of Net Assets
June 30, 2008, and June 30, 2007

(Expressed in Thousands)

	June 30, 2008	June 30, 2007
ASSETS		
Current assets:		
Cash (Note 2)	$ 238,606	$ 230,539
Receivables:		
Loans receivable	26,874	21,408
Interest receivable on loans	8	36
Total current assets	265,488	251,983
Noncurrent assets:		
Loans receivable	436,154	404,862
Total noncurrent assets	436,154	404,862
Total assets	701,642	656,845
LIABILITIES		
Current liabilities:		
Payable to borrowers (Note 3)	149	55
Total current liabilities	149	55
Noncurrent liabilities:		
Customer deposits payable (Note 2)	3,483	3,483
Total noncurrent liabilities	3,483	3,483
Total liabilities	3,632	3,538
NET ASSETS		
Unrestricted	698,010	653,307
Total net assets	$ 698,010	$ 653,307

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

Exhibit B

Clean Water State Revolving Fund
Statements of Revenues, Expenses, and Changes in Net Assets
For the Years Ended June 30, 2008, and June 30, 2007

(Expressed in Thousands)

	Year Ended June 30, 2008	Year Ended June 30, 2007
OPERATING REVENUES		
Revenue from loans	$ 13,722	$ 12,518
Interest income	9,245	12,909
Total operating revenues	22,967	25,427
OPERATING EXPENSES		
Administrative expenses	1,090	851
Total operating expenses	1,090	851
Operating income	21,877	24,576
NONOPERATING REVENUE		
Operating grant	20,453	15,492
Total nonoperating revenue	20,453	15,492
Income before transfers	42,330	40,068
Transfers in (Note 4)	2,373	3,304
Change in net assets	44,703	43,372
Net assets, July 1	653,307	609,935
Net assets, June 30	$ 698,010	$ 653,307

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

Exhibit C

Clean Water State Revolving Fund
Statements of Cash Flows
For the Years Ended June 30, 2008, and June 30, 2007

(Expressed in Thousands)

	Year Ended June 30, 2008	Year Ended June 30, 2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Payments for interfund services	$ (1,090)	$ (851)
Net cash used by operating activities	(1,090)	(851)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Operating grants received	20,453	15,492
Transfers in (Note 4)	2,373	3,304
Net cash provided by noncapital financing activities	22,826	18,796
CASH FLOWS FROM INVESTING ACTIVITIES		
Loans issued	(58,975)	(88,837)
Collections of loan principal	22,217	23,575
Interest received on loans	13,751	12,493
Interest received on investments	9,338	12,909
Net cash used by investing activities	(13,669)	(39,860)
Net increase (decrease) in cash	8,067	(21,915)
Cash, July 1	230,539	252,454
Cash, June 30	$ 238,606	$ 230,539
Reconciliation of operating income to net cash used by operating activities:		
Operating income	$ 21,877	$ 24,576
Adjustments to reconcile operating income to net cash used by operating activities:		
Revenue from loans	(13,722)	(12,518)
Interest income	(9,245)	(12,909)
Total adjustments	(22,967)	(25,427)
Net cash used by operating activities	$ (1,090)	$ (851)

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, 2008, and June 30, 2007

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.

NOTE 2. DEPOSITS

At June 30, 2008, the Clean Water State Revolving fund had $235,123,046 in the State Treasurer's pooled investment fund for operating cash purposes and $3,483,380 in customer security deposits in the Local Government Investment Pool. At June 30, 2007, the fund had $227,055,608 in the State Treasurer's pooled investment fund and $3,483,380 in the Local Government Investment Pool. The Local Government Investment Pool is 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*. The report is posted on the state's website at http://tennessee.gov/finance/act/cafr.html or may be obtained by writing to the Tennessee Department of Finance and Administration, Division of Accounts, 14th Floor William R. Snodgrass Tennessee Tower, 312 Rosa L. Parks Avenue, Nashville, Tennessee 37243-1102, or by calling (615) 741-2140.

NOTE 3. PAYABLE TO BORROWERS

This account represents loan principal overpayments that will be refunded to borrowers and interest earned on security deposits, which per the loan agreements is due to the 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 $2,373,367 during the year ended June 30, 2008, and $3,304,038, during the year ended June 30, 2007.