



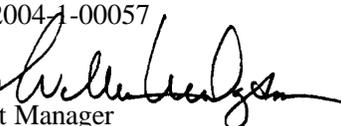
ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C

OFFICE OF
INSPECTOR GENERAL

May 6, 2004

Memorandum

Subject: Auditor's Report for the Missouri State Revolving Fund Program (the Program)
as of June 30, 2003
Audit Report No. 2004-1-00057

From: William M. Dayton 
National SRF Audit Manager

To: James B. Gulliford
Regional Administrator
EPA, Region 7
Kansas City, KS

Attached is a copy of the subject audit we sent to the State of Missouri. The audit contains reports on the financial statements, internal controls, and compliance requirements applicable to the State Revolving Fund (SRF) programs in Missouri for the year ended June 30, 2003.

We issued an unqualified of opinion on the financial statements. However, we noted several matters involving the internal control system and operations that we consider to be material weaknesses. We also qualified our opinion on the compliance requirements applicable to the SRF program because the Missouri Department of Natural Resources (DNR) did not maintain an adequate accounting system to account for SRF activities in accordance with the Clean Water Act, as detailed in the reports. In response to the draft audit report, SRF management agreed with all of our internal control and compliance items, and are taking appropriate steps to correct the deficiencies.

In accordance with EPA directive 2750, the Action Official is required to take action on the findings and recommendations in this report within 150 days.

The OIG has no objection to the release of this report to any member of the public upon request. The report contains no confidential business or proprietary information.

If you have any questions or concerns regarding this matter, please feel free to contact me at (916) 498-6590 or Mr. Paul Felz at (303) 312-6270.

Attachment



ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C

OFFICE OF
INSPECTOR GENERAL

May 6, 2004

Mr. Stephen Mahfood, Director
Missouri Department of Natural Resources
P.O. Box 176
Jefferson City, MO 65102-0176

Subject: Auditor's Report for the State of Missouri Department of Natural Resources
Clean Water State Revolving Fund for the Year Ended June 30, 2003.
EPA Audit Report No. 2004-1-00057

Dear Mr. Mahfood:

Enclosed please find an electronic copy of the final audited financial statements for the State of Missouri Department of Natural Resources Clean Water State Revolving Fund) for the year ended June 30, 2003.

The purpose of our audit was to:

- Examine the financial statements of the State of Missouri Department of Natural Resources Clean Water State Revolving Fund for the year ended June 30, 2000, and issue a report containing our opinion of the financial statements;
- Report on the internal control structure of the State of Missouri Department of Natural Resources Clean Water State Revolving Fund program;
- Report on compliance with specific program requirements of the State of Missouri Department of Natural Resources Clean Water State Revolving Fund.

We have issued an unqualified opinion on the financial statements and an qualified opinion on the compliance requirements because Missouri did not maintain an adequate accounting system to account for SRF activities in accordance with the Clean Water Act. In our report on internal controls, we also noted several matters involving the internal control structure and its operations that we considered to be a material weaknesses. We discussed these reports with your program management who generally agreed with the results of our audit.

We would like to thank you and your staff for the cooperation and courtesies we received during our audit. If you have any questions or concerns, please contact me at (916) 498-6590 or Mr. Paul Felz at (303) 312-6270.

Sincerely,

A handwritten signature in black ink, appearing to read "William M. Dayton".

William M. Dayton

National SRF Audit Manager



OIG
OFFICE OF INSPECTOR GENERAL

Catalyst for Improving the Environment

Audit Report

**Missouri Department of Natural Resources
State Revolving Funds**

**Financial Statements with
Independent Auditor's Report, June 30, 2003**

Audit Report Number 2004-1-00057

Issued May 6, 2004

**Missouri Department of Natural Resources
State Revolving Funds**

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ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C

OFFICE OF
INSPECTOR GENERAL

Independent Auditor's Report

To: Steven Mahfood, Director
Missouri Department of Natural Resources

We have audited the accompanying Combining Statement of Net Assets of the Missouri Department of Natural Resources State Revolving Funds (the Funds) as of June 30, 2003, and the related Combining Statement of Revenues, Expenses and Changes In Fund Net Assets, and Combining Statement Of Cash Flows for the year then ended. These financial statements are the responsibility of the Program's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in the United States of America and *Government Auditing Standards* issued by the Comptroller General of the United States of America. 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.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Missouri Department of Natural Resources State Revolving Funds as of June 30, 2003 and the results of their operation and cash flows for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note 1, the financial statements referred to above are intended to present the financial position and results of operations of the State Revolving Fund Programs, which are components of the general fund of the State of Missouri. These statements are not intended to present the financial position or results of operations for the State of Missouri or the Missouri Department of Natural Resources, of which the Funds are a part. Certain supplementary information referred to as Management Discussion and Analysis, although not a required part of the basic financial statements, has been omitted for this program-specific financial presentation.

In accordance with *Government Auditing Standards*, we have also issued a report dated February 18, 2004 on our consideration of the Programs' internal control structure and a report dated February 18, 2004 on their compliance with laws and regulations.

A handwritten signature in black ink, appearing to read "William J. ...", is written over the printed name of the Inspector General.

Office of the Inspector General
February 18, 2004

State of Missouri
Department of Natural Resources State Revolving Funds
Combining Balance Sheet
June 30, 2003
(in thousands)

	<u>Clean Water Enterprise</u>	<u>Drinking Water Enterprise</u>	<u>Total Enterprise Funds (Memorandum Only)</u>	<u>Combined Agency Funds</u>	<u>Totals (Memorandum Only)</u>
Assets:					
Current Assets:					
Cash and cash equivalents	\$ 286,147	\$ 9,484	\$ 295,631	\$ 282,681	\$ 578,312
Current Receivables:					
Loan interest	23,890	3,342	27,232	-	27,232
Investment interest	821	-	821	543	1,364
Administration fees	1,200	-	1,200	-	1,200
Due from other funds	288	6	294	-	294
Due from trustee	147	-	147	-	147
Due from EPA	-	1,580	1,580	-	1,580
Other	270	260	530	-	530
Current portion of loans receivable	<u>51,955</u>	<u>4,622</u>	<u>56,577</u>	<u>-</u>	<u>56,577</u>
Total current assets	<u>364,718</u>	<u>19,294</u>	<u>384,012</u>	<u>283,224</u>	<u>667,236</u>
Restricted assets - cash and cash equivalents	4,749	397	5,146	-	5,146
Non-current assets:					
Loans receivable:					
Leveraged loans	758,239	135,825	894,064	-	894,064
Reserve loans	352,987	43,788	396,775	-	396,775
Direct loans	6,637	3,650	10,287	-	10,287
Direct Non-point source loans	<u>7,734</u>	<u>-</u>	<u>7,734</u>	<u>-</u>	<u>7,734</u>
Total loans receivable	<u>1,125,597</u>	<u>183,263</u>	<u>1,308,860</u>	<u>-</u>	<u>1,308,860</u>
Less: Current portion	<u>(51,955)</u>	<u>(4,622)</u>	<u>(56,577)</u>	<u>-</u>	<u>(56,577)</u>
Loans receivable, net	<u>1,073,642</u>	<u>178,641</u>	<u>1,252,283</u>	<u>-</u>	<u>1,252,283</u>
Fixed assets, net of accumulated depreciation	<u>48</u>	<u>-</u>	<u>48</u>	<u>-</u>	<u>48</u>
Total assets	<u><u>1,443,157</u></u>	<u><u>198,332</u></u>	<u><u>1,641,489</u></u>	<u><u>283,224</u></u>	<u><u>1,924,713</u></u>
Liabilities and Net Assets:					
Liabilities:					
Current liabilities:					
Accounts payable	96	-	96	-	96
Accrued salaries and benefits	-	-	-	-	-
Project Costs Payable to Communities	-	-	-	275,609	275,609
Interest Subsidies Payable to Communities	-	-	-	6,524	6,524
Bond Interest Payable	24,201	3,342	27,543	-	27,543
Current Portion of Bonds Payable	31,457	3,385	34,842	-	34,842
Due to other funds	25	1,580	1,605	42	1,647
Other	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,049</u>	<u>1,049</u>
Total current liabilities	<u>55,779</u>	<u>8,307</u>	<u>64,086</u>	<u>283,224</u>	<u>347,310</u>
Non-current liabilities:					
Bonds Payable, net of discounts	741,782	132,440	874,222	-	874,222
Rebate Payable	<u>4,973</u>	<u>403</u>	<u>5,376</u>	<u>-</u>	<u>5,376</u>
Total non-current liabilities	<u>746,755</u>	<u>132,843</u>	<u>879,598</u>	<u>-</u>	<u>879,598</u>
Total liabilities	802,534	141,150	943,684	283,224	1,226,908
Net assets:					
Invested in capital assets, net of debt	48	-	48	-	48
Restricted for loans and debt service	<u>640,575</u>	<u>57,182</u>	<u>697,757</u>	<u>-</u>	<u>697,757</u>
Total net assets	<u>640,623</u>	<u>57,182</u>	<u>697,805</u>	<u>-</u>	<u>697,805</u>
Total liabilities and net assets	<u><u>\$ 1,443,157</u></u>	<u><u>\$ 198,332</u></u>	<u><u>\$ 1,641,489</u></u>	<u><u>\$ 283,224</u></u>	<u><u>\$ 1,924,713</u></u>

See notes to financial statements

State of Missouri
Drinking Water State Revolving Fund
Combining Income Statement Drinking Water
For the year ended June 30, 2003

	<u>Loan Fund</u>	<u>Administrative Fee Fund</u>	<u>Total Enterprise Fund</u>
Operating revenues:			
Interest income on SRF loans	\$ 5,795,738	\$ -	\$ 5,795,738
Investment income	212,260	4,011	216,271
Administrative fees	0	360,574	360,574
EPA set-aside operating grants	2,343,732	0	2,343,732
Other	0	0	0
Total operating revenues	<u>8,351,730</u>	<u>364,585</u>	<u>8,716,315</u>
Operating expenses:			
Interest expense on bonds payable	5,786,753	0	5,786,753
Salaries and benefits	1,267,053	0	1,267,053
Other administrative expenses	1,076,679	19	1,076,698
Total operating expenses	<u>8,130,485</u>	<u>19</u>	<u>8,130,504</u>
Operating income	221,246	364,566	585,811
Non-operating revenue:			
Environmental Protection Agency grant	16,253,966	0	16,253,966
State of Missouri contribution	6,320,987	0	6,320,987
Total non-operating revenue	<u>22,574,953</u>	<u>0</u>	<u>22,574,953</u>
Increase in net assets	22,796,199	364,566	23,160,764
Net assets, beginning of year	<u>33,726,744</u>	<u>294,320</u>	<u>34,021,064</u>
Net assets, end of year	<u>\$ 56,522,942</u>	<u>\$ 658,886</u>	<u>\$ 57,181,828</u>

See notes to financial statements

State of Missouri
Department of Natural Resources State Revolving Funds
Combining Statement of Cash Flows
June 30, 2003
(in thousands)

	Clean Water Enterprise	Drinking Water Enterprise	Total Enterprise Funds (Memorandum Only)
Cash flows from operating activities:			
Interest received on loans	\$ 31,804	\$ 4,938	\$ 36,742
Interest paid on bonds	(31,766)	(4,929)	(36,695)
Deposits to rebate account	498	23	521
Administrative fees	2,330	207	2,537
EPA set-aside grants	-	1,509	1,509
Salaries and benefits	(1,604)	(1,267)	(2,871)
Other administrative expenses	(1,388)	(1,077)	(2,465)
Investment Income	4,832	216	5,048
Other income	7	-	7
Repayment received from DWSRF short-term loan	190	(190)	-
Loan to stormwater program	(43)	-	(43)
Cash for Administration Fees	24	-	24
Other	(14)	835	821
Cash provided by operating activities	<u>4,870</u>	<u>265</u>	<u>5,135</u>
Cash flows from noncapital financing activities:			
Bonds issued	208,770	38,150	246,920
Bond principle retired	(25,769)	(2,230)	(27,999)
Environmental Protection Agency grant	58,266	16,444	74,710
State of Missouri contribution	10,257	6,321	16,578
Net cash provided by noncapital financing activities	<u>251,524</u>	<u>58,685</u>	<u>310,209</u>
Cash flows from investing activities:			
Loan disbursements	(252,056)	(65,375)	(317,431)
Repayments received on loans	52,580	3,965	56,545
Net cash (used) gain in investing activities	<u>(199,476)</u>	<u>(61,410)</u>	<u>(260,886)</u>
Increase in cash and cash equivalents	56,918	(2,460)	54,458
Cash and cash equivalents, beginning of year	<u>233,978</u>	<u>12,341</u>	<u>246,319</u>
Cash and cash equivalents, end of year	<u><u>290,896</u></u>	<u><u>9,881</u></u>	<u><u>300,777</u></u>
Reconciliation of net operating income to net cash provided by operating activities:			
Operating Income	3,913	586	4,499
Adjustments to reconcile net operating income to net cash provided by operations:			
Depreciation and amortization	19	-	19
Changes in assets and liabilities:			
(Increase) in current assets	(2,913)	(1,823)	(4,736)
Increase in current liabilities	3,851	1,502	5,353
Net cash provided by operating activities	<u>\$ 4,870</u>	<u>\$ 265</u>	<u>\$ 5,135</u>

See notes to financial statements

State of Missouri
Department of Natural Resources State Revolving Funds
Notes to Financial Statements

NOTE 1: Summary of Significant Accounting Policies

Reporting Entity

The Missouri Department of Natural Resources (MDNR) is responsible for administration of the State Revolving Fund (SRF) Program, consisting of the Clean Water State Revolving Fund Program (CWSRF) and the Drinking Water State Revolving Fund Program (DWSRF). In conformance with generally accepted accounting principles, the financial data of MDNR, including a portion of the SRF programs, is included with the State of Missouri's financial data reported in the Statewide Comprehensive Annual Financial Report. The SRF programs' financial statements, footnotes, and related schedules are presented for the benefit of U.S. Environmental Protection Agency. Due to differences in reporting methods, there may be differences between the amounts reported in these financial statements and the general purpose financial statements.

Clean Water State Revolving Fund:

The CWSRF was established pursuant to Title VI of the Federal Water Quality Act of 1987 (the Act). The Act established the CWSRF program to replace the construction grants program to provide loans at reduced interest rates to finance the construction of publicly owned water pollution control facilities, non point source pollution control projects, and estuary management plans. Instead of making grants to communities that pay for a portion of building wastewater treatment facilities, the CWSRF program provides for low interest rate loans to finance the entire cost of qualified projects. The CWSRF program provides a flexible financing source that can be used for a variety of pollution control projects, including nonpoint source pollution control projects, and developing estuary conservation and management plans. Loans made must be repaid within 20 years, and all repayments, including interest and principal, must remain in the loan fund.

The CWSRF was capitalized by the U.S. Environmental Protection Agency (EPA) by a series of grants starting in 1988. The State of Missouri (the State) is required to provide an additional 20 percent of the federal capitalization grant as matching funds in order to receive a grant. As of June 30, 2003, Congress authorized EPA to award \$514,237,000 in capitalization grants to the State. The State is required to contribute \$102,847,000 in matching funds.

The Missouri Clean Water Commission exercises supervision of the administration of the CWSRF program. The Missouri Environmental Improvement and Energy Resources Authority (EI ERA) issues bonds or notes, secured by SRF funds, to finance qualified projects. The program is comprised of four funds within the State, and an agency fund that holds the construction loan funds. The State funds are: the Water and Wastewater Loan Fund (fund 649) that receives the federal capitalization grant and State matching funds and makes payments to the loan reserve fund, the Water and Wastewater Loan Revolving Fund (fund 602) that receives funds as they are released from the loan reserve, the Administrative Fee Fund (fund 568) that receives the loan fees charged to borrowers, and the State Match Bond Fund (fund 300) that receives proceeds of the sale of State match bonds that will be repaid using interest earning from SRF recycled funds. The Agency Fund accounts for proceeds of bonds issued by EI ERA.

Drinking Water State Revolving Fund:

The DWSRF was established pursuant to the Safe Drinking Water Act (SDWA) Amendments of 1996. Section 1452 of this Act authorizes the Administrator of the U.S. Environmental Protection Agency to establish a Drinking Water State Revolving Fund (DWSRF) program to assist public water systems with

State of Missouri
Department of Natural Resources State Revolving Funds
Notes to Financial Statements

NOTE 1: Summary of Significant Accounting Policies (continued)

financing the costs of infrastructure needed to achieve or maintain compliance with SDWA requirements, to protect public health, and to allow states to carry out prevention programs.

The DWSRF was capitalized by the U.S. Environmental Protection Agency by a series of grants starting in 1997. States are required to provide an additional 20 percent of the federal capitalization grant as matching funds. As of June 30, 2003, Congress has authorized EPA to award \$62,330,900 in capitalization grants to the State of Missouri. The state is required to contribute \$12,466,180 in matching funds.

The DWSRF is administered by the MDNR under the supervision of the Missouri Safe Drinking Water Commission. EIERA issues bonds or notes, secured by SRF funds, to finance qualified projects. The program is comprised of five funds within the state, and an agency fund that holds the construction loan funds. The state funds are: the Water and Wastewater Loan Fund (fund 0649) that receives federal capitalization grant funds and makes payments to the loan reserve fund, the Water and Wastewater Loan Revolving Fund (fund 0602) that receives funds as they are released from the loan reserve, the Administrative Fee Fund (fund 0568) that receives the loan fees charged to borrowers, the Department of Natural Resources Federal Fund (fund 0140) that receives federal capitalization grant funds that fund set-aside activities, and the General Revenue Fund (fund 0101) that holds capitalization grant matching funds. The Agency Fund accounts for bond proceeds issued by EIERA.

Program Operations

In both the CWSRF and the DWSRF programs, Missouri leverages federal and State matching funds by issuing revenue bonds to make loans to qualified communities, and using federal grant and State matching funds to create reserves for the loans. Interest earned on the reserves subsidizes loan interest rates, and enhances the security of the loans, which are pledged to repay bond principal and interest. "Leveraged" borrowers, in essence, receive two loans: a market-rate loan funded by the revenue bond proceeds that equals project construction costs, and a zero-rate loan funded by capitalization grants and State match to fund the reserves. The CWSRF "reserve" loans equal 70 percent of the leveraged project loan (50 percent prior to 1993). The DWSRF reserve loans equal 50 percent of the leveraged project loans (33.33 percent prior to 2002). Bond proceeds are deposited to an agency fund (primarily the construction loan fund) held by the trustee bank. As communities draw on these funds to pay construction costs, an amount equaling 70 percent of the draw from the construction loan fund is transferred from MDNR to a reserve account established for each borrower. Earnings in the reserve account reduce the borrower's net interest payments on the bonds, resulting in the subsidized, blended interest rate on the project loan.

The SRFs also make direct loans in certain instances. Direct loans are funded from the Water and Wastewater Loan Revolving Fund (WWLRF). Loan proceeds are deposited to an agency fund (the construction loan fund) held by the trustee bank. As construction costs are incurred, funds are released from the trustee bank to the borrower. The borrower repays the loan by making monthly principal and interest payments to the trustee bank. On the debt service due dates, the trustee bank makes the debt service payment to the program.

Basis of Accounting

The financial statements of the loan funds are presented as enterprise funds. As such, the program is accounted for using the flow of economic resources measurement focus and is maintained on the accrual method of accounting. Under the accrual method of accounting, revenues are recognized when earned and expenses are recorded at the time the liabilities are incurred. The Agency Fund is accounted for using

State of Missouri
Department of Natural Resources State Revolving Funds
Notes to Financial Statements

NOTE 1: Summary of Significant Accounting Policies (continued)

accounting principles applicable to trust and agency funds. All assets and liabilities associated with the operations of the program are included on the Statement of Net Assets. The State has elected to follow the accounting pronouncements of the Governmental Accounting Standards Board (GASB), as well as Statements issued by the Financial Accounting Standard Board on or before November 30, 1989, unless the pronouncements conflict with or contradict GASB pronouncements.

Cash and Cash Equivalents

All monies of the program are deposited with the Missouri State Treasurer's Office, which is responsible for maintaining these deposits in accordance with State law. The program considers all such deposits to be cash. Investment interest earnings on these deposits are received by the program on a daily basis. According to State law, the Treasurer is responsible for maintaining the cash balances and investing excess cash of the program, as further discussed in Note 2. Consequently, management of the program does not have any control over the investment of the excess cash. The Statement of cash flows considers all funds deposited with the Treasurer to be cash or cash equivalents, regardless of actual maturities of the underlying investments.

Administrative Fees

The program charges an administrative fee to borrowers to fund administrative costs of operating the program. During the year ended June 30, 2003, \$2,330,000 was collected for CWSRF administrative fees and \$207,156 was collected for DWSRF administrative fees. During the same period, \$2,818,000 was used for CWSRF administrative expenses. As of June 30, 2003, the cash balance of the administrative funds was \$10,030,000 and \$399,159 for the CWSRF and DWSRF, respectively, with another \$24,000 due to the CWSRF from the loan fund.

Bonds Payable

Bonds payable are special limited obligations of EI ERA, payable from borrower loan repayments, a reserve account established for each borrower (generally equal to 70 percent of the outstanding bond principal for CWSRF borrowers and 50 percent for DWSRF borrowers), and a master trust agreement. Interest expense is reported on the accrual basis. The effects of bond discounts, premiums, and issuance costs are not reported by the program since they are passed thru to the borrowers and represent the costs/benefits of the borrowers.

Borrowers make monthly payments to debt service repayment accounts, which also earn interest that further subsidizes the interest rates. On bond payment dates, transfers are made from the repayment accounts to the debt service funds to make the semi-annual interest payments and annual bond principal payments. Interest earnings on the construction loan accounts and reserve accounts are also transferred to the debt service funds on the bond payment dates. These interest earnings reduce the amount that is needed from the repayment accounts.

As outstanding bond principal is reduced, an amount is released from the reserve account so that the reserve security equals 70 percent (CWSRF) or 50 percent (DWSRF) of the outstanding loan balance.

Amounts released flow to the master trust unallocated fund, and, if there are no loan defaults, the amount is transferred to the Water and Wastewater Loan Revolving Fund to be used to make new loans.

State of Missouri
Department of Natural Resources State Revolving Funds
Notes to Financial Statements

NOTE 1: Summary of Significant Accounting Policies (continued)

State match bonds that are immediately and directly deposited inside the CWSRF, and that will be repaid using interest earnings of the WWLRF, are recorded as bonds payable. The first State match bonds that met this criteria were sold in August 2002. State match bonds sold prior to August 2002 are not repaid using CWSRF interest earnings and are recorded as contributed capital when the State funds are transferred into the Water and Wastewater Loan Fund.

Capitalization Grants

In accordance with generally accepted accounting principles, funds received from the EPA and the State for the capitalization of the SRFs are recorded as non-operating revenues.

NOTE 2: Cash and Cash Equivalents

All cash in the enterprise funds, excluding that restricted for arbitrage rebate payments, is deposited with the State Treasurer, who is responsible for maintaining and investing the pooled cash balances in accordance with State laws. The Treasurer is required to maintain a mix of investments in order to allow funds to be withdrawn at any time to meet normal operating needs. The program's share of the investment income from the local government investment pool is based on the average daily balance for the period and is credited to the program periodically throughout the month. Details of the investments can be obtained from the State Treasurer's Office. The restricted rebate funds are held in an account with a Trustee Bank. If the rebate account is insufficient to meet the arbitrage requirements, each borrower, not the CWSRF, is to provide its allocable portion of the deficit.

All cash and investments in the local investment pool are stated at cost, which approximates fair market value. Investments in local government investment pools are not categorized because they are not evidenced by securities that exist in physical or book entry form.

	<u>Cost</u>	<u>Market Value</u>
Not subject to categorization (in thousands):		
CWSRF:		
Investment pool	\$ 276,117	\$ 276,117
Rebate Accounts with Trustee	4,749	4,749
DWSRF:		
Investment Pool	\$ 9,881	\$ 9,881
Rebate Accounts with Trustee	397	397

NOTE 3: Loans Receivable

Loans receivable consist of three types: leveraged loans, reserve loans, and direct loans. Leveraged loans are funded by the sale of revenue bonds, the proceeds of which are deposited to a construction loan fund. Borrowers are loaned funds from the construction loan fund to pay for construction costs incurred. The terms of the loans mirror the terms of the bonds in order to provide the funds to pay bond interest and principal according to the terms of the bonds. As funds are released from the construction loan fund to the borrower, an amount equal to 70 percent (CWSRF) or 50 percent (DWSRF) of the construction costs is deposited to the loan reserve fund to provide an interest subsidy to the borrower and to provide security

State of Missouri
Department of Natural Resources State Revolving Funds
Notes to Financial Statements

NOTE 3: Loans Receivable (continued)

for bond principal and interest. In general, the loans and bonds require payment of interest semi-annually and principal annually. It is the opinion of management that all loans are fully collectible, so no provision for uncollectible amounts is included in these financial statements.

Loans receivable activity during the year ended June 30, 2003 is summarized as follows (in thousands):

CWSRF:

<u>Loan Type</u>	<u>Loan Amount Authorized</u>	<u>Loan Balance June 30, 2002</u>	<u>Disbursements</u>	<u>Repayments</u>	<u>Loan Balance June 30, 2003</u>
Direct Loans	\$ 4,650	\$ -	\$ 4,650	\$ 1,000	\$ 3,650
Leveraged Loans	140,945	99,905	38,150	2,230	135,825
Reserve Loans	n/a	21,948	22,575	735	43,788
Total	<u>\$ 145,595</u>	<u>\$ 121,853</u>	<u>\$ 65,375</u>	<u>\$ 3,965</u>	<u>\$ 183,263</u>

DWSRF:

<u>Loan Type</u>	<u>Loan Amount Authorized</u>	<u>Loan Balance June 30, 2002</u>	<u>Disbursements</u>	<u>Repayments</u>	<u>Loan Balance June 30, 2003</u>
Direct Loans	\$ 4,650	\$ -	\$ 4,650	\$ 1,000	\$ 3,650
Leveraged Loans	140,945	99,905	38,150	2,230	135,825
Reserve Loans	n/a	21,948	22,575	735	43,788
Total	<u>\$ 145,595</u>	<u>\$ 121,853</u>	<u>\$ 65,375</u>	<u>\$ 3,965</u>	<u>\$ 183,263</u>

Loan Maturities

Loans mature at various intervals through 2025. The scheduled principal payments on leveraged loans and direct loans in subsequent years are as follows (in thousands):

CWSRF:

<u>Year Ending June 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2004	\$ 31,712	\$ 39,992	\$ 71,704
2005	35,877	38,677	74,554
2006	37,419	37,136	74,555
2007	37,213	34,918	72,131
2008	40,934	33,162	74,096
2009-2013	221,664	134,240	355,904
2014-2018	209,900	72,255	282,155
2019-2023	142,238	22,206	164,444
2024-2026	15,653	860	16,513
CWSRF Total	<u>\$ 772,610</u>	<u>\$ 413,446</u>	<u>\$ 1,186,056</u>

State of Missouri
Department of Natural Resources State Revolving Funds
Notes to Financial Statements

NOTE 3: Loans Receivable (continued)

DWSRF:

<u>Year Ending June 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2004	\$ 3,385	\$ 6,655	\$ 10,040
2005	4,667	6,415	11,082
2006	4,946	6,245	11,191
2007	5,075	6,057	11,132
2008	5,339	5,848	11,187
2009-2013	32,033	25,191	57,224
2014-2018	47,243	14,963	62,206
2019-2023	34,258	3,910	38,168
2024	2,529	35	2,564
DWSRF Total	<u>\$ 139,475</u>	<u>\$ 75,319</u>	<u>\$ 214,794</u>

Loans to Major Local Agencies

As of June 30, 2003, the CWSRF program had loans outstanding to ten agencies that, in the aggregate, exceeded \$15,000,000. The DWSRF program made loans to four communities that exceeded \$8,000,000. The outstanding balances of these CWSRF and DWSRF loans represent approximately 57 percent and 58 percent, respectively, of the total loans receivable for each program, as follows (in thousands):

CWSRF:

<u>Borrower</u>	<u>Loan Authorized</u>	<u>Loan Outstanding</u>	<u>Percent of Total Outstanding</u>
Kansas City	\$ 140,295	\$ 119,645	15%
Little Blue Valley Sewer District	100,205	99,495	13%
Springfield	88,530	71,526	9%
Duckett Creek	38,673	32,190	4%
Cape Girardeau	36,353	31,433	4%
Rock Creek Sewer District	25,555	24,390	3%
Jefferson City	24,875	24,875	3%
Branson	22,950	17,540	2%
Joplin	20,000	15,326	2%
St. Joseph	16,823	13,094	2%
CWSRF Total	<u>\$ 514,259.00</u>	<u>\$ 449,514</u>	<u>58%</u>

State of Missouri
Department of Natural Resources State Revolving Funds
Notes to Financial Statements

NOTE 3: Loans Receivable (continued)

DWSRF:

<u>Borrower</u>	<u>Loan Authorized</u>	<u>Loan Outstanding</u>	<u>Percent of Total Outstanding</u>
City of Osage Beach	\$ 30,660	\$ 30,660	22%
City of Cape Girardeau	25,495	22,850	16%
Jefferson County Water Authority	18,665	18,665	13%
City of Perryville	8,860	8,225	6%
DWSRF Total	<u>\$ 83,680</u>	<u>\$ 80,400</u>	<u>58%</u>

NOTE 4: Bonds Payable

The SRF programs issue revenue bonds to finance qualified projects, and uses federal capitalization grants and State matching funds to provide reserves for the bonds. The bonds are issued by EIARA and proceeds from the sales of bonds are deposited into the borrowers' accounts with the trustee banks. Bonds payable and loans receivable are recorded in the enterprise fund, and the cash and project costs payable are recorded in the Agency Fund. Interest rates on these bonds are determined by the current market rate. As borrowers incur costs, funds are transferred from the construction loan fund to the borrower.

Concurrent with disbursements to borrower, the program draws federal and State matching funds to maintain the proper loan reserve balance. Interest earned on the construction loan fund and the reserve fund subsidizes the interest on the borrower's loan. As borrowers repay the loans, the interest and principal serve as the source of funds to pay bond principal and interest.

As of June 30, 2003, 35 separate bond issues totaling \$1,023,148,000 had been issued for the CWSRF and 10 bond issues totaling \$140,945,000 had been issued for the DWSRF. The bonds mature at various intervals through January 2025.

As of June 30, 2003, the State had issued state match general obligation bonds Series A 2002 in the amount of \$15,000,000. The bonds mature at various intervals through August 2027, with interest of 3.0% to 5.25% due semi-annually through 2027. These bonds were immediately and directly deposited inside the SRF and will be repaid using interest earnings on the WWRLF.

Bond activity during the year ended June 30, 2003 is summarized as follows:

CWSRF:

	<u>6/30/02 Balance</u>	<u>Repayments</u>	<u>New Issues</u>	<u>6/30/03 Balance</u>
Program Bonds	\$ 593,132	\$ (26,243)	\$ 193,770	\$ 760,659
State Match Bonds	-	-	15,000	15,000
Less: amount deferred on refundings	(2,895)	475		(2,420)
Total	<u>\$ 590,237</u>	<u>\$ (25,768)</u>	<u>\$ 208,770</u>	<u>\$ 773,239</u>

State of Missouri
Department of Natural Resources State Revolving Funds
Notes to Financial Statements

NOTE 4: Bonds Payable (continued)

DWSRF:

	6/30/02 Balance	Repayments	New Issues	6/30/03 Balance
Program Bonds	\$ 99,905	\$ (2,230)	\$ 38,150	\$ 135,825

The required annual payments for all revenue bonds for each of the next five fiscal years, and in five-year increments thereafter until maturity are as follows (in thousands):

CWSRF:

Year Ending June 30	Principal	Interest	Total
2004	\$ 30,787	\$ 40,399	\$ 71,186
2005	35,106	39,088	74,194
2006	36,010	37,559	73,569
2007	36,588	35,352	71,940
2008	40,353	33,599	73,952
2009-2013	220,283	136,428	356,711
2014-2018	210,446	74,181	284,627
2019-2023	143,773	23,613	167,386
2024-2026	19,893	1,429	21,322
Total	\$ 773,239	\$ 421,648	\$ 1,194,887

DWSRF:

Year Ending June 30	Principal	Interest	Total
2004	\$ 3,385	\$ 6,585	\$ 9,970
2005	4,525	6,324	10,849
2006	4,800	6,157	10,957
2007	4,925	5,974	10,899
2008	5,185	5,767	10,952
2009-2013	31,205	24,849	56,054
2014-2018	46,305	14,730	61,035
2019-2023	33,195	3,801	36,996
2024-2028	2,300	29	2,329
	\$ 135,825	\$ 74,216	\$ 210,041

NOTE 5: Capital Contributions

The CWSRF program is capitalized by grants from EPA, authorized by Title VI of the Act, and matching funds from the State of Missouri. As of June 30, 2003, EPA has awarded capitalization grants totaling \$514,237,000 of which \$491,007,000 has been drawn. The following summarizes the capitalization grants awarded, amounts drawn on each grant, and balances available (in thousands):

State of Missouri
Department of Natural Resources State Revolving Funds
Notes to Financial Statements

NOTE 5: Capital Contributions (continued)

CWSRF:

Year of Allocation	Grant Amount	Total Draws June 30, 2002	2003 Draws	Total Draws June 30, 2003	Available as of June 30, 2003
1988 to 1994	\$250,695	\$250,695		\$250,695	
1995	34,136	34,136		34,136	
1996	56,212	56,212		56,212	
1997	17,277	17,277		17,277	
1998	37,329	37,329		37,329	
1999	37,332	37,093	\$ 239.00	37,332	
2000	42,206	0	42,065	42,065	\$ 141
2001	39,050	0	15,961	15,961	23,089
	<u>\$ 514,237</u>	<u>\$ 432,742</u>	<u>\$ 58,265</u>	<u>\$ 491,007</u>	<u>\$ 23,230</u>

The DWSRF program is capitalized by grants from the EPA as authorized by Section 1452 of the SDWA, and matching funds from the State of Missouri. As of June 30, 2003, EPA has awarded capitalization grants totaling \$62,330,900, of which \$39,677,699 has been drawn. The following schedule summarizes the capitalization grants awarded, amounts drawn on each grant, and balances available (in thousands):

DWSRF:

Year of Allocation	Grant Amount	Total Draws June 30, 2002	2003 Draws	Total Draws June 30, 2003	Available as of June 30, 2003
1997	\$ 21,858	\$ 16,820	\$ 3,170	\$ 19,990	\$ 1,868
1998	9,575	4,136	4,936	9,072	503
1999	10,035	769	3,302	4,071	5,964
2000	10,390	-	5,943	5,943	4,447
2001	10,473	-	602	602	9,871
	<u>\$ 62,331</u>	<u>\$ 21,725</u>	<u>\$ 17,953</u>	<u>\$ 39,678</u>	<u>\$ 22,653</u>

As of June 30, 2003, CWSRF State matching contributions were as follows:

	As of June 30, 2002	2003 Contribution	As of June 30, 2003
State Matching Contribution:			
State Appropriations	\$ 86,617	\$ 10,524	\$97,141
State Match Bonds (deposited into CWSRF)	-	1,720	1,720
Total State Match	<u>\$ 86,617</u>	<u>\$ 12,244</u>	<u>\$ 98,861</u>

State of Missouri
Department of Natural Resources State Revolving Funds
Notes to Financial Statements

NOTE 5: Capital Contributions (continued)

As of June 30, 2003, DWSRF State matching contributions were as follows:

	June 30, 2002	2003 Contribution	June 30, 2003
State Matching Contribution	\$ 6,201	\$ 6,321	\$ 12,522

NOTE 6: Set-Aside Costs

a) Loan Program Administration s - 4% Set-Aside

The costs were incurred for program management, including paying salaries, paying associated operational expenses, and providing technical assistance to potential loan applicants.

b) State Program Management - 10% Set-Aside

The costs were incurred for permitting, enforcement, operator training and certification, emergency preparedness, information management systems, capacity development, source water protection, and consumer reporting.

c) Technical Assistance for Small Systems - 2% Set-Aside

The costs were incurred for assistance with: (1) complying with crosscutting requirements of the program and state requirements, (2) locating and obtaining sources of additional funding, (3) complying with the SDWA, and (4) developing technical, managerial, and financial capacity.

d) Local Assistance - 15% Set-Aside

The costs were incurred for a separate source water protection loan program and capacity development.

Total set-aside costs charged to the Program are as follows (in thousands):

Year of Allotment	Administrative	Technical Assistance	State Program Management	Source Water Protection	Total Set-asides
FY 1997	\$ 594	\$ 483	\$ 1,386	\$ 1,467	\$ 3,930
FY 1998	348	180	867	0	1,395
FY 1999	130	180	1,123	0	1,433
FY 2000	263	192	1,089	0	1,544
FY 2001	9	14	89	0	112
Total	\$ 1,344	\$ 1,049	\$ 4,554	\$ 1,467	\$ 8,414

State of Missouri
Department of Natural Resources State Revolving Funds
Notes to Financial Statements

NOTE 7: Contingencies and Subsequent Events

Contingencies

The program is exposed to various risks of loss related to torts, thefts of assets, errors or omissions, injuries to State employees while performing program business, or acts of God.

The program maintains insurance for all risks of loss, which is included in the indirect costs allocated to the program. There have not been any claims against the program since its inception in 1989, and no contingencies came to our attention during our audit that require disclosure or accrual under Statement of Financial Accounting Standards No. 5.

Subsequent Events

The Missouri CWSRF was awarded a capitalization grant by EPA in the amount of \$36,957 in September, 2003. The CWSRF financed approximately \$16,600 in additional loans thru the issuance of debt in December, 2003.

**Independent Auditor's Report on the
Internal Control Structure Based on an
Audit of the Financial Statements
Performed In Accordance with
Government Auditing Standards**



ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C

OFFICE OF
INSPECTOR GENERAL

To: Steven Mahfood, Director
Missouri Department of Natural Resources

We have audited the financial statements of the Missouri Department of Natural Resources State Revolving Funds (the Funds) as of and for the year ended June 30, 2003, and have issued our report thereon dated February 18, 2004.

We conducted our audit in accordance with generally accepted auditing standards and *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.

The management of the Funds is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of the Funds for the year ended June 30, 2003, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk 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 structure. Accordingly, we do not express such an opinion.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the specific internal control elements does not reduce to a relatively low level the risk that errors and irregularities 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. We noted the following matters involving the internal control structure and its operations, detailed in the Internal Control Weaknesses and Recommendations section of this report, that we consider to be material weaknesses.

The state accounting system does not adequately account for Fund's activity, as required by the Clean Water Act and the Safe Drinking Water Act. Further, the subsidiary systems used to account for Fund activity, which consist primarily of a variety of spreadsheets, were not adequate to provide for proper control and accountability over fund activity, did not provide assurance that all activity was accounted for, and were not reconciled to the general ledger. As a result, the state has not been able to provide accurate, timely and meaningful financial information to management. These matters are considered to be material weaknesses as defined above.

This report is intended for the information of management of the Fund and the United States Environmental Protection Agency. However, this report is a matter of public record and distribution is not limited.



Office of Inspector General
February 18, 2004

Internal Control Weaknesses and Recommendations

State Accounting System not Adequate for SRF Program

The Missouri state accounting system, known as SAMII, does not properly account for all transactions of the Funds as required by the Clean Water Act and the Safe Drinking Water Act. Missouri established the Funds as special revenue funds using the cash basis of accounting. The cash basis of accounting assumes that all transactions are either revenues or expenses. In the case of the Funds, SAMII only accounts for the cash balance of the SRF, and does not account for loans receivable, construction loan funds, revenue bonds, bond reserves, EPA capitalization grants, and other accounts. For example, total loans receivable, excluding reserve loans, at June 30, 2003 were approximately \$773 million for the Clean Water State Revolving Fund (CWSRF) and \$139 million for the Drinking Water State Revolving Fund (DWSRF), yet SAMII does not include an account for loans receivable. Additionally, at June 30, 2003, the balance of CWSRF revenue bonds (excludes state match bonds) was over \$758 million, and the DWSRF revenue bonds was over \$132 million, but bond outstanding were not recorded in SAMII. As a result, many of the inherent controls intended to record these transactions and safeguard the activity of such large accounts were nonexistent.

The Missouri Department of Natural Resources (MDNR) has recognized the shortcomings of the accounting system and is in the process of developing and implementing a new accounting/management system designed to address them.

MDNR Response:

On December 2, 2002, the department contracted for the analysis, design, development, implementation, and training of a SRF Automated Information System (AIS).

Testing of the General Ledger was completed in December of 2003 and work continues to verify that the new SRF AIS has the ability to generate complete and accurate CW and DW Trial Balance, General Ledger, and supporting schedules. The SRF AIS receives data loads from the trustee bank and interfaces with the State Accounting System (SAM II) which allows us to account for cash balances as well as loan receivables, construction loan funds, revenue bonds (including bonds outstanding), bond reserves, EPA capitalization grants, and many other accounts.

We believe the new SRF AIS satisfies this weakness. The new system allows us to more efficiently manage the SRF program; and adds effective internal controls. We have begun enhancements of the SRF AIS, which will add additional internal controls and other features to the system.

As an interim step the department contracted for account balance compilation to prepare the 2003 annual report and to provide accurate beginning balances for the new system.

Subsidiary Systems Do Not Provide Adequate Controls Over CWSRF Balance and Activities

Accounting systems provide for the control, accountability and assurance that funds are only used for authorized purposes. SAMII does not adequately record and report the separate CWSRF and DWSRF, State Stormwater and 37G programs balances. Furthermore, CWSRF cash in Fund 602 (repayments) is commingled with cash from the DWSRF, State stormwater and 37G programs within the investment account maintained by the State Treasurer's Office. DNR developed a system of subsidiary records by using spreadsheets to account for transactions and account balances that SAMII was unable to record. However, the subsidiary systems alone were not adequate to control or account for the activity of the SRFs. This lack of control is evidenced by the use of CWSRF funds to provide initial disbursements on DWSRF loans and disbursements for the State's stormwater program. As of June 30, 2002, the CWSRF had disbursed \$189,790 in funds for DWSRF loans. This amount was not adjusted for on the CWSRF records, although the reimbursement from EPA was received in July, 2003. Also, as of June 30, 2003, the

CWSRF had disbursed \$42,537 for the State's stormwater program. This was noted only by a negative cash balance in the stormwater program. We were not provided any evidence (memos, authorizing signatures, etc.) that management was aware of or approved of these uses of the CWSRF funds.

The same situation exists for the CWSRF and DWSRF administration fees, which are considered program income under EPA regulations. DNR's Fund 568 includes activities and balances of the State's permit fees, rural water and sewer 37G programs, MDNR's stormwater program, and the restitution and settlement funds, in addition to the DWSRF and CWSRF funds. The cash balances of the CWSRF and DWSRF programs and these other programs are in the same investment account with the State Treasurer's Office and are accounted for in the same cash account of Fund 568. A spreadsheet is maintained to track the different activity of each of the programs. Adequate controls are not in place to insure that funds are not transferred between the various programs.

MDNR Response:

New accounts at the Treasurers Office have been created to separate the state program balances that have previously resided in Fund 602, the CW and DW SRF repayment account. However, both CW SRF and DW SRF balances continue to be tracked and monitored in the same account. We will evaluate whether additional accounts will allow us better ability to track and if so we will request from the proper authorities. At present, the new SRF AIS separates all transactions between Clean Water and Drinking Water. Principal and interest received from loan recipients are separated by project, and therefore, recorded as either CW or DW with regard to all transactions related to that project.

The process is similar with the administrative account, fund 568. The SRF AIS pulls in those transactions from SAM II that are coded for Drinking Water and Clean Water. Staff reconcile cash balances to total cash balances in SAM II and to balances in the new system.

The SRF AIS is designed with internal controls and separation of duties. We are working on various levels of management review procedures and reporting.

Management Unable to Access Payroll/Time Charges in Regional Offices:

The Public Drinking Water Program Management, which is the central office for the Program, is unable to review time charges of regional office employees charged to the DWSRF set-aside activities. The payroll system used by the State does not allow anyone other than regional offices to access payroll or time records. As a result, Program Management only knows about payroll charges after they are incurred. Timely monitoring of the time charging by the Program is essential internal control for the adequate and accurate time charging to the set-aside activities.

MDNR Response:

Work requested of regional offices is coordinated annually in the workplan negotiation process. Work units and corresponding time requirements are part of the planning process. Access to regional offices data was granted immediately upon request by changes to the SAM II security settings.

Recommendations:

We recommend that management of the Missouri DNR Clean Water State Revolving Fund:

1. Continue with the full development and implementation of the accounting/management system dedicated to the SRF programs that will enable recording and reporting of all SRF transactions and balances with adequate separation and controls over the SRF programs.

MDNR Response:

SRF Automated Information System (AIS) development, implementation, and training have been completed. Transactions for 2003 are being posted with the goal of a completed July 2003 trial balance, general ledger and supporting schedules before the end of April 2004, and an accurate complete annual report at the end of the fiscal year.

We believe the new AIS satisfies the OIG finding and supports the recommendation stated in the audit report and insures more efficient management of the SRF program.

2. Open separate cash accounts with the Treasurer's Office for each of the CWSRF, DWSRF and other state programs. Reconcile subsidiary systems, or the new accounting/management system, to the general ledger and the separate cash accounts with the State Treasurer's Office on a regular basis to ensure that general ledger balances are fully supported.

MDNR Response:

We are currently drafting a reconciliation plan that will be used in the monthly reconciliation of cash accounts to the general ledger. We will evaluate whether additional accounts will allow us better ability to track and if so we will request from the proper authorities.

3. Develop and implement the appropriate management approval procedures to insure that CWSRF and DWSRF cash is used only for eligible activities.

MDNR Response:

The SRF AIS is designed with internal controls and separation of duties to prevent in appropriate transactions without the required security approvals.

4. Provide the Program Management with tools to oversight the time charges of regional employees on a regular basis to the set-aside activities.

MDNR Response:

The department will develop tools for Program Management to oversee the time charges of regional employees on a regular basis to the set-aside activities.

**Independent Auditor's Report on Compliance
with the Requirements Applicable to the
Environmental Protection Agency's
State Revolving Fund Programs
in Accordance with
Government Auditing Standards**



ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C

OFFICE OF
INSPECTOR GENERAL

To: Steven Mahfood, Director
Missouri Department of Natural Resources

We have audited the financial statements of the Missouri Department of Natural Resources State Revolving Funds (the Funds) as of and for the year ended June 30, 2003 and have issued our report thereon dated February 18, 2004

We have also audited the Fund's compliance with requirements governing:

- Allowability for specific activities;
- Allowable costs/cost principles;
- Cash management;
- State matching;
- Period of availability of funds and binding commitments;
- Program income;
- Reporting;
- Subrecipient monitoring, and;
- Special tests and provisions

that are applicable to its major federal financial assistance program for the year ended June 30, 2003. The management of the Funds is responsible for the Funds' compliance with those requirements. Our responsibility is to express an opinion on those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States, and the *Environmental Protection Agency State Revolving Fund Audit Guide*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about the Fund's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, except for the matters discussed in the findings and recommendations section, the Missouri Department of Natural Resources State Revolving Funds complied, in all material respects, with the requirements governing types of service and types of costs allowed or unallowed; matching, level of effort or earmarking requirements; special reporting requirements; special tests and provisions; and claims for advances and reimbursements that are applicable to its major federal financial assistance program for the year ended June 30, 2003.

This report is intended for the information of management of the Fund and the United States Environmental Protection Agency. However, this report is a matter of public record and its distribution is not limited.


Office of Inspector General
February 18, 2004

Compliance Findings and Recommendations

Accounting System

As discussed in the preceding Independent Auditor's Report on the Internal Control Structure Based on an Audit of the Financial Statements Performed In Accordance with Government Auditing Standards, Missouri Department of Natural Resources State Revolving Funds did not comply with 40 CFR 35.3135(h) that requires the state to establish fiscal controls and accounting procedures that are sufficient to assure proper accounting of SRF activity during the year and year-end balances. The state is also required to use accounting, audit and fiscal procedures conforming to generally accepted accounting principles as established by the Governmental Accounting Standards Board.

MDNR is in the process of developing and implementing an accounting/management system that they believe bring them in compliance with these requirements.

MDNR Response:

On December 02, 2002 the department contracted for the analysis, design, development, implementation, and training of a SRF Automated Information System (AIS) of the Phase I. All of these activities have been completed. We believe the SRF AIS enables us to establish better fiscal controls and additional accounting procedures that are sufficient to assure proper accounting of SRF activity. In addition, and with the help of the system, as well as newly defined internal control procedures the SRF uses accounting, audit and fiscal procedures conforming to generally accepted accounting principles as established by the Governmental Accounting Standards Board.

Allowable Costs and Eligible Activities

Hancock Payments:

MDNR transferred \$6,627 Clean Water State Revolving Fund (CWSRF) funds and \$1,364 of CWSRF administrative funds to the state's general revenue fund to help cover the State's obligations under Article X of the Missouri State Constitution in violation of the Clean Water Act (the Act). Article X, also known as the "Hancock Amendment," established a limitation on taxes that may be imposed on the taxpayers by limiting taxes to the amount of revenues received by the state. Revenues that exceed the limitation are required to be returned to the taxpayers. However, Title VI, Section 603 of the Act identifies the types of projects that can be funded by the CWSRF, and also specifies what are allowable uses of CWSRF funds. Transferring funds from the CWSRF to return to the state's taxpayers is not an allowable use of CWSRF funds.

Management is aware that transferring CWSRF funds to the general fund violates the Act, but not transferring the calculated amount violates the Missouri Constitution. Article X specifies that Federal funds are excluded from the calculation of the amounts to be refunded, but state officials charged with implementing Article X have told management that the CWSRF funds are state funds, not Federal funds.

In an effort to avoid noncompliance, MDNR intends to reimburse amounts withdrawn for Article X from the CWSRF, from available non-CWSRF funds, on the same day as the funds withdrawn. The \$56 withdrawn from Fund 649 and the \$1,364 withdrawn from Fund 568 was reimbursed on the same day they were withdrawn. The \$6,571 withdrawn from Fund 602 was reimbursed, with interest, eight days after the withdrawal. Replacing the Article X funds on the same day the funds are transferred should only be viewed as an interim measure as such a practice still results in a violation of Title VI, Section 603 of the Act. As stated in our recommendations, the long-term solution is to exclude the CWSRF from the requirements of Article X.

MDNR Response:

The department did not transfer SRF funds to the state's general revenue funds. The transfers were made by Missouri's Office of Administration. The Office of Administration replaced the transfer out with a same-day transfer in to avoid non compliance. Replacing Article X funds on the same day the funds are transferred is only an interim measure. The department continues to pursue a long-term solution. Specific legislative language for Hancock exemption of SRF was introduced in the current legislative session. The Legislature has until May 14, 2004 to pass this language into law. Should that not occur, the department will seek passage again next year.

District Office Lease Payments:

The CWSRF was overcharged \$111,717 for lease expenses at MDNR's district offices during the year ended June 30, 2003. Based on the allocations that should have been applied to lease expense, the CWSRF should have been charged \$19,942 instead of the \$131,659 charged during the year.

MDNR Response:

We agree that the SRF was overcharged. We will make adjustments to repay these overcharges as soon as possible.

Transfer of Funds

Section 302 of the Safe Drinking Water Act Amendments of 1996 (SDWA) allowed for the Governor of a State to transfer up to 33% of the capitalization grants made pursuant to Section 1452 of the SDWA from one SRF program to another. EPA regulations allow for the Governor or a State official acting pursuant to authorization from the Governor to make this transfer. MDNR made a \$10,475,000 transfer of funds from the CWSRF to the DWSRF in September, 2001. This transfer was approved by EPA, Region 7 pending the State's Attorney General letter certifying that state law allows for the transfer, which was subsequently provided to EPA. However, we could not obtain evidence that the Governor, or a State official acting pursuant to authorization from the Governor, actually approved of the transfer.

DNR also transferred CWSRF funds to the DWSRF to provide the initial disbursements for DWSRF loans. These funds were to be transferred back to the CWSRF upon receipt of the related EPA draw. These transfers are not allowed under the Clean Water Act. Furthermore, MDNR did not have appropriate controls in place to insure that the funds were repaid when the EPA draw was received.

MDNR Response:

In the past the department secured certification from the Missouri Attorney General prior to a transfer. The transfer was approved by the Governor appointed Safe Drinking Water and the Clean Water Commissions in a public meeting. We realize this is not the authorization the OIG recommends. Therefore, the department will establish appropriated management approval procedures to insure the CW SRF cash is used only for eligible activities.

Transfers between CW SRF and the DW SRF programs will not occur in the future without appropriate approvals and controls. The SRF AIS is designed with internal controls and separation of duties to prevent in appropriate transactions without the required security approvals. All security levels will be activated upon implementation of the Business Process Redesign document. The department is currently seeking delegation of authority from the Governor for the transfer of SRF funds. Prior to approving any transfer of funds between the two programs, the finance center would secure permission from the appropriate authority, the department director.

Workplans

The set-aside workplans required for set-asides of the DWSRF program do not comply with the requirements of 40 CFR 35.3540(c)(3). Specifically, the workplans do not include the following four of the six required elements:

- (1) The goals and objectives, outputs, and deliverables for each set-aside activity;
- (2) The schedule for completing activities under each set-aside activity;
- (3) Identification and responsibilities of the agencies involved in implementing each set-aside activity, including activities proposed to be conducted by a third party;
- (4) Description of the evaluation process used to assess the success of work funded under each activity.

MDNR Response:

The Drinking Water set-aside workplans were drafted based on guidance from EPA Region-VII. During their most recent DW Annual Review, EPA explained that the department was meeting the bare minimum standards requiring set-aside workplans and suggested we do more. The department agreed to expand on workplan requirements for the FFY 2003 DW Capitalization Grant.

Recommendations:

We recommend that SRF management:

1. Take the necessary steps to exclude the SRF and related funds, including the administrative fee fund, from future Article X calculations.

MDNR Response:

The Office of Administration has agreed to the current practice of replacing Title X transfers immediately with General Revenue until a permanent solution is attained. The department continues to pursue a long-term solution. Specific legislative language for Hancock exemption of SRF was introduced in the current legislative session. The Legislature has until May 14, 2004 to pass this language into law. Should that not occur, the department will seek passage again next year.

2. Ensure that appropriate authorizations are obtained from the Governor or a State official acting pursuant to authorization from the Governor before transfers are made from one SRF to another. Absent any authorization for the transfers already made, the funds should be returned to the CWSRF.

MDNR Response:

In the past the department secured certification from the Missouri Attorney General prior to a transfer. The transfer was approved by the Governor appointed Safe Drinking Water and the Clean Water Commissions in a public meeting. We realize this is not the authorization the OIG recommends. Therefore, the department will establish appropriated management approval procedures to insure the CW SRF cash is used only for eligible activities.

Transfers between CW SRF and the DW SRF programs will not occur in the future without appropriate approvals and controls. The SRF AIS is designed with internal controls and separation of duties to prevent in appropriate transactions without the required security approvals. All security levels will be activated upon implementation of the Business Process Redesign document. The department is currently seeking delegation of authority from the Governor for the transfer of SRF funds. Prior to approving any transfer of funds between the two programs, the finance center would secure permission from the appropriate authority, the department director.

3. Refund \$111,717 for overcharged lease expenses to the CWSRF account and the procedures need to be changed to insure the proper allocation is charged.

MDNR Response:

We agree that the SRF was overcharged. We will make adjustments to repay these overcharges as soon as possible.

4. SRF management comply with 40 CFR 35.3540(c)(3) in preparation of workplans by including all required elements in order to increase the usability of the workplans for information and management purposes.

MDNR Response:

The Drinking Water set-aside workplans were drafted based on guidance from EPA Region-VII. During their most recent DW Annual Review, EPA explained that the department was meeting the bare minimum standards requiring set-aside workplans and suggested we do more. The department agreed to expand on workplan requirements for the FFY 2003 DW Capitalization Grant.

Supplemental Information

State of Missouri
Clean Water State Revolving Fund
Combining Balance Sheet
June 30, 2003
(in thousands)

Assets:	Loan Fund	Administrative Fee Fund	Total Enterprise Fund	Agency Fund	Totals
Current Assets:					
Cash and cash equivalents	\$ 276,116,952	\$ 10,030,517	\$ 286,147,469	\$ 254,551,267	\$ 540,698,736
Current Receivables:					0.00
Loan interest	23,889,843.76		23,889,843.76		23,889,843.76
Investment interest	821,471.51		821,471.51	443,044.38	1,264,515.89
Administration fees		1,199,777.36	1,199,777.36		1,199,777.36
Due from other funds	264,256.12	23,840.35	288,096.47		288,096.47
Due from trustee	147,412.81		147,412.81		147,412.81
Other	269,567.05	0.00	269,567.05	0.00	269,567.05
Current portion of loans receivable	51,954,853.77		51,954,853.77		51,954,853.77
Total current assets	<u>353,464,357.19</u>	<u>11,254,134.31</u>	<u>364,718,491.50</u>	<u>254,994,311.14</u>	<u>619,712,802.64</u>
Restricted assets - cash and cash equivalents	4,749,248.58		4,749,248.58		4,749,248.58
Non-current assets:					
Loans receivable:					
Leveraged loans	758,238,977.80		758,238,977.80		758,238,977.80
Reserve loans	352,986,524.09		352,986,524.09		352,986,524.09
Direct loans	6,636,520.00		6,636,520.00		6,636,520.00
Direct Non-point source loans	<u>7,734,095.50</u>		<u>7,734,095.50</u>		<u>7,734,095.50</u>
Total loans receivable	1,125,596,117.39	0.00	1,125,596,117.39	0.00	1,125,596,117.39
Less: Current portion	<u>51,954,853.77</u>		<u>51,954,853.77</u>		<u>51,954,853.77</u>
Loans receivable, net	<u>1,073,641,263.62</u>	<u>0.00</u>	<u>1,073,641,263.62</u>	<u>0.00</u>	<u>1,073,641,263.62</u>
Fixed assets, net of accumulated depreciation	<u>48,137.16</u>	<u>0.00</u>	<u>48,137.16</u>		<u>48,137.16</u>
Total assets	<u><u>1,431,903,006.55</u></u>	<u><u>11,254,134.31</u></u>	<u><u>1,443,157,140.86</u></u>	<u><u>254,994,311.14</u></u>	<u><u>1,698,151,452.00</u></u>
Liabilities and Net Assets:					
Liabilities:					
Current liabilities:					
Accounts payable	0.00	96,231.72	96,231.72		96,231.72
Accrued salaries and benefits	(6.07)		(6.07)		(6.07)
Project Costs Payable to Communities			0.00	248,464,006.85	248,464,006.85
Interest Subsidies Payable to Communities	0.00		0.00	6,072,507.71	6,072,507.71
Bond Interest Payable	24,201,063.29		24,201,063.29		24,201,063.29
Current Portion of Bonds Payable	31,457,268.90		31,457,268.90		31,457,268.90
Due to other funds	23,840.35		23,840.35	36,406.58	60,246.93
Other	<u>0.00</u>		<u>0.00</u>	<u>421,390.00</u>	<u>421,390.00</u>
Total current liabilities	<u>55,682,166.47</u>	<u>96,231.72</u>	<u>55,778,398.19</u>	<u>254,994,311.14</u>	<u>310,772,709.33</u>
Non-current liabilities:					
Bonds Payable, net of discounts	741,781,708.90		741,781,708.90		741,781,708.90
Rebate Payable	<u>4,973,447.94</u>		<u>4,973,447.94</u>		<u>4,973,447.94</u>
Total Liabilities	<u>746,755,156.84</u>	<u>0.00</u>	<u>746,755,156.84</u>	<u>0.00</u>	<u>746,755,156.84</u>
Net assets:					
Invested in capital assets, net of debt	48,137.16		48,137.16		48,137.16
Restricted for loans and debt service	629,417,546.08	11,157,902.59	640,575,448.67		640,575,448.67
Unrestricted	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>
Total net assets	<u>629,465,683.24</u>	<u>11,157,902.59</u>	<u>640,623,585.83</u>	<u>0.00</u>	<u>640,623,585.83</u>
Total liabilities and net assets	<u><u>\$ 1,431,903,007</u></u>	<u><u>\$ 11,254,134</u></u>	<u><u>\$ 1,443,157,141</u></u>	<u><u>\$ 254,994,311</u></u>	<u><u>\$ 1,698,151,452</u></u>

State of Missouri
Clean Water State Revolving Fund
Combined Statement of Revenues, Expenses, and Changes in Fund Net Assets
June 30, 2003
(in thousands)

	<u>Loan Fund</u>	<u>Administrative Fee Fund</u>	<u>Total Enterprise Fund</u>
Operating revenues:			
Interest income on SRF loans	\$ 35,315		\$ 35,315
Investment income	4,351	\$ 269	4,620
Administrative fees	0	2,622	2,622
Hancock Amendment refunds	7	1	8
Total operating revenues	<u>39,673</u>	<u>2,892</u>	<u>42,565</u>
Operating expenses:			
Interest expense on bonds payable	35,558		35,558
Interest Subsidy			
Salaries and benefits	3	1,666	1,669
Travel	1		1
Other administrative expenses	55	1,229	1,284
Indirect costs	131		131
Hancock Amendment	7	1	8
Total operating expenses	<u>35,755</u>	<u>2,896</u>	<u>38,651</u>
Operating income	3,918	(4)	3,914
Non-operating revenue:			
Environmental Protection Agency grant	58,266		58,266
State of Missouri contribution	10,524		10,524
Total non-operating revenue	<u>68,790</u>		<u>68,790</u>
Increase in net assets	72,708	(4)	72,704
Net assets, beginning of year	556,758	11,162	567,920
Net assets, end of year	<u>\$ 629,466</u>	<u>\$ 11,158</u>	<u>\$ 640,624</u>

**Drinking Water State Revolving Fund
Combining Balance Sheet
June 30, 2003**

	<u>Loan Fund</u>	<u>Administrative Fee Fund</u>	<u>Total Enterprise Fund</u>	<u>Agency Fund</u>	<u>Totals</u>
Assets:					
Current assets:					
Cash and cash equivalents	\$ 9,084,750	\$ 399,159	\$ 9,483,909	\$ 28,129,431	\$ 37,613,340
Receivables:					
Loan interest	3,342,286	-	3,342,286	-	3,342,286
Investment interest	-	-	-	100,560	100,560
Due from other funds	5,531	-	5,531	-	5,531
Due from trustee	-	-	-	-	-
Due from EPA	1,579,993	-	1,579,993	-	1,579,993
Other	208	259,727	259,935	-	259,935
Current portion of loans receivable	4,621,839	-	4,621,839	-	4,621,839
Total current assets	<u>18,634,607</u>	<u>658,886</u>	<u>19,293,493</u>	<u>28,229,991</u>	<u>47,523,484</u>
Restricted assets - cash and cash equivalents	397,220	-	397,220	-	397,220
Non-current assets:					
Leveraged loans	135,825,000	-	135,825,000	-	135,825,000
Reserve loans	43,788,192	-	43,788,192	-	43,788,192
Direct loans	3,650,000	-	3,650,000	-	3,650,000
Total loans receivable	<u>183,263,192</u>	<u>-</u>	<u>183,263,192</u>	<u>-</u>	<u>183,263,192</u>
Current portion	4,621,839	-	4,621,839	-	4,621,839
Loans receivable, net	<u>178,641,353</u>	<u>-</u>	<u>178,641,353</u>	<u>-</u>	<u>178,641,353</u>
Total assets	<u>197,673,180</u>	<u>658,886</u>	<u>198,332,066</u>	<u>28,229,991</u>	<u>226,562,057</u>
Liabilities and net assets:					
Current liabilities:					
Accounts payable	-	-	-	-	-
Accrued salaries and benefits	-	-	-	-	-
Project costs payable to communities	-	-	-	27,145,440	27,145,440
Interest subsidies payable to communities	-	-	-	451,657	451,657
Bond interest payable	3,342,286	-	3,342,286	-	3,342,286
Current portion of bonds payable	3,385,000	-	3,385,000	-	3,385,000
Due to other funds	1,579,993	-	1,579,993	5,531	1,585,524
Other	-	-	-	627,363	627,363
Total current liabilities	<u>8,307,279</u>	<u>-</u>	<u>8,307,279</u>	<u>28,229,991</u>	<u>36,537,270</u>
Non-current liabilities:					
Bonds payable, net of discounts	132,440,000	-	132,440,000	-	132,440,000
Rebate payable	402,959	-	402,959	-	402,959
Total non-current liabilities	<u>132,842,959</u>	<u>-</u>	<u>132,842,959</u>	<u>-</u>	<u>132,842,959</u>
Total liabilities	141,150,238	-	141,150,238	28,229,991	169,380,229
Total net assets	<u>56,522,942</u>	<u>658,886</u>	<u>57,181,828</u>	<u>-</u>	<u>57,181,828</u>
Total liabilities and net assets	<u>\$ 197,673,180</u>	<u>\$ 658,886</u>	<u>\$ 198,332,066</u>	<u>\$ 28,229,991</u>	<u>\$ 226,562,057</u>

State of Missouri
Drinking Water State Revolving Fund
Combining Income Statement Drinking Water
For the year ended June 30, 2003

	<u>Loan Fund</u>	<u>Administrative Fee Fund</u>	<u>Total Enterprise Fund</u>
Operating revenues:			
Interest income on SRF loans	\$ 5,795,738	\$ -	\$ 5,795,738
Investment income	212,260	4,011	216,271
Administrative fees	0	360,574	360,574
EPA set-aside operating grants	2,343,732	0	2,343,732
Other	0	0	0
Total operating revenues	<u>8,351,730</u>	<u>364,585</u>	<u>8,716,315</u>
Operating expenses:			
Interest expense on bonds payable	5,786,753	0	5,786,753
Salaries and benefits	1,267,053	0	1,267,053
Other administrative expenses	1,076,679	19	1,076,698
Total operating expenses	<u>8,130,485</u>	<u>19</u>	<u>8,130,504</u>
Operating income	221,246	364,566	585,811
Non-operating revenue:			
Environmental Protection Agency grant	16,253,966	0	16,253,966
State of Missouri contribution	6,320,987	0	6,320,987
Total non-operating revenue	<u>22,574,953</u>	<u>0</u>	<u>22,574,953</u>
Increase in net assets	22,796,199	364,566	23,160,764
Net assets, beginning of year	<u>33,726,744</u>	<u>294,320</u>	<u>34,021,064</u>
Net assets, end of year	<u>\$ 56,522,942</u>	<u>\$ 658,886</u>	<u>\$ 57,181,828</u>

State of Missouri
Drinking Water State Revolving Fund
Schedule of Set-Aside Expenses
Year Ended June 30, 2003

<u>Cost Category</u>	<u>Administration</u>	<u>Technical Assistance</u>	<u>Program Management</u>	<u>Local Assistance</u>	<u>Non-classified</u>	<u>Total</u>
Personnel	\$ 157,039	\$ 23,137	\$ 619,356	\$ 151,751	\$ 26,430	\$ 977,713
Fringe Benefits	51,417	6,522	182,341	40,908	8,151	289,340
Travel	4,729	2,925	1,033	518	35	9,240
Equipment	-	-	-	-	-	-
Supplies	1,209	1,120	53,238	441	3	56,011
Contractual	4,052	116,058	213,127	136,438	34,345	504,020
Other	23,247	6,367	4,828	1,062	30,168	65,673
Total Direct Cost	<u>241,693</u>	<u>156,128</u>	<u>1,073,923</u>	<u>331,119</u>	<u>99,132</u>	<u>1,901,997</u>
Indirect Cost	77,279	22,575	254,976	73,145	13,761	441,735
Total Cost	<u>\$ 318,972</u>	<u>\$ 178,704</u>	<u>\$ 1,328,899</u>	<u>\$ 404,264</u>	<u>\$ 112,893</u>	<u>\$ 2,343,732</u>

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