AUDIT REPORT
OF THE
NEBRASKA DEPARTMENT OF
ENVIRONMENTAL QUALITY
CLEAN WATER
STATE REVOLVING FUND PROGRAM

JULY 1, 2004 THROUGH JUNE 30, 2005

Issued on March 1, 2006

NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
CLEAN WATER STATE REVOLVING FUND PROGRAM

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BACKGROUND

The Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program (Program) was established pursuant to Title VI of the Federal Clean Water Act, as amended by the Water Quality Act of 1987. Neb. Rev. Stat. Section 81-15,147 created the Wastewater Treatment Facilities Construction Assistance Act. The Federal Water Quality Act and State statutes established the Clean Water State Revolving Fund Program to provide loans, at reduced interest rates, to finance the construction of publicly and privately 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 the building of wastewater treatment facilities, the Program provides for low interest loans to finance the entire cost of qualified projects. The Program provides a flexible financing source which can be used for a variety of projects. Loans made by the Program must be repaid within 20 years, and all repayments, including interest and principal, must be used for the purposes of the Program.

The Program was capitalized by the United States Environmental Protection Agency (EPA) by a series of grants starting in 1989. States are required to provide an additional 20 percent of the Federal capitalization grant as matching funds in order to receive a Federal grant. As of June 30, 2005, the EPA had awarded $114 million in capitalization grants to the State. The award of this $114 million required the State to contribute approximately $22 million in matching funds. The State provided appropriations to contribute $955 thousand of the funds to meet the State's matching requirement. Additional matching funds were obtained through the issuance of revenue bonds.

The Program is administered by the Nebraska Department of Environmental Quality (Department). The Department's primary activities with regard to the Program include the making of loans for water pollution control facilities and the management and coordination of the Program. The Nebraska Environmental Quality Council approves the rules and regulations of the Department and the Program's Intended Use Plan.

EXIT CONFERENCE

An exit conference was held February 2, 2006, with the Department to discuss the results of our examination. Those in attendance for the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program were:

NAME	TITLE
Bart Moore	Budget Officer
Rick Bay	Financial Assistance Section Supervisor

SUMMARY OF COMMENTS

During our audit of the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program, we noted certain matters involving the internal control over financial reporting and other operational matters which are presented here. Comments and recommendations are intended to improve the internal control over financial reporting, ensure compliance, or result in operational efficiencies.

1. ***Subrecipient Monitoring:*** A-133 single audit reports from subrecipients have not been reviewed since 2002 and the Department did not have controls in place to ensure all reports had been received.

2. ***Reconciliation of Bank Records to the Nebraska Information System:*** The Department of Administrative Services' reconciliation process is still not done in a timely manner and continues to reflect unknown variances.

More detailed information on the above items is provided hereafter. It should be noted this report is critical in nature since it contains only our comments and recommendations on the areas noted for improvement.

Draft copies of this report were furnished to the Department to provide them an opportunity to review the report and to respond to the comments and recommendations included in this report. The Department declined to respond.

We appreciate the cooperation and courtesy extended to our staff during the course of the audit.

COMMENTS AND RECOMMENDATIONS

1. Subrecipient Monitoring

OMB Circular A-133 states a pass-through entity is responsible for:

- *Award Identification* – At the time of the award, identifying to the subrecipient the Federal award information (e.g., CFDA title and number, award name, name of Federal agency) and applicable compliance requirements.

- *During-the-Award Monitoring* – Monitoring the subrecipient's use of Federal awards through site visits or other means to provide reasonable assurance that the subrecipient administers Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.

- *Subrecipient Audits* – Ensuring required audits are completed within nine months of the end of the subrecipient's audit period, issuing a management decision on audit findings within six months after receipt of the subrecipient's audit report, and ensuring that the subrecipient takes timely and appropriate corrective action on all audit findings.

- *Pass-Through Entity Impact* – Evaluating the impact of subrecipient activities on the pass-through entity's ability to comply with applicable Federal regulations.

The Department did not obtain all required A-133 reports from subrecipients, review the A-133 reports, or follow up on findings and related corrective action. The Department has obtained A-133 single audit reports from subrecipients; however, they have not been reviewed since 2002 and controls are not in place to ensure they have received all the reports. The Department does perform on-site and desk reviews to monitor their subreceipients' annual activity, but does not ensure proper follow up is conducted on the subrecipients' A-133 single audit reports. During the fiscal year ended June 30, 2005, 16 subrecipients received $8,477,178 for the Clean Water program. Six of the subrecipients received over $500,000 each which required an A-133 audit report. The total received for these six subrecipients was $7,669,458. This was a prior audit finding.

By not receiving and reviewing subrecipient audit reports, the Department was not in compliance with subrecipient monitoring requirements and was unable to provide assurance that the subrecipients were in compliance with Federal requirements.

> We recommend the Department continue to refine its centralized monitoring procedures and develop a monitoring tool, as well as written policies and procedures, to ensure that all required A-133 audit reports are received, reviewed, and appropriate action is taken on any findings noted within time requirements.

COMMENTS AND RECOMMENDATIONS
(Continued)

2. Reconciliation of Bank Records to the Nebraska Information System

During the audit of the Comprehensive Annual Financial Report (CAFR) of the State of Nebraska, the Auditor of Public Accounts (APA) noted the absence of reconciliation between the Nebraska State Treasurer's actual bank statements and Nebraska accounting records (in both the Nebraska Information System (NIS) and the Nebraska Accounting System (NAS), system before NIS). This has been an issue for the Department of Administrative Services Accounting Division (State Accounting) for many years. The APA's previous comments noted monthly reconciliations have not been completed in a timely manner and reconciliations performed have shown significant unknown variances between the bank records and the accounting records, with the bank being short compared to the accounting records. Although State Accounting continues to work on correcting the reconciliation of bank records to NIS, the APA continues to note areas where improvement is still needed in the reconciliation process to ensure NIS integrity and operational efficiency. Specifically, the APA noted the status of the reconciliation process as of December 19, 2005 to be as follows:

> State Accounting has worked on the reconciliation process, but continued progress is needed. State Accounting's reconciliation process has developed into a very detailed process of analyzing bank activity, compared to activity recorded on NIS, to identify reconciling items. State Accounting has completed their reconciliation process for the months of July of 2004 and May, June, and July of 2005. The APA has reviewed these reconciliations. The months of May, June, and July show variances of $3,425,381, $3,405,702, and $3,405,862, respectively. Again, the reconciliations show the bank being short compared to the accounting records. Per inquiry of management, State Accounting has started the reconciliation process for various months of the fiscal year ended June 30, 2006; however, the reconciliation process has not been a continuous monthly process and no monthly reconciliation has been completed since July of 2005.

Good internal control requires a plan of organization, procedures, and records designed to safeguard assets and provide reliable financial information. Without a timely and complete reconciliation of bank records to the NIS, there is a greater risk for fraud and errors to occur and to remain undetected.

Although State Accounting has worked on the reconciliation process, the process is still not done in a timely manner. The reconciliation continues to reflect unknown variances and shortages. Complete and timely reconciliation procedures between bank records and accounting records are required to provide control over cash and accurate financial information.

> We recommend State Accounting continue their reconciliation process, in a more timely manner, and on at least a monthly basis, to ensure all financial information is correct on NIS. We also recommend, when a consistent cash variance between the bank records and the accounting records is obtained (based on at least

COMMENTS AND RECOMMENDATIONS
(Continued)

2. <u>Reconciliation of Bank Records to the Nebraska Information System</u> (Concluded)

> six months of reconciliations), DAS submit their plan for adjusting NIS to the Governor and the Legislature so they may take appropriate action to correct NIS and resolve the variances noted.

This issue is the responsibility of State Accounting; however, as the variances have not been identified by fund or agency, this issue directly affects all Nebraska State agencies' financial information and must be disclosed in this report.

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NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
CLEAN WATER STATE REVOLVING FUND PROGRAM

INDEPENDENT AUDITORS' REPORT

Nebraska Department of Environmental Quality
Lincoln, Nebraska

We have audited the accompanying financial statements of the business-type activities of the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program (Program), as of and for the year ended June 30, 2005, as listed in the Table of Contents. 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 auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program and are not intended to present fairly the financial position and results of operations of the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program 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 respective financial position of the business-type activities of the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program, as of June 30, 2005, and the respective changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 2, 2006, on our consideration of the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

In accordance with the *U.S. Environmental Protection Agency Audit Guide for Clean Water and Drinking Water State Revolving Fund Programs*, we have also issued our report dated February 2, 2006, on our consideration of the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program's compliance with certain provisions of laws, regulations, and grants.

Our audit was performed for the purpose of forming an opinion on the financial statements of the Program taken as a whole. Management's Discussion and Analysis is presented for purposes of additional analysis and is not a required part of the basic financial statements. The Management's Discussion and Analysis has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

Pat Reding, CPA

February 2, 2006 Assistant Deputy Auditor

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)

This section of the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program's (Program) financial report presents a narrative overview and analysis of the financial activities of the Program for the fiscal year ended June 30, 2005. This analysis has been prepared by management of the Department and is intended to be read with the financial statements and related footnotes that follow this section.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to the Program's basic financial statements. The Program's basic financial statements include: 1) Balance Sheet, 2) Statement of Revenues, Expenses, and Changes in Net Assets, 3) Statement of Cash Flows, and 4) Notes to Financial Statements.

The Balance Sheet presents information on all of the Program's assets and liabilities, with the difference between the two reported as net assets.

The Statement of Revenues, Expenses, and Changes in Net Assets presents information showing how the Program's net assets changed during the most recent fiscal year.

The Statement of Cash Flows presents the Program's flows of cash by defined categories. The primary purpose of the Statement of Cash Flows is to provide information about the Program's cash receipts and payments during the year.

The Notes to Financial Statements provide additional information that is essential to a full understanding of the data provided in the financial statements.

ANALYSIS OF BALANCES AND TRANSACTIONS OF ENTERPRISE FUND

Changes in Net Assets

For the fiscal year ended June 30, 2005, net assets of the Program increased by 9%.

	2005	2004
Current Assets	$ 62,339,906	$ 61,219,110
Noncurrent Assets	90,666,648	79,631,862
Total Assets	153,006,554	140,850,972
Current Liabilities	307,085	1,166,489
Noncurrent Liabilities	-	-
Total Liabilities	307,085	1,166,489
Net Assets		
Unrestricted	152,699,469	139,684,483
Total Net Assets	$ 152,699,469	$ 139,684,483

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)
(Continued)

	2005	2004
Operating Revenues	$ 5,671,183	$ 5,730,175
Operating Expenses	1,074,032	1,146,170
Operating Income	4,597,151	4,584,005
Capital Federal Grants	8,417,835	5,523,733
Change in Net Assets	13,014,986	10,107,738
Net Assets, Beginning of Year	139,684,483	129,576,745
Net Assets, End of Year	$ 152,699,469	$ 139,684,483

The most significant changes from the fiscal year ended June 30, 2004 to the fiscal year ended June 30, 2005, include increases in loans receivable and capital federal grants.

Loans receivable increased by approximately $12.1 million and capital federal grants increased by approximately $2.9 million during the fiscal year as the result of increased loans paid out. Fifteen new loans, totaling $7.4 million, were paid during the fiscal year ended June 30, 2005. Bertrand, Paxton, and West Point received $3.6 million more in loan payments during the fiscal year ended June 30, 2005, than they received during the fiscal year ended June 30, 2004.

See the Notes to Financial Statements for additional discussion of loans receivable.

ECONOMIC OUTLOOK

No conditions were noted that would be expected to have a significant effect on the financial position or results of operations of the Program.

NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
CLEAN WATER STATE REVOLVING FUND PROGRAM
BALANCE SHEET
June 30, 2005

	Enterprise Fund
ASSETS	
CURRENT ASSETS	
Cash & Cash Equivalents:	
Cash in State Treasury (Note 2)	$ 55,313,471
Deposits Held by Trustee (Note 2)	19,300
Interest Receivables	175,205
Loans Receivable - Current (Note 3)	6,831,930
TOTAL CURRENT ASSETS	62,339,906
NON-CURRENT ASSETS	
Loans Receivable (Note 3)	90,666,648
TOTAL NON-CURRENT ASSETS	90,666,648
TOTAL ASSETS	$ 153,006,554
LIABILITIES	
CURRENT LIABILITIES	
Accounts Payable	$ 307,085
TOTAL CURRENT LIABILITIES	307,085
TOTAL LIABILITIES	307,085
NET ASSETS	
Unrestricted	152,699,469
TOTAL NET ASSETS	152,699,469
TOTAL LIABILITIES AND NET ASSETS	$ 153,006,554

The accompanying notes are an integral part of the financial statements.

NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
CLEAN WATER STATE REVOLVING FUND PROGRAM

STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

For the Year Ended June 30, 2005

	Enterprise Fund
OPERATING REVENUES:	
Loan Fees Administration (Note 6)	$ 816,037
Interest on Loans	2,856,157
Interest on Fund Balance - Trustee	19,278
Interest on Fund Balance - State Operating Pool (Note 7)	1,979,662
Miscellaneous Revenue	49
TOTAL OPERATING REVENUES	5,671,183
OPERATING EXPENSES:	
Administrative Costs	598,332
Small Town Grants (Note 8)	475,722
Interest Expense - State Match Bonds	(22)
TOTAL OPERATING EXPENSES	1,074,032
OPERATING GAIN	4,597,151
CAPITAL CONTRIBUTIONS - FEDERAL GRANTS	8,417,835
CHANGE IN NET ASSETS	13,014,986
TOTAL NET ASSETS, BEGINNING OF YEAR	139,684,483
TOTAL NET ASSETS, END OF YEAR	$ 152,699,469

The accompanying notes are an integral part of the financial statements.

NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
CLEAN WATER STATE REVOLVING FUND PROGRAM
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2005

	Enterprise Fund
CASH FLOWS FROM OPERATING ACTIVITIES:	
Receipts From Customers	$ 11,255,323
Interest on Investments	1,823,735
Payments to Borrowers	(19,653,560)
Payments to Employees and Vendors	(313,136)
Miscellaneous Receipts	49
Small Town Grants	(475,722)
Bond Principal Payments	(1,125,000)
Bond Interest Payments	(19,578)
NET CASH PROVIDED BY OPERATING ACTIVITIES	(8,507,889)
CASH FLOWS FROM NON-CAPITAL & RELATED FINANCING ACTIVITIES:	
Funds Received From the Environmental Protection Agency	8,417,835
NET CASH FROM NON-CAPITAL & RELATED FINANCING ACTIVITIES:	8,417,835
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	55,422,825
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 55,332,771

RECONCILIATION OF OPERATING GAIN (LOSS) TO NET CASH PROVIDED BY OPERATING ACTIVITIES:	
Operating Gain	$ 4,597,151
ADJUSTMENTS TO RECONCILE OPERATING GAIN (LOSS) TO NET CASH PROVIDED BY OPERATING ACTIVITIES:	
(Increase)/Decrease in Loans Receivable	(12,070,431)
(Increase)/Decrease in Interest Receivables	(175,205)
Increase/(Decrease) in Bonds Payable	(1,125,000)
Increase/(Decrease) in Accrued Bond Interest Payable	(19,600)
Increase/(Decrease) in Cost of Issuance Payable	(4,000)
Increase/(Decrease) in Accounts Payable	289,196
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ (8,507,889)

The accompanying notes are an integral part of the financial statements.

NOTES TO FINANCIAL STATEMENTS

For the Fiscal Year Ended June 30, 2005

1. Summary of Significant Accounting Policies

A. Basis of Presentation. The accompanying financial statements of the Nebraska Department of Environmental Quality (Department) - Clean Water State Revolving Fund Program (Program) have been prepared in conformance with generally accepted accounting principles (GAAP) as applied to governmental units. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

The financial statements have been prepared primarily from accounts maintained by the State Accounting Administrator of the Department of Administrative Services.

B. Reporting Entity. The Clean Water State Revolving Fund Program is a program within the Department and is established under and governed by the Clean Water Act of the Federal Government and by laws of the State of Nebraska. The Department is a State agency established under and governed by the laws of the State of Nebraska. As such, the Department is exempt from State and Federal income taxes. The Program's management has also considered all potential component units of the Program for which it is financially accountable, and other organizations which are fiscally dependent on the Program's management, or the significance of their relationship with the Program's management are such that exclusion would be misleading or incomplete. GASB has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body and (1) the ability of the Department to impose its will on that organization or (2) the potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the Department.

As required by generally accepted accounting principles, these financial statements present the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program. No component units were identified. The Program is part of the primary government for the State of Nebraska's reporting entity.

C. Fund Structure. The Program's accounts are maintained in accordance with the principles of fund accounting to ensure compliance with limitations and restrictions placed on the use of resources available to it. Under fund accounting,

1. <u>Summary of Significant Accounting Policies</u> (Continued)

individual funds are established for the purpose of carrying on activities or attaining objectives in accordance with specific regulations, restrictions, or limitations. Each individual fund is a self-balancing set of accounts recording cash and other financial resources, together with liabilities and residual equities or balances, and changes therein. The Program includes the following funds as identified in the Wastewater Treatment Facilities Construction Assistance Act:

- Clean Water Facilities Fund – General Fund 10000, Federal Funds 48412 and 48413, and Bond Funds 68470, 68471, 68472, and 68473.
- Clean Water Administration Fund – Cash Funds 28460, 28461, and 28462.

These funds are used to account for revenues and expenses for loans and administrative expenses of the Program.

The activity of these ten State of Nebraska funds have been combined and reported as an enterprise fund, which under governmental GAAP is a proprietary fund type. This fund type reflects transactions used to account for those operations that are financed and operated in a manner similar to a private business. The accounting for the Program's transactions in this manner is a requirement of the Environmental Protection Agency (EPA) as they and the Department have decided that the determination of revenues earned, expenses incurred, and/or net income is necessary to demonstrate the success of the Program and to assure the EPA the Program will be available in perpetuity as intended.

This fund classification differs from the classification used in the State of Nebraska's Comprehensive Annual Financial Report (CAFR). The CAFR classifies the Cash funds, Federal funds, and Bond funds as Special Revenue funds because the major source of revenue is Federal assistance.

D. **Basis of Accounting.** The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. An enterprise fund is accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities associated with the operation of the fund are included on the balance sheet. Enterprise fund operating statements present increases (i.e., revenues) and decreases (i.e., expenses) in net total assets.

Enterprise funds utilize the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

NOTES TO FINANCIAL STATEMENTS
(Continued)

1. **Summary of Significant Accounting Policies** (Concluded)

In reporting the financial activity of its enterprise fund, the Program's management applied all applicable GASB pronouncements as well as the following pronouncements issued on or before November 30, 1989, unless these pronouncements conflict with or contradict GASB pronouncements: Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinion, and Accounting Research Bulletins of the Committee on Accounting Procedures.

E. **Cash and Cash Equivalents.** Cash in State Treasury and Deposits Held by Trustee are considered cash equivalents due to their liquid nature.

F. **Loans Receivables.** The State operates the Program as a direct loan program, whereby loans are made to communities. The entire Clean Water Program is funded, on average, 83.33% from Federal capitalization grants and 16.67% from State matching funds. Loan funds are disbursed to the local agencies as they expend funds for the purposes of the loan. Interest is calculated from the date funds are advanced, and after the final disbursement has been made, the payment schedule identified in the loan agreement is adjusted for the actual amounts disbursed, and accrued interest during the project period. The interest rates on loans range from 2.5% to 5.25% and the terms are between 10 to 20 years. The current loans receivable amount was determined using the amount of principal payment due to the Program at June 30, 2005, which was collectible in fiscal year 2006.

No provisions were made for uncollectible accounts as all loans were current, and management believed all loans would be repaid according to the loan terms. There was a provision for the Program to intercept State aid to a community in default of its loan.

G. **Accounts Payable.** The Nebraska Information System (NIS) has the capability of showing the amount of accounts payable at any time. The amount shown at June 30, 2005, is the figure that was used for this amount.

H. **Restricted Net Assets.** When both restricted and unrestricted resources are available for use, it is the Department's policy to use restricted resources first, then unrestricted resources, as they are needed. Net assets are reported as restricted when they are held in a separate account that can be used to pay debt principal and interest only and cannot be used to pay other current liabilities.

2. Cash, Cash Equivalents, and Investments

Cash in State Treasury. Cash in State Treasury represents the cash balance as reflected on NIS. Investment of all available cash is made by the State Investment Officer on a daily basis, based on total bank balances. Investment income is distributed based on the average daily book cash balance of funds designated for investment. Interest on funds held by the State Treasurer is periodically distributed to the participating agencies. These funds are considered to be cash and cash equivalents which are available for expenditure as needed. These funds are held in the State of Nebraska Operating Investment Pool (OIP), an internal investment pool. All funds of the Clean Water State Revolving Fund Program were designated for investment during the fiscal year ended June 30, 2005. The State Investment Officer invests the State's funds in accordance with Neb. Rev. State Section 72-1239.01 and the prudent person rule. The investment policy of the OIP includes the following objectives:

- Safety – Investments will be undertaken in a manner that seeks to ensure preservation of capital on a total return basis.

- Liquidity – The OIP will remain sufficiently liquid to meet the daily cash flow needs of the State and other entities participating in the OIP.

- Return on Investment – The objective is to attain a competitive income rate of return given the risk constraints and cash flow characteristics of the portfolio.

The investment strategy is to minimize short-term investments while maintaining sufficient funds to provide for required cash outflows. The investments of the OIP at June 30, 2005, include Commercial Paper, U.S. Treasury Securities, U.S. Agency Securities, Corporate Bonds, Money Market Mutual Funds, and Bank Deposits. Additional information on the OIP can be found in the State of Nebraska's Comprehensive Annual Financial Report for the fiscal year ended June 30, 2005.

Deposits Held by Trustee. The Nebraska Investment Finance Authority (NIFA) (the "Issuer") issues revenue bonds payable by the Department from certain portions of the fund (see Note 4 Bonds Payable) to provide additional funds to meet the 20% match requirements of the Capitalization Grants. Wells Fargo Bank Iowa, National Association, (Trustee), as trustee, holds these accounts. The Trustee, in accordance with the Bond Indenture, establishes the appropriate accounts and invests the monies. At June 30, 2005, the cash held by the trustee of $19,300, stated at Fair Market Value, was invested in a money market account.

NOTES TO FINANCIAL STATEMENTS
(Continued)

2. Cash, Cash Equivalents, and Investments (Concluded)

In accordance with GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements,* deposits and investments are to be disclosed as to custodial credit risk. The Deposits Held by Trustee was uninsured and uncollateralized during and at the end of fiscal year 2005. There is no policy regarding custodial credit risk.

3. Loans Receivable

As of June 30, 2005, the Program had 115 outstanding loans with communities that totaled $97,498,578. The outstanding balances of the ten largest loans, which represent 50.9% of the total loans, were as follows:

City	Outstanding Balance
Omaha	$ 14,349,189
Gibbon	7,438,931
Scottsbluff	5,327,646
Wahoo	4,356,260
West Point	4,192,754
Valley	3,712,476
Schuyler	2,929,541
Fremont	2,716,121
Kearney	2,324,302
Cozad	2,256,485
Total	$ 49,603,705

4. Bonds Payable

The Environmental Protection Agency (EPA) requires the Program to provide matching funds. During the fiscal year, the Program issued $0 in short-term revenue bonds to meet this requirement.

The State has entered into a special financing arrangement with NIFA, an independent instrumentality of the State exercising essential public functions, to provide matching funds for the State’s Clean Water Program. NIFA issues the bonds and the proceeds are held by the Trustee until they are needed by the Program for loan purposes. The Series 2004B Bonds are limited obligations of NIFA, payable only from and secured only by the Trust Estate. The Series 2004B Bonds are revenue bonds. The Series 2004B Bonds shall not constitute a debt, liability, general obligation of the State, or a pledge of the faith and Credit of the State, but are payable solely out of the revenue or money NIFA pledged to

NOTES TO FINANCIAL STATEMENTS
(Continued)

4. Bonds Payable (Concluded)

the Trust Estate. Neither the faith and credit nor the taxing power of the State is pledged for the payment of the principal of, premium, if any, or the interest on the Series 2004B Bonds. The current bonds payable amount was determined using the amount of bond principal to be retired in fiscal year 2005. Bonds payable for the fiscal year ended June 30, 2005, is as follows:

	Beginning Balance	Additions	Retirements	Ending Balance
Bonds Payable	$ 1,125,000	$ -	$ 1,125,000	$ -

5. Net Assets

Included in the Net Assets is the total amount of capitalization grants drawn from the EPA by the Department. The following summarizes the EPA capitalization grants awarded, drawn, and the remaining balance as of June 30, 2005.

Year	Grant Amount	Amount Drawn	Balance
1989	$ 4,773,100	$ 4,773,100	$ -
1990	4,964,560	4,964,560	-
1991	10,821,580	10,821,580	-
1992	9,938,500	9,938,500	-
1993	9,830,300	9,830,300	-
1994	6,061,600	6,061,600	-
1995	6,263,600	6,263,600	-
1996	10,319,661	10,319,661	-
1997	3,119,900	3,119,900	-
1998	7,019,996	7,019,996	-
1999	6,857,600	6,857,600	-
2000	6,834,000	6,834,000	-
2001	6,797,400	6,797,400	-
2002	6,855,000	6,855,000	-
2003	7,069,900	7,069,900	-
2004	6,747,100	6,747,100	-
Totals	$ 114,273,797	$ 114,273,797	$ -

NOTES TO FINANCIAL STATEMENTS
(Continued)

5. Net Assets (Concluded)

The following is a summary of changes in the total contributed capital.

Contributed Capital July 1, 2004	$ 106,810,962
Contributed During the Year	
Funds Received From EPA	8,417,835
Contributed Capital June 30, 2005	$ 115,228,797

Also included in the Contributed Capital is a total of all general funds received by the Program from the Legislature of the State of Nebraska. These assets were to be used as match for the Program for the initial capitalization grant received by the State. The State contributed $300,000 and $655,000 in the fiscal years ended June 30, 1989 and 1990, respectively.

6. Loan Fees Administration

The reported amount comes from a fee charged to loan recipients each year based on the amount of the loan outstanding. The fee ranged from .5% to 1% per annum and is collected semi-annually. Of the total collected, $0 will be used as match for the fiscal year 2004 capitalization grant.

7. Interest on Fund Balance – State Operating Pool

The reported amount represents the earnings the Program has received from idle funds invested by the Treasurer of the State of Nebraska. Interest is credited on approximately the twenty-fifth day of each subsequent month.

8. Small Town Grants

Small Town Grants are made to communities that have a population of 5,000 people or less. The total maximum of Small Town Grants awarded in any one fiscal year is $500,000. The maximum a community can receive is $100,000 concurrent with a Program loan. The Loan Fees Administration is used to fund these grants.

9. Operating Revenues and Expenses

Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the Program's principal ongoing operations. The principal operating revenue of the Program is the Loan Fees Administration. Interest revenues are also operating revenues since making loans is the primary purpose of the Program. The principal operating expenses of the Program are administration expenses and small town grants. Interest expenses are also operating expenses since making loans is the primary purpose of the Program.

10. State Employee's Retirement Plan (Plan)

The single-employer plan became effective by statute on January 1, 1964. Prior to January 1, 2003, the plan consisted of a defined contribution plan that covered State employees. Effective January 1, 2003, a cash balance benefit was added to the State Employees Retirement Act. The cash balance benefit is a type of defined benefit plan. Each member employed and participating in the retirement system prior to January 1, 2003, elected to either continue participation in the defined contribution benefit or begin participation in the cash balance benefit. The defined contribution benefit is closed to new entrants. All new members of the Plan on and after January 1, 2003, become members of the cash balance benefit. The benefits and funding policy of the Plan is established and can only be amended by the Nebraska Legislature.

All permanent full-time employees who have 12 continuous months of service are required to begin participation in the retirement system. All permanent full-time or permanent part-time employees who have 12 months of service within a five-year period, and who have attained the age of 20, may exercise the option to begin participation in the retirement system.

Contribution. Each member contributes 4.33% of his or her monthly compensation until $864 has been contributed and 4.8% of pay for the rest of the calendar year. The Department matches the member's contribution at a rate of 156%. The employee's and employer's contributions are kept in separate accounts.

The employee's account is fully vested. The employer's account is vested 100% after a total of three years of participation in the system, including the twelve-month eligibility period or credit for participation in another governmental plan prior to actual contribution to the Plan.

Defined Contribution Benefit. Upon attainment of age 55, regardless of service, the retirement allowance shall be equal to the sum of the employee and employer account. Members have several forms of payment available, including withdrawals, deferrals, annuities, or a combination of these.

Cash Balance Benefit. Upon attainment of age 55, regardless of service, the retirement allowance shall be equal to the accumulated employee and employer cash balance accounts, including interest credits, annuitized for payment in the normal form. The normal form of payment is a single life annuity with five year certain, payable monthly. Members will have the option to convert their member cash balance account to a monthly annuity with built in cost-of-living adjustments of 2.5% annually. Also available are additional forms of payment allowed under the Plan which are actuarially equivalent to the normal form, including the option of lump-sum or partial lump-sum.

NOTES TO FINANCIAL STATEMENTS
(Continued)

10. State Employee's Retirement Plan (Plan) (Concluded)

For the fiscal year ended June 30, 2005, the Clean Water State Revolving Fund Program's employees contributed $15,561 and the Department contributed $24,275. A separate plan report is issued and can be obtained from the Nebraska Public Employees Retirement System. This report contains full pension-related disclosures.

11. Contingencies and Commitments

Risk Management. The Department is exposed to various risks of loss related to torts, theft of, damage to, and destruction of assets, errors and omissions, injuries to employees, and natural disasters. The Department, as part of the primary government for the State, participates in the State's risk management program. The Nebraska Department of Administrative Services (DAS) Division of Risk Management is responsible for maintaining the insurance and self-insurance programs for the State with the exception of the health and life insurance programs which are maintained by the DAS Personnel Division. The State has chosen to purchase insurance for:

A. Motor vehicle liability, which is insured for the first $5 million of exposure per accident with a self-insured retention of $300,000 per accident, except for accidents involving vehicular pursuit which have a $1,000,000 self-insured retention per accident. Insurance is also purchased for medical payments, physical damage, and uninsured and underinsured motorists with various limits and deductibles. State agencies have the option to purchase coverage for physical damage to vehicles.

B. Health care and life insurance for eligible employees.

C. Crime coverage, with a limit of $1 million for each loss, and a $25,000 self-insured retention per incident.

D. Real and personal property on a blanket basis for losses up to $100,000,000, with a self-insured retention of $200,000 per loss occurrence. Newly acquired properties are covered up to $1,000,000 for 60 days or until the value of the property is reported to the insurance company. The perils of flood and earthquake are covered up to $10,000,000. Acts of terrorism are covered up to $2,500,000 aggregate per year. State agencies have the option to purchase building contents and inland marine coverage.

No settlements exceeded commercial insurance coverage in any of the past three fiscal years. Health care insurance is funded in the Compensation Insurance Trust Fund through a combination of employee and State contributions. Workers' compensation is also funded in the Workers' Compensation Internal Service Fund through assessments on each agency based on total agency payroll and past experience. Tort claims, theft of,

NOTES TO FINANCIAL STATEMENTS
(Continued)

11. Contingencies and Commitments (Concluded)

damage to, or destruction of assets, errors and omissions, and natural disasters would be funded through the State General Fund or by individual agency assessments as directed by the Legislature, unless covered by purchased insurance. No amounts for estimated claims have been reported in the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund's financial statements.

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NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
CLEAN WATER STATE REVOLVING FUND PROGRAM

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*

Nebraska Department of Environmental Quality
Lincoln, Nebraska

We have audited the financial statements of the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program as of and for the year ended June 30, 2005, and have issued our report thereon dated February 2, 2006. The Independent Auditors' Report was modified to emphasize the financial statements present only the funds of the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. A reportable condition is described in the Comments Section of the report as Comment Number 2 (Reconciliation of Bank Records to the Nebraska Information System).

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Nebraska Department of Environmental Quality - Clean Water State Revolving Fund Program's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We also noted an additional item that we have reported to management of the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program in a separate letter dated February 2, 2006.

This report is intended solely for the information and use of the Program, the appropriate Federal and regulatory agencies. However, this report is a matter of public record and its distribution is not limited.

Pat Reding, CPA

February 2, 2006 Assistant Deputy Auditor

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NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
CLEAN WATER STATE REVOLVING FUND PROGRAM

REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER COMPLIANCE WITH REQUIREMENTS APPLICABLE TO THE NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY CLEAN WATER STATE REVOLVING FUND PROGRAM IN ACCORDANCE WITH *U.S. ENVIRONMENTAL PROTECTION AGENCY AUDIT GUIDE FOR CLEAN WATER AND DRINKING WATER STATE REVOLVING FUND PROGRAMS*

Nebraska Department of Environmental Quality
Lincoln, Nebraska

We have audited the compliance of the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program with the types of compliance requirements described in the *U.S. Environmental Protection Agency Audit Guide for Clean Water and Drinking Water State Revolving Fund Programs* that were applicable for the year ended June 30, 2005. We audited the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program'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. Compliance with these requirements is the responsibility of the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program's management. Our responsibility is to express an opinion on the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program's compliance based on our audit.

<u>Compliance</u>

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States; and the *U.S. Environmental Protection Agency Audit Guide for Clean Water and Drinking Water State Revolving Fund Programs.* Those standards require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on the Program occurred. An audit includes examining, on a test basis, evidence about the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program's compliance with those requirements.

The Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program did not comply with the compliance requirements as described in the Comments Section of our report as Comment Number 1 (Subrecipient Monitoring). Compliance with such requirements is necessary, in our opinion, for the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program to comply with requirements applicable to the Federal program.

In our opinion, because of the effects of the noncompliance described in the preceding paragraph, the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program did not comply, in all material respects, with the requirements referred to above that are applicable to the Program for the fiscal year ended June 30, 2005.

Internal Control Over Compliance

The management of the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants. In planning and performing our audit, we considered the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program's internal control over compliance with requirements that could have a direct and material effect in order to determine our auditing procedures for the purpose of expressing an opinion on compliance and to test and report on the internal control over compliance.

We noted a certain matter involving the internal control over compliance and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the Nebraska Department of Environmental Quality – Clean Water State Revolving Fund Program's ability to administer the Federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. The reportable condition is described in the Comments Section of the report as Comment Number 1 (Subrecipient Monitoring).

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants caused by error or fraud that would be material in relation to the Federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we consider the reportable condition described above, Comment Number 1 (Subrecipient Monitoring), to be a material weakness.

This report is intended solely for the information and use of the Program and the appropriate Federal and regulatory agencies. However, this report is a matter of public record and its distribution is not limited.

Pat Reding, CPA

February 2, 2006 Assistant Deputy Auditor