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

JULY 1, 2010 THROUGH JUNE 30, 2011

Issued on April 10, 2012

NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
DRINKING WATER STATE REVOLVING FUND PROGRAM

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DRINKING WATER STATE REVOLVING FUND PROGRAM

BACKGROUND

The Nebraska Department of Environmental Quality (Agency) - Drinking Water State Revolving Fund Program (Program) was established pursuant to the Federal Safe Drinking Water Act of 1996. Neb. Rev. Stat. §§ 71-5314 to 71-5327 created the Drinking Water State Revolving Fund Act. The Federal Safe Drinking Water Act and State statutes established the Drinking Water State Revolving Fund Program to provide loans, at reduced interest rates, to finance the construction of publicly and privately owned drinking water facilities. Instead of making grants to communities that pay for a portion of the building of drinking water 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. Disadvantaged communities have 30 years to repay all loans.

The Program was capitalized by the United States Environmental Protection Agency (EPA) 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 in order to receive a Federal grant. As of June 30, 2011, the EPA had awarded $121.5 million in capitalization grants to the State, plus $19.5 million in American Recovery and Reinvestment Act (ARRA) funds. The award of this $121.5 million required the State to contribute approximately $24 million in matching funds. The State provided appropriations to contribute $2.33 million of the funds to meet the State's matching requirement. Additional matching funds were obtained through the issuance of revenue bonds of $5,530,000 in June 2000, $1,815,000 in March 2001, $2,000,000 in December 2002, $1,700,000 in June 2003, $1,890,000 in September 2004, $1,920,000 in August 2005, $1,915,000 in June 2006, $1,920,000 in September 2007, $1,965,000 in October 2008, and $3,110,000 in November 2010. The 2009 Capitalization grant was matched with $1,629,000 of Administrative Cash Funds.

The Program is administered by the Nebraska Department of Environmental Quality (Agency) and the Nebraska Department of Health and Human Services – Division of Public Health. The Agency's primary activities with regard to the Program include the making of loans for facilities and the management and coordination of the Program. The Nebraska Environmental Quality Council approves the rules and regulations of the Agency and the Program's Intended Use Plan. The Nebraska Department of Health and Human Services – Division of Public Health sets the funding priorities.

NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
DRINKING WATER STATE REVOLVING FUND PROGRAM

EXIT CONFERENCE

An exit conference was held March 1, 2012, with the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program to discuss the results of our examination. Those in attendance for the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program were:

NAME	TITLE
Tom Lamberson	Deputy Director
Martie Guthrie	Budget Officer III
Shelley Schneider	Division Administrator
Mark B. Herman	Compliance Specialist
Kris Young	Accountant
Amy Wilson	State Accounting
Curtis Youngman	State Accounting
Donna Garden	Financial Assistance Section Supervisor
Chin Chew	Department of Health and Human Services - Engineering Section Supervisor
Marty Link	Acting Water Quality Division Administrator
Mary Brady	Federal Aid Administrator II

SUMMARY OF COMMENTS

During our audit of the Nebraska Department of Environmental Quality (Agency) - Drinking Water State Revolving Fund Program, we noted certain matters involving the internal control over financial reporting and other operational matters that are presented here.

1. ***Cash Management:*** The Agency withdrew Federal funds to reimburse expenses prior to incurring those expenses.

2. ***Federal Reporting:*** Various problems and lack of internal controls were identified related to Federal reporting.

3. ***Loan Testing:*** The Agency was not in compliance with various Federal regulations.

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 Agency to provide them an opportunity to review the report and to respond to the comments and recommendations included in this report. All formal responses received have been incorporated into this report. Where no response has been included, the Agency declined to respond. Responses have been objectively evaluated and recognized, as appropriate, in the report. Responses that indicate corrective action has been taken were not verified at this time, but will be verified in the next audit.

COMMENTS AND RECOMMENDATIONS

1. Cash Management – [Note: The following comment was included in both the Drinking and Clean Water SRF fiscal year end June 30, 2011, audit reports due to the cross cutting nature of the finding]

Program: CFDA 66.458 – Capitalization Grants for Clean Water State Revolving Fund and ARRA CWSRF; CFDA 66.468 – Capitalization Grants for Drinking Water State Revolving Fund and ARRA DWSRF – Cash Management

Grant Number & Year: All open grants including #2W-97705101, FFY 2009 (ARRA); #CS-31000110, FFY 2010; #2F-97705601, FFY 2009 (ARRA); #FS-99780507, FFY 2007; #FS-99780509, FFY 2009; and #FS-9978510, FFY 2010

Federal Grantor Agency: U.S. Environmental Protection Agency (EPA)

Criteria: 31 CFR § 205.12(b)(5) (July 2010) states "Reimbursable funding means that a Federal Program Agency transfers Federal funds to a State after that State has already paid out the funds for Federal assistance program purposes."

Per the EPA's Performance Evaluation Report dated September 22, 2011, "If a draw error of a substantial sum (i.e., $500K) is made, the NDEQ [Agency] should return the funds rather than use the book entry adjustment method, regardless of the limitations in the ASAP system for displaying available balances."

Good internal controls and sound business practices require an adequate accounting of funds including tracking the amount spent from each grant, reconciling total draws with total expenditures, and maintaining documentation for figures used to support Federal draws were expended.

Condition: The Agency drew down $2,808,754 in Federal funds for the Clean Water State Revolving Fund (CWSRF) and Drinking Water State Revolving Fund (DWSRF) on April 7, 2011. The Agency had not incurred expenses to warrant this Federal draw. In addition, during testing the Agency did not initially provide the final copy of the draw spreadsheet used to track the excess funds to the Auditor of Public Accounts (APA).

Questioned Costs: None

Context: On April 7, 2011, the Agency drew down $3,595,223 in Federal funds from the Federal Automated Standard Application for Payments (ASAP) System for the CWSRF and DWSRF programs in anticipation of a Federal government shutdown. Of this amount, $786,469 could be paid out right away after invoices had been verified. The remaining $2,808,754 was drawn in excess and should have been returned to the EPA within 30 days. The Agency reported they were not aware of a legitimate process to return these funds, and elected to keep the funds to use on future expenditures. The EPA performs biannual reviews of the State's Clean and Drinking Water Revolving Funds. The EPA was aware of this large draw and reviewed it and incorporated this in their Performance Evaluation Report.

COMMENTS AND RECOMMENDATIONS
(Continued)

1. **Cash Management – [Note: The following comment was included in both the Drinking and Clean Water SRF fiscal year end June 30, 2011, audit reports due to the cross cutting nature of the finding]** (Continued)

In order to track how the early draws were paid, the Agency developed a spreadsheet where expenditures were grouped by grant and tracked until the early draw had been completely paid. Per the spreadsheet, the last expenditure paid from the early CWSRF draw was on June 23, 2011, and the last expenditure paid from the early DWSRF draw was on June 27, 2011.

Based on the APA's review of the spreadsheet, we noted:

- There were variances between the original spreadsheet we received and the final one received from the EPA. Variances were not significant.
- Documentation was not readily available to support the expenditure and adjustment amounts on the spreadsheet. The APA was able to observe in the State's accounting system that these Federal funds were eventually disbursed; however, the Agency was unable to easily recreate some of the expenditure and adjustment figures included in their spreadsheet.
- The total draws did not agree to total expenditures on the spreadsheet. Expenditures exceeded cash draws by $81,091 and the Agency was not able to explain these excess expenditures.

Cause: The Agency was not aware of a legitimate process to return excess funds.

Effect: The Agency was not in compliance with Federal regulations. Federal cash draws for funds not specifically requested by a political subdivision increase the risk Federal funds will be improperly used.

Recommendation: We recommend the Agency implement procedures to ensure that funds are only drawn on a reimbursement basis. We further recommend the Agency implement procedures to ensure that if excess funds of $500,000 or more are drawn that they properly return them to the Federal government within 30 days.

> **Management Response:** The situation described was an atypical one, in which the Agency reacted to legitimate reimbursement requests from SRF loan recipients. The problem occurred due to drawing Federal funds for reimbursements that ultimately were paid as recycled principal. EPA ASAP instructions did not provide the option of returning funds within 30 days if they were drawn incorrectly. The Agency used excess funds drawn as quickly as possible against other Federal draw needs within the Agency, per instructions within the EPA ASAP program.

COMMENTS AND RECOMMENDATIONS
(Continued)

1. Cash Management – [Note: The following comment was included in both the Drinking and Clean Water SRF fiscal year end June 30, 2011, audit reports due to the cross cutting nature of the finding] (Concluded)

Corrective Action: The Agency draws funds on a reimbursement basis the vast majority of time. We are now aware that if funds are drawn in error, they may be returned to the EPA within 30 days without affecting the grant balance. The Agency has also added the subledger (loan number) to receipts within the State Accounting System when draws are made, which will make it easier to match draw requests to specific expenditure payments.

Contact: Martie Guthrie, Budget Officer III

Anticipated Completion Date: Completed

2. Federal Reporting

Program: CFDA 66.468 – Capitalization Grants for Drinking Water State Revolving Fund (DWSRF) and ARRA DWSRF – Reporting

Grant Number & Year: #FS-99780505, FFY 2005; #2F-97705601, FFY 2009 (ARRA)

Federal Grantor Agency: U.S. Environmental Protection Agency (EPA)

Criteria: The Federal Financial Report (FFR), which replaced the Financial Status Report, requires total Federal program income earned to be reported.

OMB Circular A-133 § 315 states, "The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee shall prepare a summary schedule of prior audit findings … The summary schedule of prior audit findings shall report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to Federal awards … When audit findings were fully corrected the summary schedule need only list the audit findings and state that corrective action was taken. When audit findings were not corrected or were only partially corrected, the summary schedule shall describe the planned corrective action as well as any partial corrective action taken."

A good internal control plan requires:

- Federal financial reports are reviewed by management level personnel not involved in report preparation and the review be adequately documented,
- adequate documentation be maintained to support figures reported, and
- a process be in place to ensure data reported agrees to EnterpriseOne, the State's accounting system.

COMMENTS AND RECOMMENDATIONS
(Continued)

2. Federal Reporting (Continued)

Condition: During testing it was noted:

- Two of two FFRs tested were not complete and accurate as program income was not reported.
- Two of two FFRs did not have documentation to support they were prepared and approved by separate individuals.
- The report used to prepare the March 2011 ARRA 1512 report could not be provided or regenerated.
- There was no documentation that EnterpriseOne data was compared to the system the Agency used to generate the data submitted on the March 2011 ARRA 1512 report. This was noted in the prior audit.
- There was no documented supervisory review of the 1512 report prior to the report being submitted to Recovery.gov. This was noted in the prior audit.
- While the receipts reported on the ARRA 1512 report were correct, the APA identified a variance of $81,675 between the receipts reported on the 1512 report and the receipts recorded in EnterpriseOne. Since EnterpriseOne is the State's accounting system, all receipts and adjustments to receipts recorded on the Federal Automated Standard Application for Payments (ASAP) system should agree to EnterpriseOne.

The summary schedule of prior audit findings in the Nebraska Statewide Single Audit Report for Finding #10-84-07 states the corrective action is complete. The Agency's corrective action was to implement additional reviews and approvals prior to submitting reports. The APA could not observe any documentation to support the reviews or approvals were performed. As of June 30, 2011, this action was not complete.

Questioned Costs: Unknown

Context: During testing it was noted:

- The Agency is required to submit FFRs for non-ARRA grants after the close of the grant period and interim annual FFRs for the ARRA grant. For both the ARRA and FFY 2005 grant, the program income section was left blank on the FFR. The Agency is working with the EPA to address this.
- On October 19, 2010, there was an adjustment done in ASAP to transfer $81,675 from other grants to the DWSRF ARRA grant. When this adjustment was done in ASAP, a similar entry should have been done in EnterpriseOne, the State's accounting system, to transfer the revenues to the ARRA grant; however, this entry was not completed until May 4, 2011. Because the Agency used the ASAP system figures to report receipts they did not misreport DWSRF ARRA receipts.

COMMENTS AND RECOMMENDATIONS
(Continued)

2. <u>Federal Reporting</u> (Concluded)

Cause: During testing it was noted:

- The Agency was working with the EPA to determine how they should report program income on the FFR. An EPA approved methodology had not been determined.
- The Agency did not have documentation to support various reviews and approvals were done prior to report submission. In addition, the Agency did not have documentation to support reconciliations were performed between Federal and State information systems.
- The Agency did not regularly reconcile the Federal information system to the State's accounting system. As a result, an adjustment made in the Federal system and not made in the State's accounting system was not identified until seven months later.

Effect: The Agency was not in compliance with Federal requirements of the ARRA and fiscal year 2005 grant agreements. In addition, without adequate controls in place there is an increased risk reporting to the Federal government will be inaccurate.

Recommendation: We recommend the Agency continue to work with the EPA to develop an approved methodology for calculating and reporting program income. We also recommend the Agency implement procedures to ensure reports submitted to the Federal government have a documented supervisory review. We further recommend the Agency maintain documentation to support the figures included in the reports.

> **Management Response:** On February 20, 2012, a program income computation methodology was agreed upon with Region 7 EPA. This was shared with the APA. FFR reports prepared subsequent to the audit period have adequate documentation attached, as well as approval signatures on the face of the reports.
>
> Due to the Supervisor of the Financial Assistance Section retiring, and the position not being filled until nearly a year later, some processes that had been planned to be implemented after the prior year audit were missed.
>
> **Corrective Action:** Documentation will be saved that indicates supervisory approval for the submittal of the 1512 report and the corresponding reconciliation of the PBR Federal information system to the State Accounting System for the same time period. On February 20, 2012, a program income computation methodology was agreed upon with Region 7 EPA. This was shared with the APA. FFR reports prepared subsequent to the audit period have adequate documentation attached, as well as approval signatures on the face of the reports.
>
> **Contact:** Martie Guthrie, Budget Officer III and Donna Garden, Financial Assistance Section Supervisor
>
> **Anticipated Completion Date:** April 14, 2012

COMMENTS AND RECOMMENDATIONS
(Continued)

3. Loan Testing

Program: CFDA 66.468 – Capitalization Grants for Drinking Water State Revolving Fund (DWSRF) and ARRA DWSRF – Cash Management/Subrecipient Monitoring

Grant Number & Year: All open grants including #FS-99780509, FFY 2009; #FS-99780510, FFY 2010; #2F-977056010, FFY 2009 (ARRA)

Federal Grantor Agency: U.S. Environmental Protection Agency (EPA)

Criteria: 31 CFR § 205.12(b)(5) (July 1, 2010) states, "Reimbursable funding means that a Federal Program Agency transfers Federal funds to a State after that State has already paid out the funds for Federal assistance program purposes."

2 CFR § 176.210(c) (January 1, 2011) states, "Recipients agree to separately identify to each subrecipient, and document at the time of subaward and at the time of disbursement of funds, the Federal award number, CFDA number, and amount of Recovery Act funds. When a recipient awards Recovery Act funds for an existing program, the information furnished to subrecipients shall distinguish the subawards of incremental Recovery Act funds from regular subawards under the existing program."

2 CFR § 176.210(d) (January 1, 2011) states, "Recipients agree to require their subrecipients to include on their SEFA information to specifically identify Recovery Act funding similar to the requirements for the recipient SEFA described above. This information is needed to allow the recipient to properly monitor subrecipient expenditure of ARRA funds as well as oversight by the Federal awarding agencies, Offices of Inspector General and the Government Accountability Office."

OMB Circular A-133 § 315 states, "The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee shall prepare a summary schedule of prior audit findings … The summary schedule of prior audit findings shall report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to Federal awards … When audit findings were fully corrected the summary schedule need only list the audit findings and state that corrective action was taken. When audit findings were not corrected or were only partially corrected, the summary schedule shall describe the planned corrective action as well as any partial corrective action taken."

A good internal control plan requires procedures be in place to complete a loan award checklist for every project to ensure all administrative and mailing procedures have been completed for all loans awarded. A good internal control plan requires adequate procedures be in place to ensure disbursements are recorded correctly, which includes identifying which funding source is to be used.

COMMENTS AND RECOMMENDATIONS
(Continued)

3. Loan Testing (Continued)

Condition: During State fiscal year 2011 the Agency paid out $4,372,384 to 42 political subdivisions. During testing the APA selected 5 loans to political subdivisions who received a total of $3,440,045 during the State fiscal year and performed detail testing on $1,105,464 of those disbursements. During testing it was noted:

- For 2 of 14 disbursements tested, the request for reimbursement was sent and reimbursement funds were received prior to the costs being paid to the community.
- For all 5 loans tested, the loan agreement did not contain the CFDA (Catalog of Federal Domestic Assistance) number and title, or the award name and number. In addition, if the loan was ARRA funded, the loan did not include the requirement for the political subdivision to provide appropriate identification of ARRA funds in their Schedule of Expenditures of Federal Awards (SEFA) and SF-SAC (Data Collection Form). This was noted in the prior audit.
- For all 3 loans tested for ARRA funded disbursements, the Federal award number was not communicated to the community.
- For 4 of 5 loans tested, the loan award checklist was not on file. This was noted in the prior audit.
- During testing the APA noted the April 21, 2011, disbursement to Bridgeport was coded incorrectly in the State accounting system (EnterpriseOne) which resulted in payment being made from the incorrect Federal grant.

The summary schedule of prior audit findings in the Nebraska Statewide Single Audit Report for Finding #10-84-06 states the corrective action is complete. The Agency's corrective action was to reinstitute their loan checklist to ensure compliance requirements were met. The corrective action also included adding more items to review during their engineer's onsite checklist. While the Agency did address some of the items reported last year, there were other items that had not been adequately addressed as of June 30, 2011.

Questioned Costs: Unknown

Context: During testing it was noted:

- In October 2010 the Agency drew down excess funds in error. These funds were used to make payments of $17,901 to Gresham on November 22, 2010. In addition, a $36,788 payment was made on April 21, 2011, to Bridgeport and this payment used funds drawn on April 7, 2011, which is explained in more detail in Finding #11-84-01 in the Nebraska Statewide Single Audit Report and in Comment Number 1 in this report.
- During the State fiscal year ended June 30, 2011, the standard loan contract did not include the CFDA name and title, as well as the Federal award name and number. As of February 1, 2012, the standard loan contract has been revised and this information has been added.

COMMENTS AND RECOMMENDATIONS
(Continued)

3. <u>Loan Testing</u> (Continued)

- The Agency currently sends out a letter annually to each subrecipient that includes Federal dollars paid by the Agency. This letter includes CFDA information, ARRA funds paid, and SEFA and SF-SAC identification requirements. However, the Federal award number is not included in the letter.
- The Agency began using the loan checklist during the State fiscal year ended June 30, 2011. We noted a loan entered in November 2010 had a loan checklist in the loan file.
- A $36,788 payment to Bridgeport was paid from the incorrect Federal grant.

Cause:

- Excess funds were drawn in October 2010 due to error and excess funds were drawn in April due to fear of a Federal government shutdown.
- The Agency is now using a loan template which includes the CFDA name and title, as well as the Federal award name and number.
- The Agency was not aware they needed to include the Federal award number on the letter sent to political subdivisions.
- The Agency started using the loan checklist during the State fiscal year ended June 30, 2011.
- Incorrect coding in EnterpriseOne was the result of a clerical error.

Effect: There is an increased potential for noncompliance with Agency Rules and Regulations as well as Federal grant compliance requirements.

Recommendation: We recommend the following:

- The Agency implement procedures to ensure requests for Federal funds are only made after payment to the political subdivisions have been made.
- The Agency incorporate the Federal grant award number in their annual correspondence with political subdivisions.
- A loan award checklist is completed for every loan that is awarded.
- The Agency implement procedures to ensure disbursements are recorded to the correct business unit.

Management Response: The Agency recognizes the importance of a good internal control plan for loan processing and monitoring, to ensure necessary steps are completed, as well as compliance with Federal regulations. Due to the Supervisor of the Financial Assistance Section retiring, and the position not being filled until nearly a year later, some processes that had been planned to be implemented after the prior year audit were delayed.

COMMENTS AND RECOMMENDATIONS
(Continued)

3. Loan Testing (Concluded)

Corrective Action: As of February 1, 2012, the Agency adopted and is using a new template for loan contracts that includes the CFDA number and title, as well as the Federal grant award name and number. The Agency will use the standard grant award number without the fiscal year extension, so that contracts would be inclusive of any currently open or future grants available for payment of reimbursement requests.

The Agency will continue to send out a yearly letter to remind political subdivisions of the Single Audit Act. The letter will provide the amount of Federal and State loan funds, loan forgiveness, and ARRA funds. The letter will contain CFDA name and number and the Federal grant award name and number.

The Agency will continue to include in the file of every loan awarded, the loan award checklist to ensure all administrative and mailing procedures have been completed for all loans awarded.

Contact: Pat Rice, Assistant Director, Water Division; Donna Garden, Supervisor Financial Assistance Section

Anticipated Completion Date: 2/1/12 – for new contract templates; 10/1/12 – for annual Single Audit Act letter to subdivisions

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NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
DRINKING 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 - Drinking Water State Revolving Fund Program, as of and for the year ended June 30, 2011, which collectively comprise the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program's basic financial statements as listed in the Table of Contents. These basic 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 of the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program are intended to present the financial position and changes in financial position of only that portion of the business type activities of the State that is attributable to the transactions of the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program. They do not purport to, and do not, present fairly the financial position of the business type activities of the State of Nebraska as of June 30, 2011, and its changes in financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the business type activities of the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program, as of June 30, 2011, and the respective changes in financial position 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 April 2, 2012, on our consideration of the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

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 April 2, 2012, on our consideration of the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program's compliance with certain provisions of laws, regulations, and grants.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program's basic financial statements. Management's Discussion and Analysis is presented for purposes of additional analysis and is not a required part of the basic financial statements. 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 it.

Signed Original on File

April 2, 2012

Don Dunlap, CPA
Assistant Deputy Auditor

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)

This section of the Nebraska Department of Environmental Quality (Agency) - Drinking 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, 2011. This analysis has been prepared by management of the Agency, and is intended to be read in conjunction with the Program's 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 the 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 the Financial Statements are an integral part of the financial statements and provide 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, 2011, net assets of the Program increased by 5% due to increased interest revenues from loans to political subdivisions and fewer ARRA Principal Forgiveness expenses incurred since the majority of ARRA funds had been expended during the prior fiscal year. Revenues for the Program increased 16% as the increase in the number of loans awarded due to ARRA the previous year, began to increase repayments on loans. Expenses decreased by 58% also due to the fact that the majority of ARRA loans had been awarded and paid the previous year. The amount drawn from the EPA from grant awards decreased by 74%, as most of the ARRA grants had been paid out to communities in the form of loans.

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

NET ASSETS

	2011	2010	% Change
Current Assets	$ 46,280,045	$ 48,078,694	(4%)
Noncurrent Assets	90,185,920	80,611,326	12%
Total Assets	136,465,965	128,690,020	6%
Current Liabilities	1,940,733	1,619,054	20%
Noncurrent Liabilities	14,875,703	13,110,000	13%
Total Liabilities	16,816,436	14,729,054	14%
Net Assets:			
Restricted	2,273,757	1,968,875	15%
Unrestricted	117,375,772	111,992,091	5%
Total Net Assets	$ 119,649,529	$ 113,960,966	5%

CHANGES IN NET ASSETS

	2011	2010	% Change
Loan Fees Administration	$ 913,202	$ 732,680	25%
Interest	3,928,206	3,440,707	14%
Fines, Forfeits, and Penalties	199	-	100%
Total Operating Revenues	4,841,607	4,173,387	16%
Administration	1,942,189	2,371,214	(18%)
Bond Expenses	757,236	660,133	15%
ARRA Loan Forgiveness	1,495,884	8,481,804	(82%)
Non ARRA Loan Forgiveness	631,428	-	100%
Total Operating Expenses	4,826,737	11,513,151	(58%)
Operating Income	14,870	(7,339,764)	100%
Capital Federal Grants	4,387,064	14,422,710	(70%)
Capital Contributions ARRA Grants	3,275,783	15,715,842	(79%)
Change in Net Assets	7,677,717	22,798,788	(66%)
Beginning Net Assets July 1	113,960,966	91,162,178	25%
Prior Period Adjustment	(1,989,154)	-	100%
Total Net Assets, Beginning of Year	111,971,812	91,162,178	23%
Ending Net Assets June 30	$ 119,649,529	$ 113,960,966	5%

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

The most significant change from the fiscal year ended June 30, 2010, to the fiscal year ended June 30, 2011, was the increase in Operating Income. The American Recovery and Reinvestment Act (ARRA) funds received by the Agency, in the form of community loans, had a principal forgiveness component in it. This was recorded as an expense in the year it was paid out. Most of the loans paid with principal forgiveness components in them, were paid out during fiscal year 2010. Therefore in fiscal year 2011, as the grants were depleted, due to reaching the limits of awards to be made, less funds were expended as principal forgiveness. Federal funds will vary each year depending on the size of each draw, the timing of each draw, the number of communities applying for loans, and the number of loans successfully processed. Changes are inherent in the Drinking Water program and are expected when draws are based on community requests.

ECONOMIC OUTLOOK

Nebraska's economy has been affected by the national economic decline in recent years; however, net State tax revenues for fiscal year 2011 finished the year 4% above projections. The State has continued to take steps to avert major economic impacts both statewide and within communities. The small rural makeup of the State remains to be a challenge for communities in funding major capital projects. Declining population bases make it difficult to draw the amount of user fees needed to fund infrastructure requirements. For the fiscal year ended June 30, 2011, the Program received $3.3 million in ARRA funds (compared to $15.7 million of ARRA funds in fiscal year 2010), and about half of those funds were provided as principal forgiveness to communities. The ARRA funding does not require a State match.

DEBT ADMINISTRATION

Long-Term Debt

The Drinking Water State Revolving Fund had long-term debt activity during the fiscal year as shown above in the line titled Noncurrent Liabilities in the Net Assets section. See the Notes to the Financial Statements for more detailed information on the Bonds Payable, which represents the Fund's long-term debt activity for the year.

AMERICAN RECOVERY AND REINVESTMENT ACT

The Nebraska State Drinking Water Revolving Fund Program received $19.5 million in American Recovery and Reinvestment Act (ARRA) funding for upgrades to public water systems. ARRA provides new, one-time funding, which is combined with $30 million in existing funds from the Drinking Water State Revolving Fund. Funding is administered by the Department of Health and Human Services (DHHS) Division of Public Health to provide financial assistance to communities.

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

The average ARRA base blended loans are 25 percent principal forgiveness. The remaining 75 percent is issued to communities as low-interest loans at 2 percent. ARRA requires the State to use at least 50 percent of the funds provided by this grant to provide additional subsidization in the form of principal forgiveness.

DHHS ranked the State's public water supply needs using the fund's established ranking system, with some modifications made to direct funds to projects that were further along in the planning stages. ARRA requires 20 percent of recovery funds go to water efficiency projects, such as water meter installation.

NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
DRINKING WATER STATE REVOLVING FUND PROGRAM

BALANCE SHEET

June 30, 2011

		Enterprise Fund
ASSETS		
CURRENT ASSETS		
Cash and Cash Equivalents:		
Cash in State Treasury (Note 2)	$	24,061,483
Amounts Held by Trustee (Note 2)		16,232,570
Interest Receivable		50,950
Loan Interest Receivable		5,895
Administrative Fees Receivable		3,423
Loans Receivable (Note 3)		5,925,724
TOTAL CURRENT ASSETS		46,280,045
NON-CURRENT ASSETS		
Loans Receivable (Note 3)		90,185,920
TOTAL NON-CURRENT ASSETS		90,185,920
TOTAL ASSETS	$	136,465,965
LIABILITIES		
CURRENT LIABILITIES		
Accounts Payable	$	229,910
Compensated Absences (Note 5)		1,182
Accrued Bond Interest Payable		349,641
Bonds Payable (Note 4)		1,360,000
TOTAL CURRENT LIABILITIES		1,940,733
NON-CURRENT LIABILITIES		
Compensated Absences (Note 5)		15,703
Bonds Payable (Note 4)		14,860,000
TOTAL NON-CURRENT LIABILITIES		14,875,703
TOTAL LIABILITIES		16,816,436
NET ASSETS		
Restricted for Bond Payments		2,273,757
Unrestricted		117,375,772
TOTAL NET ASSETS		119,649,529
TOTAL LIABILITIES AND NET ASSETS	$	136,465,965

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

NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
DRINKING WATER STATE REVOLVING FUND PROGRAM

STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

For the Year Ended June 30, 2011

		Enterprise Fund
OPERATING REVENUES:		
Loan Fees Administration (Note 7)	$	913,202
Interest on Loans		2,726,366
Interest on Fund Balance - Trustee		437,126
Interest on Fund Balance - State Operating Investment Pool (Note 8)		764,714
Fines, Forfeits, and Penalties		199
TOTAL OPERATING REVENUES		4,841,607
OPERATING EXPENSES:		
Administration From Fees (Note 10)		485,024
4% Administrative Costs from Grant		125,000
15% Source Water Assessment Program (Note 10)		634,837
2% Technical Assistance to Small Systems (Note 10)		272,716
10% Public Water Supply System (Note 10)		424,612
30% Principal Forgiveness (Note 10)		631,428
50% Principal Forgiveness ARRA (Note 10)		1,495,884
Bond Rebate Fee Expense		39,435
Interest Expense - State Match Bonds (Note 10)		660,152
Cost of Bond Issuance		57,649
TOTAL OPERATING EXPENSES		4,826,737
OPERATING INCOME		14,870
CAPITAL CONTRIBUTIONS - FEDERAL GRANTS		4,387,064
CAPITAL CONTRIBUTIONS - ARRA FEDERAL GRANTS		3,275,783
CHANGE IN NET ASSETS		7,677,717
TOTAL NET ASSETS, BEGINNING OF YEAR		113,960,966
PRIOR PERIOD ADJUSTMENT (Note 14)		(1,989,154)
NET ASSETS, BEGINNING OF YEAR, AS RESTATED		111,971,812
TOTAL NET ASSETS, END OF YEAR	$	119,649,529

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

NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
DRINKING WATER STATE REVOLVING FUND PROGRAM
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2011

		Enterprise Fund
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts From Customers	$	10,179,778
Interest on Investments		1,201,841
Payments to Borrowers		(12,842,039)
Payments to Borrowers ARRA		(1,992,035)
Payments for Administration		(552,795)
15% Source Water Assessment Program		(532,766)
2% Technical Assistance to Small Systems		(217,994)
10% Public Water Supply System		(391,839)
Principal Forgiveness		(843,564)
Principal Forgiveness ARRA		(1,283,748)
Bond Principal Payments		(1,295,000)
Bond Interest Payments		(634,566)
Bond Issue		3,070,565
Cost of Bond Issuance		(57,649)
NET CASH PROVIDED BY OPERATING ACTIVITIES		(6,191,811)
CASH FLOWS FROM NON-CAPITAL & RELATED FINANCING ACTIVITIES:		
Funds Received From the Environmental Protection Agency		4,387,064
Funds Repaid to the Environmental Protection Agency		(1,989,154)
ARRA Funds Received From the Environmental Protection Agency		3,275,783
NET CASH FROM NON-CAPITAL & RELATED FINANCING ACTIVITIES		5,673,693
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR		40,812,171
CASH AND CASH EQUIVALENTS, END OF YEAR	$	40,294,053
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating Income	$	14,870
ADJUSTMENTS TO RECONCILE OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
(Increase)/Decrease in Loans Receivable		(8,333,445)
(Increase)/Decrease in Interest Receivable		48,700
(Increase)/Decrease in Loan Interest Receivable		(5,895)
(Increase)/Decrease in Admin Fees Receivable		(3,423)
Increase/(Decrease) in Bonds Payable		1,815,000
Increase/(Decrease) in Accrued Interest on Bonds		25,587
Increase/(Decrease) in Accounts Payable		229,910
Increase/(Decrease) in Compensated Absences		16,885
NET CASH PROVIDED BY OPERATING ACTIVITIES	$	(6,191,811)

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

NOTES TO THE FINANCIAL STATEMENTS

For the Fiscal Year Ended June 30, 2011

1. Summary of Significant Accounting Policies

A. Basis of Presentation

The accompanying basic financial statements of the Nebraska Department of Environmental Quality (Agency) - Drinking Water State Revolving Fund Program (Program) have been prepared in conformity with accounting principles generally accepted in the United States of America (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 basic financial statements have been prepared primarily from accounts maintained by the State Accounting Administrator of the Department of Administrative Services (DAS) and the Trustee (Wells Fargo Bank, Iowa) for the State match bond accounts.

B. Reporting Entity

The Drinking Water State Revolving Fund Program is a program within the Agency and is established under and governed by the Safe Drinking Water Act of the Federal Government and the Drinking Water State Revolving Fund Act of the State of Nebraska. The Agency is a State agency established under and governed by the laws of the State of Nebraska. As such, the Agency is exempt from State and Federal income taxes. The Program's management has considered all potential component units of the Program for which it is financially accountable, and other organizations which are fiscally dependent on the Program, or the significance of their relationship with the Program 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 Agency 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 Agency.

As required by generally accepted accounting principles, these financial statements present the Nebraska Department of Environmental Quality - Drinking 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, individual funds are established for the

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

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 on the State accounting system includes the following funds as identified in the Drinking Water State Revolving Fund Act:

- Drinking Water Facilities Funds – General Fund 10000, Federal Funds 48416, 48417, and 48418, and Bond Funds 68480, 68481, 68482, 68483, and 68484.

- Drinking Water Administration Fund – Cash Fund 28630.

In addition to the funds above, the Agency created Fund 48410 to track ARRA activity.

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

The activity of these 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 Agency 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. Measurement Focus, 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 total net assets.

1. Summary of Significant Accounting Policies (Continued)

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.

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 Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures.

E. Cash and Cash Equivalents

In addition to bank accounts and petty cash, this classification includes all short-term investments such as certificates of deposit, repurchase agreements, and U.S. treasury bills. These short-term investments may have original maturities (remaining time to maturity at acquisition) greater than three months; however, cash is available and is considered cash and cash equivalents for reporting purposes. These investments are stated at cost, which at June 30, 2011, approximates market. Banks pledge collateral, as required by law, to guarantee State funds held in time and demand deposits.

Cash and Cash Equivalents are under the control of the State Treasurer or other administrative bodies as determined by law. All cash deposited with the State Treasurer is initially maintained in a pooled cash account. On a daily basis, the State Treasurer invests cash not needed for current operations with the State's Investment Council that maintains an operating investment pool for such investments. Interest earned on these investments is allocated to funds based on their percentage of the investment pool.

Amounts Held by Trustee are considered cash equivalents due to their liquid nature.

F. Loans Receivable

The State operates the Program as a direct loan program, whereby loans are made to communities. The entire Drinking Water Program is funded, on average, 83.33% from Federal capitalization grants and 16.67% from State matching funds, except American Recovery and Reinvestment Act (ARRA) funds. ARRA funds do not require 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 the 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 2.0% to 4.3% and the terms are

1. Summary of Significant Accounting Policies (Continued)

between 5 to 20 years. Disadvantaged communities may have up to 30 years to repay. The current loans receivable amount was determined using the amount of principal payment due to the Program at June 30, 2011, which is collectible in fiscal year 2012.

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. Restricted Net Assets

When both restricted and unrestricted resources are available for use, it is the Agency'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.

H. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at fiscal year end and revenues and expenses during the reporting period. Actual results could differ from those estimates.

I. Compensated Absences

All permanent employees working for the Program earn sick and annual leave and are allowed to accumulate compensatory leave rather than being paid overtime. Temporary and intermittent employees are not eligible for paid leave. The liability has been calculated using the vesting method, in which leave amounts, for both employees who are currently eligible to receive termination payments and other employees who are expected to become eligible in the future to receive such payments upon termination, are included.

Program employees accrue vested annual leave at a variable rate based on years of service. Generally, accrued annual leave cannot exceed 35 days at the end of a calendar year. Employees accrue sick leave at a variable rate based on years of service. In general, accrued sick leave cannot exceed 180 days. There is no maximum limit on the accumulation of sick leave days for employees under certain labor contracts. Sick leave is not vested except upon death or upon reaching the retirement eligibility age of 55, or at

1. Summary of Significant Accounting Policies (Concluded)

a younger age if the employee meets all criteria necessary to retire under the primary retirement plan covering his/her State employment, at which time the State is liable for 25 percent of the employee's accumulated sick leave. Employees under certain labor contracts can only be paid a maximum of 60 days.

The Program financial statements recognize the expense and accrued liability when vacation and compensatory leave is earned or when sick leave is expected to be paid as termination payments.

2. Cash in State Treasury and Amounts Held by Trustee

Cash in State Treasury as reported on the balance sheet is under the control of the Nebraska State Treasurer or other administrative bodies as determined by law. Investment of all available cash is made by the State Investment Officer on a daily basis, based on total bank balances. These funds are held in the State of Nebraska Operating Investment Pool (OIP), an internal investment pool. Additional information on the deposits and investments portfolio including investment policies, risks, and types of investments can be found in the State of Nebraska's CAFR for the fiscal year ended June 30, 2011. All interest revenue is allocated to the general fund except allocations required by law to be made to other funds. All funds of the Drinking Water State Revolving Fund Program were designated for investment during fiscal year 2011. Amounts are allocated on a monthly basis based on average balances of all invested funds.

Amounts Held by Trustee. The Nebraska Investment Finance Authority (NIFA) (the "Issuer") issues revenue bonds, the proceeds which are used by the Agency to provide the 20% match requirements for the Agency's Federal Capitalization Grants (See Note 4, Bonds Payable, for more details on these bonds). Wells Fargo Bank, N.A. (Trustee), as Trustee, establishes the appropriate accounts and invests the monies in accordance with the Bond Indenture. At June 30, 2011, the amount held by the Trustee of $16,232,570 was considered cash and cash equivalents and was stated at fair value, except for the amounts invested in Guaranteed Investment Contracts (GICs), where no readily ascertainable fair value was available. For this investment, the Program manager received an estimate of fair value from the Trustee. The amount held by the Trustee consisted of the following:

	Fair Value
Cash	$ 70,090
Money Market Account	10,481,250
Guaranteed Investment Contracts (GICs) in CDC Funding Corporation	5,681,230
TOTAL	$ 16,232,570

2. Cash in State Treasury and Amounts Held by Trustee (Continued)

The amounts shown as cash and as a money market account above are deposits as defined by GASB. As such, those deposits have custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the Program's deposits may be lost. Of the $10,551,340 in deposits held by the Trustee, $250,000 was covered by FDIC insurance and $10,301,340 was uninsured and uncollateralized during and at the end of the fiscal year ended June 30, 2011, and thus exposed to custodial credit risk. The Program does not have a custodial credit risk policy for deposits.

The Program monies identified in this section are held and invested by the Trustee in its capacity as trustee for the bonds as specified in the Master Trust Indenture Section 5.07 dated as of June 1, 2000. That document defines "Investment Obligations" as:

(a) direct obligations of, or obligations the prompt payment of principal and interest on which are fully guaranteed by, the United States of America;

(b) bonds, debentures, notes or other evidences of indebtedness issued or fully insured or guaranteed by any agency or instrumentality of the United States of America which is backed by the full faith and credit of the United States of America;

(c) interest-bearing time or demand deposits, certificates of deposit or other similar banking arrangements with any Depository (including the Trustee), provided that such deposits, certificates and other arrangements are fully insured by the Federal Deposit Insurance Corporation or secured by obligations described in clauses (a) to (b), inclusive, of this definition, or a combination thereof;

(d) money market funds or similar fund which invests exclusively in obligations described in clause (a), (b), or (e) of this definition, or a combination thereof;

(e) bonds, debentures, notes or other evidences of indebtedness issued by any state of the United States of America or any political subdivision thereof or any public authority of body or instrumentality thereof which constitute obligations described in Section 103(a) of the Code which have a fixed par value and a fixed amount due at maturity and on call dates and are either rated "MIG 1" by Moody's and rated "SP-1+" by Standard & Poor's for short-term obligations or rated no lower than the rating on the Outstanding Bonds by Standard & Poor's and by Moody's;

(f) any repurchase agreement or similar financial transaction with a national banking association (including the Trustee), a bank or trust company organized under laws of any state, or a government bond dealer reporting to, trading with, and recognized as a primary dealer by the Federal Reserve Bank of New York or other corporation, association or entity which has a long-term debt rating by Standard & Poor's and Moody's no

2. Cash in State Treasury and Amounts Held by Trustee (Concluded)

lower than the rating on the Outstanding bond, which agreement is secured by a perfected security interest in any one or more of the securities described in clause (a) or (b) and which have an aggregate market value at least equal to the amount invested;

(g) investment contracts issued, secured or guaranteed by a corporation (or its guarantor), a national banking association or a state banking association which has a long-term debt rating by Standard & Poor's and Moody's no lower than the rating on the Outstanding Bonds, or by a foreign bank or a United State branch or agency of a foreign bank, which foreign bank consents to in personal jurisdiction and which has a long-term debt rating by Standard & Poor's and Moody's no lower than the rating on the Outstanding Bonds; or

(h) obligations of an insurance company which has a long-term debt rating by Standard & Poor's and Moody's no lower than the rating on the Outstanding Bonds.

The amounts held by the Trustee in GICs were investments as defined by GASB. The Trustee, in accordance with the Series 2000A Supplemental Bond Indenture invests funds in a private debt obligations fund, which is considered a debt security. This debt security has the following risks:

- Credit Risk – Credit risk is a risk that an issuer of debt securities or another counterparty to an investment transaction will not fulfill an obligation and is commonly expressed in terms of the credit quality rating issued by a national rating organization. As of June 30, 2011, the GIC was rated AAA by Standard & Poor's Rating Group.

- Custodial Credit Risk of Investments – Custodial credit risk for investments is the risk that in the event of the failure of a counterparty, the Program will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The GIC fund held by the Trustee was uninsured and held by and in the name of the Trustee, not in the name of the Program.

- Concentration of Credit Risk – When investments are concentrated in one issuer, this concentration represents heightened risk of potential loss. No specific percentage identifies when concentration risk is present. GASB has adopted a principle that governments should provide note disclosure when 5% of the total government investments are concentrated in any one issuer. The Program had 100% of its total investments in the GIC fund.

The Program did not have a custodial credit risk policy for debt securities.

3. **Loans Receivable**

As of June 30, 2011, the Program had 123 outstanding balances totaling $96,111,644. The outstanding balances of the ten communities with the largest loan balances, which represents 58% of the total loans, were as follows:

Community	**Outstanding Balance**
Kearney	$ 9,926,709
McCook	7,909,547
North Platte	6,510,416
Gering	6,269,471
Sidney	5,801,711
Metropolitan Utilities District	5,585,946
Auburn	4,772,585
Alliance	3,981,810
Blair	3,660,484
Hickman	1,521,976
TOTAL	$ 55,940,655

4. **Bonds Payable**

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 Drinking 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 2000A, 2001A, 2002A, 2003A, 2004A, 2005A, 2006A, 2007A, 2008A, and 2010A Bonds are limited obligations of NIFA, payable only from and secured only by the Trust Estate. The Series 2000A, 2001A, 2002A, 2003A, 2004A, 2005A, 2006A, 2007A, 2008A, and 2010A Bonds are revenue bonds. The Series 2000A, 2001A, 2002A, 2003A, 2004A, 2005A, 2006A, 2007A, 2008A, and 2010A 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 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 2000A, 2001A, 2002A, 2003A, 2004A, 2005A, 2006A, 2007A, 2008A, and 2010A Bonds. The current bonds payable amount was determined using the amount of bond principal to be retired in fiscal year 2012. Bonds payable for the fiscal year ended June 30, 2011, is as follows:

	Beginning Balance	Additions	Retirement	Ending Balance	Current Portion
Bonds Payable	$ 14,405,000	$ 3,110,000	$ 1,295,000	$ 16,220,000	$ 1,360,000

4. Bonds Payable (Concluded)

Bonds payable at June 30, 2011, consist of the following:

Series	Original Issue	Retirements	2011 Balance	Interest Rate	Final Maturity Date
2000A	$ 5,530,000	$ 2,850,000	$ 2,680,000	4.8-5.7%	July 1, 2015
2001A	1,815,000	920,000	895,000	3.9-5.15%	Jan. 1, 2016
2002A	2,000,000	920,000	1,080,000	1.8-4.6%	Jan. 1, 2017
2003A	1,700,000	700,000	1,000,000	1.3-3.8%	Jan. 1, 2018
2004A	1,890,000	640,000	1,250,000	1.6-4.75%	July 1, 2019
2005A	1,920,000	515,000	1,405,000	2.75-4.2%	July 1, 2020
2006A	1,915,000	450,000	1,465,000	3.6-4.3%	Jan. 1, 2021
2007A	1,920,000	330,000	1,590,000	3.5-4.35%	Jan. 1, 2022
2008A	1,965,000	220,000	1,745,000	2.75-5.0%	Jan. 1, 2023
2010A	3,110,000	-	3,110,000	0.9-4.0%	July 1, 2025

The 2000A Series Bonds were issued June 29, 2000, the 2001A Series Bonds were issued March 28, 2001, the 2002A Series Bonds were issued December 19, 2002, the 2003A Series Bonds were issued June 19, 2003, the 2004A Series Bonds were issued September 16, 2004, the 2005A Series Bonds were issued August 15, 2005, the Series 2006A Bonds were issued June 8, 2006, the Series 2007A Bonds were issued September 28, 2007, and the Series 2008A Bonds were issued October 3, 2008, and the Series 2010A Bonds were issued November 12, 2010. Bonds mature at various intervals through July 2025. The debt service requirements on bonds maturing in subsequent years are as follows:

Year Ending June 30	Principal	Interest	Total
2012	$ 1,360,000	$ 677,196	$ 2,037,196
2013	1,605,000	610,219	2,215,219
2014	1,665,000	545,453	2,210,453
2015	1,715,000	475,686	2,190,686
2016	2,530,000	385,574	2,915,574
2017-2021	5,565,000	971,973	6,536,973
2022-2026	1,780,000	162,963	1,942,963
TOTAL	$ 16,220,000	$ 3,829,064	$ 20,049,064

NOTES TO THE FINANCIAL STATEMENTS
(Continued)

5. Noncurrent Liabilities

Changes in noncurrent liabilities for the year ended June 30, 2011, were as follows:

	Beginning Balance	Increases	Decreases	Ending Balance	Amounts Due Within One Year
Compensated Absences	$ 38,088	$ -	$ 21,203	$ 16,885	$ 1,182

6. Net Assets

Included in the Net Assets is the total amount of capitalization grants drawn from the EPA by the Agency. The following summarizes the EPA capitalization grants awarded, drawn, and the remaining balance as of June 30, 2011. The year column relates directly to the grant amount column and represents the year the grant funds were appropriated by Congress. The amount drawn column is as of June 30, 2011, and may have been drawn over multiple years.

Federal Fiscal Year Available	Grant Amount	Amount Drawn	Balance
1997	$ 12,824,000	$ 12,824,000	$ -
1998	7,121,300	7,121,300	-
1999	7,463,800	7,463,800	-
2000	7,757,000	7,757,000	-
2001	7,789,126	7,789,126	-
2002	8,052,500	8,052,500	-
2003	8,004,100	8,004,100	-
2004	8,303,100	8,303,100	-
2005	8,285,500	8,285,500	-
2006	8,229,300	8,223,624	5,676
2007	8,229,000	8,150,313	78,687
2008	8,146,000	7,867,111	278,889
2009 ARRA	19,500,000	18,779,489	720,511
2009	8,146,000	6,711,351	1,434,649
2010	13,573,000	666,968	12,906,032
TOTAL	$ 141,423,726	$ 125,999,282	$ 15,424,444

The 2010 grant was delayed and was not awarded until October 22, 2010, after the end of State fiscal year 2010. Although the 2010 grant was delayed, the grant award allowed the Agency to charge expenditures for projects to the grant effective October 1, 2010.

6. Net Assets (Concluded)

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

Contributed Capital July 1, 2010	$ 124,283,425
Contributed During the Year:	
Funds From EPA	4,387,064
Funds Returned to the EPA	(1,989,154)
Funds From ARRA	3,275,783
Contributed Capital June 30, 2011	$ 129,957,118

Also included in the Contributed Capital is a total of all general funds received by the Program from the Nebraska State Legislature. These assets were to be used as match for the Program for the initial capitalization grant received by the State. The State contributed $1,162,318 and $1,166,518 in the fiscal years ended June 30, 1998, and 1999, respectively. The State also used $1,629,000 of Administrative Cash Funds to provide the match for the 2009 capitalization grant during the fiscal year ended June 30, 2010.

7. 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 is 1% per annum and is collected semi-annually.

8. Interest on Fund Balance – State Operating Investment Pool

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

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 primary operating revenues of the Program are the Loan Fees Administration and interest from loans, since making loans is the primary purpose of the Program. The principal operating expenses of the Program are administration expenses and principal forgiveness. Interest expenses are also operating expenses since making loans is the primary purpose of the Program.

10. Operating Expenses

The Operating Expenses of the Drinking Water State Revolving Fund Program are classified, for financial reporting purposes, into seven categories. There are four set-aside activities established under § 1452 of the Safe Drinking Water Act. The four set-aside activities are:

- 4% Administration
- 15% Source Water Assessment Program
- 2% Technical Assistance to Small Systems
- 10% Public Water Supply System

The Nebraska Department of Health and Human Services is provided funding under the following set-asides: Administration, Public Water Supply System, Small Systems Technical Assistance, and Source Water Assessment Program. A Memorandum of Understanding was entered into between the Agency and the Nebraska Department of Health and Human Services to provide support to the Program.

All are required to be federally funded. State match dollars can only be used for the purpose of providing loans to owners of Public Water Supply Systems. Other significant categories of expenses are 30% Loan Forgiveness, and Interest Expense-State Match Bonds.

Following is an explanation of these categories:

<u>4% Administration</u>

A state may use up to 4 percent of the funds allotted to it for the reasonable costs of administering the program and providing technical assistance. These costs may include such activities as issuing debt; start up costs; audit costs; financial management; legal consulting fees; development of IUP (Intended Use Plan) and priority ranking system; development of affordability criteria; and costs of support services provided by other state agencies. If the state does not obligate the entire 4 percent for administrative costs in one year, it can bank the excess balance and use it for administrative costs in later years.

<u>15% Source Water Assessment Program</u>

Identified in Federal regulations as local assistance and other state programs, a state may use up to 15% of the capitalization grant amount for specified uses as follows:

- Assistance to a public water system to acquire land or a conservation easement for source water protection purposes;

10. Operating Expenses (Continued)

- Assistance to a community water system to implement voluntary, incentive-based source water quality protection measures;
- Provide funding to delineate and assess source water protection areas;
- To support the establishment and implementation of wellhead protection programs; and
- To provide funding to a Public Water System to implement technical and/or financial assistance under the capacity development strategy.

2% Technical Assistance to Small Systems

A state may use up to 2 percent of its allotment to provide technical assistance to public water systems serving 10,000 people or less. If the state does not use the entire 2 percent for these activities against a given allotment, it can bank the excess balance and use it for the same activities in later years. A state may use these funds to support a technical assistance team or to contract with outside organizations to provide technical assistance.

10% Public Water Supply System

A state may use up to 10 percent of its allotment to:

- Administer the State Public Water Supply System program;
- Administer or provide technical assistance through source water protection programs, which includes the Class V portion of the Underground Injection Control Program;
- Develop and implement a capacity development strategy; and
- Develop and implement an operator certification program.

30% Principal Forgiveness

The amount of expenses reported as Principal Forgiveness is the amount the State forgave principal payments on loans to communities meeting the definition "disadvantaged" or, which the State expects to become disadvantaged as a result of the project. The amount of these subsidies during a particular fiscal year's capitalization grant cannot exceed 30 percent of the amount of the capitalization grant for that year.

10. Operating Expenses (Concluded)

ARRA provided additional funding in the form of principal forgiveness; however, the grant had different forgiveness regulations than regular base Drinking Water loans. ARRA requires the State to use at least 50 percent of the funds provided by this grant to provide additional subsidization in the form of principal forgiveness.

Interest Expense-State Match Bonds

The amount is interest paid to bond holders at the time bond principal was retired during the fiscal year.

11. State Employees Retirement Plan (Plan)

The single-employer plan became effective by statute on January 1, 1964. The Plan consists of a defined contribution option and a cash balance benefit. 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 option or begin participation in the cash balance benefit. The defined contribution option 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 are required to begin participation in the retirement system upon employment. All permanent part-time employees, who have attained the age of twenty years, may exercise the option to begin participation in the retirement system.

Contribution. Per statute, each member contributes 4.8% of his or her monthly compensation. The Agency 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 fully vested after a total of three years of participation in the system, including credit for participation in another Nebraska governmental plan prior to actual contribution to the Plan.

Defined Contribution Option. 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.

11. State Employees Retirement Plan (Plan) (Concluded)

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.

For the fiscal year ended June 30, 2011, employees contributed $9,953 and the Agency contributed $15,527. A separate plan report is issued and can be obtained from the Nebraska Public Employees Retirement System. This report contains full pension-related disclosures.

The State of Nebraska CAFR also includes pension-related disclosures. The CAFR is available from the Nebraska Department of Administrative Services – Accounting Division or on the Nebraska Auditor of Public Accounts website at www.auditors.nebraska.gov.

12. Contingencies and Commitments

Risk Management. The Agency is exposed to various risks of loss related to torts, theft of, damage to, or destruction of assets, errors or omissions, injuries to employees, and natural disasters. The Agency, as part of the primary government for the State, participates in the State's risk management program. DAS is responsible for maintaining the insurance and self-insurance programs for the State. The State generally self-insures for general liability, employee health care, employee indemnification, and Workers' compensation. 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 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. Life insurance for eligible employees.

C. Crime coverage, with a limit of $31 million for each loss, and a $25,000 self-insured retention per incident subject to specific conditions, limits, and exclusions.

NOTES TO THE FINANCIAL STATEMENTS
(Continued)

12. Contingencies and Commitments (Concluded)

D. Real and personal property on a blanket basis for losses up to $250,000,000, with a self-insured retention of $200,000 per loss occurrence. Newly acquired properties are covered up to $5,000,000 for 120 days or until the value of the property is reported to the insurance company. The perils of flood, earthquake, and acts of terrorism have various coverage, sub-limits, and self insurance. State agencies have the option to purchase building contents and inland marine coverage.

Details of the various insurance coverages are available from DAS - Risk Management Division.

No settlements exceeded commercial insurance coverage in any of the past three fiscal years. Health care insurance is funded in the Insurance Trust Funds through a combination of employee and State contributions. Workers' compensation is 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, damage to, or destruction of assets, errors or 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 Program's financial statements.

Litigation. The potential amount of liability involved in litigation pending against the Agency, if any, could not be determined at this time. However, it is the Agency's opinion that final settlement of those matters should not have an adverse effect on the Agency's ability to administer current programs. Any judgment against the Agency would have to be processed through the State Claims Board and be approved by the Legislature.

13. Subsequent Event

Two significant items occurred after the fiscal year ended June 30, 2011.

On July 1, 2011, subsequent to June 30, 2011, the Agency redeemed series 2001A, 2002A, 2003A, 2005A, and 2006A bonds in the principal amount of $5,725,000 and accrued interest in the amount of $124,123.

Prior to the end of the fiscal year, the Agency was in discussions with the City of Lincoln to issue an unpledged loan to them for $15,000,000 out of the Drinking Water State Revolving Fund. The loan was not finalized until after the end of the fiscal year, as the agreement was dated July 26, 2011. As of the date of this report, payments have not yet

13. Subsequent Event (Concluded)

been made to the City of Lincoln for this agreement. However the Agency was aware of its potential impact on debt service and considered this impact prior to finalizing a loan. The Agency applied the situation and modeled the attestation report with a $15,000,000 unpledged City of Lincoln loan to observe its impact on debt service. The debt service ratio was not adversely affected; therefore, the Agency proceeded in finalizing a loan with the City of Lincoln.

14. Prior Period Adjustment

The Agency has restated its Net Assets at July 1, 2010, as a result of overstating revenues last year related to a Federal draw of $1,989,154 during fiscal year 2010 which was ultimately paid back to the Federal government during fiscal year 2011. The effect of this adjustment on beginning Net Assets on July 1, 2010, was a decrease of $1,989,154.

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NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
DRINKING 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 - Drinking Water State Revolving Fund Program as of and for the year ended June 30, 2011, and have issued our report thereon dated April 2, 2012. The report was modified to emphasize the financial statements present only the funds of the Nebraska Department of Environmental Quality - Drinking 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.

<u>Internal Control Over Financial Reporting</u>
Management of the Nebraska Department of Environmental Quality – Drinking Water State Revolving Fund Program is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Nebraska Department of Environmental Quality - Drinking 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 grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted additional items that we reported to management of the Nebraska Department of Environmental Quality – Drinking Water State Revolving Fund Program in the Comments Section of this report as Comment Number 1 (Cash Management), Comment Number 2 (Federal Reporting), and Comment Number 3 (Loan Testing).

The Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program's written response to the findings identified in our audit are described in the Comments Section of the report. We did not examine the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program's responses and accordingly, we express no opinion on them.

This report is intended solely for the information and use of management, others within the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program, and the appropriate Federal and regulatory agencies. However, this report is a matter of public record and its distribution is not limited.

Signed Original on File

April 2, 2012

Don Dunlap, CPA
Assistant Deputy Auditor

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NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY
DRINKING WATER STATE REVOLVING FUND PROGRAM

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

Nebraska Department of Environmental Quality
Lincoln, Nebraska

Compliance

We have audited the compliance of the Nebraska Department of Environmental Quality - Drinking 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, 2011. We audited the Nebraska Department of Environmental Quality - Drinking 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 - Drinking Water State Revolving Fund Program's management. Our responsibility is to express an opinion on the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program's compliance based on our audit.

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 - Drinking 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 - Drinking Water State Revolving Fund Program's compliance with those requirements.

In our opinion, except for the noncompliance described in the preceding paragraph, the Nebraska Department of Environmental Quality complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on the Program for the year ended June 30, 2011. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements which are required to be reported in accordance with the *U.S. Environmental Protection Agency Audit Guide for Clean Water and Drinking Water State Revolving Fund Programs* and which are described in the Comments Section of this report as Comment Number 1 (Cash Management), Comment 2 (Federal Reporting), and Comment Number 3 (Loan Testing).

<u>Internal Control Over Compliance</u>
The management of the Nebraska Department of Environmental Quality - Drinking 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 - Drinking Water State Revolving Fund Program's internal control over compliance with requirements that could have a direct and material effect on the Program in order to determine our auditing procedures for the purpose of expressing an opinion on compliance and to test and report on internal control over compliance with the *U.S. Environmental Protection Agency Audit Guide for Clean Water and Drinking Water State Revolving Fund Programs*, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Agency's internal control over compliance.

A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a Federal program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a Federal program will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above. However, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies as described in the Comments Section of this report as Comment Number 1 (Cash Management) and Comment Number 2 (Federal Reporting). A significant deficiency in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a Federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

The Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program's written response to the findings identified in our audit are described in the Comments Section of the report. We did not examine the Nebraska Department of Environmental Quality - Drinking Water State Revolving Fund Program's response and accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, others within the Nebraska Department of Environmental Quality, and the appropriate Federal and regulatory agencies. However, this report is a matter of public record and its distribution is not limited.

Signed Original on File

April 2, 2012

Don Dunlap CPA
Assistant Deputy Auditor