

FINANCIAL AUDIT
INCLUDING THE PROVISIONS OF THE SINGLE AUDIT ACT
OF THE
DEPARTMENT OF ENVIRONMENTAL QUALITY

October 1, 2001 through September 30, 2003

“...The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.”

– Article IV, Section 53 of the Michigan Constitution

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Michigan
Office of the Auditor General
REPORT SUMMARY

Financial Audit

*Including the Provisions of the Single Audit Act
October 1, 2001 through September 30, 2003*

Department of Environmental Quality

Report Number:
76-100-04

Released:
June 2004

A Single Audit is designed to meet the needs of all financial report users, including an entity's federal grantor agencies. The audit determines if the financial schedules and/or financial statements are fairly presented; considers internal control over financial reporting and internal control over federal program compliance; determines compliance with State compliance requirements material to the financial schedules and/or financial statements; and assesses compliance with direct and material requirements of the major federal programs.

Financial Statements and Financial Schedules:

Auditor's Reports Issued

We issued unqualified opinions on the Department of Environmental Quality's (DEQ's) financial statements and financial schedules.

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Internal Control Over Financial Reporting

We did not report any findings related to internal control over financial reporting.

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Noncompliance Material to the Financial Statements and Financial Schedules

We did not identify any instances of noncompliance applicable to the financial statements and financial schedules that are required to be reported under *Government Auditing Standards*.

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Federal Awards:

Auditor's Reports Issued on Compliance

We audited 4 programs as major programs and issued 4 unqualified opinions. The federal programs audited as major programs are identified on the back of this summary.

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Internal Control Over Major Programs

We did not identify any material weaknesses in internal control over major programs. However, we did identify a reportable condition (Finding 1).

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Required Reporting of Noncompliance

We identified an instance of noncompliance that is required to be reported in accordance with U.S. Office of Management and Budget (OMB) Circular A-133 (Finding 1).

~ ~ ~ ~ ~

Systems of Accounting and Internal Control:

We determined that DEQ was in substantial compliance with Sections 18.1483 - 18.1487 of the *Michigan Compiled Laws*.

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We audited the following programs as major programs:

<u>CFDA Number</u>	<u>Program Title</u>	<u>Compliance Opinion</u>
66.458	Capitalization Grants for Clean Water State Revolving Funds	Unqualified
66.468	Capitalization Grants for Drinking Water State Revolving Funds	Unqualified
66.606	Surveys, Studies, Investigations and Special Purpose Grants	Unqualified
66.805	Leaking Underground Storage Tank Trust Fund Program	Unqualified

A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: <http://audgen.michigan.gov>



Michigan Office of the Auditor General
201 N. Washington Square
Lansing, Michigan 48913

Thomas H. McTavish, C.P.A.
Auditor General

Scott M. Strong, C.P.A., C.I.A.
Deputy Auditor General



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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

June 30, 2004

Mr. Steven E. Chester, Director
Department of Environmental Quality
Constitution Hall
Lansing, Michigan

Dear Mr. Chester:

This is our report on the financial audit, including the provisions of the Single Audit Act, of the Department of Environmental Quality (DEQ) for the period October 1, 2001 through September 30, 2003.

This report contains our report summary; our independent auditor's reports on the financial statements and on the financial schedules; and the DEQ financial statements and financial schedules, notes to the financial statements and financial schedules, and supplemental financial statements and financial schedules. This report also contains our independent auditor's reports on compliance and on internal control over financial reporting and on compliance with requirements applicable to each major program and on internal control over compliance in accordance with U.S. Office of Management and Budget Circular A-133 and our schedule of findings and questioned costs. In addition, this report contains DEQ's summary schedule of prior audit findings, its corrective action plan, and a glossary of acronyms and terms.

Our finding and recommendation are contained in Section III of the schedule of findings and questioned costs. The agency preliminary response is contained in the corrective action plan. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

AUDITOR GENERAL

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TABLE OF CONTENTS

DEPARTMENT OF ENVIRONMENTAL QUALITY

	<u>Page</u>
INTRODUCTION	
Report Summary	1
Report Letter	3

INDEPENDENT AUDITOR'S REPORTS, FINANCIAL STATEMENTS, AND FINANCIAL SCHEDULES

Independent Auditor's Report on the Financial Statements	10
Independent Auditor's Report on the Financial Schedules	12
Department of Environmental Quality Financial Statements and Financial Schedules	
Combined Balance Sheet	14
Combined Statement of Revenues, Expenditures, and Changes in Fund Balances	15
Schedule of General Fund Revenues and Transfers	16
Schedule of Sources and Disposition of General Fund Authorizations	17
Notes to the Financial Statements and Financial Schedules	18

SUPPLEMENTAL FINANCIAL STATEMENTS AND FINANCIAL SCHEDULES

Special Revenue Funds	
Description of Special Revenue Funds	26
Combining Balance Sheet	28
Combining Statement of Revenues, Expenditures, and Changes in Fund Balances	29

Balance Sheet - Combined Environmental Protection Bond Fund	30
Statement of Revenues, Expenditures, and Changes in Fund Balances - Combined Environmental Protection Bond Fund	31
Agency Fund	
Description of Agency Fund	33
Statement of Changes in Assets and Liabilities - Environmental Quality Deposits Fund, Fiscal Year Ended September 30, 2003	34
Statement of Changes in Assets and Liabilities - Environmental Quality Deposits Fund, Fiscal Year Ended September 30, 2002	35
Schedule of Expenditures of Federal Awards	36

INDEPENDENT AUDITOR'S REPORTS ON
COMPLIANCE AND INTERNAL CONTROL

Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting	44
Independent Auditor's Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133	46

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Section I: Summary of Auditor's Results	50
Section II: Findings Related to the Financial Statements and Financial Schedules	51
Section III: Findings and Questioned Costs Related to Federal Awards	52
1. State Revolving Fund (SRF) Program Administrative Expenditures	52

OTHER SCHEDULES

Summary Schedule of Prior Audit Findings	55
Corrective Action Plan	57

GLOSSARY

Glossary of Acronyms and Terms

59

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INDEPENDENT AUDITOR'S REPORTS,
FINANCIAL STATEMENTS, AND
FINANCIAL SCHEDULES



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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on the Financial Statements

March 26, 2004

Mr. Steven E. Chester, Director
Department of Environmental Quality
Constitution Hall
Lansing, Michigan

Dear Mr. Chester:

We have audited the financial statements of the Department of Environmental Quality as of and for the fiscal years ended September 30, 2003 and September 30, 2002, as identified in the table of contents. These financial statements are the responsibility of the Department'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 the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1d, these financial statements present only the special revenue and agency funds of the Department of Environmental Quality and do not purport to, and do not, present fairly the financial position of the State of Michigan or its special revenue and agency funds as of September 30, 2003 and September 30, 2002 and the changes in financial position thereof for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the special revenue and agency funds of the Department of Environmental Quality as of September 30, 2003 and September 30, 2002 and the changes in financial position for the fiscal years 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 a report dated March 26, 2004 on our tests of the Department's compliance with certain provisions of laws, regulations, contracts, and grants and on our consideration of its internal control over financial reporting. 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.

The accompanying supplemental financial statements, as identified in the table of contents, are presented for purposes of additional analysis and are not a required part of the Department's financial statements referred to in the first paragraph. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

AUDITOR GENERAL



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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on the Financial Schedules

March 26, 2004

Mr. Steven E. Chester, Director
Department of Environmental Quality
Constitution Hall
Lansing, Michigan

Dear Mr. Chester:

We have audited the financial schedules of the Department of Environmental Quality for the fiscal years ended September 30, 2003 and September 30, 2002, as identified in the table of contents. These financial schedules are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial schedules 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 schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial schedules. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Notes 1c and 1d, the financial schedules include only the revenues and transfers and the sources and disposition of authorizations for the Department of Environmental Quality's General Fund accounts, presented using the current financial resources measurement focus and the modified accrual basis of accounting. Accordingly, these financial schedules do not purport to, and do not, constitute a complete financial presentation of either the Department or the State's General Fund in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial schedules referred to in the first paragraph present fairly, in all material respects, the revenues and transfers and the sources and disposition of authorizations of the Department of Environmental Quality for the fiscal years ended September 30, 2003 and September 30, 2002, on the basis of accounting described in Note 1c.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 26, 2004 on our tests of the Department's compliance with certain provisions of laws, regulations, contracts, and grants and on our consideration of its internal control over financial reporting. 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.

The schedule of expenditures of federal awards, required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and other supplemental financial schedules, as identified in the table of contents, are presented for purposes of additional analysis and are not a required part of the Department's financial schedules referred to in the first paragraph. Such information has been subjected to the auditing procedures applied in the audit of the financial schedules and, in our opinion, is fairly stated, in all material respects, in relation to the financial schedules taken as a whole.

AUDITOR GENERAL

DEPARTMENT OF ENVIRONMENTAL QUALITY
 Combined Balance Sheet
As of September 30
 (in thousands)

	<u>Governmental Fund Types</u>		<u>Fiduciary Fund Types</u>	
	<u>Special Revenue</u>		<u>Agency</u>	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
ASSETS				
Current Assets:				
Cash	\$	\$ 45	\$	\$
Equity in common cash	196,378	120,510	3,931	4,233
Taxes, interest, and penalties receivable	5,539	6,377		
Amounts due from local units	1,563	380		
Amounts due from other funds	1,500	35,020		
Other current assets	3,932	4,449		
Total Current Assets	<u>\$ 208,913</u>	<u>\$ 166,781</u>	<u>\$ 3,931</u>	<u>\$ 4,233</u>
Amounts due from local units	4,057	4,642		
Other noncurrent assets	571	561		
Total Assets	<u><u>\$ 213,541</u></u>	<u><u>\$ 171,984</u></u>	<u><u>\$ 3,931</u></u>	<u><u>\$ 4,233</u></u>
LIABILITIES AND FUND BALANCES				
Current Liabilities:				
Warrants outstanding	\$ 590	\$ 2,027	\$	\$
Accounts payable and other liabilities	34,910	40,425	3,931	4,233
Amounts due to other funds	4,623	39,317		
Deferred revenue	1,133	1,473		
Total Current Liabilities	<u>\$ 41,256</u>	<u>\$ 83,243</u>	<u>\$ 3,931</u>	<u>\$ 4,233</u>
Deferred revenue	571	561		
Total Liabilities	<u>\$ 41,827</u>	<u>\$ 83,804</u>	<u>\$ 3,931</u>	<u>\$ 4,233</u>
Fund Balances:				
Reserves for:				
Budgetary carry-forwards:				
Encumbrances	\$ 3,440	\$ 2,978	\$	\$
Restricted revenues	87,086	120,537		
Multi-year projects	7,418	15,669		
Revolving loan programs	5,484	5,473		
Funds held as permanent investments (Note 7)	19,481	16,052		
Total Reserved	<u>\$ 122,909</u>	<u>\$ 160,709</u>	<u>\$ -</u>	<u>\$ -</u>
Unreserved (Note 6)	48,804	(72,530)		
Total Fund Balances	<u>\$ 171,713</u>	<u>\$ 88,180</u>	<u>\$ -</u>	<u>\$ -</u>
Total Liabilities and Fund Balances	<u><u>\$ 213,541</u></u>	<u><u>\$ 171,984</u></u>	<u><u>\$ 3,931</u></u>	<u><u>\$ 4,233</u></u>

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

DEPARTMENT OF ENVIRONMENTAL QUALITY
 Combined Statement of Revenues, Expenditures, and Changes in Fund Balances
Fiscal Years Ended September 30
 (in thousands)

	<u>Governmental Fund Types</u>	
	<u>Special Revenue</u>	
	<u>2003</u>	<u>2002</u>
REVENUES		
Taxes	\$ 57,720	\$ 60,514
Interest and other miscellaneous	30,058	34,720
Total Revenues	<u>\$ 87,778</u>	<u>\$ 95,234</u>
EXPENDITURES		
Current:		
General government	\$ 1,231	\$ 326
Health services	1,318	1,435
Environmental	99,818	114,564
Total Expenditures	<u>\$ 102,367</u>	<u>\$ 116,325</u>
Excess of Revenues Over (Under) Expenditures	<u>\$ (14,588)</u>	<u>\$ (21,091)</u>
OTHER FINANCING SOURCES (USES)		
Proceeds from bond issues	\$ 172,390	\$ 5,000
Premium on bond issuance	9,413	
Transfers from other funds	3,500	4,000
Transfers to other funds	(87,181)	(66,622)
Total Other Financing Sources (Uses)	<u>\$ 98,122</u>	<u>\$ (57,622)</u>
Excess of Revenues and Other Sources Over (Under) Expenditures and Other Uses	<u>\$ 83,534</u>	<u>\$ (78,713)</u>
Fund Balances - Beginning of fiscal year	<u>88,180</u>	<u>166,893</u>
Fund Balances - End of fiscal year	<u><u>\$ 171,713</u></u>	<u><u>\$ 88,180</u></u>

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

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of General Fund Revenues and Transfers
Fiscal Years Ended September 30
(in thousands)

	2003	2002
REVENUES		
Taxes	\$ 1,095	\$ 1,005
Federal (Note 5)	47,199	43,360
Licensing and permits	24,369	21,199
Miscellaneous:		
Section 29	2,436	6,717
Gas and oil privilege fees	5,962	4,494
Environmental pollution judgments/settlements	3,973	5,021
Other	16,396	12,260
Total Revenues	\$ 101,430	\$ 94,056
 TRANSFERS		
From Michigan Transportation Fund	\$ 754	\$ 824
Total Transfers	\$ 754	\$ 824
 Total Revenues and Transfers	 \$ 102,184	 \$ 94,879

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

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of Sources and Disposition of General Fund Authorizations
Fiscal Years Ended September 30
(in thousands)

	<u>2003</u>	<u>2002</u>
SOURCES OF AUTHORIZATIONS (Note 2)		
General purpose appropriations	\$ 66,653	\$ 77,982
Balances carried forward	115,103	135,852
Restricted financing sources	107,922	102,986
Less: Intrafund expenditure reimbursements	<u>(10,800)</u>	<u>(14,307)</u>
 Total	 <u><u>\$ 278,878</u></u>	 <u><u>\$ 302,513</u></u>
 DISPOSITION OF AUTHORIZATIONS (Note 2)		
Gross expenditures and transfers out	\$ 180,272	\$ 199,482
Less: Intrafund expenditure reimbursements	<u>(10,800)</u>	<u>(14,307)</u>
Net expenditures and transfers out	<u>\$ 169,472</u>	<u>\$ 185,175</u>
Balances carried forward:		
Encumbrances	\$ 10,077	\$ 19,772
Restricted revenues - not authorized/used	92,154	90,331
Revolving loan programs	5,000	5,000
Total balances carried forward	<u>\$ 107,231</u>	<u>\$ 115,103</u>
Balances lapsed	<u>\$ 2,175</u>	<u>\$ 2,235</u>
 Total	 <u><u>\$ 278,878</u></u>	 <u><u>\$ 302,513</u></u>

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

Notes to the Financial Statements and Financial Schedules

Note 1 Significant Accounting Policies

a. Reporting Entity - Financial Statements

The accompanying financial statements report the financial position and results of operations of the following funds administered by the Department of Environmental Quality (DEQ) as of and for the fiscal years ended September 30, 2003 and September 30, 2002:

Special Revenue Funds

Combined Environmental Protection Bond Fund (includes the Environmental Protection Bond Fund and the Clean Michigan Initiative Bond Fund)

Michigan Underground Storage Tank Financial Assurance Fund

Bottle Deposits Fund

Agency Fund

Environmental Quality Deposits Fund

These funds are a part of the State of Michigan reporting entity and are reported on in the *State of Michigan Comprehensive Annual Financial Report (SOMCAFR)*.

b. Reporting Entity - Financial Schedules

The accompanying financial schedules report the results of the governmental operations of DEQ for the fiscal years ended September 30, 2003 and September 30, 2002. The governmental operations of DEQ are accounted for principally in the State's General Fund and are reported on in the *SOMCAFR*. Other DEQ activities related to environmental cleanup are reported in various special revenue funds.

c. Measurement Focus and Basis of Accounting

The governmental fund financial statements and financial schedules contained in this report are presented using the current financial resources measurement focus and the modified accrual basis of accounting, as provided by generally accepted accounting principles applicable to

governments. Under the modified accrual basis of accounting, revenues are recognized as they become susceptible to accrual, generally when they are both measurable and available. Revenues are considered to be available when they are collected within the current period or soon enough thereafter to pay liabilities of the current period. Expenditures generally are recorded when a liability is incurred; however, certain expenditures related to long-term obligations are recorded only when payment is due and payable. The fiduciary fund financial statement contained in this report is presented using the economic resources measurement focus and the accrual basis of accounting, as provided by generally accepted accounting principles applicable to governments.

d. Basis of Presentation

The accompanying financial statements present only the funds listed in Note 1a. The accompanying financial schedules present only the revenues and transfers and the sources and disposition of authorizations for DEQ's General Fund accounts. The *SOMCAFR* provides more extensive general disclosures regarding the State's Summary of Significant Accounting Policies; Budgeting, Budgetary Control and Legal Compliance; Treasurer's Common Cash; Pension Benefits and Other Postemployment Benefits; and Interfund Receivables and Payables.

Accordingly, these financial statements and financial schedules do not purport to, and do not, present fairly the financial position and changes in financial position or constitute a complete financial presentation of DEQ, the State of Michigan, the State's General Fund, or the State's special revenue and agency funds in conformity with generally accepted accounting principles.

The financial transactions of DEQ are recorded in the General Fund and individual funds in the State's central accounting system. The various

environmental quality funds are combined in the *SOMCAFR* into fund types described as follows:

Governmental Fund Types

Special Revenue Funds: This fund group includes operating fund activities financed by specific revenue sources that are legally restricted for specified purposes.

Fiduciary Fund Types

Agency Funds: This group includes assets held by DEQ on behalf of outside parties. DEQ's responsibility is custodial in nature, and the asset and liability balances, but not operating results, are included within these statements.

Note 2 Schedule of Sources and Disposition of General Fund Authorizations

The various elements of the schedule of sources and disposition of General Fund authorizations are defined as follows:

- a. General purpose appropriations: Original appropriations and any supplemental appropriations that are financed by General Fund/general purpose revenues.
- b. Balances carried forward: Authorizations for multi-year projects, encumbrances, restricted revenues - authorized, and restricted revenues - not authorized/used that were not spent as of the end of the prior fiscal year. These authorizations are available for expenditure in the current fiscal year for the purpose of the carry-forward without additional legislative authorization, except for the restricted revenues - not authorized/used.
- c. Restricted financing sources: Collections of restricted revenues, restricted transfers, and restricted intrafund expenditure reimbursements to finance programs as detailed in the appropriations act. These financing sources are authorized for expenditure up to the amount appropriated. Depending upon program statute, any amounts received in excess of the appropriation are, at year-end, either converted to general purpose

financing sources and made available for general appropriation in the next fiscal year or carried forward to the next fiscal year as either restricted revenues - authorized or restricted revenues - not authorized/used.

- d. Intrafund expenditure reimbursements: Funding from other General Fund departments to finance a program or a portion of a program that is the responsibility of the receiving department.
- e. Encumbrances: Authorizations carried forward to finance payments for goods or services ordered in the old fiscal year but not received by fiscal year-end. These authorizations are generally limited to obligations funded by general purpose appropriations.
- f. Restricted revenues - not authorized/used: Revenues that, by statute, are restricted for use to a particular program or activity. Generally, the expenditure of the restricted revenues is subject to annual legislative appropriation. However, the restricted revenues may also be used in subsequent years to finance expenditures for multi-year appropriations (\$22,204,621 and \$11,777,784 in fiscal years 2002-03 and 2001-02, respectively) and encumbrances carried forward (\$4,155,750 and \$1,996,960 in fiscal years 2002-03 and 2001-02, respectively).
- g. Balances lapsed: Authorizations that were unexpended and unobligated at the end of the fiscal year. These amounts are available for legislative appropriation in the subsequent fiscal year.

Note 3 Joint Venture

The State, represented by DEQ, is a participant in a joint venture known as the Great Lakes Protection Fund. The joint venture is not reflected within this report because it did not meet generally accepted accounting principles' criteria for inclusion. A description of the joint venture follows. Complete financial statements may be obtained directly by contacting the Financial Reporting Section, Office of Financial Management, Department of Management and Budget, at (517) 373-3029.

The Great Lakes Protection Fund is a not-for-profit corporation located in Evanston, Illinois. Its purpose is to finance and support research with respect to water quality of the Great Lakes. The eight states bordering on the Great

Lakes are eligible to become members if they make a required contribution to the endowment of the Fund. Contribution requirements were established based upon water consumption and usage. Michigan is the largest contributor to the Fund, having made a contribution of \$25 million, constituting approximately 31% of the total. Michigan made its required contribution in fiscal year 1989-90 by issuing the Fund a general obligation bond authorized as part of the State's environmental protection bond program. No additional contributions from Michigan will be required.

Each of the participating seven member states is represented by two members on the Fund's Board of Directors. The Board members are selected by the states' respective governors. The Fund's financing and budgeting operations are controlled by the directors within requirements established by the Articles of Incorporation. Net earnings after operating expenses are divided into parts. One-third of the net earnings on total contributions is granted to the respective states in proportion to their contributions to the Fund, to be used for the purposes of the Fund. Two-thirds of the net earnings are available to the Fund to make other grants. The State's equity interest in the Great Lakes Protection Fund of \$25 million is reflected in the *SOMCAFR* in the government-wide statement of net assets.

Note 4 MUSTFA Obligations

The special revenue fund named the Michigan Underground Storage Tank Financial Assurance (MUSTFA) Fund that is included in this report is not a full presentation of all activities related to the MUSTFA Program. The MUSTFA Finance Authority was established to provide financing, including short- and long-term debt instruments, for the MUSTFA Fund. The Finance Authority's activities are recorded in this special revenue fund and a debt service fund both named Michigan Underground Storage Tank Financial Assurance Finance Authority. Other MUSTFA Program obligations are recorded as long-term obligations on the government-wide statement of net assets. These additional funds and statements are a part of the State of Michigan reporting entity and are reported on in the *SOMCAFR*.

Other MUSTFA Program financial activities are reported elsewhere as follows (in millions):

	Fiscal Year	
	2002-03	2001-02
Obligations:		
Government-wide statement of net assets:		
Bonds outstanding	\$ 121.6	\$ 137.5
Claims outstanding	.2	.2
Debt service fund:		
MUSTFA Finance Authority fund balance	(164.1)	(132.1)
Net Obligations	<u>\$ (42.3)</u>	<u>\$ 5.6</u>

Also see Note 8.

Note 5 Federal Revenues and Expenditures

Federal revenues in the schedule of General Fund revenues and transfers vary from the expenditures reported in the schedule of expenditures of federal awards. The schedule of expenditures of federal awards includes payments made by the Michigan Municipal Bond Authority to subrecipients* in the State Revolving Fund and the Drinking Water State Revolving Fund*. These expenditures and related federal revenues are not recorded in DEQ's accounting records.

Note 6 Fund Balance Deficits

The Combined Environmental Protection Bond Fund, which was one of three special revenue funds reported in the total combined special revenue fund balance, had a fund balance deficit of \$68.4 million at September 30, 2002. The deficit was caused by expenditures for projects for which bonds have not been issued.

Note 7 Funds Held as Permanent Investments

Funds held as permanent investments represent amounts that have been legally restricted for the purpose of providing a long-term source of investment

* See glossary at end of report for definition.

income. These investments can include either specific investments held for the fund or portions of the fund's share of the common cash pool.

Note 8 Contingencies and Litigation

MUSTFA

The MUSTFA Fund, a special revenue fund, receives revenue dedicated to reimbursing owners/operators of underground storage tanks for costs incurred related to conducting corrective actions at sites where a release has occurred from an underground storage tank. The MUSTFA Fund was declared insolvent and received no additional claims after June 29, 1995. The revenue is still collected to pay off two main obligations of the MUSTFA Fund: the long-term liability for incurred claims recorded in the government-wide statement of net assets and the debt and the debt service charges associated with the financial borrowing mechanisms utilized to expedite reimbursement to eligible owners/operators.

K & K Construction, Inc.

K & K Construction, Inc., filed suit against DEQ in a land use/takings issue under the Wetlands Management Act. A liability has not been recorded in DEQ's financial statements because the case has not been settled. The original court decision was against DEQ for \$3.7 million plus interest. However, the Michigan Supreme Court vacated the judgment and remanded for redetermination of whether a taking occurred. DEQ believes that it will prevail at the appellate level.

SUPPLEMENTAL
FINANCIAL STATEMENTS AND
FINANCIAL SCHEDULES

Description of Special Revenue Funds

COMBINED ENVIRONMENTAL PROTECTION BOND FUND

This Fund, which is administered by the Department of Environmental Quality (DEQ), was established by Act 328, P.A. 1988, to account for the proceeds of \$660 million of Environmental Protection general obligation bonds approved by Michigan voters in November 1988. The Act specifies that the proceeds of these bonds be available to clean up sites of toxic and other environmental contamination; for solid waste projects; to capitalize the State Water Pollution Control Loan Fund; and to fund Michigan's participation in a regional Great Lakes Protection Fund. Act 380, P.A. 1996, provides that interest earnings and unappropriated or lapsed solid waste project allocations be transferred to the Cleanup and Redevelopment Subfund (CRF).

Act 284, P.A. 1998, as amended, expanded this Fund to account for the proceeds of \$570 million of Clean Michigan Initiative general obligation bonds approved by Michigan voters in November 1998. The Act directs that bond proceeds be used for: environmental response activities at facilities; waterfront improvements; remediation of contaminated lake and river sediments; nonpoint source pollution prevention and control projects or wellhead protection projects; water quality monitoring and water resources protection and pollution control activities; and pollution prevention programs.

MICHIGAN UNDERGROUND STORAGE TANK FINANCIAL ASSURANCE (MUSTFA) FUND

The MUSTFA Fund was established by Act 518, P.A. 1988, to assist certain owners and operators of underground storage tank systems in meeting their financial responsibility requirements provided for in the Solid Waste Disposal Act. It is administered by DEQ and an 11-member advisory board.

The primary source of revenues is an environmental protection regulatory fee of 7/8 of a cent per gallon imposed on all refined petroleum products sold for resale. Expenditures are primarily amounts spent to assist in environmental cleanup. Acts 252 and 269, P.A. 1995, limit the MUSTFA Fund's liability for claims to those billings received by June 29, 1995. The State's liability for environmental cleanup claims is further limited by law to the amount of available resources. Liabilities, in excess of available funds, for unpaid work performed on eligible environmental cleanup claims will be paid from future years' revenues and are recorded as a liability in the State of Michigan's government-wide financial statements.

BOTTLE DEPOSITS FUND

This Fund was created by Act 384, P.A. 1996, to provide for the disposition of unredeemed bottle deposits. The Fund is jointly administered by the Department of Treasury and DEQ. The law mandates that an annual distribution of funds be made as follows: 25% returned to the dealers and 75% to fund several subfunds.

The 75% is initially deposited into the Cleanup and Redevelopment Trust Subfund (CRTF) and, if not further distributed, remains there until the principal amount reaches \$200 million. Additionally, of funds received annually by CRTF, 80% is allocated to the Cleanup and Redevelopment Subfund (CRF) and 10% to the Community Pollution Prevention Subfund.

Act 380, P.A. 1996, moved the former Environmental Response Fund (ERF) to a subfund of CRF. The law mandates that proceeds of all cost recovery actions taken and settlements entered into pursuant to ERF (excluding natural resource damages) by DEQ or the Attorney General, or both, shall be credited to ERF.

DEPARTMENT OF ENVIRONMENTAL QUALITY
Combining Balance Sheet
Special Revenue Funds
As of September 30
(in thousands)

	Combined Environmental Protection Bond Fund		Michigan Underground Storage Tank Financial Assurance Fund		Bottle Deposits Fund		Totals	
	2003	2002	2003	2002	2003	2002	2003	2002
ASSETS								
Current Assets:								
Cash	\$		\$		\$	45	\$	45
Equity in common cash	75,516		582	1,976	120,281	118,534	196,378	120,510
Taxes, interest, and penalties receivable			5,539	6,377			5,539	6,377
Amounts due from local units	1,389	380			174		1,563	380
Amounts due from other funds			1,500	1,000		34,020	1,500	35,020
Other current assets	6	2	1	8	3,925	4,438	3,932	4,449
Total Current Assets	\$ 76,911	\$ 382	\$ 7,622	\$ 9,361	\$ 124,380	\$ 157,037	\$ 208,913	\$ 166,781
Taxes, interest, and penalties receivable			113	124				
Amounts due from local units					4,057	4,642	4,057	4,642
Other noncurrent assets					459	437	571	561
Total Assets	\$ 76,911	\$ 382	\$ 7,735	\$ 9,485	\$ 128,895	\$ 162,117	\$ 213,541	\$ 171,984
LIABILITIES AND FUND BALANCES								
Current Liabilities:								
Warrants outstanding	\$ 473	\$ 656	\$ 7	\$ 53	\$ 111	\$ 1,317	\$ 590	\$ 2,027
Accounts payable and other liabilities	27,935	34,060	138	224	6,837	6,142	34,910	40,425
Amounts due to other funds	13	34,023	4,552	5,290	58	4	4,623	39,317
Deferred revenue			1,002	1,100	131	373	1,133	1,473
Total Current Liabilities	\$ 28,420	\$ 68,739	\$ 5,698	\$ 6,667	\$ 7,137	\$ 7,836	\$ 41,256	\$ 83,243
Deferred revenue			113	124	459	437	571	561
Total Liabilities	\$ 28,420	\$ 68,739	\$ 5,811	\$ 6,791	\$ 7,596	\$ 8,273	\$ 41,827	\$ 83,804
Fund Balances:								
Reserves for:								
Budgetary carry-forwards:								
Encumbrances	\$	\$	\$ 1	\$ 239	\$ 3,440	\$ 2,739	\$ 3,440	\$ 2,978
Restricted revenues			1,409	1,627	85,676	118,910	87,086	120,537
Multi-year projects			200	5,000	7,218	10,669	7,418	15,669
Revolving loan programs					5,484	5,473	5,484	5,473
Funds held as permanent investments					19,481	16,052	19,481	16,052
Total Reserved	\$ 0	\$ 0	\$ 1,610	\$ 6,866	\$ 121,300	\$ 153,843	\$ 122,909	\$ 160,709
Unreserved	48,490	(68,357)	314	(4,172)			48,804	(72,530)
Total Fund Balances	\$ 48,490	\$ (68,357)	\$ 1,923	\$ 2,694	\$ 121,300	\$ 153,843	\$ 171,713	\$ 88,180
Total Liabilities and Fund Balances	\$ 76,911	\$ 382	\$ 7,735	\$ 9,485	\$ 128,895	\$ 162,117	\$ 213,541	\$ 171,984

DEPARTMENT OF ENVIRONMENTAL QUALITY
Combining Statement of Revenues, Expenditures, and Changes in Fund Balances
Special Revenue Funds
Fiscal Years Ended September 30
(in thousands)

	Combined Environmental Protection Bond Fund		Michigan Underground Storage Tank Financial Assurance Fund		Bottle Deposits Fund		Totals	
	2003	2002	2003	2002	2003	2002	2003	2002
	REVENUES							
Taxes	\$	\$	\$ 57,720	\$ 60,514	\$	\$	\$ 57,720	\$ 60,514
Interest and other miscellaneous	2,421	2,600	12	37	27,626	32,083	30,058	34,720
Total Revenues	<u>\$ 2,421</u>	<u>\$ 2,600</u>	<u>\$ 57,732</u>	<u>\$ 60,551</u>	<u>\$ 27,626</u>	<u>\$ 32,083</u>	<u>\$ 87,778</u>	<u>\$ 95,234</u>
EXPENDITURES								
Current:								
General government	\$ 1,008	\$	\$ 223	\$ 326	\$	\$	\$ 1,231	\$ 326
Health services	1,318	1,435					1,318	1,435
Environmental	65,031	85,761	3,837	3,443	30,951	25,359	99,818	114,564
Total Expenditures	<u>\$ 67,357</u>	<u>\$ 87,197</u>	<u>\$ 4,059</u>	<u>\$ 3,769</u>	<u>\$ 30,951</u>	<u>\$ 25,359</u>	<u>\$ 102,367</u>	<u>\$ 116,325</u>
Excess of Revenues Over (Under) Expenditures	<u>\$ (64,936)</u>	<u>\$ (84,597)</u>	<u>\$ 53,673</u>	<u>\$ 56,782</u>	<u>\$ (3,325)</u>	<u>\$ 6,724</u>	<u>\$ (14,588)</u>	<u>\$ (21,091)</u>
OTHER FINANCING SOURCES (USES)								
Proceeds from bond issues	\$ 172,390	\$ 5,000	\$	\$	\$	\$	\$ 172,390	\$ 5,000
Premium on bond issuance	9,413						9,413	
Transfers from other funds			3,500	4,000			3,500	4,000
Transfers to other funds	(19)	(21)	(57,943)	(66,451)	(29,219)	(151)	(87,181)	(66,622)
Total Other Financing Sources (Uses)	<u>\$ 181,784</u>	<u>\$ 4,979</u>	<u>\$ (54,443)</u>	<u>\$ (62,451)</u>	<u>\$ (29,219)</u>	<u>\$ (151)</u>	<u>\$ 98,122</u>	<u>\$ (57,622)</u>
Excess of Revenues and Other Sources Over (Under) Expenditures and Other Uses	<u>\$ 116,848</u>	<u>\$ (79,618)</u>	<u>\$ (770)</u>	<u>\$ (5,669)</u>	<u>\$ (32,544)</u>	<u>\$ 6,573</u>	<u>\$ 83,534</u>	<u>\$ (78,713)</u>
Fund Balances - Beginning of fiscal year	<u>(68,357)</u>	<u>11,261</u>	<u>2,694</u>	<u>8,363</u>	<u>153,843</u>	<u>147,270</u>	<u>88,180</u>	<u>166,893</u>
Fund Balances - End of fiscal year	<u>\$ 48,490</u>	<u>\$ (68,357)</u>	<u>\$ 1,923</u>	<u>\$ 2,694</u>	<u>\$ 121,300</u>	<u>\$ 153,843</u>	<u>\$ 171,713</u>	<u>\$ 88,180</u>

DEPARTMENT OF ENVIRONMENTAL QUALITY
 Balance Sheet
 Combined Environmental Protection Bond Fund
Fiscal Years Ended September 30
 (in thousands)

	<u>Environmental Protection</u> <u>Bond Fund</u>		<u>Clean Michigan Initiative</u> <u>Bond Fund</u>		<u>Totals</u>	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
ASSETS						
Current Assets:						
Equity in common cash	\$ 12,074	\$	\$ 63,441	\$	\$ 75,516	\$ 0
Amounts due from local units	109	300	1,280	80	1,389	380
Other current assets			6	2	6	2
Total Current Assets	<u>\$ 12,183</u>	<u>\$ 300</u>	<u>\$ 64,727</u>	<u>\$ 82</u>	<u>\$ 76,911</u>	<u>\$ 382</u>
 Total Assets	 <u>\$ 12,183</u>	 <u>\$ 300</u>	 <u>\$ 64,727</u>	 <u>\$ 82</u>	 <u>\$ 76,911</u>	 <u>\$ 382</u>
LIABILITIES AND FUND BALANCES						
Current Liabilities:						
Warrants outstanding	\$ 144	\$ 111	\$ 329	\$ 546	\$ 473	\$ 656
Accounts payable and other liabilities	10,726	6,496	17,209	27,563	27,935	34,060
Amounts due to other funds		11,326	13	22,697	13	34,023
Total Current Liabilities	<u>\$ 10,870</u>	<u>\$ 17,933</u>	<u>\$ 17,551</u>	<u>\$ 50,806</u>	<u>\$ 28,420</u>	<u>\$ 68,739</u>
Total Liabilities	<u>\$ 10,870</u>	<u>\$ 17,933</u>	<u>\$ 17,551</u>	<u>\$ 50,806</u>	<u>\$ 28,420</u>	<u>\$ 68,739</u>
 Fund Balances:						
Total Unreserved Fund Balances	<u>1,314</u>	<u>(17,633)</u>	<u>47,176</u>	<u>(50,724)</u>	<u>48,490</u>	<u>(68,357)</u>
 Total Liabilities and Fund Balances	 <u>\$ 12,183</u>	 <u>\$ 300</u>	 <u>\$ 64,727</u>	 <u>\$ 82</u>	 <u>\$ 76,911</u>	 <u>\$ 382</u>

DEPARTMENT OF ENVIRONMENTAL QUALITY
Statement of Revenues, Expenditures, and Changes in Fund Balances
Combined Environmental Protection Bond Fund
Fiscal Years Ended September 30
(in thousands)

	<u>Environmental Protection Bond Fund</u>		<u>Clean Michigan Initiative Bond Fund</u>		<u>Totals</u>	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
REVENUES						
Interest and other miscellaneous	\$ 373	\$ 1,346	\$ 2,048	\$ 1,255	\$ 2,421	\$ 2,600
Total Revenues	<u>\$ 373</u>	<u>\$ 1,346</u>	<u>\$ 2,048</u>	<u>\$ 1,255</u>	<u>\$ 2,421</u>	<u>\$ 2,600</u>
EXPENDITURES						
Current:						
General government	\$ 1,008	\$	\$	\$	\$ 1,008	\$ 0
Health services			1,318	1,435	1,318	1,435
Environmental	20,518	21,584	44,514	64,177	65,031	85,761
Total Expenditures	<u>\$ 21,526</u>	<u>\$ 21,584</u>	<u>\$ 45,831</u>	<u>\$ 65,613</u>	<u>\$ 67,357</u>	<u>\$ 87,197</u>
Excess of Revenues Over (Under) Expenditures	<u>\$ (21,153)</u>	<u>\$ (20,238)</u>	<u>\$ (43,783)</u>	<u>\$ (64,358)</u>	<u>\$ (64,936)</u>	<u>\$ (84,597)</u>
OTHER FINANCING SOURCES (USES)						
Proceeds from bond issues	\$ 38,024	\$	\$ 134,367	\$ 5,000	\$ 172,390	\$ 5,000
Premium on bond issuance	2,076		7,336		9,413	0
Transfers to other funds			(19)	(21)	(19)	(21)
Total Other Financing Sources (Uses)	<u>\$ 40,100</u>	<u>\$ 0</u>	<u>\$ 141,684</u>	<u>\$ 4,979</u>	<u>\$ 181,784</u>	<u>\$ 4,979</u>
Excess of Revenues and Other Sources Over (Under) Expenditures and Other Uses	\$ 18,947	\$ (20,238)	\$ 97,901	\$ (59,380)	\$ 116,848	\$ (79,618)
Fund Balances - Beginning of fiscal year	<u>(17,633)</u>	<u>2,605</u>	<u>(50,724)</u>	<u>8,655</u>	<u>(68,357)</u>	<u>11,261</u>
Fund Balances - End of fiscal year	<u>\$ 1,314</u>	<u>\$ (17,633)</u>	<u>\$ 47,176</u>	<u>\$ (50,724)</u>	<u>\$ 48,490</u>	<u>\$ (68,357)</u>

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Description of Agency Fund

ENVIRONMENTAL QUALITY DEPOSITS FUND

This Fund was reauthorized by Act 451, P.A. 1994, as amended, to account for cash bonds posted by applicants desiring licenses to operate hazardous and solid waste disposal areas. Because the Scrap Tire Regulatory Fund created by Act 451, P.A. 1994, has similar provisions, both of these activities are accounted for in this Fund. In accordance with Act 451, P.A. 1994, as amended, interest earnings up to an annual rate of 6% are credited to the applicant's account. This Act also specifies the circumstances under which the director of the Department of Environmental Quality is authorized to use the deposits to close and maintain a facility or return the deposit upon the operator's satisfactory closure and maintenance of the facility.

DEPARTMENT OF ENVIRONMENTAL QUALITY
 Statement of Changes in Assets and Liabilities
 Environmental Quality Deposits Fund
Fiscal Year Ended September 30, 2003
 (in thousands)

	Balance October 1, 2002	Additions	Deductions	Balance September 30, 2003
ASSETS				
Current Assets:				
Equity in common cash	\$ 4,233	\$ 562	\$ 865	\$ 3,931
Total Assets	\$ 4,233	\$ 562	\$ 865	\$ 3,931
 LIABILITIES				
Current Liabilities:				
Accounts payable and other liabilities	\$ 4,233	\$ 562	\$ 865	\$ 3,931
Total Liabilities	\$ 4,233	\$ 562	\$ 865	\$ 3,931

DEPARTMENT OF ENVIRONMENTAL QUALITY
 Statement of Changes in Assets and Liabilities
 Environmental Quality Deposits Fund
Fiscal Year Ended September 30, 2002
 (in thousands)

	<u>Balance October 1, 2001</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance September 30, 2002</u>
ASSETS				
Current Assets:				
Equity in common cash	\$ 3,407	\$ 1,007	\$ 181	\$ 4,233
Total Assets	<u>\$ 3,407</u>	<u>\$ 1,007</u>	<u>\$ 181</u>	<u>\$ 4,233</u>
LIABILITIES				
Current Liabilities:				
Accounts payable and other liabilities	\$ 3,407	\$ 1,007	\$ 181	\$ 4,233
Total Liabilities	<u>\$ 3,407</u>	<u>\$ 1,007</u>	<u>\$ 181</u>	<u>\$ 4,233</u>

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of Expenditures of Federal Awards (1)
For the Period October 1, 2001 through September 30, 2003

Federal Agency/Program	CFDA (2) Number	Pass-Through Identification Number	For the Fiscal Year Ended September 30, 2002		
			Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
Financial Assistance					
U.S. Department of Commerce					
Direct Program:					
Coastal Zone Management Administration Awards	11.419		\$ 1,497,892	\$ 1,378,031	\$ 2,875,923
Total U.S. Department of Commerce			\$ 1,497,892	\$ 1,378,031	\$ 2,875,923
U.S. Department of Defense					
Direct Program:					
State Memorandum of Agreement Program for the Reimbursement of Technical Services	12.113		\$ 252,212	\$	\$ 252,212
Total U.S. Department of Defense			\$ 252,212	\$ 0	\$ 252,212
U.S. Department of the Interior					
Direct Programs:					
Fish and Wildlife Management Assistance	15.608		\$	\$	\$
Wildlife Conservation and Appreciation	15.617		93,831	27,000	120,831
U.S. Geological Survey - Research and Data Acquisition	15.808		18,662		18,662
National Cooperative Geologic Mapping Program	15.810		85,487		85,487
Total U.S. Department of the Interior			\$ 197,980	\$ 27,000	\$ 224,980
U.S. Environmental Protection Agency					
Direct Programs:					
EPA Generalist (3)	66.000		\$ 85,923	\$	\$ 85,923
Air Pollution Control Program Support	66.001		3,789,320		3,789,320
State Indoor Radon Grants	66.032		235,179	100,797	335,976
Surveys, Studies, Investigations, Demonstrations and Special Purpose Activities Relating to the Clean Air Act	66.034				0
Water Pollution Control - State and Interstate Program Support	66.419		6,648,029	239,127	6,887,156
State Public Water System Supervision	66.432		4,010,010	28,090	4,038,100
Water Quality Management Planning	66.454		315,961	209,787	525,748
Capitalization Grants for Clean Water State Revolving Funds	66.458		1,642,302	47,587,127	49,229,429
Nonpoint Source Implementation Grants	66.460		899,374	4,752,458	5,651,832
Wetland Program Development Grants	66.461		187,248	27,978	215,226
Water Quality Cooperative Agreements	66.463		334,481		334,481
Wastewater Operator Training Grant Program (Technical Assistance)	66.467		49,000		49,000
Capitalization Grants for Drinking Water State Revolving Funds	66.468		2,022,251	26,112,270	28,134,521
Great Lakes Program	66.469		638,315	14,725	653,040
Hardship Grants Program for Rural Communities	66.470		661	1,102,169	1,102,830
State Grants to Reimburse Operators of Small Water Systems for Training and Certification Costs	66.471		6,225	306,700	312,925
Beach Monitoring and Notification Program Implementation Grants	66.472				0
Water Protection Grants to the States	66.474				0
Environmental Protection - Consolidated Research	66.500				0
Surveys, Studies, Investigations and Special Purpose Grants	66.606		1,050,082	225,660	1,275,742
State Information Grants	66.608		249,098		249,098
Pollution Prevention Grants Program	66.708		81,368	49,121	130,489
Capacity Building Grants and Cooperative Agreements for States and Tribes	66.709		15,992		15,992
Hazardous Waste Management State Program Support	66.801		3,601,357	54,701	3,656,058

This schedule continued on next page.

For the Fiscal Year Ended September 30, 2003

Directly Expended	Distributed to Subrecipients	Total Expended and Distributed	Total Expended and Distributed for the Two-Year Period
\$ 3,790,788	\$ 680,223	\$ 4,471,011	\$ 7,346,934
\$ 3,790,788	\$ 680,223	\$ 4,471,011	\$ 7,346,934
\$ 383,126	\$	\$ 383,126	\$ 635,338
\$ 383,126	\$ 0	\$ 383,126	\$ 635,338
\$ 57,547	\$ 30,135	\$ 87,682	\$ 87,682
		0	120,831
65,906		65,906	84,568
25,492	41,125	66,617	152,104
\$ 148,945	\$ 71,260	\$ 220,205	\$ 445,185
\$ 1,023,776	\$	\$ 1,023,776	\$ 1,109,699
3,861,128		3,861,128	7,650,448
228,160	103,071	331,231	667,207
386,924	79,400	466,324	466,324
7,312,962	299,932	7,612,894	14,500,050
4,026,400		4,026,400	8,064,500
227,362	190,372	417,734	943,482
1,556,839	59,954,990	61,511,829	110,741,258
1,341,545	4,112,253	5,453,798	11,105,630
304,165		304,165	519,391
61,264	87,698	148,962	483,443
68,500		68,500	117,500
1,869,031	28,758,058	30,627,089	58,761,610
425,068	15,268	440,336	1,093,376
595	815,995	816,590	1,919,420
125,239	387,925	513,164	826,089
14,566	208,225	222,791	222,791
132,837		132,837	132,837
192,195		192,195	192,195
1,011,316		1,011,316	2,287,058
989,930		989,930	1,239,028
48,032	13,741	61,773	192,262
24,008		24,008	40,000
3,481,380	37,178	3,518,558	7,174,616

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of Expenditures of Federal Awards (1)
For the Period October 1, 2001 through September 30, 2003
Continued

Federal Agency/Program	CFDA (2) Number	Pass-Through Identification Number	For the Fiscal Year Ended September 30, 2002		
			Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
Superfund State, Political Subdivision, and Indian Tribe Site - Specific Cooperative Agreements	66.802		\$ 2,215,034	\$	\$ 2,215,034
State and Tribal Underground Storage Tanks Program	66.804		198,575		198,575
Leaking Underground Storage Tank Trust Fund Program	66.805		1,927,534		1,927,534
Superfund State and Indian Tribe Core Program Cooperative Agreement	66.809		1,201,824		1,201,824
Total Direct Programs			<u>\$ 31,405,143</u>	<u>\$ 80,810,710</u>	<u>\$ 112,215,853</u>
Pass-Through Programs:					
Great Lakes Commission					
Great Lakes Program	66.469	A995353-02	\$ 20,837	\$	\$ 20,837
Wayne County					
Surveys, Studies, Investigations and Special Purpose Grants	66.606	XP995743-02	\$ 12,532	\$	\$ 12,532
Surveys, Studies, Investigations and Special Purpose Grants	66.606	XP995743-04	61,760		61,760
Inter-Tribal					
Surveys, Studies, Investigations and Special Purpose Grants	66.606	PM975229-01	9,812		9,812
Lake Michigan Air Directors Consortium					
Surveys, Studies, Investigations and Special Purpose Grants	66.606	A975226-01	10,636		10,636
Grand Traverse					
Surveys, Studies, Investigations and Special Purpose Grants	66.606	A975613-01			0
Environmental Council of the States					
Surveys, Studies, Investigations and Special Purpose Grants	66.606	X830307-01	11,680		11,680
Total Surveys, Studies, Investigations and Special Purpose Grants			<u>\$ 106,420</u>	<u>\$ 0</u>	<u>\$ 106,420</u>
Total Pass-Through Programs			<u>\$ 127,257</u>	<u>\$ 0</u>	<u>\$ 127,257</u>
Total U.S. Environmental Protection Agency			<u>\$ 31,532,400</u>	<u>\$ 80,810,710</u>	<u>\$ 112,343,110</u>
<u>U.S. Department of Homeland Security (FEMA) (4)</u>					
Direct Programs:					
National Dam Safety Program (83.550)	97.041		\$ 63,166	\$	\$ 63,166
Cooperating Technical Partners (83.555)	97.045		69,986		69,986
Total Direct Programs			<u>\$ 133,152</u>	<u>\$ 0</u>	<u>\$ 133,152</u>
Pass-Through Programs:					
Michigan Department of State Police					
Community Assistance Program - State Support Services Element (83.105)	97.023	EMC-2000-GR-7011	\$ 174,770	\$	\$ 174,770
Community Assistance Program - State Support Services Element (83.105)	97.023	EMC-2001-GR-7009			0
Total Community Assistance Program - State Support Services Element (83.105)			<u>\$ 174,770</u>	<u>\$ 0</u>	<u>\$ 174,770</u>
Hazard Mitigation Grant (83.548)	97.039	A1346.521	6,000		6,000
Total Pass-Through Programs			<u>\$ 180,770</u>	<u>\$ 0</u>	<u>\$ 180,770</u>
Total U.S. Department of Homeland Security			<u>\$ 313,922</u>	<u>\$ 0</u>	<u>\$ 313,922</u>
Total Financial Assistance			<u>\$ 33,794,406</u>	<u>\$ 82,215,741</u>	<u>\$ 116,010,147</u>
<u>Nonfinancial Assistance</u>					
<u>U.S. Environmental Protection Agency</u>					
Direct Programs:					
State Indoor Radon Grants	66.032		\$	\$	\$ 0
Surveys, Studies, Investigations, Demonstrations and Special Purpose Activities Relating to the Clean Air Act	66.034				0
Water Pollution Control - State and Interstate Program Support	66.419		274,800	49,979	324,779
Environmental Protection - Consolidated Research	66.500				0

This schedule continued on next page.

For the Fiscal Year Ended September 30, 2003

Directly Expended	Distributed to Subrecipients	Total Expended and Distributed	Total Expended and Distributed for the Two-Year Period
\$ 2,414,186	\$	\$ 2,414,186	\$ 4,629,220
186,000		186,000	384,575
2,055,506		2,055,506	3,983,040
1,020,257		1,020,257	2,222,081
\$ 34,389,171	\$ 95,064,106	\$ 129,453,277	\$ 241,669,130

\$ 47,222	\$	\$ 47,222	\$ 68,059
\$	\$	\$ 0	\$ 12,532
41,725		41,725	103,485
13,833		13,833	23,645
7,931		7,931	18,567
7,274		7,274	7,274
32,827		32,827	44,507
\$ 103,590	\$ 0	\$ 103,590	\$ 210,010
\$ 150,812	\$ 0	\$ 150,812	\$ 278,069
\$ 34,539,983	\$ 95,064,106	\$ 129,604,089	\$ 241,947,199

\$ 49,992	\$	\$ 49,992	\$ 113,158
		0	69,986
\$ 49,992	\$ 0	\$ 49,992	\$ 183,144

\$ 64,230	\$	\$ 64,230	\$ 239,000
181,797		181,797	181,797
\$ 246,027	\$ 0	\$ 246,027	\$ 420,797
		0	6,000
\$ 246,027	\$ 0	\$ 246,027	\$ 426,797
\$ 296,019	\$ 0	\$ 296,019	\$ 609,941
\$ 39,158,861	\$ 95,815,589	\$ 134,974,450	\$ 250,984,597

\$ 12,275	\$	\$ 12,275	\$ 12,275
113,154		113,154	113,154
534,053		534,053	858,832
30,014		30,014	30,014

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of Expenditures of Federal Awards (1)
For the Period October 1, 2001 through September 30, 2003
Continued

Federal Agency/Program	CFDA (2) Number	Pass-Through Identification Number	For the Fiscal Year Ended September 30, 2002		
			Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
Surveys, Studies, Investigations and Special Purpose Grants	66.606		\$ 778,474	\$	\$ 778,474
Hazardous Waste Management State Program Support	66.801				0
Total U.S. Environmental Protection Agency			\$ 1,053,274	\$ 49,979	\$ 1,103,253
Total Nonfinancial Assistance			\$ 1,053,274	\$ 49,979	\$ 1,103,253
Total Expenditures of Federal Awards			<u>\$ 34,847,680</u>	<u>\$ 82,265,720</u>	<u>\$ 117,113,400</u>

(1) Basis of Presentation: This schedule includes the federal grant activity of the Department of Environmental Quality (DEQ) and is presented on the modified accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the financial statements and financial schedules.

(2) CFDA is defined as *Catalog of Federal Domestic Assistance*.

(3) The EPA Generalist grant represents funding from the EPA's share of the Oil Spill Liability Trust Fund that is being used to reimburse DEQ for cleanup at the Lakeside Pipeline site.

(4) Grants from the Federal Emergency Management Agency (FEMA) are now reported as from the U.S. Department of Homeland Security. The original FEMA CFDA numbers are noted in parentheses following the program names

For the Fiscal Year Ended September 30, 2003

Directly Expended	Distributed to Subrecipients	Total Expended and Distributed	Total Expended and Distributed for the Two-Year Period
\$ 359,412 281,379	\$	\$ 359,412 281,379	\$ 1,137,886 281,379
\$ 1,330,287	\$ 0	\$ 1,330,287	\$ 2,433,540
\$ 1,330,287	\$ 0	\$ 1,330,287	\$ 2,433,540
<u>\$ 40,489,148</u>	<u>\$ 95,815,589</u>	<u>\$ 136,304,737</u>	<u>\$ 253,418,137</u>

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INDEPENDENT AUDITOR'S REPORTS ON
COMPLIANCE AND INTERNAL CONTROL



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
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(517) 334-8050
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting

March 26, 2004

Mr. Steven E. Chester, Director
Department of Environmental Quality
Constitution Hall
Lansing, Michigan

Dear Mr. Chester:

We have audited the financial statements and financial schedules of the Department of Environmental Quality as of and for the fiscal years ended September 30, 2003 and September 30, 2002, as identified in the table of contents, and have issued our report thereon dated March 26, 2004. 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.

Compliance

As part of obtaining reasonable assurance about whether the Department's financial statements and financial schedules are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement and financial schedule 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 that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and financial schedules and not to provide assurance on internal control over financial reporting. Our consideration of internal control over financial reporting would not necessarily disclose all matters in internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of

the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements and financial schedules being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the State's management, the Legislature, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

AUDITOR GENERAL



STATE OF MICHIGAN
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on Compliance With
Requirements Applicable to Each Major Program
and on Internal Control Over Compliance in
Accordance With OMB Circular A-133

March 26, 2004

Mr. Steven E. Chester, Director
Department of Environmental Quality
Constitution Hall
Lansing, Michigan

Dear Mr. Chester:

Compliance

We have audited the compliance of the Department of Environmental Quality with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement that are applicable to each major federal program for the two-year period ended September 30, 2003. The Department's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each major federal program is the responsibility of the Department's management. Our responsibility is to express an opinion on the Department'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 OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to in the previous paragraph that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Department'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 Department's compliance with those requirements.

In our opinion, the Department of Environmental Quality complied, in all material respects, with the requirements referred to in the second previous paragraph that are applicable to each major federal program for the two-year period ended September 30, 2003. However, the results of our auditing procedures disclosed an instance of noncompliance with those requirements, which is required to be reported in accordance with OMB Circular A-133 and which is described in the accompanying schedule of findings and questioned costs as Finding 1.

Internal Control Over Compliance

The management of the Department is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Department's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

We noted a matter involving internal control over compliance and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control over compliance that, in our judgment, could adversely affect the Department's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. The reportable condition is described in the accompanying schedule of findings and questioned costs as Finding 1.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of internal control over compliance would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that the reportable condition identified in the previous paragraph is not a material weakness.

This report is intended solely for the information and use of the State's management, the Legislature, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

AUDITOR GENERAL

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Section I: Summary of Auditor's Results

Financial Statements and Financial Schedules

Type of auditor's report issued:	Unqualified*
Internal control* over financial reporting:	
Material weaknesses* identified?	No
Reportable conditions* identified that are not considered to be material weaknesses?	None reported
Noncompliance material to the financial statements and financial schedules?	No

Federal Awards

Internal control over major programs:	
Material weaknesses identified?	No
Reportable condition identified that is not considered to be a material weakness?	Yes
Type of auditor's report issued on compliance for major programs:	Unqualified
Any audit findings disclosed that are required to be reported in accordance with U.S. Office of Management and Budget (OMB) Circular A-133, Section 510(a)?	Yes

* See glossary at end of report for definition.

Identification of major programs:

<u>CFDA Number</u>	<u>Name of Federal Program</u>
66.458	Capitalization Grants for Clean Water State Revolving Funds
66.468	Capitalization Grants for Drinking Water State Revolving Funds
66.606	Surveys, Studies, Investigations and Special Purpose Grants
66.805	Leaking Underground Storage Tank Trust Fund Program

Dollar threshold used to distinguish between type A and type B programs: \$3,000,000

Auditee qualified as a low-risk auditee*? No

Section II: Findings Related to the Financial Statements and Financial Schedules

We did not report any findings related to the financial statements and financial schedules.

* See glossary at end of report for definition.

Section III: Findings and Questioned Costs* Related to Federal Awards

FINDING 760401

1. **State Revolving Fund* (SRF) Program* Administrative Expenditures**

U.S. Environmental Protection Agency	CFDA 66.458: Capitalization Grants for Clean Water State Revolving Funds
Award Number: CS260001-01	Award Period: 10/01/2000 - 09/30/2002
	Questioned Costs: \$65,756

The Department of Environmental Quality's (DEQ's) controls did not ensure that SRF Program administrative expenditures were allowable costs.

OMB Circular A-87 states that costs cannot be assigned to a federal award as a direct cost if any other cost incurred for the same purpose has been allocated to the federal award as an indirect cost. Further, costs charged to a federal award must be necessary and reasonable for the administration of the federal award and be adequately supported.

SRF Program administrative expenditures totaled approximately \$1.4 million for fiscal year 2001-02.

We reviewed SRF Program administrative expenditures for fiscal year 2001-02 and noted that DEQ directly charged \$65,756 to the Program even though these costs were appropriated for inclusion in DEQ's indirect cost allocation plan and charged to the Program at the indirect cost rate approved by the U.S. Environmental Protection Agency. Of these direct charges, \$37,156 were related to contractual lease payments that were not necessary or reasonable for the administration of the SRF Program. Also, DEQ had not maintained supporting documentation for \$48,119 of these direct charges to the Program.

Our review of SRF Program administrative expenditures for fiscal year 2002-03 disclosed that DEQ had not directly charged the Program for similar costs.

* See glossary at end of report for definition.

RECOMMENDATION

We recommend that DEQ improve its controls to ensure that SRF Program administrative expenditures are allowable costs.

The status of the findings related to federal awards that were reported in prior Single Audits is disclosed in the summary schedule of prior audit findings.

OTHER SCHEDULES

DEPARTMENT OF ENVIRONMENTAL QUALITY
Summary Schedule of Prior Audit Findings
As of September 30, 2003

PRIOR AUDIT FINDINGS RELATED TO THE FINANCIAL STATEMENTS AND FINANCIAL SCHEDULES

There were no findings related to the financial statements and financial schedules in the prior Single Audit*.

PRIOR AUDIT FINDINGS RELATED TO FEDERAL AWARDS

Audit Findings That Have Been Fully Corrected:

Audit Period: October 1, 1999 through September 30, 2001
Finding Number: 760201
Finding Title: State Revolving Fund (SRF) Program Subrecipient Designation

Finding: SRF Program subrecipient municipalities either did not submit Single Audit reports or submitted reports that did not identify disbursements received from SRF and the Drinking Water State Revolving Fund (DWSRF) as federal financial assistance on their schedules of expenditures of federal awards. This indicates that the municipalities' use of SRF Program money was not subject to audit testing for compliance with applicable federal program laws and regulations.

Comments: In response to a similar finding regarding subrecipient monitoring in a prior Single Audit, the Department of Environmental Quality (DEQ) implemented, as recognized in the finding, specific actions in fiscal year 2001-02 to ensure that recipients are aware that SRF and DWSRF disbursements are federal financial assistance. These actions were considered adequate by the U.S. Environmental Protection Agency. DEQ will continue to implement these actions.

* See glossary at end of report for definition.

DEQ has also worked with the Michigan Municipal Bond Authority to develop detailed procedures to ensure compliance with the requirements of the Single Audit Act. The most significant change entails a detailed notification with each loan draw confirmation that alerts the recipient to the fact that a certain percentage of the draw is federal and that requirements of the Single Audit Act must be satisfied. The use of this letter took effect October 1, 2002. The changes made to the administration of the SRF Program and the DWSRF Program* to address this finding will be included in a revision to the Interagency Agreement between DEQ and the Authority.

* See glossary at end of report for definition.

DEPARTMENT OF ENVIRONMENTAL QUALITY

Corrective Action Plan

As of June 11, 2004

FINDINGS RELATED TO THE FINANCIAL STATEMENTS AND FINANCIAL SCHEDULES

There were no findings related to the financial statements and financial schedules for fiscal years 2001-02 and 2002-03.

FINDINGS RELATED TO FEDERAL AWARDS

Finding Number: 760401
Finding Title: State Revolving Fund (SRF) Program Administrative Expenditures

Management Views: The Department of Environmental Quality (DEQ) agrees and, since fiscal year 2002-03, has complied.

Corrective Action: DEQ has discontinued charges to the SRF Program for private rent or building occupancy costs that had been the policy position of the former DEQ Administration and is obtaining a change in its appropriation structure for these accounts.

In order to ensure that only necessary and reasonable costs are charged to the SRF Program, Revolving Loan and Operator Certification Section staff will query the accounting database for all entries recorded on the SRF Program on a monthly basis. They will review the charges to verify grant eligibility and inform the Environmental Science and Services Division budget liaison of any necessary corrections.

Anticipated Completion Date: Completed

Responsible Individual: Karen Best, Environmental Science and Services Division

GLOSSARY

Glossary of Acronyms and Terms

CFDA	<i>Catalog of Federal Domestic Assistance.</i>
CRF	Cleanup and Redevelopment Subfund.
CRTF	Cleanup and Redevelopment Trust Subfund.
DEQ	Department of Environmental Quality.
Drinking Water State Revolving Fund (DWSRF)	A fund established within the Michigan Municipal Bond Authority to provide loans and other types of financial assistance to eligible public water systems.
DWSRF Program	The federal grant program that provides capitalization grants to states for establishing revolving funds to be used for the construction of drinking water systems in compliance with the Safe Drinking Water Act.
EPA	U.S. Environmental Protection Agency.
ERF	Environmental Response Fund.
FEMA	Federal Emergency Management Agency.
financial audit	An audit that is designed to provide reasonable assurance about whether the financial schedules and/or financial statements of an audited entity are fairly presented in conformity with the disclosed basis of accounting.
internal control	A process, effected by management, designed to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

low-risk auditee	As provided for in OMB Circular A-133, an auditee that may qualify for reduced federal audit coverage if it receives an annual Single Audit and it meets other criteria related to prior audit results. In accordance with State statute, this Single Audit was conducted on a biennial basis; consequently, this auditee is not considered a low-risk auditee.
material misstatement	A misstatement in the financial schedules and/or financial statements that causes the schedules and/or statements to not present fairly the financial position or the results of operations or cash flows in conformity with the disclosed basis of accounting.
material noncompliance	Violations of laws and regulations that could have a direct and material effect on major federal programs or on financial schedule and/or financial statement amounts.
material weakness	A reportable condition related to the design or operation of internal control that does not reduce to a relatively low level the risk that either misstatements caused by error or fraud in amounts that would be material in relation to the financial schedules and/or financial statements or noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.
MUSTFA	Michigan Underground Storage Tank Financial Assurance.
OMB	U.S. Office of Management and Budget.
questioned cost	A cost that is questioned by the auditor because of an audit finding: (1) which resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to

match federal funds; (2) where the costs, at the time of the audit, are not supported by adequate documentation; or (3) where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

reportable condition

A matter coming to the auditor's attention relating to a significant deficiency in the design or operation of internal control that, in the auditor's judgment, could adversely affect the entity's ability to (1) record, process, summarize, and report financial data consistent with the assertions of management in the financial schedules and/or financial statements or (2) administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants.

Single Audit

A financial audit, performed in accordance with the Single Audit Act Amendments of 1996, that is designed to meet the needs of all federal grantor agencies and other financial report users. In addition to performing the audit in accordance with the requirements of auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, a Single Audit requires the assessment of compliance with requirements that could have a direct and material effect on a major federal program and the consideration of internal control over compliance in accordance with OMB Circular A-133.

SOMCAFR

State of Michigan Comprehensive Annual Financial Report.

SRF Program

The federal grant program that provides capitalization grants to states for establishing revolving funds to be used for the construction of municipal wastewater treatment projects or for the development and implementation of nonpoint source

or estuary conservation management programs and plans in compliance with the Clean Water Act.

State Revolving Fund (SRF)

A fund established within the Michigan Municipal Bond Authority to provide low-interest loans to municipalities for the construction of publicly owned water pollution control facilities.

subrecipient

A nonfederal entity that expends federal awards received from another nonfederal entity to carry out a federal program.

unqualified opinion

An auditor's opinion in which the auditor states that:

- a. The financial schedules and/or financial statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting; or
- b. The financial schedules and/or financial statements presenting supplemental financial information are fairly stated in relation to the basic financial schedules and/or financial statements. In issuing an "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules to the extent necessary to form an opinion on the basic financial schedules and/or financial statements, but did not apply auditing procedures to the extent that would be necessary to express an opinion on the supplemental financial schedules taken by themselves; or
- c. The audited agency complied, in all material respects, with the cited requirements that are applicable to each major federal program.