



MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT



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

“...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

Report Number:
64-810-05

Michigan Broadband Development Authority

Fiscal Year Ended September 30, 2004

Released:
June 2005

A financial audit determines if the financial statements are fairly presented; considers internal control over financial reporting; and determines compliance with State compliance requirements material to the financial statements. This financial audit of the Michigan Broadband Development Authority (MBDA) was conducted as part of the constitutional responsibility of the Office of the Auditor General.

Financial Statements:

Auditor's Report Issued

We issued an unqualified opinion on MBDA's financial statements.

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Internal Control Over Financial Reporting

We did not identify any material weaknesses in internal control over financial reporting. However, we did identify reportable conditions (Findings 1 through 4).

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**Noncompliance and Other Matters
Material to the Financial Statements**

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

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Background:

MBDA was created by Act 49, P.A. 2002, to assist in the development and utilization of high-speed broadband Internet services and infrastructure across Michigan. MBDA is governed by an 11-member board of directors that consists of the director of the Department of Labor and Economic Growth, the State Treasurer, the executive director of the Michigan State Housing Development Authority, and 8 members appointed by the Governor with the advice and consent of the Senate.

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A copy of the full report can be
obtained by calling 517.334.8050
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<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



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

June 17, 2005

Mr. Jay B. Rising, State Treasurer
Acting Chairperson, Board of Directors
Michigan Broadband Development Authority
Treasury Building
Lansing, Michigan
and
Mr. James W. Butler III, Vice President
Michigan Broadband Development Authority
735 East Michigan Avenue
Lansing, Michigan

Dear Mr. Rising and Mr. Butler:

This is our report on the financial audit of the Michigan Broadband Development Authority (MBDA) for the period October 1, 2003 through September 30, 2004. MBDA is a component unit of the State of Michigan.

This report contains our report summary; our independent auditor's report on the financial statements; the MBDA management's discussion and analysis; the MBDA financial statements and notes to the financial statements; and our independent auditor's report on internal control over financial reporting and on compliance and other matters. This report also contains our findings, recommendations, and agency preliminary responses and a glossary of acronyms and terms.

The agency preliminary responses were taken from the agency's responses subsequent to our audit fieldwork. 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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INDEPENDENT AUDITOR'S REPORT



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

Independent Auditor's Report on the Financial Statements

Mr. Jay B. Rising, State Treasurer
Acting Chairperson, Board of Directors
Michigan Broadband Development Authority
Treasury Building
Lansing, Michigan
and
Mr. James W. Butler III, Vice President
Michigan Broadband Development Authority
735 East Michigan Avenue
Lansing, Michigan

Dear Mr. Rising and Mr. Butler:

We have audited the financial statements of the Michigan Broadband Development Authority, a component unit of the State of Michigan, as of and for the fiscal year ended September 30, 2004, as identified in the table of contents. These financial statements are the responsibility of the Michigan Broadband Development Authority'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 1, the financial statements present only the Michigan Broadband Development Authority and do not purport to, and do not, present fairly the financial position of the State of Michigan or its component units as of September 30, 2004 and

the changes in financial position and cash flows thereof for the fiscal year 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 Michigan Broadband Development Authority as of September 30, 2004 and the changes in financial position and cash flows for the fiscal 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 a report dated December 22, 2004 on our consideration of the Michigan Broadband Development Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 11 through 14 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

AUDITOR GENERAL

December 22, 2004

MANAGEMENT'S DISCUSSION AND ANALYSIS

This is a discussion and analysis of the financial performance of the Michigan Broadband Development Authority (MBDA) for the period October 1, 2003 through September 30, 2004. Act 49, P.A. 2002, which created MBDA, was enacted on March 14, 2002. MBDA is a public body corporate and a component unit of the financial reporting entity of the State of Michigan. MBDA's management is responsible for the financial statements, notes to the financial statements, and this discussion.

Using the Financial Report

This financial report is prepared in accordance with Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*.

The reporting standards require a statement of net assets; a statement of revenues, expenses, and changes in net assets; and a statement of cash flows (direct method).

This financial report includes the report of independent auditors, management's discussion and analysis, the basic financial statements, and the notes to the financial statements.

Bond and note financing is the source of funding for MBDA's loan programs. There are no State appropriations for the administration of MBDA's programs.

The financial statements are interrelated and represent the financial status of MBDA. The balance sheet is now referred to as the statement of net assets, which includes assets and liabilities.

The statement of revenues, expenses, and changes in net assets presents the revenues earned and expenses incurred during the year.

The statement of cash flows presents information related to cash in-flows and out-flows summarized by operating, noncapital financing, and investing activities.

Analysis of Financial Activities

The MBDA Board of Directors approves an annual budget and the investment policy. The vice president is responsible for implementing the programs approved by the MBDA Board of Directors.

Condensed Financial Information
From the Statement of Net Assets
As of September 30

	2004	2003
Current assets	\$ 2,547,738	\$ 45,764,231
Noncurrent assets	3,626,457	120,212
Total Assets	\$ 6,174,195	\$ 45,884,443
Current liabilities	\$ 4,049,517	\$ 3,523,057
Noncurrent liabilities	13,731,325	50,096,768
Total Liabilities	\$ 17,780,842	\$ 53,619,824
Net Assets		
Restricted net assets	\$ 2,000	\$ 0
Unrestricted net assets (deficit)	(11,608,647)	(7,735,381)
Total Net Assets	\$ (11,606,647)	\$ (7,735,381)

Current assets primarily consist of U.S. government mutual funds, money market accounts, checking accounts, the current portion of loans receivable, and amounts retained by the State of Michigan in its equity in common cash for the payment of future expenses. Interest earned on funds retained in the common cash pool is the income for the State and does not get transferred to MBDA. Current assets have declined significantly because of the restructuring of the bond agreement with the Michigan State Housing Development Authority (MSHDA).

Noncurrent assets consist of loans receivable. This figure has dramatically increased since 2003 because of an increase in loans receivable.

Current liabilities primarily consist of accounts payable, interest payable, and the current portion of compensated absences.

Noncurrent liabilities primarily consist of bonds payable in the amount of \$13,574,013 due to MSHDA. The bond has available draws of \$36,425,987. The amount of noncurrent liabilities has decreased sharply from the prior year because of the restructuring of the bond agreement with MSHDA.

Condensed Financial Information
From the Statement of Revenues, Expenses, and Changes in Net Assets
For the Fiscal Year Ended September 30

	2004	2003
Operating Revenues		
Interest income from loans	\$ 80,836	\$ 3,445
Commitment fees and closing costs	101,198	17,692
Miscellaneous income	2,083	2,026
Income from grants	0	45,875
Total Operating Revenues	\$ 184,117	\$ 69,038
Operating Expenses		
Salaries, wages, and other administrative expenses	\$ 3,275,852	\$ 4,121,435
Interest on bonds	796,211	2,931,933
Total Operating Expenses	\$ 4,072,063	\$ 7,053,368
Operating income (loss)	\$ (3,887,946)	\$ (6,984,330)
Nonoperating Revenues		
Investment and interest income	\$ 49,501	\$ 701,188
Net increase (decrease) in the fair value of investments	(32,820)	(9,368)
Total Nonoperating Revenues	\$ 16,680	\$ 691,820
Change in net assets	\$ (3,871,266)	\$ (6,292,510)
Total net assets - Beginning	(7,735,381)	(1,442,871)
Total net assets - Ending	\$ (11,606,647)	\$ (7,735,381)

Salaries, wages, and other administrative expenses decreased during the period by increasing MBDA staff, which allowed for duties to be shifted from contract vendors, thus lowering the contract expense. In addition, through attrition, MBDA lowered its operating expenses. MBDA initiates and approves expenses and some payments are made through the State of Michigan's warrant processing system. MBDA also issues checks and makes payments directly to vendors.

Interest on bonds has decreased from the prior year because of the bond restructuring agreement with MSHDA. Of the original \$50,000,000, there was a repayment to MSHDA of \$42,925,987, thus lowering the interest expense. The bond agreement is now set up to allow MBDA to take draws on the principal not to exceed \$50,000,000. Therefore, interest expense on bonds is calculated only on the outstanding draws, not the entire \$50,000,000.

Investment and interest income relates to the restructuring of the bond with MSHDA. A large portion of the bond was repaid to MSHDA, which decreased the available amount for investments. As a result, investment and interest income decreased. In addition, MBDA sold U.S. Treasury notes on October 14, 2003 to repay principal to MSHDA on the bonds. As of October 14, 2003, the sale price of the U.S. Treasury notes was \$133,746 higher than the cost. As of September 30, 2003, the market value of MBDA investments was \$166,566 higher than the cost. As a result, \$32,820 was recorded as a reduction in revenues to reflect the loss in fair value of investments on September 30, 2004.

Change in net assets reflects the effect of expenses exceeding revenues for the current year.

Condensed Financial Information
From the Statement of Cash Flows
For the Fiscal Year Ended September 30

	2004	2003
Cash provided (used) by:		
Operating activities	\$ (6,761,101)	\$ (4,191,463)
Noncapital financing activities	(36,725,987)	16,466,667
Investing activities	15,201,082	16,602,822
Net increase (decrease) in cash	\$ (28,286,006)	\$ 28,878,026
Cash - Beginning	30,562,683	1,684,657
Cash - Ending	\$ 2,276,676	\$ 30,562,683

FINANCIAL STATEMENTS

MICHIGAN BROADBAND DEVELOPMENT AUTHORITY
Statement of Net Assets
As of September 30, 2004

ASSETS

Current Assets:	
Cash and cash equivalents (Note 2)	\$ 2,276,676
Investments (Note 2)	17,146
Interest receivable	10,939
Accounts receivable	144
Current loans receivable	241,237
Other current assets	1,596
Total Current Assets	<u>\$ 2,547,738</u>
Noncurrent Assets:	
Loans receivable	<u>3,626,457</u>
Total Assets	<u>\$ 6,174,195</u>

LIABILITIES

Current Liabilities:	
Accounts payable	\$ 163,532
Deferred revenue	18,695
Compensated absences (Note 4)	55,745
Interest payable	3,811,544
Total Current Liabilities	<u>\$ 4,049,517</u>
Noncurrent Liabilities:	
Bonds payable (Note 3)	\$ 13,574,013
Compensated absences (Note 4)	102,593
Loan reserves payable	54,719
Total Noncurrent Liabilities	<u>\$ 13,731,325</u>
Total Liabilities	<u>\$ 17,780,842</u>

NET ASSETS

Restricted net assets	\$ 2,000
Unrestricted net assets (deficit)	<u>(11,608,647)</u>
Total Net Assets (Note 8)	<u>\$ (11,606,647)</u>

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

MICHIGAN BROADBAND DEVELOPMENT AUTHORITY
Statement of Revenues, Expenses, and Changes in Net Assets
For the Fiscal Year Ended September 30, 2004

OPERATING REVENUES	
Interest income from loans	\$ 80,836
Loan fees	101,198
Miscellaneous income	2,083
Total Operating Revenues	<u>\$ 184,117</u>
 OPERATING EXPENSES	
Salaries and wages	\$ 462,122
Employee benefits (Note 6)	324,242
Contractual services employee compensation	456,836
Contractual services	1,806,754
Interest on bonds	796,211
Administrative and general	225,898
Total Operating Expenses	<u>\$ 4,072,063</u>
Operating income (loss)	<u>\$ (3,887,946)</u>
 NONOPERATING REVENUES	
Investment income	\$ 16,941
Interest income	32,560
Net increase (decrease) in the fair value of investments	(32,820)
Total Nonoperating Revenues	<u>\$ 16,680</u>
Change in net assets	\$ (3,871,266)
Total Net Assets - Beginning	<u>(7,735,381)</u>
Total Net Assets - Ending (Note 8)	<u>\$ (11,606,647)</u>

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

MICHIGAN BROADBAND DEVELOPMENT AUTHORITY
Statement of Cash Flows
For the Fiscal Year Ended September 30, 2004

CASH FLOWS FROM OPERATING ACTIVITIES

Fees	\$ 36,165
Other operating revenue	2,083
Loans to customers	(3,675,038)
Principal and interest payments on loans	120,515
Payments to employees	(701,708)
Payments to suppliers	(2,543,118)
Net cash provided (used) by operating activities	\$ (6,761,101)

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

Interest paid	\$ (300,000)
Proceeds from issuance of bonds	6,500,000
Principal payments on bonds	(42,925,987)
Net cash provided (used) by noncapital financing activities	\$ (36,725,987)

CASH FLOWS FROM INVESTING ACTIVITIES

Purchase of investments	\$ (17,146)
Proceeds from the sale and maturity of investments	15,145,320
Interest on investments	72,908
Net cash provided (used) by investing activities	\$ 15,201,082

Net increase (decrease) in cash - all activities	\$ (28,286,006)
Cash and cash equivalents - Beginning	30,562,683
Cash and cash equivalents - Ending	\$ 2,276,676

RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES:

Operating income (loss)	\$ (3,887,946)
Adjustments to reconcile operating income (loss) to net cash provided (used) by operating activities:	
Loans to customers and principal on loans reported as cash flows from operating activities	(3,747,482)
Interest payments on debt reported as cash flows from financing activities	300,000
Change in assets and liabilities:	
Interest receivable	(10,939)
Accounts receivable and other assets	(1,740)
Accounts payable	(40,169)
Interest payable	496,211
Compensated absences	72,791
Deferred revenue	18,695
Loan reserves payable	39,478
Net cash provided (used) by operating activities	\$ (6,761,101)

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

Notes to the Financial Statements

Note 1 Significant Accounting Policies

The accounting policies of the Michigan Broadband Development Authority (MBDA) conform to accounting principles generally accepted in the United States of America as applicable to governmental units. The following is a summary of the more significant policies:

a. Reporting Entity

MBDA was created by Act 49, P.A. 2002, to assist in the development and utilization of high-speed broadband Internet services and infrastructure across Michigan. MBDA has the responsibility to remain self-sufficient by generating revenues from project lending and joint venture activity. MBDA came into existence on March 14, 2002.

MBDA is governed by an 11-member board of directors that consists of the director of the Department of Labor and Economic Growth, the State Treasurer, the executive director of the Michigan State Housing Development Authority (MSHDA), and 8 members appointed by the Governor with the advice and consent of the Senate.

MBDA is a component unit of the financial reporting entity of the State of Michigan. The decision to include a potential component unit in the reporting entity is made by applying the criteria set forth in Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*. The basic criteria include the appointment of a voting majority of the governing board of MBDA; the legal separation of the State and MBDA; the fiscal independence of MBDA; whether exclusion of the unit would make the *State of Michigan Comprehensive Annual Financial Report (SOMCAFR)* misleading; and whether there is a potential for MBDA to provide specific financial benefits to, or impose financial burdens on, the State.

b. Measurement Focus and Presentation

(1) Fund Accounting: The accounts of the component units of the State of Michigan are organized on the basis of funds, each of which is

considered a separate accounting entity. MBDA's operations are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, net assets, revenues, and expenses. Government resources are allocated to and accounted for in separate funds, based upon the purposes for which they are to be spent and the means by which spending activities are controlled.

- (2) Proprietary Funds: MBDA is a proprietary fund. Proprietary funds are accounted for using a flow of economic resources measurement focus and the accrual basis of accounting. The accounting objectives are a determination of net income, financial position, and cash flow. All assets and liabilities associated with the proprietary fund activities are included on the statement of net assets.

Proprietary funds are used to account for the operations that are financed and operated in a manner similar to private business enterprises, i.e., where the intent of the governing body is that the costs (expenses) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges or where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

The accompanying financial statements present only MBDA. Accordingly, they do not purport to, and do not, present fairly the financial position and the changes in financial position and cash flows of the State of Michigan or its component units in conformity with generally accepted accounting principles.

c. Basis of Accounting

Proprietary fund types use the accrual basis of accounting. The accrual basis emphasizes the measurement of "net income" (i.e., "capital maintenance" focus). Using this basis, revenues are recognized when "earned" and expenses are recognized when "incurred." Revenues are considered to be available when collected within the current period or soon enough thereafter to pay liabilities of the current period. Generally, this is within 12 months. Operating revenues and expenses generally

result from providing services to the public and to State and local units of government. All financial resources and obligations of a fund, whether current or noncurrent, are recorded in the fund. MBDA follows all GASB pronouncements and those Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures that were issued on or before November 30, 1989, except those that conflict with a GASB pronouncement.

d. Financial Data

MBDA financial statements primarily present the following:

- (1) Operating Expenses: Expenses related to the administration of MBDA and bond interest expenses.
- (2) Operating Revenues: Revenues consist of interest income and fees on loans.
- (3) Nonoperating Revenues: Revenues consist of investment earnings and the decrease in the fair value of investments.
- (4) Cash Equivalents: MBDA considers U.S. government money market funds to be cash equivalents.
- (5) Investments: MBDA reports all marketable investments at fair value with gains and losses included in the statement of revenues, expenses, and changes in net assets.
- (6) Equipment: Purchases of equipment by MBDA for use in its operations that meet the requirements of the State of Michigan's capitalization policy are capitalized in accordance with GASB Statement No. 34. For the period ended September 30, 2004, MBDA had no equipment purchases capitalized.

Note 2 Deposits and Investments

a. General Information

Act 49, P.A. 2002, allows MBDA to invest funds at its discretion, in any obligations that it determines to be proper. Deposits of MBDA are held in a financial institution approved by the State Treasurer. GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, requires certain disclosures regarding policies and practices with respect to deposits and investments and the custodial credit risk associated with them.

b. Deposits

In accordance with GASB Statement No. 3, deposits are classified into three categories of credit risk as follows:

Category 1: Insured or collateralized with securities held by the entity or by its agent in the entity's name.

Category 2: Collateralized with securities held by the pledging financial institution's trust department or agent in the entity's name.

Category 3: Uncollateralized, including bank balances that are collateralized with securities held by the pledging financial institution or by its trust department or agent, but not in the entity's name.

Certain types of deposits and investments are not categorized because they are not evidenced by securities that exist in physical or book entry form. In general, deposits and investments in pools managed by other governments or in mutual funds should be disclosed but not categorized.

As of September 30, 2004, the reported amount of MBDA's deposits was \$2,276,676 and the total bank balance was \$2,228,515, consisting of the following:

U.S. government money market funds	\$ 77,791
Cash in bank	2,150,724
Total Bank Balance	<u>\$ 2,228,515</u>

Of this amount, \$166,451 was covered by federal depository insurance (GASB credit risk category 1), \$1,984,273 was uninsured and uncollateralized (GASB credit risk category 3), and \$77,791 was held in money market funds which are not categorized.

c. Investments

In accordance with GASB Statement No. 3, investments are also classified into three categories of credit risk as follows:

Category 1: Investments that are insured or registered or for which the securities are held by the entity or its agent in the entity's name.

Category 2: Uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the entity's name.

Category 3: Uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent but not in the entity's name.

The following table shows the fair value of investments at September 30, 2004 by investment type and in total:

Investment Type	GASB Credit Risk Category			Not Categorized	Fair Value
	1	2	3		
Time deposits	\$ 17,146	\$	\$	\$	\$ 17,146
Total Investments	<u>\$ 17,146</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 17,146</u>

Note 3 Bonds Payable

MBDA is authorized to issue bonds to fund its operations and to finance or refinance the private and public sectors' development of the broadband infrastructure. Such bonds constitute a general obligation of MBDA and are not a debt of the State of Michigan. Bonds are secured by the pledge to repay the principal and interest related to those bonds. Interest on such debt is payable annually, and the bonds are subject to optional redemption provisions as set forth in the official statement for the bond issue. See Note 7 for additional information related to bonds issued.

The following table displays the aggregate changes in bonds payable for the period October 1, 2003 through September 30, 2004:

Beginning bonds payable	\$ 50,000,000
Additional proceeds and borrowings	6,500,000
Redemptions	(42,925,987)
Ending bonds payable	<u>\$ 13,574,013</u>

MBDA limited obligations outstanding as of September 30, 2004 were:

Michigan Broadband Development Authority Purposes Funding Taxable Subordinate Bond Series 2002A, payable through May 1, 2022 with an interest rate of 6%	\$ 13,574,013
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The annual requirements to amortize all debt outstanding, including interest, as of September 30, 2004, are as follows:

Fiscal Year	Principal	Interest	Total
2004-05	\$	\$ 764,379	\$ 764,379
2005-06		814,441	814,441
2006-07		814,441	814,441
2007-08		814,441	814,441
2008-09		814,441	814,441
Total for fiscal years 2004-05 through 2008-09	\$ 0	\$ 4,022,143	\$ 4,022,143
2009-10 through 2013-14		4,072,205	4,072,205
2014-15 through 2018-19		4,072,205	4,072,205
2019-20 through 2021-22	13,574,013	2,103,973	15,677,986
Total	<u>\$ 13,574,013</u>	<u>\$14,270,526</u>	<u>\$27,844,539</u>

A minimum interest payment is calculated based on the investment agreement and due each February 1. Interest continues to accrue on the difference between the interest calculated and the minimum interest payment.

Effective October 15, 2003, MBDA restructured the existing bond payable with MSHDA to a bond agreement with the option to take advances on the principal as needed. MBDA repaid \$42,925,987 to MSHDA with available assets to reduce the bond payable. The remaining debt of \$7,074,013 is due May 1, 2022. MBDA may take additional draws on the bond as long as the maximum principal amount does not exceed \$50,000,000. During the fiscal year, MBDA drew down an additional \$6,500,000. Interest on the investment (and the bond which evidences it) shall be the lower of the prime rate or 6% per annum for short-term advances which are outstanding for 360 days or less; 6% per annum on long-term advances; and 6% per annum on short-term advances from and after the date on which they remain outstanding for more than 360 days. Interest is to be compounded annually, calculated on the basis of a 360-day year composed of twelve 30-day months. As of September 30, 2004, the portion of the principal balance calculated at the short-term rate of 4.5% was \$3,798,099.

Note 4 Compensated Absences

Noncurrent liabilities are accrued when incurred in proprietary funds (using the accrual basis of accounting). The following table summarizes compensated absences liabilities of MBDA:

	Beginning Balance	Additions	Reductions	Ending Balance	Due Within One Year
Compensated absences	\$ 85,548	\$ 101,038	\$ 28,247	\$158,339	\$ 55,745

Note 5 Leases

MBDA is presently housed in the MSHDA building. The initial term of the occupancy agreement between MBDA and MSHDA began on November 1, 2003 and ended on February 29, 2004. Thereafter, the agreement was and shall continue to be automatically renewed on an annual basis on each March 1. This agreement is an open-ended operational lease and may be terminated by either party after giving written notice to the other with at least a 90-day notice.

MBDA paid MSHDA a lump sum of \$33,983 for the partial year lease on November 1, 2003. This payment covered the period from November 1, 2003 through February 29, 2004. The annual lease amount for March 1, 2004 through February 28, 2005 is \$101,949. Total lease expense recorded for the period November 1, 2003 through September 30, 2004 was \$93,453. The lease payments are inclusive of all expenses for taxes, maintenance, utilities, office services, and similar expenses. The lease amount shall be reviewed annually for adjustment and any increase or adjustment will be assessed with the annual lease renewal.

Note 6 Employee Benefits

The employer's share of life, health, optical, dental, and long-term disability insurance premiums are charged by the State of Michigan to MBDA biweekly for each State employee's selected coverage.

State employees who meet certain eligibility requirements are also enrolled in a noncontributory defined benefit plan or a defined contribution plan through the State Employees' Retirement System. Details and data regarding the plan descriptions, accounting policies, vesting and eligibility requirements, actuarial cost methods and assumptions, funding status and requirements, and ten-year

historical trend information are provided in the *SOMCAFR* and the plans' detailed financial reports, issued by the Office of Retirement Services, Department of Management and Budget.

Note 7 Related Party Transactions

The MBDA Board of Directors includes the executive director of MSHDA. MBDA entered into an investment agreement with MSHDA for the sale of a bond to MSHDA. The bond agreement was restructured on October 15, 2003 to a bond agreement with the option to take advances on the principal as needed. The total amount of the bond issue was \$13,574,013 as of September 30, 2004. MBDA can continue to draw from this bond issue as long as the principal balance does not exceed \$50,000,000. See Note 3 for additional information relating to the bonds payable.

In addition, MBDA is housed in the MSHDA building and makes annual lease payments to MSHDA. See Note 5 for additional information relating to MBDA's lease agreement with MSHDA.

Note 8 Fund Deficit

MBDA had a negative net asset balance as of September 30, 2004. MBDA's fund deficit of \$11,606,647 was caused by start-up expenses and expenses for projects that began during fiscal year 2003-04 for which all corresponding revenue had not been received.

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INDEPENDENT AUDITOR'S REPORT ON
INTERNAL CONTROL AND COMPLIANCE



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

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

Mr. Jay B. Rising, State Treasurer
Acting Chairperson, Board of Directors
Michigan Broadband Development Authority
Treasury Building
Lansing, Michigan
and
Mr. James W. Butler III, Vice President
Michigan Broadband Development Authority
735 East Michigan Avenue
Lansing, Michigan

Dear Mr. Rising and Mr. Butler:

We have audited the financial statements of the Michigan Broadband Development Authority, a component unit of the State of Michigan, as of and for the fiscal year ended September 30, 2004, as identified in the table of contents, and have issued our report thereon dated December 22, 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Michigan Broadband Development Authority's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Michigan Broadband Development Authority's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in Findings 1 through 4.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions identified in the previous paragraph is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Michigan Broadband Development Authority'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*.

This report is intended solely for the information and use of the Michigan Broadband Development Authority's Board of Directors and management and the Legislature 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

December 22, 2004

FINDINGS, RECOMMENDATIONS,
AND AGENCY PRELIMINARY RESPONSES

FINDING

1. **Contract Services**

The Michigan Broadband Development Authority (MBDA) did not obtain sufficient documentation to support expenses for contracted services and prepaid for some of the contracted services. As a result, MBDA could not ensure that it was paying for services that were actually received.

MBDA contracts with an outside company for professional consulting services. MBDA's contract for the period October 1, 2003 through September 30, 2004 provided that the contractor shall be paid on a monthly basis pursuant to invoices detailing the professional services performed on a daily basis in the preceding month.

Our review of MBDA's expenses in fiscal year 2003-04 for contract services paid to the consulting company disclosed:

- a. MBDA did not obtain detailed invoices related to the daily professional services received. Without proper documentation of the services provided, MBDA cannot ensure that it received the services agreed upon in the contract. MBDA paid approximately \$1.2 million for professional consulting services in fiscal year 2003-04.
- b. MBDA prepaid \$115,000 and \$80,000 for professional services to be provided in April 2004 and May 2004, respectively. Department of Management and Budget (DMB) Administrative Guide policy 1260 provides that payments for services should be made after the receipt of services, receipt of a completed invoice for the services, or receipt of a complete contract for the services, whichever is later.

Prepaying for services reduces MBDA's level of accountability and control over expenses and increases the risk that payments are made for services that were not received.

RECOMMENDATION

We recommend that MBDA obtain sufficient documentation to support expenses for contracted services and that MBDA pay for services only after they are received.

AGENCY PRELIMINARY RESPONSE

MBDA agrees and informed us that it has strong procedures and is continuously working toward improving established procedures. MBDA informed us that it has moved to improve its process and is now requesting more detailed invoices.

MBDA also stated that invoices were received and, as both payments were made halfway through the month, the true amounts prepaid were \$57,500 and \$40,000. MBDA concurs that it should not make payments for services yet to be rendered.

FINDING

2. Transaction Approvals

MBDA did not have controls to ensure that the review and approval of financial transactions were properly documented. Without proper documentation, MBDA management cannot be assured that financial transactions were accurately processed. This also increases the risk that errors or irregularities could occur and not be detected.

MBDA staff electronically entered financial transactions into MBDA's internal accounting system. However, MBDA's internal accounting system was not set up to allow electronic approval by management of the transactions that were processed. Most of MBDA's financial transactions consisted of payments of invoices. MBDA staff also entered monthly and yearly adjusting entries for financial reporting purposes. MBDA used manual signatures to document that management staff reviewed and approved payments of invoices, but MBDA had no process to document that management reviewed and approved adjusting entries.

Our review of 61 transactions processed by MBDA during fiscal year 2003-04 disclosed that there was no documentation that MBDA management staff had reviewed and approved 41 (67.2%) of these transactions, totaling approximately \$1 million.

RECOMMENDATION

We recommend that MBDA implement controls to ensure that the review and approval of financial transactions are properly documented.

AGENCY PRELIMINARY RESPONSE

MBDA agrees and informed us that it has a system in effect to review all financial transactions; however, approvals have not been consistently documented.

MBDA also informed us that it has instituted a procedure that will require written approval of the Department of Labor and Economic Growth (DLEG) expenditure reports, vendor payment reports, and all adjusting journal entries prior to their entry in the financial system.

FINDING

3. Compliance With DMB Procurement Procedures

MBDA did not obtain approval for its purchases of certain commodities and services from DMB as required by DMB procedures.

Section 18.1261 of the *Michigan Compiled Laws* (a section of Act 431, P.A. 1984) provides that DMB shall issue directives for the procurement, receipt, inspection, and storage of supplies, materials, and equipment and for printing and services needed by State agencies. In accordance with Act 431, P.A. 1984, these provisions apply to all State agencies, including departments, boards, commissions, offices, agencies, authorities, or other units of State government.

DMB Administrative Guide section 500 provides the policies and procedures by which executive branch departments and sub-units (which include independent or autonomous agencies in the executive branch) shall procure supplies, materials, equipment, and services. DMB Administrative Guide procedure 0510.13 and State Administrative Board Resolution No. 2003-1 require that certain types of purchase requests exceeding \$25,000 be submitted for processing and approval to DMB Acquisition Services and the State Administrative Board. These procedures are mandatory unless specifically provided otherwise by statute.

During fiscal year 2003-04, the MBDA Board of Directors approved the extension of 6 contracts totaling \$1.9 million and approved 1 new contract for \$100,000. All 7 contracts exceeded the \$25,000 threshold established by DMB Acquisition Services and the State Administrative Board; however, none of the contracts were submitted to DMB Acquisition Services or the State Administrative Board for processing and approval.

MBDA received a letter dated July 11, 2002 from DMB which states that, from a DMB perspective, the MBDA Board of Directors, as with all statutory authorities governed by a board, will have the final authority for business approvals on behalf of MBDA. However, this letter did not specifically state that MBDA is exempt from obtaining DMB Acquisition Services and State Administrative Board approvals for its contracts. In addition, our review of Act 49, P.A. 2002, which created MBDA, did not note any language that specifically exempted MBDA from following the procedures of the DMB Administrative Guide.

RECOMMENDATION

We recommend that MBDA obtain approval for its purchases of certain commodities and services from DMB as required by DMB procedures.

AGENCY PRELIMINARY RESPONSE

MBDA disagrees and informed us that it believes that Act 49, P.A. 2002, and subsequent Executive Order No. 2003-18, transferring MBDA from the Department of Treasury to DLEG, grants MBDA exceptions under certain instances. Section 6(8), Act 49, P.A. 2002, states:

The authority may employ or contract for legal, financial, and technical experts, and officers, agents, and employees, permanent and temporary, as the authority requires, and shall determine their qualifications, duties, and compensation.

MBDA informed us that MBDA's purchasing contracts have been approved by DLEG (or the Department of Treasury) in accordance with Act 49, P.A. 2002, and Executive Order No. 2003-18 and that CS-138 forms and AS-1 forms were processed for all contract employees, as required. MBDA also informed us that it has complied with all terms of its memorandum of understanding with DLEG for budget, finance, and business services and that it will continue to work with DLEG to ensure that all appropriate consultations with DMB and others are made.

FINDING

4. Business Plan

MBDA needs to establish a comprehensive business plan that provides specific goals and objectives for improving its financial position and achieving its goal of

becoming self-sufficient. MBDA's total net assets were negative amounts as of September 30, 2004, September 30, 2003, and September 30, 2002 (\$11,606,647, \$7,735,381, and \$1,442,871, respectively).

A comprehensive business plan can be a useful management tool to document management's goals and objectives and to present an effective strategy for meeting those goals and objectives.

MBDA was established in March 2002 to assist in the development and utilization of high-speed broadband Internet services and infrastructure across Michigan. Because it is still a relatively new entity, MBDA is still developing its organizational structure and business plans needed to accomplish its goals and objectives. However, one of MBDA's stated goals is to have its operations achieve self-sufficiency.

MBDA's business plan, which was last revised in June 2004, does not provide a comprehensive strategy for eliminating MBDA's negative financial position and becoming self-sufficient. As of September 30, 2004, MBDA's net financial position was a deficit of \$11.6 million. MBDA has projected operating revenues and expenses through fiscal year 2008-09. Based on MBDA's estimates and projections, MBDA's revenues will begin to exceed expenses by fiscal year 2007-08 and MBDA will be able to eliminate a portion of its deficit. However, as of the end of fiscal year 2008-09, MBDA will have a projected deficit of approximately \$16 million.

MBDA does not receive any outside funding and must rely solely on revenues generated by its loan activities. As a result, MBDA should develop a business plan that, based on attainable revenue and expenditure projections, will allow MBDA to eliminate its operating deficit and achieve its goal of self-sufficiency.

RECOMMENDATION

We recommend that MBDA establish a comprehensive business plan that provides specific goals and objectives for improving its financial position and achieving its goal of becoming self-sufficient.

AGENCY PRELIMINARY RESPONSE

MBDA agrees that its activities should be guided by a business plan with specific goals and objectives but disagrees with this audit-oriented assessment of its current plan.

MBDA informed us that while concise, its June 2004 business plan is the right plan for MBDA and is reviewed regularly by senior management and the MBDA Board of Directors. MBDA also informed us that its leadership team and Board of Directors are composed of both experienced business people and key leaders within government and that these leaders are in the best position to judge and evaluate MBDA's strategic direction. MBDA stated that it greatly respects the auditing skill and background of those working on this audit, but it believes this matter falls beyond the scope of such experience.

MBDA informed us that it was created to meet important long-term public policy objectives and, as a start-up organization, a negative net asset scenario was always anticipated. MBDA also informed us that that is why MBDA's loan with MSHDA is structured over 20 years and does not require any near-term principal repayment. MBDA stated that it believes that the Office of the Auditor General's short-term focus on net assets fails to recognize this important point and overlooks the mission and underlying purpose of MBDA as established by Act 49, P.A. 2002.

GLOSSARY

Glossary of Acronyms and Terms

DLEG	Department of Labor and Economic Growth.
DMB	Department of Management and Budget.
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.
GASB	Governmental Accounting Standards Board.
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.
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 changes in financial position or cash flows in conformity with the disclosed basis of accounting.
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 misstatements caused by error or fraud in amounts that would be material in relation to the financial schedules and/or financial statements may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.
MBDA	Michigan Broadband Development Authority.

MSHDA Michigan State Housing Development Authority.

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 initiate, record, process, and report financial data consistent with the assertions of management in the financial schedules and/or financial statements.

SOMCAFR State of Michigan Comprehensive Annual Financial Report.

unqualified opinion An auditor's opinion in which the auditor states that 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.

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