



# 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

Audit report information may be accessed at:

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Michigan  
*Office of the Auditor General*  
**REPORT SUMMARY**

*Financial Audit*

*Michigan Broadband Development Authority  
 (A Component Unit of the State of Michigan)  
 Fiscal Year Ended September 30, 2005*

Report Number:  
 64-810-06

Released:  
 April 2006

*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 report any findings related to internal control over financial reporting.

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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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<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

April 28, 2006

Board of Directors  
Michigan Broadband Development Authority  
and  
Mr. James W. Butler III, Vice President  
Michigan Broadband Development Authority  
300 North Washington Square  
Lansing, Michigan

Dear Members of the Board and Mr. Butler:

This is our report on the financial audit of the Michigan Broadband Development Authority (MBDA), a component unit of the State of Michigan, for the period October 1, 2004 through September 30, 2005.

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

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

AUDITOR GENERAL



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# INDEPENDENT AUDITOR'S REPORT



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

## Independent Auditor's Report on the Financial Statements

Board of Directors  
Michigan Broadband Development Authority  
and  
Mr. James W. Butler III, Vice President  
Michigan Broadband Development Authority  
300 North Washington Square  
Lansing, Michigan

Dear Members of the Board and Mr. Butler:

We have audited the accompanying 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, 2005, 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, 2005 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, 2005 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.

As discussed in Notes 10 and 11 to the financial statements, on November 16, 2005, the Michigan Broadband Development Authority restructured its bond payable and pledged all of its current and future loans receivable and future receipts on those loans receivable in an amended investment agreement with the Michigan State Housing Development Authority. Notes 10 and 11 provide the details of the amended investment agreement, explain the limited amount of funding that is available for operations, and describe management's plans to allocate the limited funding accordingly.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 13, 2006 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 the 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 15 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

January 13, 2006

# 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, 2004 through September 30, 2005. 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 reports of independent auditors, management's discussion and analysis, the basic financial statements, and the notes to the financial statements.

Bond 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

	<u>2005</u>	<u>2004</u>
Current assets	\$ 4,458,689	\$ 2,547,738
Noncurrent assets	9,886,085	3,626,457
Total Assets	<u>\$ 14,344,774</u>	<u>\$ 6,174,195</u>
Current liabilities	\$ 734,955	\$ 4,049,517
Noncurrent liabilities	28,134,494	13,731,325
Total Liabilities	<u>\$ 28,869,449</u>	<u>\$ 17,780,842</u>
Net Assets		
Restricted net assets	\$ 2,000	\$ 2,000
Unrestricted net assets (deficit)	(14,526,675)	(11,608,647)
Total Net Assets	<u>\$ (14,524,675)</u>	<u>\$ (11,606,647)</u>

**Current assets** primarily consist of money market accounts, checking accounts, certificates of deposit, and the current portion of loans receivable. Current assets have increased because of the purchase of more certificates of deposit.

**Noncurrent assets** consist of loans receivable. With the addition of several new loans, the amount of noncurrent assets has greatly increased.

**Current liabilities** primarily consist of accounts payable, interest payable, amounts due to primary government, and the current portion of compensated absences. The large decrease is a result of MBDA reclassifying \$4,460,286 from short-term interest payable to long-term interest payable. If this reclassification had not occurred, current liabilities would have increased as a result of the increase in the prime interest rate and as a result of accrued interest associated with the additional \$9,870,000 of principal that MBDA drew on the bond with the Michigan State Housing Development Authority (MSHDA) during fiscal year 2004-05.

**Noncurrent liabilities** primarily consist of bonds payable in the amount of \$23,444,013 due to MSHDA. The large increase in noncurrent liabilities is a result of MBDA drawing

an additional \$9,870,000 of principal on the bond with MSHDA and the reclassification of \$4,460,286 from short-term interest payable to long-term interest payable.

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

	2005	2004
Operating Revenues		
Interest income from loans	\$ 484,177	\$ 80,836
Loan fees	315,830	101,198
Miscellaneous income	8,580	2,083
Total Operating Revenues	\$ 808,587	\$ 184,117
Operating Expenses		
Salaries, wages, and other administrative expenses	\$ 2,554,374	\$ 3,275,852
Interest on bonds	1,219,492	796,211
Total Operating Expenses	\$ 3,773,866	\$ 4,072,063
 Operating Income (Loss)	 \$ (2,965,279)	 \$ (3,887,946)
Nonoperating Revenues		
Investment and interest income	\$ 47,251	\$ 49,501
Net increase (decrease) in the fair value of investments	0	(32,820)
Total Nonoperating Revenues	\$ 47,251	\$ 16,680
 Change in net assets	 \$ ( 2,918,028)	 \$ (3,871,266)
Total net assets - Beginning	(11,606,647)	(7,735,381)
 Total net assets - Ending	 \$ (14,524,675)	 \$ (11,606,647)

**Interest income from loans** and **loan fees** increased during the period as a result of the addition of several new loans.

**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 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 increased as a result of an increase in the prime interest rate and as a result of accrued interest associated with the additional \$9,870,000 of principal that MBDA drew on the bond with MSHDA during fiscal year 2004-05.

**Net increase (decrease) in the fair value of investments** has a zero balance. A U.S. Treasury note was sold during fiscal year 2003-04, and the only investments in fiscal year 2004-05 were certificates of deposit, which are recorded on a cost basis and, therefore, do not have changes in the fair value.

**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**

	2005	2004
Cash provided (used) by:		
Operating activities	\$ (9,069,863)	\$ (6,761,101)
Noncapital financing activities	9,749,250	(36,725,987)
Investing activities	(1,585,896)	15,201,082
Net cash provided (used) - all activities	\$ (906,509)	\$ (28,286,006)
Cash - Beginning	2,276,676	30,562,683
Cash - Ending	\$ 1,370,167	\$ 2,276,676

**Significant Subsequent Event Having a Major Effect on Financial Position**

Effective November 16, 2005, MBDA amended its investment agreement with MSHDA. This subsequent event will have a substantial impact on MBDA in fiscal year 2005-06. As a result of the amended investment agreement, the prior bond has been canceled and returned to MBDA, MBDA will pay MSHDA \$2,264,577, and the current and future MBDA revenues are pledged to MSHDA as security on a new bond. In addition, MBDA has been allocated the following amounts from MSHDA: up to \$4,992,613 for advances on existing loans; up to \$17,000,000 for new loans; up to \$250,000 for accounts

payable and accrued expenses prior to November 16, 2005; and up to \$995,000 for operating expenses. These amounts will be deposited by MSHDA in an escrow fund and will be available to MBDA as needed.

MBDA management is implementing a plan that will budget the resources available for operating expenses to enable MBDA to function past the end of fiscal year 2005-06. It has not yet been determined how far into fiscal year 2006-07 MBDA will continue operations. For further details relating to this subsequent event, see the notes to the financial statements (Notes 10 and 11).

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# FINANCIAL STATEMENTS

MICHIGAN BROADBAND DEVELOPMENT AUTHORITY  
Statement of Net Assets  
As of September 30, 2005

**ASSETS**

Current Assets:	
Cash and cash equivalents (Note 2)	\$ 1,370,167
Investments (Note 2)	1,650,293
Interest receivable	36,262
Accounts receivable	137
Loans receivable (Notes 10 and 11)	1,401,831
Total Current Assets	<u>\$ 4,458,689</u>
Noncurrent Assets:	
Loans receivable (Notes 10 and 11)	<u>9,886,085</u>
Total Assets	<u>\$ 14,344,774</u>

**LIABILITIES**

Current Liabilities:	
Accounts payable	\$ 59,404
Deferred revenue	37,905
Compensated absences (Note 4)	97,027
Amounts due primary government	90,620
Interest payable (Notes 3, 10, and 11)	450,000
Total Current Liabilities	<u>\$ 734,955</u>
Noncurrent Liabilities:	
Bonds payable (Notes 3, 10, and 11)	\$ 23,444,013
Compensated absences (Note 4)	100,609
Loan reserves	129,586
Interest payable (Notes 3, 10, and 11)	4,460,286
Total Noncurrent Liabilities	<u>\$ 28,134,494</u>
Total Liabilities	<u>\$ 28,869,449</u>

**NET ASSETS**

Restricted net assets	\$ 2,000
Unrestricted net assets (deficit)	<u>(14,526,675)</u>
Total Net Assets (Note 8)	<u>\$ (14,524,675)</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, 2005

<b>OPERATING REVENUES</b> (Notes 10 and 11)	
Interest income from loans	\$ 484,177
Loan fees	315,830
Miscellaneous income	8,580
Total Operating Revenues	<u>\$ 808,587</u>
<b>OPERATING EXPENSES</b> (Notes 10 and 11)	
Salaries and wages	\$ 510,548
Employee benefits (Note 6)	348,591
Contractual services employee compensation	462,566
Contractual services	1,033,845
Interest on bonds	1,219,492
Administrative and general	198,824
Total Operating Expenses	<u>\$ 3,773,866</u>
Operating Income (Loss)	<u>\$ (2,965,279)</u>
<b>NONOPERATING REVENUES</b>	
Investment income	\$ 29,901
Interest income	17,350
Total Nonoperating Revenues	<u>\$ 47,251</u>
Change in net assets	\$ (2,918,028)
Total Net Assets - Beginning	<u>(11,606,647)</u>
Total Net Assets - Ending (Note 8)	<u><u>\$ (14,524,675)</u></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, 2005

**CASH FLOWS FROM OPERATING ACTIVITIES**

Fees	\$ 197,130
Other operating revenue	8,580
Loans to customers	(7,500,576)
Principal and interest payments on loans	751,994
Payments to employees	(770,494)
Payments to suppliers	(1,756,497)
Net cash provided (used) by operating activities	<u>\$ (9,069,863)</u>

**CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES**

Interest paid	\$ (120,750)
Proceeds from issuance of bonds	9,870,000
Net cash provided (used) by noncapital financing activities	<u>\$ 9,749,250</u>

**CASH FLOWS FROM INVESTING ACTIVITIES**

Purchase of investments	\$ (1,633,147)
Interest on investments	47,251
Net cash provided (used) by investing activities	<u>\$ (1,585,896)</u>

Net cash provided (used) - all activities	\$ (906,509)
Cash and cash equivalents - Beginning	<u>2,276,676</u>
Cash and cash equivalents - Ending	<u><u>\$ 1,370,167</u></u>

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

Operating income (loss)	\$ (2,965,279)
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	(7,420,221)
Interest payments on debt reported as cash flows from financing activities	120,750
Change in assets and liabilities:	
Interest receivable	(25,323)
Accounts receivable and other assets	1,604
Accounts payable	(13,510)
Interest payable	1,098,742
Compensated absences	39,297
Unearned revenue	19,210
Loan reserves payable	74,867
Net cash provided (used) by operating activities	<u><u>\$ (9,069,863)</u></u>

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 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, regardless of the timing of cash flows. 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 consist primarily of those 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 and interest earnings.
- (4) Cash Equivalents: MBDA considers money market funds to be cash equivalents.
- (5) Investments: Investments consist of certificates of deposit.
- (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, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*. For the period ended September 30, 2005, MBDA had no equipment purchases capitalized.

Note 2 Deposits

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. 40, *Deposit and Investment Risk Disclosures*, an amendment of GASB Statement

No. 3, requires certain disclosures regarding policies and practices with respect to deposits and investments and the custodial credit risk associated with them.

Custodial credit risk for deposits is the risk that, in the event of the failure of a depository financial institution, MBDA will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party. MBDA does not have a deposit policy for custodial credit risk. As of September 30, 2005, the reported amount of MBDA's deposits was \$3,020,460 and the bank balance was \$3,183,382, consisting of the following:

Money market funds	\$ 1,111,493
Cash in bank	421,596
Certificates of deposit	<u>1,650,293</u>
 Total Deposits	 <u><u>\$ 3,183,382</u></u>

Of this amount, \$1,300,000 was covered by federal depository insurance and \$1,883,382 was uninsured and uncollateralized.

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 obligations of MBDA and are not debts of the State of Michigan. Bonds are secured by the pledge to repay the principal and interest related to those bonds. Minimum amounts of 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, 2004 through September 30, 2005:

Beginning bonds payable	\$ 13,574,013
Additional proceeds and borrowings	<u>9,870,000</u>
 Ending Bonds Payable	 <u><u>\$ 23,444,013</u></u>

MBDA general obligations outstanding as of September 30, 2005 were:

Michigan Broadband Development Authority Purposes  
 Funding Taxable Subordinate Bond Series 2002A, payable  
 through May 1, 2022 with an interest rate of 6% \$ 23,444,013

The annual requirements to amortize all debt outstanding, including interest, as of September 30, 2005, are as follows:

Fiscal Year	Principal	Interest	Total
2005-06	\$	\$ 1,406,641	\$ 1,406,641
2006-07		1,406,641	1,406,641
2007-08		1,406,641	1,406,641
2008-09		1,406,641	1,406,641
2009-10		1,406,641	1,406,641
Total for fiscal years 2005-06 through 2009-10	\$ 0	\$ 7,033,205	\$ 7,033,205
2010-11 through 2014-15		7,033,205	7,033,205
2015-16 through 2019-20		7,033,205	7,033,205
2020-21 through 2021-22	23,444,013	2,227,181	25,671,194
Total	<u>\$23,444,013</u>	<u>\$23,326,796</u>	<u>\$46,770,809</u>

Prior to the subsequent event discussed in Note 10, a minimum interest payment was calculated based on the investment agreement and was due each February 1. Interest continued to accrue on the difference between the interest calculated and the minimum interest payment. Accrued interest that exceeded minimum interest payments was due when the bond matured.

At September 30, 2005, the bond debt of \$23,444,013 was due May 1, 2022. The bond was structured so that MBDA could take additional draws as long as the maximum principal amount did not exceed \$50 million. Interest on the investment (and the bond which evidences it) was the lower of the prime rate or 6% per annum for short-term advances that were 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 remained outstanding for

more than 360 days. Interest was compounded annually, calculated on the basis of a 360-day year composed of twelve 30-day months. As of September 30, 2005, the prime rate was greater than the bond interest rate of 6%. The principal balance calculated at a lower short-term rate is \$0.

Subsequent event: See the subsequent event note (Note 10), which provides further information regarding MBDA's bond payable.

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	\$ 158,339	\$ 86,079	\$ 46,782	\$197,636	\$ 97,027

Note 5 Leases

MBDA was housed in the MSHDA office building through November 15, 2005. 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 automatically renewed on an annual basis on each March 1.

The annual lease amount for March 1, 2005 through February 28, 2006 was \$101,949. The lease payments were inclusive of all expenses for taxes, maintenance, utilities, office services, and similar expenses.

As of November 15, 2005, the lease with MSHDA was canceled and MBDA relocated its offices within the Michigan Economic Development Corporation (MEDC) office building. However, a lease agreement with MEDC had not been executed.

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 10-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 as well as the director of the Department of Labor and Economic Growth and the State Treasurer. In April 2002, MBDA entered into an investment agreement with MSHDA for the sale of a bond to MSHDA. The investment agreement was amended on October 15, 2003 to include an option to take advances on the bond principal as needed. The total amount of the bond issue was \$23,444,013 as of September 30, 2005. See Note 3 for additional information relating to the bonds payable and Note 10 for a subsequent event with MSHDA.

In addition, MBDA was housed in the MSHDA office building and made monthly lease payments to MSHDA. See Note 5 for more details regarding the lease.

Note 8 Net Asset Deficit

As of September 30, 2005, MBDA had a net asset deficit of \$14,524,675, which resulted from start-up expenses and expenses for projects exceeding corresponding revenue.

Note 9 Differences in Reporting From the *SOMCAFR*

MBDA's agreement with MSHDA states that there is a minimum interest payment due in February of each year. As of September 30, 2005, the estimated minimum interest payment due in February 2006 was \$450,000 and the remaining interest payable of \$4,460,286 was not due until the bond matured in the year 2022. As a result, the MBDA statement of net assets was adjusted from the fiscal year 2004-05 *SOMCAFR* in order to split interest payable between short-term and long-term. The Office of Financial

Management, Department of Management and Budget, has issued a waiver that allows for this presentation that is different from the presentation in the *SOMCAFR* for the fiscal year ended September 30, 2005.

Note 10 Subsequent Event

In April 2002, MBDA entered into a \$50 million investment agreement with MSHDA, which was evidenced by a bond indenture. In October 2003, the investment agreement was amended to become a line-of-credit type arrangement. Effective November 16, 2005, the MBDA Board of Directors and the MSHDA Board approved and executed a second amendment of the investment agreement.

The Second Amended and Restated Investment Agreement restructures the financing as follows:

- a. MBDA shall pay \$2,264,577 to MSHDA and irrevocably pledge to MSHDA loans receivable of \$12,246,197 (approximately \$1.4 million of current and approximately \$10.8 million of noncurrent) as of November 16, 2005 and subsequent interest collections on these loans along with any future collections of principal and interest relating to additional loans originating with MBDA. The agreement also provides that the \$2,264,577 payment and irrevocable pledge shall be deemed to be a final accounting of the then-outstanding \$23,444,013 principal amount on the prior bond and \$5,118,319 of accrued and unpaid interest thereon as of the closing date, with any difference being thereupon forgiven by MSHDA and extinguished. The prior bond shall be canceled and returned to MBDA.
- b. MBDA issued a new bond to MSHDA, with a principal amount of \$35,483,810. The new bond is to be collateralized with \$23,237,613 in funds to be held in an escrow fund in the name of MSHDA and the pledged \$12,246,197 of existing loans financed by MBDA with prior bond proceeds.

- c. MSHDA will accept directions from MBDA regarding the usage of escrow funds subject to the following limitations:
  - (1) An amount not greater than \$4,992,613 shall be available to make advances relating to existing loan agreements.
  - (2) An amount not greater than \$17,000,000 shall be available to borrowers at 4% to make Rural Broadband Initiative (RBI) loans resulting from a request for proposals that was issued on November 30, 2005. The loans will be issued for the purpose of expanding access to broadband communications for residents, public entities, and private businesses in regions that have been historically underserved in terms of access to high-speed Internet services.
  - (3) An amount not greater than \$250,000 shall be available for the settlement of accounts payable and other accrued expenses.
  - (4) An amount not greater than \$995,000 shall be available for the operating expenses of MBDA.
- d. MBDA will transfer the balance in the escrow fund with equal reduction in bonds payable to MSHDA at the 17-month calendar anniversary of the closing date (April 16, 2007), with certain exceptions and conditions.
- e. The rate of interest on the new bond shall be 0% per annum.
- f. The new bond is characterized as a limited obligation of MBDA payable solely from the MBDA pledged assets and is not a debt of the State of Michigan.
- g. On each interest payment date of the new bond (defined as the 15<sup>th</sup> of the month subsequent to November 16, 2005), all borrower payments received by MBDA shall be released from the escrow fund and paid over to MSHDA as payment on the bond.
- h. MSHDA shall service MBDA loans in accordance with loan documents and the loan servicing provisions of the agreement.

#### Note 11 Going Concern

The financing described in Note 10 will change MBDA operations in the foreseeable future. Current and future MBDA revenues are now pledged to MSHDA as security on the bond. Further, repayment on past debt that MBDA owes to MSHDA is forgiven in full regardless of the overall amount of revenue ultimately generated from MBDA loans. MBDA plans to allocate the \$995,000 described in Note 10, item c.(4) accordingly so that MBDA operations can be sustained through fiscal year 2005-06 and into fiscal year 2006-07.

In order to sustain operations within this allocation, MBDA has reduced its staffing level to 5 employees and has recast its operations and future mission. In the future, the MBDA plans to focus on the following:

- a. Marketing the RBI request for proposal and managing underwriting processes when loan applications are received.
- b. Managing the Digital Divide Investment (grant) Program, which is a collaborative program supported by MBDA, MSHDA, and MEDC. The program combines MBDA loans with federal Community Development Block Grants and is intended to make broadband service more affordable for low and moderate income households.
- c. Offering consulting services to rural communities in support of broadband expansion efforts in their regions.
- d. Developing a series of survey tools to gauge broadband use and services across the State.
- e. Promoting new technologies and expansion programs by attracting pilot projects and facilitating and seeking out collaborative grant-making opportunities.
- f. Monitoring loans and administering necessary meetings with the MBDA Board of Directors for approval of loans and modifications of existing lending agreements.

MBDA plans to process all loan applications from the new RBI request for proposals and make recommendations to the MBDA Board of Directors for approval of any loans through this program. For the time being, RBI will be the sole lending mechanism for MBDA. After it concludes, MBDA plans to continue focusing on items b. through f.

RBI has been undertaken to build on the successes of MBDA and to focus remaining loan dollars on the State's most underserved regions. In eligible areas, qualifying broadband providers may receive 4% loans with interest-only draw periods of up to 24 months. The investment agreement designates up to \$17,000,000 for RBI. The new investment agreement with MSHDA also includes a servicing arrangement. As necessary, MBDA plans to work with MSHDA staff to review applications and develop loan documents for the MBDA Board of Directors' consideration. MSHDA staff will also help close loans and consult with MBDA on occasion to recommend to the MBDA Board of Directors any changes to loan agreements as necessary.

Given the shift in focus and realignment of resources, MBDA management is implementing a plan that allocates available resources for MBDA past the end of fiscal year 2005-06. This plan provides for MBDA staff to fully execute RBI and process loan applications for the MBDA Board of Directors' consideration. It has not yet been determined how far into fiscal year 2006-07 MBDA will continue operations. Once all RBI loan applications are processed, other MBDA functions may cease or MBDA may obtain further financial support through other offices or operational divisions within State government.

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INDEPENDENT AUDITOR'S REPORT ON  
INTERNAL CONTROL AND COMPLIANCE



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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

Board of Directors  
Michigan Broadband Development Authority  
and  
Mr. James W. Butler III, Vice President  
Michigan Broadband Development Authority  
300 North Washington  
Lansing, Michigan

Dear Members of the Board 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, 2005, as identified in the table of contents, and have issued our report thereon dated January 13, 2006. 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control 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 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 the internal control over financial reporting and its operation that we consider to be material weaknesses.

### 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

January 13, 2006

# GLOSSARY

## Glossary of Acronyms and Terms

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.
MEDC	Michigan Economic Development Corporation.
MSHDA	Michigan State Housing Development Authority.
RBI	Rural Broadband Initiative.

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.







