



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 can be accessed at:

<http://audgen.michigan.gov>



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, 2006*

Report Number:
641-0810-07

Released:
July 2007

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.

~ ~ ~ ~ ~

Internal Control Over Financial Reporting

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

~ ~ ~ ~ ~

**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*.

~ ~ ~ ~ ~

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 (MSHDA), and 8 members appointed by the Governor with the advice and consent of the Senate.

MBDA management has implemented a plan that will budget the resources available for operating expenses to enable MBDA to function past the end of fiscal year 2005-06. The resources should enable MBDA to function through April 16, 2007. After this date, MBDA will be inactive and MSHDA will assume all MBDA responsibilities.

~ ~ ~ ~ ~

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



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

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

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



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

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

July 11, 2007

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, 2005 through September 30, 2006.

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. 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

TABLE OF CONTENTS

MICHIGAN BROADBAND DEVELOPMENT AUTHORITY

	<u>Page</u>
INTRODUCTION	
Report Summary	1
Report Letter	3
INDEPENDENT AUDITOR'S REPORT	
Independent Auditor's Report on the Financial Statements	8
MANAGEMENT'S DISCUSSION AND ANALYSIS	
Management's Discussion and Analysis	11
FINANCIAL STATEMENTS	
Michigan Broadband Development Authority Financial Statements	
Statement of Net Assets	18
Statement of Revenues, Expenses, and Changes in Net Assets	19
Statement of Cash Flows	20
Notes to the Financial Statements	21
INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE	
Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters	30

GLOSSARY

Glossary of Acronyms and Terms

33

INDEPENDENT AUDITOR'S REPORT



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

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, 2006, 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, 2006 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, 2006 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 8 and 10 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 financing agreement with the Michigan State Housing Development Authority that raise substantial doubt about its ability to continue as a going concern. Note 10 provides the details of the amended financing agreement, explains the limited amount of funding that is available for operations, and describes management's plans to allocate the limited funding accordingly.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 20, 2007 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 16 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

March 20, 2007

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, 2005 through September 30, 2006. 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 and chief executive officer are 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

	2006	2005
Current assets	\$ 3,622,664	\$ 4,458,689
Noncurrent assets	12,119,496	9,886,085
Total assets	<u>\$ 15,742,160</u>	<u>\$ 14,344,774</u>
Current liabilities	\$ 3,519,667	\$ 734,955
Noncurrent liabilities	12,295,854	28,134,494
Total liabilities	<u>\$ 15,815,521</u>	<u>\$ 28,869,449</u>
Net Assets		
Restricted net assets	\$	\$ 2,000
Unrestricted net assets (Deficit)	(73,361)	(14,526,675)
Total net assets (Deficit)	<u>\$ (73,361)</u>	<u>\$ (14,524,675)</u>

Current assets consist of three money market customer reserve accounts, one operational checking account, amounts due from the Michigan State Housing Development Authority (MSHDA), and the current portion of loans receivable. Current assets have decreased because MBDA now maintains a lower operational checking account balance and because of the continued reduction of operational expenses.

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

Current liabilities consist of accounts payable, amounts due to local government, the current portion of compensated absences, amounts due to primary government, and amounts due to MSHDA, which equal the current portion of loans receivable. The increase is a result of establishing a new current liability account entitled "amounts - due to MSHDA" as a result of the second amended and restated investment agreement with MSHDA. This account had a fiscal year-end balance of \$2,833,977.

Noncurrent liabilities consist of the long-term portion of compensated absences, loan reserves, and amounts due to MSHDA, which equal the noncurrent portion of customer loans receivable. The large decrease in noncurrent liabilities is a result of the restated

investment agreement in which the prior bond was canceled and, accordingly, a net total of \$14,521,283 of combined bond payable and interest payable amounts were forgiven by MSHDA.

Significant Event Having a Major Effect on Financial Position

Effective November 16, 2005, MBDA amended its investment agreement with MSHDA. This agreement had a substantial impact on MBDA. As a result of the amended investment agreement, the prior bond has been canceled and, accordingly, both the bond and interest payable amounts were forgiven. As consideration for this forgiveness of debt, MBDA paid \$2,148,009 to MSHDA and all current loans receivable and applicable future revenues are pledged to MSHDA. A new investment vehicle was created by MSHDA totaling \$23,237,613 to be allocated as follows: (1) \$4,992,613 for additional advances on existing loans; (2) \$17,000,000 for new loans under the Governor's rural broadband initiative; (3) \$250,000 for accounts payable and accrued expenses of MBDA prior to November 16, 2005; and (4) \$995,000 for MBDA operating expenses for up to 17 months after the effective date of the agreement. These amounts have been deposited by MSHDA in an escrow fund and are available for disbursement as needed. All monies allocated for loans are sent from MSHDA directly to the borrower.

MBDA management has implemented a plan that will budget the resources available for operating expenses to enable MBDA to function past the end of fiscal year 2005-06. The resources should enable MBDA to function through April 16, 2007. After this date, MBDA will be inactive and MSHDA will assume all MBDA responsibilities.

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

	2006	2005
Operating revenues		
Interest income from loans	\$ 168,579	\$ 484,177
Loan fees	0	315,830
Miscellaneous income	153,840	8,580
Federal revenue	597,000	0
Total operating revenues	\$ 919,419	\$ 808,587
Operating expenses		
Salaries, wages, and other administrative expenses	\$ 1,572,894	\$ 2,554,374
Interest on bonds	183,299	1,219,492
Total operating expenses	\$ 1,756,193	\$ 3,773,866
Operating income (loss)	\$ (836,774)	\$ (2,965,279)
Nonoperating revenues		
Investment and interest income	\$ 29,137	\$ 47,251
Nonoperating subsidy from MSHDA	601,500	0
Total nonoperating revenues	\$ 630,637	\$ 47,251
Income (loss) before special item	\$ (206,137)	\$ (2,918,028)
Special item - Forgiveness of debt	14,657,451	0
Change in net assets	\$ 14,451,314	\$ (2,918,028)
Total net assets - Beginning	(14,524,675)	(11,606,647)
Total net assets - Ending	\$ (73,361)	\$ (14,524,675)

Interest income from loans and **loan fees** has decreased significantly from the prior fiscal year. Interest income from loans was captured by MBDA through December 1, 2005. Thereafter, all payments and interest income from loans were received and

booked directly by MSHDA. This change was in accordance with the amended investment agreement with MSHDA, which took effect November 16, 2005.

Miscellaneous income is the direct result of reducing the accrued liability for compensated absences from the previous year. Compensated absences account for MBDA's liability (at year-end) as it pertains to vacation pay, sick leave, and banked leave time accumulated by the State of Michigan civil service employees. There were eight State civil service employees on staff at the end of the previous period, and as of September 30, 2006, there were two State civil service employees on staff. This resulted in a recapture of previously expensed amounts as miscellaneous income in fiscal year 2005-06.

Federal revenue is the result of MBDA administering the Digital Divide Investment Program (DDIP). DDIP is a collaborative program among MBDA, MSHDA, and the Michigan Economic Development Corporation (MEDC) that utilizes federal Community Development Block Grant funds to support large-scale deployment of broadband infrastructure. MEDC is the direct recipient of these federal funds.

Salaries, wages, and other administrative expenses decreased during the period because of a reduction in MBDA staff and a decreasing amount of contract services. 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 decreased based on the second amended and restated investment agreement with MSHDA. The interest expense incurred covered the period October 1 through November 16, 2005.

Nonoperating subsidy from MSHDA reflects operational funds received from MSHDA since November 16, 2005. In accordance with the second amended and restated investment agreement with MSHDA, the cap on these funds is \$995,000.

Special item - Forgiveness of debt reflects the net amount forgiven by MSHDA on the previous bond outstanding. See "Significant Event Having a Major Effect on Financial Position" discussion.

Change in net assets reflects the effect of the combination of operating and nonoperating revenues exceeding expenses for the current year.

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

	2006	2005
Cash provided (used) by:		
Operating activities	\$ (4,494,831)	\$ (9,069,863)
Noncapital financing activities	1,636,921	9,749,250
Investing activities	1,679,430	(1,585,896)
Net cash provided (used) - all activities	\$ (1,178,480)	\$ (906,509)
Cash - Beginning	1,370,167	2,276,676
Cash - Ending	\$ 191,687	\$ 1,370,167

FINANCIAL STATEMENTS

MICHIGAN BROADBAND DEVELOPMENT AUTHORITY
Statement of Net Assets
As of September 30, 2006

ASSETS

Current assets:

Cash and cash equivalents (Note 2)	\$ 191,687
Amounts due from Michigan State Housing Development Authority (MSHDA) (Note 11)	597,000
Loans receivable (Note 3)	<u>2,833,977</u>
Total current assets	<u>\$ 3,622,664</u>

Noncurrent assets:

Loans receivable (Note 3)	<u>12,119,496</u>
---------------------------	-------------------

Total assets	<u>\$ 15,742,160</u>
--------------	----------------------

LIABILITIES

Current liabilities:

Accounts payable	\$ 12,145
Amounts due to primary government (Note 11)	48,108
Amounts due to local government	597,000
Compensated absences (Note 4)	28,437
Amounts due to MSHDA (Note 3)	<u>2,833,977</u>
Total current liabilities	<u>\$ 3,519,667</u>

Noncurrent liabilities:

Compensated absences (Note 4)	\$ 15,359
Loan reserves	160,999
Bonds payable (Notes 5, 8, and 10)	
Amounts due to MSHDA (Note 3)	<u>12,119,496</u>
Total noncurrent liabilities	<u>\$ 12,295,854</u>

Total liabilities	<u>\$ 15,815,521</u>
-------------------	----------------------

NET ASSETS

Unrestricted net assets (deficit) (Note 9)	<u>\$ (73,361)</u>
--	--------------------

Total net assets (deficit)	<u><u>\$ (73,361)</u></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, 2006

OPERATING REVENUES

Interest income from loans	\$ 168,579
Miscellaneous income (Note 4)	153,840
Federal revenue (Note 11)	597,000
Total operating revenues	\$ 919,419

OPERATING EXPENSES

Salaries and wages	\$ 199,446
Employee benefits (Note 7)	119,130
Contractual services employee compensation	372,056
Contractual services	235,993
Contractual services - Digital Divide Investment Program (Note 11)	597,000
Interest on bonds (Note 10)	183,299
Administrative and general (Note 6)	49,269
Total operating expenses	\$ 1,756,193

Operating income (loss)	\$ (836,775)
-------------------------	--------------

NONOPERATING REVENUES

Investment income	\$ 21,984
Interest income	7,153
Nonoperating subsidy - MSHDA (Notes 8 and 10)	601,500
Total nonoperating revenues	\$ 630,637

Income (loss) before special item	\$ (206,137)
-----------------------------------	--------------

Special item - Forgiveness of debt (Note 11)	14,657,451
--	------------

Change in net assets	\$ 14,451,314
----------------------	---------------

Total net assets (deficit) - Beginning	(14,524,675)
--	--------------

Total net assets (deficit) - Ending	\$ (73,361)
-------------------------------------	-------------

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, 2006

CASH FLOWS FROM OPERATING ACTIVITIES

Fees	\$ 31,550
Other operating revenue	153,840
Loans to customers	(5,143,092)
Principal and interest payments on loans	1,682,375
Payments to employees	(472,415)
Payments to suppliers	(747,089)
Net cash provided (used) by operating activities	\$ (4,494,831)

CASH FLOW FROM NONCAPITAL FINANCING ACTIVITIES

Operating subsidy from MSHDA	\$ 601,500
Subsidies from MSHDA to provide loans to customers	2,883,431
Proceeds from issuance of debt	300,000
Principal payments on bonds	(2,148,010)
Net cash provided by (used in) noncapital financing activities	\$ 1,636,921

CASH FLOWS FROM INVESTING ACTIVITIES

Proceeds from the sale and maturity of investments	\$ 1,650,293
Interest on investments	29,137
Net cash provided by (used in) investing activities	\$ 1,679,430

Net cash provided (used) - all activities	\$ (1,178,480)
Cash and cash equivalents - Beginning	1,370,167

Cash and cash equivalents - Ending	\$ 191,687
------------------------------------	------------

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

Operating income (loss)	\$ (836,775)
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:	
Loans to customers and principal on loans reported as cash flows from operating activities	(3,665,557)
Change in assets and liabilities:	
Interest receivable	36,262
Accounts receivable and other assets	137
Amounts due from MSHDA	(597,000)
Accounts payable	(47,259)
Amounts due to primary government	(42,512)
Interest payable	183,299
Compensated absences	(153,839)
Amounts due to local government	597,000
Loan reserves payable	31,413
Net cash provided by operating activities	\$ (4,494,831)

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.

As disclosed in Note 10, MBDA management has implemented a plan that will enable MBDA to function through April 16, 2007. After this date, MBDA will be inactive and MSHDA will assume all MBDA responsibilities.

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 accounting principles generally accepted in the United States of America.

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.

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.

b. Deposits

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, 2006, the reported amount of MBDA's deposits was \$191,687, consisting of the following:

Customer Reserve Accounts - Money market funds	\$ 160,999
MBDA - Money market funds	2,789
MBDA - Cash in bank	27,899
Total deposits	<u><u>\$ 191,687</u></u>

Of this amount, \$100,000 was covered by federal depository insurance and \$91,687 was uninsured and uncollateralized.

Note 3 Loans Receivable and Amounts Due to MSHDA

The current and noncurrent loan receivable amounts are equal to current and noncurrent amounts due to MSHDA amounts, respectively. This balance represents the principal amounts of customer loans that will be paid by the customer directly to MSHDA. This is in accordance with the second amended and restated investment agreement summarized in Note 10.

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	\$ 197,636	\$ 0	\$ 153,840	\$ 43,796	\$ 28,437

Because of significant reductions in the number of MBDA employees, the liability balance at year-end was less than the prior year-end balance.

Note 5 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.

Effective November 16, 2005, MBDA amended its investment agreement with MSHDA, which included the elimination of bonds payable to MSHDA. The following table displays the aggregate changes in bonds payable for the period October 1, 2005 through September 30, 2006:

Beginning bonds payable	\$ 23,444,013
Additional proceeds and borrowings	300,000
Cash payments made to MSHDA by MBDA	(2,148,009)
Elimination of bonds payable	<u>\$ (21,596,004)</u>
Ending bonds payable	<u>\$ 0</u>

Note 6 Leases

MBDA is housed in the Michigan Economic Development Corporation building. MBDA's lease arrangement fell under the umbrella agreement between the Department of Labor and Economic Growth (DLEG) and the Michigan Economic Development Corporation. The initial term of the occupancy began on November 1, 2005 and ends September 30, 2007. MBDA is only responsible for its portion of lease payments (\$1,850 per month).

The annualized lease amount as of December 2006 was \$22,200. The lease payments were inclusive of all expenses for taxes, maintenance, utilities, office services, and similar expenses.

Note 7 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 are also enrolled in a noncontributory defined benefit plan or a defined contribution plan through the State Employees' Retirement System upon meeting certain eligibility requirements. 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 8 Related Party Transactions

The MBDA Board of Directors includes the executive director of MSHDA. During 2002, MBDA entered into an investment agreement with MSHDA for the sale of a \$50,000,000 bond to MSHDA. The bond agreement was restructured on October 15, 2003 to a line of credit. As of September 30, 2005, the total amount of the bond issue and bond interest payable under this arrangement was \$23,444,013 and \$4,910,286, respectively. Effective November 16, 2005, the MBDA/MSHDA investment agreement was amended. As a result, the prior bond and related interest were canceled and, accordingly, both the bond and interest payable amounts were forgiven. As consideration for this forgiveness of debt, MBDA paid \$2,148,009 to MSHDA and pledged all current loan receivables (\$12,168,306) and applicable future revenues to MSHDA. This resulted in a special forgiveness of MBDA's debt in the amount of \$14,657,451.

In addition, on November 16, 2005, a new investment vehicle was created by MSHDA totaling \$23,237,613 to be allocated as follows: (1) \$4,992,613 for additional advances on existing loans; (2) \$17,000,000 for new loans under the Governor's rural broadband initiative; (3) \$250,000 for accounts payable and accrued expenses of MBDA prior to November 16, 2005; and (4) \$995,000 for MBDA operating expenses for up to 17 months after the effective date of agreement.

These amounts have been deposited by MSHDA in an escrow fund and are available for disbursement as needed. All monies allocated for loans are sent from MSHDA directly to the borrower.

Note 9 Fund Deficit

As of September 30, 2006, MBDA had a fund deficit of \$73,361. This balance consists of:

MBDA cash in bank	\$ 27,899
MBDA - money market funds	2,789
Amounts due to primary government	(48,108)
Accounts payable	(12,145)
Compensated absences - short term	(28,437)
Compensated absences - long term	(15,359)
Fund deficit	<u>\$ (73,361)</u>

Note 10 Summary of Second Amended and Restated Investment Agreement

Effective November 16, 2005, MBDA restructured the existing bond payable with MSHDA that raise substantial doubt about its ability to continue as a going concern.

Cancellation of prior bond: On November 16, 2005, the principal amount of the prior bond outstanding was \$23,744,013 and accrued and unpaid interest under the prior bond equaled \$5,093,585.

As consideration for the bond cancellation arrangement, MSHDA received all cash held by MBDA exceeding amounts required for operational expenses and all future customer payments.

On November 16, 2005, a new financing arrangement which includes provisions creating the Investment Escrow Fund that shall contain \$23,237,613 was created. MSHDA shall direct the investment of the Fund prior to direction regarding the usage of the funds by MBDA. MBDA shall direct the usage of the Fund for the following allowable purposes:

- \$4,992,613 for advances on existing loans (8% per annum).
- \$17,000,000 for Rural Broadband Initiative (RBI) customer loans (4% per annum).
- \$250,000 for MBDA accounts payable.
- \$995,000 for MBDA operating expenses.

The agreement provides that MSHDA shall receive any earnings on the Fund as reasonable and appropriate consideration for the investment and the efforts expended by MSHDA in administering customer loans and the Fund. Funds under the agreement bear interest at a 0% per annum to MBDA and are not an obligation of the MBDA or the State of Michigan.

After 17 months from the date of closing, MSHDA is to receive the balance of funds in the Investment Escrow Fund not obligated for advances on existing loans, RBI loans, or RBI commitments.

If MBDA concludes prior to the 17-month anniversary of the closing that funds cannot be expended for the designated allowable purpose, no additional funds

will be distributed by MSHDA. MBDA management has implemented a plan that will enable MBDA to function through April 16, 2007. After this date, MBDA will be inactive and MSHDA will assume all MBDA responsibilities.

Note 11 Differences in Reporting From the SOMCAFR

Department of Management and Budget Administrative Guide procedure 1210.09 prohibits State agencies from issuing financial information inconsistent with the *SOMCAFR* unless they have received a waiver to do so from the Office of Financial Management, Department of Management and Budget. The Office of Financial Management issued waivers for the following:

- a. Amounts due from MSHDA, amounts due to local government, and corresponding revenues and expenses recognize the amount of \$597,000 to record the funding of a federal Community Development Block Grant to provide wireless Internet service for Muskegon County. This was not recognized in the *SOMCAFR*.
- b. The financial statements are corrected to report the forgiveness of debt owed to MSHDA as a special item, which was not recognized in the *SOMCAFR*.

INDEPENDENT AUDITOR'S REPORT ON
INTERNAL CONTROL AND COMPLIANCE



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

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 Square
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, 2006, as identified in the table of contents, and have issued our report thereon dated March 20, 2007. 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, the State's 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

March 20, 2007

GLOSSARY

Glossary of Acronyms and Terms

DLEG	Department of Labor and Economic Growth.
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.
<i>SOMCAFR</i>	<i>State of Michigan Comprehensive Annual Financial Report.</i>
unqualified opinion	An auditor's opinion in which the auditor states that: <ul style="list-style-type: none"> a. The financial schedules and/or financial statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting; or b. The financial schedules and/or financial statements presenting supplemental financial information are fairly stated in relation to the basic financial schedules and/or financial statements. In issuing this "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules to the extent necessary to form an opinion on the basic financial schedules and/or financial statements, but did not apply auditing procedures to the extent that would be necessary to express an opinion on the supplemental financial schedules taken by themselves.

