



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
Including the Provisions of the Single Audit Act
Department of Environmental Quality
October 1, 2005 through September 30, 2007

Report Number:
761-0100-08

Released:
June 2008

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

Financial Statements and Financial Schedules:

Auditor's Reports Issued

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

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Internal Control Over Financial Reporting

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

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**Noncompliance or Other Matters
Material to the Financial Statements
and/or Financial Schedules**

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

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Federal Awards:

Auditor's Reports Issued on Compliance

We audited 6 programs as major programs and issued 4 unqualified opinions and 2 qualified opinions. The opinions issued by major program are identified on the back of this summary.

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Internal Control Over Major Programs

We identified significant deficiencies in internal control over federal program compliance (Findings 1 through 5). We consider Findings 1 and 5 to contain material weaknesses. In addition, we identified four recommendations repeated from our prior report for the two-year period ended September 30, 2005 (Findings 1 through 4).

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Required Reporting of Noncompliance

We identified instances of noncompliance that are required to be reported in accordance with U.S. Office of Management and Budget (OMB) Circular A-133 (Findings 1 through 5).

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Systems of Accounting and Internal Control:

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

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We audited the following programs as major programs:

<u>CFDA Number</u>	<u>Program Title</u>	<u>Compliance Opinion</u>
11.419	Coastal Zone Management Administration Awards	Qualified
66.458	Capitalization Grants for Clean Water State Revolving Funds	Unqualified
66.460	Nonpoint Source Implementation Grants	Unqualified
66.468	Capitalization Grants for Drinking Water State Revolving Funds	Unqualified
66.605	Performance Partnership Grants	Qualified
66.805	Leaking Underground Storage Tank Trust Fund Program	Unqualified

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



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

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



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

June 30, 2008

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

Dear Mr. Chester:

This is our report on the financial audit, including the provisions of the Single Audit Act, of the Department of Environmental Quality (DEQ) for the period October 1, 2005 through September 30, 2007.

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

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

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

AUDITOR GENERAL

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



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

Independent Auditor's Report on the Financial Statements

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

Dear Mr. Chester:

We have audited the accompanying financial statements of the Department of Environmental Quality as of and for the fiscal years ended September 30, 2007 and September 30, 2006, as identified in the table of contents. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, the financial statements present only the Department of Environmental Quality's special revenue and agency funds and do not purport to, and do not, present fairly the financial position of the State of Michigan or its special revenue and agency funds as of September 30, 2007 and September 30, 2006 and the changes in financial position thereof for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Department of Environmental Quality's special revenue and agency funds as of September 30, 2007 and September 30, 2006

and the changes in financial position for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 16, 2008 on our consideration of the Department'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 schedule of expenditures of federal awards, required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and the supplemental financial statements, as identified in the table of contents, are presented for purposes of additional analysis and are not a required part of the Department's financial statements referred to in the first paragraph. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

AUDITOR GENERAL

June 16, 2008



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THOMAS H. MCTAVISH, C.P.A.
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Independent Auditor's Report on the Financial Schedules

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

Dear Mr. Chester:

We have audited the accompanying financial schedules of the Department of Environmental Quality for the fiscal years ended September 30, 2007 and September 30, 2006, as identified in the table of contents. These financial schedules are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial schedules based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial schedules. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

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

In our opinion, the financial schedules referred to in the first paragraph present fairly, in all material respects, the revenues and other financing sources and the sources and disposition of authorizations of the Department of Environmental Quality for the fiscal years ended September 30, 2007 and September 30, 2006 on the basis of accounting described in Note 1.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 16, 2008 on our consideration of the Department'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 schedule of expenditures of federal awards, required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is presented for purposes of additional analysis and is not a required part of the Department's financial schedules referred to in the first paragraph. Such information has been subjected to the auditing procedures applied in the audit of the financial schedules and, in our opinion, is fairly stated, in all material respects, in relation to the financial schedules taken as a whole.

AUDITOR GENERAL

June 16, 2008

DEPARTMENT OF ENVIRONMENTAL QUALITY
 Combined Balance Sheet
As of September 30
 (In Thousands)

	<u>Special Revenue Funds</u>		<u>Agency Fund</u>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
ASSETS				
Current assets:				
Equity in common cash (Note 3)	\$ 118,128	\$ 157,995	\$ 3,055	\$ 2,887
Amounts due from component units	16	118		
Amounts due from local units	1,234	1,212		
Other current assets	2,612	754		
Total current assets	<u>\$ 121,989</u>	<u>\$ 160,078</u>	<u>\$ 3,055</u>	<u>\$ 2,887</u>
Amounts due from local units	11,277	5,474		
Other noncurrent assets	857	643		
Total assets	<u>\$ 134,123</u>	<u>\$ 166,195</u>	<u>\$ 3,055</u>	<u>\$ 2,887</u>
LIABILITIES AND FUND BALANCES				
Current liabilities:				
Warrants outstanding	\$ 1,659	\$ 508	\$	\$
Accounts payable and other liabilities	15,521	17,700	3,055	2,887
Amounts due to other funds	76	191		
Deferred revenue	280	429		
Total current liabilities	<u>\$ 17,536</u>	<u>\$ 18,828</u>	<u>\$ 3,055</u>	<u>\$ 2,887</u>
Long-term liabilities:				
Deferred revenue	857	643		
Total liabilities	<u>\$ 18,393</u>	<u>\$ 19,471</u>	<u>\$ 3,055</u>	<u>\$ 2,887</u>
Fund balances (Note 2):				
Reserves for:				
Budgetary carry-forwards:				
Encumbrances	\$ 2,566	\$ 1,865	\$	\$
Restricted revenues	35,461	27,046		
Multi-year projects	4,998	6,718		
Revolving loan programs	21,621	20,723		
Funds held as permanent investments	6,172	3,650		
Total reserved	<u>\$ 70,818</u>	<u>\$ 60,002</u>	<u>\$ 0</u>	<u>\$ 0</u>
Unreserved	44,913	86,722		
Total fund balances	<u>\$ 115,730</u>	<u>\$ 146,724</u>	<u>\$ 0</u>	<u>\$ 0</u>
Total liabilities and fund balances	<u>\$ 134,123</u>	<u>\$ 166,195</u>	<u>\$ 3,055</u>	<u>\$ 2,887</u>

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

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

	<u>Special Revenue Funds</u>	
	<u>2007</u>	<u>2006</u>
REVENUES		
From federal agencies	\$ 1,153	\$ 103
Interest and other miscellaneous	25,132	26,244
Total revenues	<u>\$ 26,285</u>	<u>\$ 26,346</u>
EXPENDITURES		
Current:		
General government	\$	\$ 127
Environmental	56,875	129,312
Debt service:		
Bond interest and fiscal charges		174
Total expenditures	<u>\$ 56,875</u>	<u>\$ 129,614</u>
Excess of revenues over (under) expenditures	<u>\$ (30,590)</u>	<u>\$ (103,267)</u>
OTHER FINANCING SOURCES (USES)		
Bond issued	\$	\$ 152,000
Premium on bond issuance		3,520
Transfers from other funds	8,000	
Transfers to other funds (Notes 9)	<u>(8,404)</u>	<u>(34,596)</u>
Total other financing sources (uses)	<u>\$ (404)</u>	<u>\$ 120,925</u>
Excess of revenues and other sources over (under) expenditures and other uses	<u>\$ (30,994)</u>	<u>\$ 17,657</u>
Fund balances - Beginning of fiscal year	<u>146,724</u>	<u>129,067</u>
Fund balances - End of fiscal year	<u><u>\$ 115,730</u></u>	<u><u>\$ 146,724</u></u>

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

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of General Fund Revenues and Other Financing Sources (Note 8)
Fiscal Years Ended September 30
(In Thousands)

	<u>2007</u>	<u>2006</u>
REVENUES		
Taxes	\$ 27,975	\$ 30,770
From federal agencies (Note 6)	45,850	47,492
Licensing and permits	29,576	30,291
Miscellaneous:		
Gas and oil privilege fees	8,617	7,676
Environmental pollution judgments/settlements	4,283	3,980
Solid waste facility surcharge	3,904	4,381
Other	22,973	21,258
Total revenues	<u>\$ 143,178</u>	<u>\$ 145,847</u>
OTHER FINANCING SOURCES		
Transfers from other funds (Note 9)	<u>\$</u>	<u>\$ 22,095</u>
Total other financing sources	<u>\$ 0</u>	<u>\$ 22,095</u>
 Total revenues and other financing sources	 <u><u>\$ 143,178</u></u>	 <u><u>\$ 167,942</u></u>

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

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

	<u>2007</u>	<u>2006</u>
SOURCES OF AUTHORIZATIONS (Note 4)		
General purpose appropriations	\$ 30,788	\$ 31,810
Budgetary adjustment	240	
Balances carried forward	181,323	159,636
Restricted financing sources (Note 8)	154,294	176,682
Less: Intrafund expenditure reimbursements	<u>(13,165)</u>	<u>(12,586)</u>
Total	<u>\$ 353,480</u>	<u>\$ 355,542</u>
DISPOSITION OF AUTHORIZATIONS (Note 4)		
Gross expenditures and transfers out	\$ 185,665	\$ 186,229
Less: Intrafund expenditure reimbursements	<u>(13,165)</u>	<u>(12,586)</u>
Net expenditures and transfers out	<u>\$ 172,499</u>	<u>\$ 173,643</u>
Act 41, P.A. 2007, required transfer of surplus (Note 8)	<u>\$ 70,000</u>	<u>\$</u>
Balances carried forward:		
Encumbrances	\$ 79	\$ 49
Restricted revenues - not authorized or used	105,434	176,274
Revolving loan programs	5,000	5,000
Total balances carried forward	<u>\$ 110,513</u>	<u>\$ 181,323</u>
Balances lapsed	<u>\$ 467</u>	<u>\$ 576</u>
Total	<u>\$ 353,480</u>	<u>\$ 355,542</u>

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

Notes to the Financial Statements and Financial Schedules

Note 1 Significant Accounting Policies

a. Reporting Entity - Financial Statements

The accompanying financial statements report the financial position and the changes in financial position of the following funds administered by the Department of Environmental Quality (DEQ) as of and for the fiscal years ended September 30, 2007 and September 30, 2006:

Special Revenue Funds

Combined Environmental Protection Bond Fund (includes the Environmental Protection Bond Fund, the Clean Michigan Initiative Bond Fund, and the Great Lakes Water Quality Bond Fund)

Bottle Deposits Fund

Agency Fund

Environmental Quality Deposits Fund

These funds principally account for DEQ's environmental cleanup and grant and loan program activity. They are a part of the State of Michigan's reporting entity and are reported on in the *State of Michigan Comprehensive Annual Financial Report (SOMCAFR)*.

b. Reporting Entity - Financial Schedules

The accompanying financial schedules report the results of DEQ's financial transactions for the fiscal years ended September 30, 2007 and September 30, 2006. The financial transactions of DEQ are accounted for principally in the State's General Fund and are reported on in the *SOMCAFR*.

c. Measurement Focus and Basis of Accounting

The special revenue fund financial statements and the General Fund financial schedules contained in this report are presented using the current financial resources measurement focus and the modified accrual basis of accounting as provided by accounting principles generally

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

d. Basis of Presentation

The accompanying financial statements present only the funds listed in Note 1a. The accompanying financial schedules present only the revenues and other financing sources and the sources and disposition of authorizations for DEQ's General Fund accounts. The *SOMCAFR* provides more extensive disclosures regarding the State's significant accounting policies; budgeting, budgetary control, and legal compliance; common cash; pension benefits and other postemployment benefits; and interfund receivables and payables.

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

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

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

Governmental Fund Types

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

Fiduciary Fund Types

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

Note 2 Combined Balance Sheet Reserves

The elements of the reserves are defined as follows:

- a. Encumbrances: Reserves to finance payments for goods or services ordered during the fiscal year but not received by fiscal year-end. These reserves are generally limited to obligations funded by general purpose appropriations.
- b. Restricted revenues: Revenues that, by statute, are restricted for use to a particular program or activity. Generally, the expenditure of the restricted revenues is subject to annual legislative appropriation. However, the restricted revenues may also be used in subsequent years to finance expenditures for multi-year appropriations (\$26.4 million and \$32.6 million in fiscal years 2006-07 and 2005-06, respectively) and encumbrances carried forward (\$3.4 million and \$3.5 million in fiscal years 2006-07 and 2005-06, respectively).
- c. Multi-year projects: Reserves to finance work projects approved by the Legislature. These reserves are limited to work projects funded by general purpose authorizations.

- d. Revolving loan programs: Reserves to finance loans to local units of government and brownfield redevelopment authorities for response activities at known or suspected facilities with redevelopment potential. Also, the reserves finance loans to local units of government and to brownfield redevelopment authorities for environmental assessments, demolition, and other remedial actions.
- e. Funds held as permanent investments: Amounts that have been restricted for the purpose of providing a long-term source of investment income. These investments are held as a portion of the fund's share of the State's common cash pool.

Note 3 Equity in Common Cash

Custodial Credit Risk: All of DEQ's deposits are managed by the State Treasurer. "Equity in common cash" represents an interest in the State's common cash pool, which is used by most State funds as a short-term investment vehicle. DEQ's deposits are included in the State of Michigan's equity in common cash.

DEQ's common cash balances were as follows (in thousands):

	As of September 30			
	Special Revenue Funds		Agency Fund	
	2007	2006	2007	2006
Equity in common cash	\$118,128	\$157,995	\$3,055	\$2,887

These amounts do not include common cash for State-restricted subfunds within the General Fund.

The Governmental Accounting Standards Board (GASB) requires certain disclosures related to custodial credit risk for deposits. Custodial credit risk for deposits is the risk that, in the event of a bank failure, DEQ's deposits will not be returned to it. Deposits are exposed to custodial credit risk if they are not covered by depository insurance and are uncollateralized, collateralized with securities held by pledging financial institutions, or collateralized with securities held by the pledging financial institution's trust department or agent but not in DEQ's name. The State

Treasurer evaluates each financial institution it deposits common cash funds with and assesses the level of risk of each institution. Only those institutions with an acceptable estimated risk level are used as depositories.

Note 4 Schedule of Sources and Disposition of General Fund Authorizations

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

- a. General purpose appropriations: Original appropriations and any supplemental appropriations that are financed by General Fund/general purpose revenues.
- b. Balances carried forward: Authorizations for multi-year projects, encumbrances, restricted revenues - authorized, and restricted revenues - not authorized or used that were not spent as of the end of the prior fiscal year. These authorizations are available for expenditure in the current fiscal year for the purpose of the carry-forward without additional legislative authorization, except for the restricted revenues - not authorized or used.
- c. Restricted financing sources: Collections of restricted revenues and restricted transfers, net of restricted intrafund expenditure reimbursements, to finance programs as detailed in the appropriations act. These financing sources are authorized for expenditure up to the amount appropriated. Depending upon program statute, any amounts received in excess of the appropriation are, at year-end, either converted to general purpose financing sources and made available for general appropriation in the next fiscal year or carried forward to the next fiscal year as either restricted revenues - authorized or restricted revenues - not authorized or used.
- d. Intrafund expenditure reimbursements: Funding from other General Fund departments to finance a program or a portion of a program that is the responsibility of the receiving department.
- e. Encumbrances: Authorizations carried forward to finance payments for goods or services ordered during the fiscal year but not received by fiscal

year-end. These authorizations are generally limited to obligations funded by general purpose appropriations.

- f. Restricted revenues - not authorized or used: Revenues that, by statute, are restricted for use to a particular program or activity. Generally, the expenditure of the restricted revenues is subject to annual legislative appropriation. However, the restricted revenues may also be used in subsequent years to finance expenditures for multi-year environmental cleanup appropriations (\$35.5 million and \$103.0 million in fiscal years 2006-07 and 2005-06, respectively) and encumbrances carried forward (\$13.6 million and \$8.8 million in fiscal years 2006-07 and 2005-06, respectively).
- g. Balances lapsed: Authorizations that were unexpended and unobligated at the end of the fiscal year. These amounts are available for legislative appropriation in the subsequent fiscal year.

Note 5 Joint Venture

The State, represented by DEQ, is a participant in a joint venture known as the Great Lakes Protection Fund. The joint venture is not reflected within this report because it did not meet GAAP's criteria for inclusion.

The Great Lakes Protection Fund is a not-for-profit corporation located in Evanston, Illinois. Its purpose is to finance and support research with respect to the water quality of the Great Lakes. The eight states bordering on the Great Lakes are eligible to become members if they make a required contribution to the endowment of the Fund. Contribution requirements were established based upon water consumption and usage. Michigan is the largest contributor to the Fund, having made a contribution of \$25 million, constituting approximately 31% of the total. Michigan made its required contribution in fiscal year 1989-90 by issuing the Fund a general obligation bond authorized as part of the State's environmental protection bond program. No additional contributions from Michigan will be required.

Each of the participating seven member states is represented by two members on the Fund's Board of Directors. The Board members are selected by the states' respective governors. The Fund's financing and budgeting operations are controlled by the directors within requirements established by the Articles

of Incorporation. Net earnings on total contributions after operating expenses are divided into parts. One-third of the net earnings on total contributions are granted to the respective states in proportion to their contributions to the Fund, to be used for the purposes of the Fund. Two-thirds of the net earnings are available to the Fund to make other grants. The State's equity interest in the Great Lakes Protection Fund of \$25 million is reflected in the *SOMCAFR* in the government-wide statement of net assets.

Complete financial statements may be obtained directly by contacting the Financial Reporting Section within the Office of Financial Management, Office of the State Budget, Department of Management and Budget, at (517) 373-3029.

Note 6 Federal Revenues and Expenditures

Federal revenues in the schedule of General Fund revenues and other financing sources differ from the expenditures reported in the schedule of expenditures of federal awards. The schedule of expenditures of federal awards includes payments totaling \$128.4 million made by the Michigan Municipal Bond Authority, a discretely presented component unit of the State of Michigan, to subrecipients* from its State Revolving Fund* and the Drinking Water State Revolving Fund*. These expenditures and related federal revenues are not recorded in DEQ's accounting records because DEQ has administrative responsibility for the expenditures, but the subrecipient loan disbursements and repayments flow through and are accounted for by the Michigan Municipal Bond Authority.

Note 7 Proceeds From Bonds Issued

Article IX, Section 15 of the Michigan Constitution authorizes general obligation long-term borrowing, subject to approval by the Legislature and a majority of voters at a general election. General obligation bonds are backed by the full

* See glossary at end of report for definition.

faith and credit of the State. DEQ related general obligation bonds issued during fiscal year 2005-06 were as follows:

General Obligation Bonds Issued	Amounts Issued	Fiscal Year Maturities		Average Interest Rate Percentage
		First Year	Last Year	
Series 2006 A (1) (2)	\$ 105.0	2014	2026	4.58%
Series 2006 B	\$ 47.0	2007	2009	5.19%

- (1) Sections 324.19301 and 324.71301 of the *Michigan Compiled Laws* authorized the issuance of bonds totaling \$800.0 million. As of September 30, 2007, \$791.5 million of such bond proceeds had been received, leaving remaining authorization of \$8.5 million.
- (2) Section 324.95102 of the *Michigan Compiled Laws* authorized the issuance of bonds totaling \$675.0 million. As of September 30, 2007, \$495.1 million of such bond proceeds had been received, leaving remaining authorization of \$179.9 million.

Note 8 Statutorily Required Revenue Transfer of Surplus

Act 41, P.A. 2007, effective July 12, 2007, required a transfer of \$70 million in surplus funds from the Refined Petroleum Fund (RPF) to the Environmental Protection Fund (EPF), which are both State restricted subfunds of the General Fund. The EPF funds were then appropriated to the Department of Treasury to pay for debt service. Because both DEQ and the Department of Treasury are included within the General Fund, this had no effect on reported revenue within the *SOMCAFR*. However, because DEQ is reported separately, the effect of the transaction would result in negative revenue being reported for DEQ. Because this was a transfer of accumulated revenue from prior years, the transaction has been reported as a disposition of fiscal year 2006-07 authorization and the effect of the revenue reduction has been removed from the schedule of General Fund revenues and other financing sources. The Office of Financial Management, Office of the State Budget, Department of Management and Budget, issued a waiver to DEQ, which allows this presentation that differs from the presentation in the *SOMCAFR*.

Note 9 Transfer of Surplus Bottle Deposits Funds

Act 153, P.A. 2006, effective May 25, 2006, transferred \$10 million of funds, determined to be surplus, from the Community Pollution Prevention Fund, a subfund of the Bottle Deposits Fund, to two subfunds in the General Fund. In

addition, \$3 million was transferred to the Waste Reduction Fee Revenue Fund and \$7 million was transferred to the Environmental Protection Fund (EPF).

Act 153, P.A. 2006, also transferred \$12 million of funds, determined to be surplus, from the Cleanup and Redevelopment Trust Fund, a subfund of the Bottle Deposits Fund, to the EPF, a subfund of the General Fund.

Note 10 General Fund Contingencies and Litigation

- a. Rexair, Inc.: In 1991, DEQ entered a consent decree with Rexair, Inc., to halt migration of and to remediate trichloroethylene (TCE) released at the Rexair facility. The TCE plume escaped the groundwater capture system, and DEQ filed a motion for dispute resolution through the consent decree to have Rexair address the problem. For legal reasons, DEQ tried to withdraw this motion, but the circuit court denied the request. On March 24, 2006, the circuit court ordered a dismissal of the dispute resolution with prejudice and awarded Rexair attorney fees and costs, which are to be determined at a hearing to be set by the court. Rexair has claimed it has fees and costs in excess of \$2 million. DEQ filed an application for leave of appeal, which was granted by the Court of Appeals on May 8, 2008. Rexair has filed a leave for appeal to the Supreme Court. As of the publication date of this report, it is not known if the Supreme Court will hear the case. This lawsuit liability is not recorded in these financial statements. In accordance with State accounting policy for governmental funds, liabilities are accrued when cases are settled and the amount is due and payable.

- b. Richfield Landfill, Inc.: Richfield Landfill, Inc., filed suit against DEQ in a temporary takings claim based upon the denial of an operating license for a solid waste landfill. Richfield Landfill has claimed damages in excess of \$5 million. In accordance with GAAP and the modified accrual basis of accounting, a liability is not recorded in these financial statements and financial schedules because liabilities are accrued when cases are settled and the amount is due and payable.

Note 11 Subsequent Events

Long-Term Borrowing: In April 2008, the State issued two series of general obligation bonds. The first, Series 2008A, was issued in the amount of \$15.0 million (tax-exempt) for the Clean Michigan Initiative Bond Fund. The

bonds had an interest rate of 5% and maturity dates ranging from 2011 through 2019.

The second, Series 2008B, was issued in the amount of \$10.0 million (federally taxable) with an average interest rate of 4.56% and maturity dates ranging from 2011 through 2019. This series of bonds was divided between the Clean Michigan Initiative Bond Fund (\$7.5 million) and the Great Lakes Water Quality Bond Fund (\$2.5 million).

SUPPLEMENTAL
FINANCIAL STATEMENTS AND
SCHEDULE

Description of Special Revenue Funds

COMBINED ENVIRONMENTAL PROTECTION BOND FUND

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

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

Act 397, P.A. 2002, expanded this Fund to account for the proceeds of \$1 billion of Great Lakes Water Quality general obligation bonds approved by Michigan voters in November 2002. The Act directs that bond proceeds be used to finance sewage treatment works projects, storm water projects, and nonpoint source projects that improve the quality of the waters of the State. The Great Lakes Water Quality Bond Fund records the bond proceeds and the administrative costs of the Department of Environmental Quality (DEQ). All programmatic loan and grant payments are reported in the financial statements of the Michigan Municipal Bond Authority, a discretely presented component unit of the State of Michigan.

BOTTLE DEPOSITS FUND

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

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

Act 380, P.A. 1996, moved the former Environmental Response Fund to a subfund of CRF. The law mandates that proceeds of all cost recovery actions taken and settlements entered into pursuant to Part 201, Act 451, P.A. 1994, as amended, excluding natural resource damages, by DEQ or the Attorney General, or both, shall be credited to the Environmental Response Fund.

Several DEQ subfunds are administratively housed within the Bottle Deposits Fund, although they receive no bottle deposit revenue. The State Site Cleanup Subfund, established in accordance with Act 380, P.A. 1996, to provide for response activities at facilities where the State is liable as the owner or operator, is one such subfund. Also included are the following loan programs administered by DEQ: the Brownfield Revolving Loan Fund, created by Act 253, P.A. 2003; the Revitalization Revolving Loan Fund, created by Act 383, P.A. 1996; and the federal Brownfield Cleanup Revolving Fund.

DEPARTMENT OF ENVIRONMENTAL QUALITY

Combining Balance Sheet

Special Revenue Funds

As of September 30

(In Thousands)

	Combined Environmental Protection Bond Fund		Bottle Deposits Fund		Totals	
	2007	2006	2007	2006	2007	2006
	ASSETS					
Current assets:						
Equity in common cash	\$ 58,285	\$ 99,504	\$ 59,843	\$ 58,491	\$ 118,128	\$ 157,995
Amounts due from component units	16	118			16	118
Amounts due from local units	900	900	334	311	1,234	1,212
Other current assets		19	2,612	735	2,612	754
Total current assets	<u>\$ 59,201</u>	<u>\$ 100,541</u>	<u>\$ 62,788</u>	<u>\$ 59,538</u>	<u>\$ 121,989</u>	<u>\$ 160,078</u>
Amounts due from local units			11,277	5,474	11,277	5,474
Other noncurrent assets			857	643	857	643
Total assets	<u>\$ 59,201</u>	<u>\$ 100,541</u>	<u>\$ 74,923</u>	<u>\$ 65,655</u>	<u>\$ 134,123</u>	<u>\$ 166,195</u>
LIABILITIES AND FUND BALANCES						
Current liabilities:						
Warrants outstanding	\$ 871	\$ 460	\$ 789	\$ 48	\$ 1,659	\$ 508
Accounts payable and other liabilities	13,411	13,336	2,110	4,364	15,521	17,700
Amounts due to other funds	7	23	69	169	76	191
Deferred revenue			280	429	280	429
Total current liabilities	<u>\$ 14,288</u>	<u>\$ 13,819</u>	<u>\$ 3,248</u>	<u>\$ 5,009</u>	<u>\$ 17,536</u>	<u>\$ 18,828</u>
Long-term liabilities:						
Deferred revenue			857	643	857	643
Total liabilities	<u>\$ 14,288</u>	<u>\$ 13,819</u>	<u>\$ 4,105</u>	<u>\$ 5,652</u>	<u>\$ 18,393</u>	<u>\$ 19,471</u>
Fund balances:						
Reserves for:						
Budgetary carry-forwards:						
Encumbrances	\$	\$	\$ 2,566	\$ 1,865	\$ 2,566	\$ 1,865
Restricted revenues			35,460	27,046	35,461	27,046
Multi-year projects			4,998	6,718	4,998	6,718
Revolving loan programs			21,621	20,723	21,621	20,723
Funds held as permanent investments			6,172	3,650	6,172	3,650
Total reserved	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 70,818</u>	<u>\$ 60,002</u>	<u>\$ 70,818</u>	<u>\$ 60,002</u>
Unreserved	44,912	86,722			44,912	86,722
Total fund balances	<u>\$ 44,912</u>	<u>\$ 86,722</u>	<u>\$ 70,818</u>	<u>\$ 60,002</u>	<u>\$ 115,730</u>	<u>\$ 146,724</u>
Total liabilities and fund balances	<u>\$ 59,201</u>	<u>\$ 100,541</u>	<u>\$ 74,923</u>	<u>\$ 65,655</u>	<u>\$ 134,123</u>	<u>\$ 166,195</u>

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

	Combined Environmental Protection Bond Fund		Bottle Deposits Fund		Totals	
	2007	2006	2007	2006	2007	2006
REVENUES						
From federal agencies	\$	\$	\$ 1,153	\$ 103	\$ 1,153	\$ 103
Interest and other miscellaneous	4,158	3,306	20,974	22,938	25,132	26,244
Total revenues	<u>\$ 4,158</u>	<u>\$ 3,306</u>	<u>\$ 22,127</u>	<u>\$ 23,040</u>	<u>\$ 26,285</u>	<u>\$ 26,346</u>
EXPENDITURES						
Current:						
General government	\$	\$ 127	\$	\$	\$ 0	\$ 127
Environmental	37,942	103,007	18,933	26,305	56,875	129,312
Debt service:						
Bond interest and fiscal charges		174			0	174
Total expenditures	<u>\$ 37,942</u>	<u>\$ 103,309</u>	<u>\$ 18,933</u>	<u>\$ 26,305</u>	<u>\$ 56,875</u>	<u>\$ 129,614</u>
Excess of revenues over (under) expenditures	<u>\$ (33,784)</u>	<u>\$ (100,003)</u>	<u>\$ 3,194</u>	<u>\$ (3,264)</u>	<u>\$ (30,590)</u>	<u>\$ (103,267)</u>
OTHER FINANCING SOURCES (USES)						
Bonds issued	\$	\$ 152,000	\$	\$	\$ 0	\$ 152,000
Premium on bond issuance		3,520			0	3,520
Transfers from other funds			8,000		8,000	0
Transfers to other funds	(8,026)	(24)	(379)	(34,571)	(8,404)	(34,596)
Total other financing sources (uses)	<u>\$ (8,026)</u>	<u>\$ 155,496</u>	<u>\$ 7,621</u>	<u>\$ (34,571)</u>	<u>\$ (404)</u>	<u>\$ 120,925</u>
Excess of revenues and other sources over (under) expenditures and other uses	\$ (41,809)	\$ 55,493	\$ 10,815	\$ (37,835)	\$ (30,994)	\$ 17,657
Fund Balances - Beginning of fiscal year	<u>86,722</u>	<u>31,229</u>	<u>60,002</u>	<u>97,838</u>	<u>146,724</u>	<u>129,067</u>
Fund Balances - End of fiscal year	<u>\$ 44,912</u>	<u>\$ 86,722</u>	<u>\$ 70,818</u>	<u>\$ 60,002</u>	<u>\$ 115,730</u>	<u>\$ 146,724</u>

DEPARTMENT OF ENVIRONMENTAL QUALITY
Combining Balance Sheet
Combined Environmental Protection Bond Fund
As of September 30
(In Thousands)

	Environmental Protection Bond Fund		Clean Michigan Initiative Bond Fund		Great Lakes Water Quality Bond Fund		Totals	
	2007	2006	2007	2006	2007	2006	2007	2006
ASSETS								
Current assets:								
Equity in common cash	\$ 18,940	\$ 31,379	\$ 39,335	\$ 68,095	\$ 10	\$ 30	\$ 58,285	\$ 99,504
Amounts due from component units					16	118	16	118
Amounts due from local units			900	900			900	900
Other current assets				19			0	19
Total current assets	<u>\$ 18,940</u>	<u>\$ 31,379</u>	<u>\$ 40,235</u>	<u>\$ 69,014</u>	<u>\$ 26</u>	<u>\$ 148</u>	<u>\$ 59,201</u>	<u>\$ 100,541</u>
Total assets	<u>\$ 18,940</u>	<u>\$ 31,379</u>	<u>\$ 40,235</u>	<u>\$ 69,014</u>	<u>\$ 26</u>	<u>\$ 148</u>	<u>\$ 59,201</u>	<u>\$ 100,541</u>
LIABILITIES AND FUND BALANCES								
Current liabilities:								
Warrants outstanding	\$ 56	\$ 127	\$ 815	\$ 333	\$	\$	\$ 871	\$ 460
Accounts payable and other liabilities	1,394	2,675	11,991	10,516	26	145	13,411	13,336
Amounts due to other funds			7	20		3	7	23
Total current liabilities	<u>\$ 1,449</u>	<u>\$ 2,802</u>	<u>\$ 12,813</u>	<u>\$ 10,869</u>	<u>\$ 26</u>	<u>\$ 148</u>	<u>\$ 14,288</u>	<u>\$ 13,819</u>
Total liabilities	\$ 1,449	\$ 2,802	\$ 12,813	\$ 10,869	\$ 26	\$ 148	\$ 14,288	\$ 13,819
Fund balances:								
Total unreserved fund balances	<u>17,490</u>	<u>28,577</u>	<u>27,422</u>	<u>58,145</u>	<u>0</u>	<u>0</u>	<u>44,912</u>	<u>86,722</u>
Total liabilities and fund balances	<u>\$ 18,940</u>	<u>\$ 31,379</u>	<u>\$ 40,235</u>	<u>\$ 69,014</u>	<u>\$ 26</u>	<u>\$ 148</u>	<u>\$ 59,200</u>	<u>\$ 100,541</u>

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

	Environmental Protection Bond Fund		Clean Michigan Initiative Bond Fund		Great Lakes Water Quality Bond Fund		Totals	
	2007	2006	2007	2006	2007	2006	2007	2006
REVENUES								
Interest and other miscellaneous	\$ 88	\$ 692	\$ 3,871	\$ 2,415	\$ 200	\$ 198	\$ 4,158	\$ 3,306
Total revenues	\$ 88	\$ 692	\$ 3,871	\$ 2,415	\$ 200	\$ 198	\$ 4,158	\$ 3,306
EXPENDITURES								
Current:								
General government	\$	\$ 127	\$	\$	\$	\$	\$ 0	\$ 127
Environmental	3,174	5,824	34,570	50,000	198	47,184	37,942	103,007
Debt service:								
Bond interest and fiscal charges						174	0	174
Total expenditures	\$ 3,174	\$ 5,951	\$ 34,570	\$ 50,000	\$ 198	\$ 47,359	\$ 37,942	\$ 103,309
Excess of revenues over (under) expenditures	\$ (3,087)	\$ (5,259)	\$ (30,699)	\$ (47,584)	\$ 2	\$ (47,160)	\$ (33,784)	\$ (100,003)
OTHER FINANCING SOURCES (USES)								
Bonds issued	\$	\$ 25,000	\$	\$ 80,000	\$	\$ 47,000	\$ 0	\$ 152,000
Premium on bond issuance		2,786		573		161	0	3,520
Transfers to other funds	(8,000)		(24)	(24)	(2)		(8,026)	(24)
Total other financing sources (uses)	\$ (8,000)	\$ 27,786	\$ (24)	\$ 80,549	\$ (2)	\$ 47,160	\$ (8,026)	\$ 155,496
Excess of revenues and other sources over (under) expenditures and other uses	\$ (11,087)	\$ 22,528	\$ (30,723)	\$ 32,965	\$	\$	\$ (41,809)	\$ 55,493
Fund balances - Beginning of fiscal year	28,577	6,049	58,145	25,180			86,722	31,229
Fund balances - End of fiscal year	\$ 17,490	\$ 28,577	\$ 27,422	\$ 58,145	\$ 0	\$ 0	\$ 44,912	\$ 86,722

Description of Agency Fund

ENVIRONMENTAL QUALITY DEPOSITS FUND

This Fund was reauthorized by Act 451, P.A. 1994, as amended, to account for cash bonds posted by applicants desiring licenses to operate hazardous and solid waste disposal areas. Because the Scrap Tire Regulatory Fund created by Act 451, P.A. 1994, has similar provisions, both of these activities are accounted for in this Fund. In accordance with Act 451, P.A. 1994, as amended, interest earnings at the rate of interest accrued on the State's common cash pool, not to exceed an annual rate of 6% are credited to the applicant's account. The receipt of cash bonds and interest earnings are recorded as additions to assets and liabilities.

This Act also specifies the circumstances under which the director of the Department of Environmental Quality is authorized to use the deposits to close and maintain a facility or return the deposit upon the operator's satisfactory closure and maintenance of the facility. The use or return of deposits and interest are recorded as deductions to assets and liabilities.

DEPARTMENT OF ENVIRONMENTAL QUALITY
Statement of Changes in Assets and Liabilities
Environmental Quality Deposits Fund
Fiscal Year Ended September 30, 2007
(In Thousands)

	Balance October 1, 2006	Additions	Deductions	Balance September 30, 2007
ASSETS				
Equity in common cash	\$ 2,887	\$ 176	\$ 8	\$ 3,055
Total assets	<u>\$ 2,887</u>	<u>\$ 176</u>	<u>\$ 8</u>	<u>\$ 3,055</u>
LIABILITIES				
Accounts payable and other liabilities	\$ 2,887	\$ 176	\$ 8	\$ 3,055
Total liabilities	<u>\$ 2,887</u>	<u>\$ 176</u>	<u>\$ 8</u>	<u>\$ 3,055</u>

DEPARTMENT OF ENVIRONMENTAL QUALITY
Statement of Changes in Assets and Liabilities
Environmental Quality Deposits Fund
Fiscal Year Ended September 30, 2006
(In Thousands)

	Balance October 1, 2005	Additions	Deductions	Balance September 30, 2006
ASSETS				
Equity in common cash	\$ 2,775	\$ 201	\$ 89	\$ 2,887
Total assets	<u>\$ 2,775</u>	<u>\$ 201</u>	<u>\$ 89</u>	<u>\$ 2,887</u>
LIABILITIES				
Accounts payable and other liabilities	\$ 2,775	\$ 201	\$ 89	\$ 2,887
Total liabilities	<u>\$ 2,775</u>	<u>\$ 201</u>	<u>\$ 89</u>	<u>\$ 2,887</u>

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of Expenditures of Federal Awards (1)
For the Period October 1, 2005 through September 30, 2007

Federal Agency/Program	CFDA (2) Number	Pass-Through Identification Number	For the Fiscal Year Ended September 30, 2006		
			Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
Financial Assistance					
<u>U.S. Department of Commerce</u>					
Direct Program:					
Coastal Zone Management Administration Awards	11.419		\$ 1,895,092	\$ 1,653,462	\$ 3,548,554
Pass-Through Program:					
University of Michigan Sea Grant Support	11.417	NA05OAR4171067	345		345
Total U.S. Department of Commerce			\$ 1,895,437	\$ 1,653,462	\$ 3,548,899
<u>U.S. Department of Defense</u>					
Direct Program:					
State Memorandum of Agreement Program for the Reimbursement of Technical Services	12.113		\$ 930,731	\$	\$ 930,731
Total U.S. Department of Defense			\$ 930,731	\$ 0	\$ 930,731
<u>U.S. Department of the Interior</u>					
Direct Programs:					
Fish and Wildlife Management Assistance	15.608		\$ 52,943	\$ 16,995	\$ 69,938
U.S. Geological Survey - Research and Data Collection	15.808		44,360		44,360
National Cooperative Geologic Mapping Program	15.810		22,788		22,788
Total U.S. Department of the Interior			\$ 120,091	\$ 16,995	\$ 137,086
<u>U.S. Environmental Protection Agency</u>					
Direct Programs:					
Air Pollution Control Program Support	66.001		\$ 3,666,685	\$	\$ 3,666,685
State Indoor Radon Grants	66.032		309,600		309,600
Surveys, Studies, Investigations, Demonstrations and Special Purpose Activities Relating to the Clean Air Act	66.034		795,602	129,474	925,076
Water Pollution Control, State, Interstate, and Tribal Program Support (4)	66.419		(19,344)		(19,344)
Surveys, Studies, Investigations, Demonstrations, and Training Grants and Cooperative Agreements - Section 104(B)(3) of the Clean Water Act	66.436			47,878	47,878
Water Quality Management Planning	66.454		510,944	340,648	851,592
Capitalization Grants for Clean Water State Revolving Funds (1)	66.458		1,887,559	56,814,741	58,702,300
Nonpoint Source Implementation Grants	66.460		2,705,943	2,724,185	5,430,128
Regional Wetland Program Development Grants	66.461		218,374		218,374
Water Quality Cooperative Agreements	66.463		244,955		244,955
Wastewater Operator Training Grant Program (Technical Assistance)	66.467		37,840		37,840
Capitalization Grants for Drinking Water State Revolving Funds (1)	66.468		3,423,664	17,003,948	20,427,612
Great Lakes Program	66.469		504,830		504,830
Hardship Grants Program for Rural Communities	66.470		285,013		285,013
State Grants to Reimburse Operators of Small Water Systems for Training and Certification Costs	66.471		368,147	359,475	727,622
Beach Monitoring and Notification Program Implementation Grants	66.472		65,218	239,476	304,694
Water Protection Grants to the States	66.474		143,567		143,567
Wetland Program Grants - State/Tribal Environmental Outcome Wetland Demonstration Program	66.479		910		910
Environmental Protection - Consolidated Research	66.500		724,682		724,682
Performance Partnership Grants	66.605		12,325,127		12,325,127
Surveys, Studies, Investigations and Special Purpose Grants	66.606		82,222		82,222
Environmental Information Exchange Network Grant Program and Related Assistance	66.608		491,735	14,700	506,435
Environmental Policy and Innovation Grants	66.611		26,019		26,019

This schedule continued on next page.

For the Fiscal Year Ended September 30, 2007

Directly Expended	Distributed to Subrecipients	Total Expended and Distributed	Total Expended and Distributed for the Two-Year Period
\$ 1,472,436	\$ 762,282	\$ 2,234,718	\$ 5,783,272
		0	345
\$ 1,472,436	\$ 762,282	\$ 2,234,718	\$ 5,783,617
\$ 954,178	\$	\$ 954,178	\$ 1,884,909
\$ 954,178	\$ 0	\$ 954,178	\$ 1,884,909
\$ 30,492	\$	\$ 30,492	\$ 100,430
3,304		3,304	47,664
32,792		32,792	55,580
\$ 66,588	\$ 0	\$ 66,588	\$ 203,674
\$ 3,810,802	\$	\$ 3,810,802	\$ 7,477,487
321,000		321,000	630,600
583,860	105,403	689,263	1,614,339
77,000		77,000	57,656
	148,694	148,694	196,572
278,376	143,307	421,683	1,273,275
2,309,194	36,287,786	38,596,980	97,299,280
2,842,064	3,097,552	5,939,616	11,369,744
206,379	21,262	227,641	446,015
88,022	47,567	135,589	380,544
29,916		29,916	67,756
3,457,564	18,260,561	21,718,125	42,145,737
702,824	95,330	798,154	1,302,984
		0	285,013
355,921	335,900	691,821	1,419,443
48,364	198,009	246,373	551,067
399,951		399,951	543,518
322,863	18,896	341,759	342,669
		0	724,682
12,775,175		12,775,175	25,100,302
46,017		46,017	128,239
469,182		469,182	975,617
103,868		103,868	129,887

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of Expenditures of Federal Awards (1)
For the Period October 1, 2005 through September 30, 2007
Continued

Federal Agency/Program	CFDA (2) Number	Pass-Through Identification Number	For the Fiscal Year Ended September 30, 2006		
			Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
Pollution Prevention Grants Program	66.708		\$ 119,293	\$	\$ 119,293
Source Reduction Assistance	66.717		21,109		21,109
Hazardous Waste Management State Program Support	66.801		3,474,301		3,474,301
Superfund State, Political Subdivision, and Indian Tribe Site-Specific Cooperative Agreements	66.802		1,059,413		1,059,413
State and Tribal Underground Storage Tanks Program	66.804		186,000		186,000
Leaking Underground Storage Tank Trust Fund Program	66.805		1,764,194		1,764,194
Solid Waste Management Assistance Grants	66.808				0
Superfund State and Indian Tribe Core Program Cooperative Agreements	66.809		450,731		450,731
State and Tribal Response Program Grants	66.817		1,004,835		1,004,835
Brownfields Assessment and Cleanup Cooperative Agreements	66.818		173,815		173,815
U.S. Environmental Protection Agency Generalist (3)	66.G01015		507,244		507,244
Total Direct Programs			\$ 37,560,227	\$ 77,674,525	\$ 115,234,752
Pass-Through Programs:					
Little River Band of Ottawa Indians Surveys, Studies, Investigations, Demonstrations and Special Purpose Activities Relating to the Clean Air Act	66.034	XA965859-01	\$ 1,587	\$	\$ 1,587
Gun Lake Tribe Targeted Watersheds Grants	66.439	WS-9656901	\$	\$ 5,130	\$ 5,130
Great Lakes Commission Great Lakes Program	66.469	XA975171-01	\$ 22,250	\$	\$ 22,250
National Fish and Wildlife Foundation Great Lakes Program	66.469	2004-0005-008	34,272		34,272
Total Great Lakes Program			\$ 56,522	\$ 0	\$ 56,522
State of Minnesota Performance Partnership Grants	66.605	BG985688-07	\$	\$	\$ 0
Environmental Council of the States Surveys, Studies, Investigations and Special Purpose Grants	66.606	X830307-01	\$ 46,684	\$	\$ 46,684
Inter-Tribal Surveys, Studies, Investigations and Special Purpose Grants	66.606	PM975229-01	2,765		2,765
Lake Michigan Air Directors Consortium Surveys, Studies, Investigations and Special Purpose Grants	66.606	XA965860-01	3,277		3,277
Grand Traverse Band of Ottawa and Chippewa Indians Surveys, Studies, Investigations and Special Purpose Grants	66.606	A975613-01	1,039		1,039
Surveys, Studies, Investigations and Special Purpose Grants	66.606	XA965856-01			0
Total Surveys, Studies, Investigations and Special Purpose Grants			\$ 53,765	\$ 0	\$ 53,765
Environmental Council of the States Environmental Information Exchange Network Grant Program and Related Assistance	66.608	OS832786-01	\$ 30,009	\$	\$ 30,009
Environmental Information Exchange Network Grant Program and Related Assistance	66.608	OS833457-01			0
Total Environmental Information Exchange Network Grant Program and Related Assistance Grants			\$ 30,009	\$ 0	\$ 30,009
Total Pass-Through Programs			\$ 141,883	\$ 5,130	\$ 147,013
Total U.S. Environmental Protection Agency			\$ 37,702,110	\$ 77,679,655	\$ 115,381,765

This schedule continued on next page.

For the Fiscal Year Ended September 30, 2007

Directly Expended	Distributed to Subrecipients	Total Expended and Distributed	Total Expended and Distributed for the Two-Year Period
\$ 73,756	\$ 745	\$ 74,501	\$ 193,794
		0	21,109
3,425,943		3,425,943	6,900,244
772,459		772,459	1,831,872
286,000		286,000	472,000
1,550,000		1,550,000	3,314,194
15,470		15,470	15,470
528,206		528,206	978,937
1,096,084		1,096,084	2,100,919
738,599		738,599	912,414
		0	507,244
<u>\$ 37,714,859</u>	<u>\$ 58,761,012</u>	<u>\$ 96,475,871</u>	<u>\$ 211,710,623</u>
\$ 962	\$	\$ 962	\$ 2,549
\$ 863	\$	\$ 863	\$ 5,993
\$ 30,000	\$	\$ 30,000	\$ 52,250
		0	34,272
<u>\$ 30,000</u>	<u>\$ 0</u>	<u>\$ 30,000</u>	<u>\$ 86,522</u>
\$ 1,123	\$	\$ 1,123	\$ 1,123
\$	\$	\$ 0	\$ 46,684
		0	2,765
		0	3,277
		0	1,039
1,227		1,227	1,227
<u>\$ 1,227</u>	<u>\$ 0</u>	<u>\$ 1,227</u>	<u>\$ 54,992</u>
\$	\$	\$ 0	\$ 30,009
79,262		79,262	79,262
<u>\$ 79,262</u>	<u>\$</u>	<u>\$ 79,262</u>	<u>\$ 109,271</u>
<u>\$ 113,437</u>	<u>\$ 0</u>	<u>\$ 113,437</u>	<u>\$ 260,450</u>
<u>\$ 37,828,296</u>	<u>\$ 58,761,012</u>	<u>\$ 96,589,308</u>	<u>\$ 211,971,073</u>

DEPARTMENT OF ENVIRONMENTAL QUALITY
Schedule of Expenditures of Federal Awards (1)
For the Period October 1, 2005 through September 30, 2007
Continued

Federal Agency/Program	CFDA (2) Number	Pass-Through Identification Number	For the Fiscal Year Ended September 30, 2006		
			Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
<u>U.S. Department of Health and Human Services</u>					
Pass-Through Programs:					
Michigan Department of Community Health					
Surveillance of Hazardous Substance Emergency Events	93.204	U614/ATU574142-02	\$ 6,500	\$	\$ 6,500
Surveillance of Hazardous Substance Emergency Events	93.204	N614/ATU574142-03			0
Total U.S. Department of Health and Human Services			\$ 6,500	\$ 0	\$ 6,500
<u>U.S. Department of Homeland Security</u>					
Direct Programs:					
Community Assistance Program State Support Services Element (CAP-SSSE)	97.023		\$ 216,093	\$	\$ 216,093
National Dam Safety Program	97.041		402		402
Cooperating Technical Partners	97.045		385,985		385,985
Map Modernization Management Support	97.070		69,727		69,727
Homeland Security Biowatch Program	97.091		138,605		138,605
Total Direct Programs			\$ 810,812	\$ 0	\$ 810,812
Total U.S. Department of Homeland Security			\$ 810,812	\$ 0	\$ 810,812
Total Financial Assistance			\$ 41,465,681	\$ 79,350,112	\$ 120,815,793
<u>Nonfinancial Assistance</u>					
<u>U.S. Environmental Protection Agency</u>					
Direct Programs:					
Air Pollution Control Program Support	66.001		\$ 84,207	\$	\$ 84,207
State Indoor Radon Grants	66.032		43,402		43,402
Surveys, Studies, Investigations, Demonstrations and Special Purpose Activities Relating to the Clean Air Act	66.034		499,333		499,333
Water Pollution Control, State, Interstate, and Tribal Program Support	66.419		582,346		582,346
Surveys, Studies, Investigations and Special Purpose Grants	66.606		53,399		53,399
Hazardous Waste Management State Program Support	66.801		429,422		429,422
Total U.S. Environmental Protection Agency			\$ 1,692,109	\$ 0	\$ 1,692,109
Total Nonfinancial Assistance			\$ 1,692,109	\$ 0	\$ 1,692,109
Total Expenditures of Federal Awards			\$ 43,157,790	\$ 79,350,112	\$ 122,507,902

(1) Basis of Presentation: This schedule presents the federal grant activity of the Department of Environmental Quality (DEQ) on the modified accrual basis of accounting and in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the financial statements and financial schedules. In addition, this schedule includes payments totaling \$128.4 million made by the Michigan Municipal Bond Authority to subrecipients in the State Revolving Fund and the Drinking Water State Revolving Fund. These expenditures and related federal revenues are not recorded in DEQ's accounting records.

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

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

(4) The negative balance reported for the fiscal year ended September 30, 2006 represents a write-off of a prior year account payable.

Note: The Michigan Department of State Police (MSP) provided \$1,006,603 of Homeland Security funds (CFDA programs 97.004, 97.008, and 97.067) to assist MSP in the implementation of the programs. These programs were not included in this schedule.

For the Fiscal Year Ended September 30, 2007

Directly Expended	Distributed to Subrecipients	Total Expended and Distributed	Total Expended and Distributed for the Two-Year Period
\$ 3,000	\$	\$ 0	\$ 6,500
<u>3,000</u>	<u></u>	<u>3,000</u>	<u>3,000</u>
\$ 3,000	\$ 0	\$ 3,000	\$ 9,500
\$ 216,093	\$	\$ 216,093	\$ 432,186
46,329		46,329	46,731
259,013		259,013	644,998
98,512		98,512	168,239
1,115,805		1,115,805	1,254,410
<u>\$ 1,735,752</u>	<u>\$ 0</u>	<u>\$ 1,735,752</u>	<u>\$ 2,546,564</u>
\$ 1,735,752	\$ 0	\$ 1,735,752	\$ 2,546,564
\$ 42,060,250	\$ 59,523,294	\$ 101,583,544	\$ 222,399,337
\$ 59,317	\$	\$ 59,317	\$ 143,524
486		486	43,888
417,937		417,937	917,270
358,258		358,258	940,604
13,350		13,350	66,749
253,815		253,815	683,237
<u>\$ 1,103,163</u>	<u>\$ 0</u>	<u>\$ 1,103,163</u>	<u>\$ 2,795,272</u>
\$ 1,103,163	\$ 0	\$ 1,103,163	\$ 2,795,272
\$ 43,163,413	\$ 59,523,294	\$ 102,686,707	\$ 225,194,609

INDEPENDENT AUDITOR'S REPORTS ON
INTERNAL CONTROL AND COMPLIANCE



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
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LANSING, MICHIGAN 48913
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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. Steven E. Chester, Director
Department of Environmental Quality
Constitution Hall
Lansing, Michigan

Dear Mr. Chester:

We have audited the financial statements and financial schedules of the Department of Environmental Quality as of and for the fiscal years ended September 30, 2007 and September 30, 2006, as identified in the table of contents, and have issued our report thereon dated June 16, 2008. 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 Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements and financial schedules, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements and/or financial schedules that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements and/or financial schedules will not be prevented or detected by the entity's internal control.

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Department's financial statements and financial schedules are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement and financial schedule amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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

AUDITOR GENERAL

June 16, 2008



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

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

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

Dear Mr. Chester:

Compliance

We have audited the compliance of the Department of Environmental Quality with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to each major federal program for the two-year period ended September 30, 2007. The Department's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each major federal program is the responsibility of the Department's management. Our responsibility is to express an opinion on the Department's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to in the previous paragraph that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Department's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the Department's compliance with those requirements.

As described in Findings 1 and 5 in the accompanying schedule of findings and questioned costs, the Department did not comply with requirements regarding allowable costs/cost principles that are applicable to its Coastal Zone Management Administration Awards and Performance Partnership Grants. Compliance with such requirements is necessary, in our opinion, for the Department to comply with the requirements applicable to those programs.

In our opinion, except for the noncompliance described in the previous paragraph, the Department of Environmental Quality complied, in all material respects, with the requirements referred to in the first paragraph that are applicable to each of its major federal programs for the two-year period ended September 30, 2007. The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB

Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as Findings 1 through 5.

Internal Control Over Compliance

The management of the Department is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Department's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the Department's internal control that might be significant deficiencies or material weaknesses as defined below. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies and others that we consider to be material weaknesses.

A control deficiency in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs as Findings 1 through 5 to be significant deficiencies.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control. Of the significant deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs, we consider Findings 1 and 5 to be material weaknesses.

The Department's responses to the findings identified in our audit are described in the accompanying corrective action plan. We did not audit the Department's responses and, accordingly, we express no opinion on them.

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

AUDITOR GENERAL

June 16, 2008

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Section I: Summary of Auditor's Results

Financial Statements and Financial Schedules

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

Federal Awards

Internal control over major programs:	
Material weaknesses* identified?	Yes
Significant deficiencies* identified that are not considered to be material weaknesses?	Yes
Type of auditor's report issued on compliance for major programs:	
Unqualified for all major federal programs except for Coastal Zone Management Administration Awards and Performance Partnership Grants, which are qualified*.	
Any audit findings disclosed that are required to be reported in accordance with U.S. Office of Management and Budget (OMB) Circular A-133, Section 510(a)?	Yes

Identification of major programs:

<u>CFDA Number</u>	<u>Name of Federal Program</u>
11.419	Coastal Zone Management Administration Awards
66.458	Capitalization Grants for Clean Water State Revolving Funds
66.460	Nonpoint Source Implementation Grants

* See glossary at end of report for definition.

66.468	Capitalization Grants for Drinking Water State Revolving Funds
66.605	Performance Partnership Grants
66.805	Leaking Underground Storage Tank Trust Fund Program

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

Auditee qualified as a low-risk auditee*? No

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

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

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

FINDING (7610801)

1. Coastal Zone Management Administration Awards (CZM), CFDA 11.419

U.S. Department of Commerce	CFDA 11.419: Coastal Zone Management Administration Awards
Award Number: NA05NOS4191168 NA06NOS4190250	Award Period: 10/01/2005 - 03/31/2007 10/01/2006 - 03/31/2008
	Questioned Costs: \$118,757

The Department of Environmental Quality's (DEQ's) internal control over the CZM Program did not ensure compliance with federal laws and regulations regarding activities allowed or unallowed; allowable costs/cost principles; subrecipient monitoring; and procurement and suspension and debarment. Our review

* See glossary at end of report for definition.

disclosed material weaknesses in internal control and material noncompliance* with compliance requirements related to allowable costs/cost principles. As a result, we issued a qualified opinion on compliance with federal laws and regulations for the CZM Program.

Internal control that does not ensure compliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of CZM Program awards.

Federal expenditures for the CZM Program totaled \$5.8 million for the two-year period ended September 30, 2007. We identified known questioned costs of \$118,757 and known and likely questioned costs totaling \$824,050.

Our exceptions, by compliance area, are as follows:

a. Activities Allowed or Unallowed

DEQ's internal control did not ensure compliance with federal laws and regulations regarding activities allowed or unallowed.

Appendix A, section C(1) of Title 2, Part 225 of the *Code of Federal Regulations (CFR)* (OMB Circular A-87*) states that costs must conform to any limitations or exclusions set forth in federal laws, terms, and conditions of the federal award or other governing regulations. Funds may be used only to implement and enhance the states' approved CZM programs. Also, federal regulation 15 *CFR* 923.93 states that funds may be used for activities such as performing feasibility studies, issuing preliminary engineering reports, and increasing public access to coastal areas.

Our review disclosed that 2 (11%) of 19 randomly sampled employees improperly charged 100% their payroll costs to CZM Program awards. DEQ estimated that 2% to 5% of these employees' activities were not related to CZM Program grant activities. As a result, we identified known questioned costs of \$48 and known and likely questioned costs totaling \$7,088 in part b.(2) of this finding.

* See glossary at end of report for definition.

b. Allowable Costs/Cost Principles

DEQ's internal control did not ensure that CZM Program expenditures met the allowable cost principles of federal regulation 2 *CFR* 225. Our review disclosed:

- (1) DEQ overcharged administrative payroll costs to CZM Program awards. Appendix B, section 8(h) of federal regulation 2 *CFR* 225 requires DEQ to adjust costs charged to federal awards to reflect activity actually performed. Our review disclosed that DEQ allocated administrative payroll costs to CZM Program awards based on the estimated percentage of direct staff hours charged to the awards rather than the actual percentage of direct hours charged. As a result, we identified known questioned costs of \$115,248.
- (2) DEQ did not maintain the required payroll certifications to support payroll costs charged to the CZM Program for 4 (21%) of 19 employees reviewed. Appendix B, section 8(h) of federal regulation 2 *CFR* 225 requires employees who are expected to work solely on a single federal award to semiannually certify that they worked solely on that program. Because DEQ did not document that these employees worked solely on the CZM Program, it could not verify that the payroll costs charged to the Program were appropriate. As a result, we identified known questioned costs of \$3,509 and known and likely questioned costs totaling \$708,802.

c. Subrecipient Monitoring

DEQ's internal control did not ensure compliance with the pass-through entity* responsibilities as established by OMB Circular A-133.

OMB Circular A-133 establishes the responsibilities for state entities that provide federal funds to subrecipients that carry out federal programs. DEQ is considered a pass-through entity in these cases.

* See glossary at end of report for definition.

We reviewed 38 subrecipients, of which 6 received CZM Program funding. Our review of DEQ's subrecipient monitoring efforts disclosed:

- (1) DEQ did not receive an A-133 audit report for 3 (50%) of the 6 CZM subrecipients we reviewed. OMB Circular A-133, Section 400(d) requires DEQ to ensure that subrecipients expending \$500,000 or more in federal awards meet the A-133 audit requirements for a fiscal year. After we informed DEQ of the 3 subrecipients that did not submit an A-133 audit report, DEQ obtained and reviewed the subrecipients' A-133 audit reports. These 3 audit reports disclosed issues that required DEQ to issue a management decision. We reported a similar condition in our prior Single Audit*. DEQ indicated in its May 2006 corrective action plan that it would implement procedures to obtain and review 100% of the required A-133 audit reports.
- (2) DEQ did not document the receipt date of an A-133 audit report for 1 (33%) of the 3 CZM subrecipients we reviewed that submitted an A-133 audit report. OMB Circular A-133, Section 400(d) requires DEQ to issue a management decision on audit findings within six months after receipt of a subrecipient's audit report and to ensure that the subrecipient takes appropriate and timely corrective action. Without documentation of the receipt date of the A-133 audit report, we could not test compliance for this subrecipient.
- (3) DEQ did not issue a management decision within the required time frame for 1 (50%) of the 2 CZM subrecipients we reviewed that had audit findings disclosed in their A-133 audit reports. OMB Circular A-133, Section 400(d) requires DEQ to issue a management decision on audit findings within six months after receipt of a subrecipient's audit report and to ensure that the subrecipient takes appropriate and timely corrective action. We reported a similar condition in our prior Single Audit. DEQ indicated in its May 2006 corrective action plan that it would implement procedures to issue management decisions within the required time frames.

* See glossary at end of report for definition.

d. Procurement and Suspension and Debarment

DEQ had not established internal control to ensure that it did not contract with or make grant awards to parties that had been suspended or debarred.

Federal regulation 2 *CFR* 180.300 requires DEQ to verify that an entity is not suspended or debarred by checking the federal Excluded Parties List System, collecting a certification from that entity, or adding a clause or condition to the covered transaction with that person.

Our review of 17 CZM Program subrecipient contracts disclosed that none of the subrecipients were on the Excluded Parties List System. However, the lack of controls designed to ensure compliance with federal laws and regulations could result in future sanctions and/or disallowances. We reported a similar condition in our prior Single Audit. DEQ indicated in its May 2006 corrective action plan that it would implement procedures to obtain assurances that grant funds are not awarded to grantees that have been suspended or debarred from federal procurement.

RECOMMENDATIONS

We recommend that DEQ improve its internal control over the CZM Program to ensure compliance with federal laws and regulations regarding activities allowed or unallowed and allowable costs/cost principles.

WE AGAIN RECOMMEND THAT DEQ IMPROVE ITS INTERNAL CONTROL OVER THE CZM PROGRAM TO ENSURE COMPLIANCE WITH FEDERAL LAWS AND REGULATIONS REGARDING SUBRECIPIENT MONITORING AND PROCUREMENT AND SUSPENSION AND DEBARMENT.

FINDING (7610802)

2. Capitalization Grants for Clean Water State Revolving Funds (SRF), CFDA 66.458

U.S. Environmental Protection Agency	CFDA 66.458: Capitalization Grants for Clean Water State Revolving Funds
Award Number: CS260001-04 CS260001-05 CS260001-06 CS260001-07	Award Period: 10/01/2003 - 09/30/2005 10/01/2004 - 09/30/2006 (extended to 09/30/2007) 10/01/2005 - 09/30/2008 10/01/2006 - 09/30/2008
	Questioned Costs: \$0

DEQ's internal control over the SRF Program* did not ensure compliance with federal laws and regulations regarding subrecipient monitoring.

Internal control that does not ensure compliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of SRF Program awards.

Federal expenditures for the SRF Program totaled \$97.3 million for the two-year period ended September 30, 2007.

DEQ monitors subrecipients at the program and departmental levels. DEQ's program staff are responsible for informing subrecipients of the *Catalog of Federal Domestic Assistance (CFDA)* and federal award information. Also, program staff are responsible for monitoring subrecipients' activities to ensure that they used federal awards for authorized purposes. DEQ's Financial and Business Services Division is responsible for obtaining and reviewing DEQ's subrecipients' A-133 audit reports and issuing management decisions.

We reviewed 16 supplemental agreements and related projects at the program level to assess DEQ's efforts to inform subrecipients of the required *CFDA* and federal award information and to monitor subrecipients' activities. Also, we reviewed grant files for 38 subrecipients, of which 12 received SRF funding, at the departmental level to assess DEQ's efforts to obtain and review subrecipients' A-133 audit reports and to issue management decisions.

* See glossary at end of report for definition.

Our review of DEQ's subrecipient monitoring efforts for the SRF Program disclosed:

- a. DEQ did not consistently inform subrecipients of *CFDA* and federal award information as required by federal laws and regulations. OMB Circular A-133, Section 400(d) requires DEQ to inform subrecipients of the *CFDA* title and number, award name and number, award year, and name of the federal agency and if the award is for research and development. Also, OMB Circular A-133 states that if some of the required information is not available, DEQ shall provide the best information available to describe the federal award. We reviewed 16 supplemental agreements that included 5 agreements established during our audit period. Our review disclosed that DEQ did not inform the subrecipient of the information required by OMB Circular A-133 in any of the 5 supplemental agreements established during our audit period. We reported a similar condition in our prior Single Audit. DEQ indicated in its May 2006 corrective action plan that it would develop standardized supplemental agreement language that will include the required award information.
- b. DEQ did not consistently monitor the activities of subrecipients to ensure that they used federal awards for authorized purposes. OMB Circular A-133, Section 400(d) requires DEQ to monitor the activities of subrecipients to ensure that they used federal awards in compliance with federal laws and regulations. Our review of 16 supplemental agreements for projects under construction disclosed that DEQ did not maintain evidence that it monitored 11 (69%) of the 16 projects. Effective monitoring of subrecipients by DEQ can be accomplished through regular discussions with the subrecipients and on-site inspections. The U.S. Environmental Protection Agency (EPA) also recommended, in its fiscal year 2005-06 State Revolving Fund Program Evaluation Report, that DEQ institute an on-site inspection program to monitor projects that are under construction to protect the significant capital invested in the SRF Program.
- c. DEQ did not receive an A-133 audit report for 1 (8%) of 12 subrecipients we reviewed. OMB Circular A-133, Section 400(d) requires DEQ to ensure that subrecipients expending \$500,000 or more in federal awards meet the A-133 audit requirements for a fiscal year. We reported a similar condition in our prior Single Audit. DEQ indicated in its May 2006 corrective action plan that it

would implement procedures to obtain and review 100% of the required A-133 audit reports.

- d. DEQ did not document the receipt date of A-133 audit reports for 3 (27%) of the 11 subrecipients we reviewed that submitted an A-133 audit report. OMB Circular A-133, Section 400(d) requires DEQ to issue a management decision on audit findings within six months after receipt of a subrecipient's audit report and to ensure that the subrecipient takes appropriate and timely corrective action. Without documentation of the receipt date of the A-133 audit reports, we could not test compliance for 1 of these subrecipients. In the remaining 2 instances, we were able to determine compliance using the date of the subrecipient's audit report or the subrecipient's audit report did not require DEQ to issue a management decision.

RECOMMENDATION

WE AGAIN RECOMMEND THAT DEQ IMPROVE ITS INTERNAL CONTROL OVER THE SRF PROGRAM TO ENSURE COMPLIANCE WITH FEDERAL LAWS AND REGULATIONS REGARDING SUBRECIPIENT MONITORING.

FINDING (7610803)

3. Nonpoint Source Implementation Grants (NPS), CFDA 66.460

U.S. Environmental Protection Agency	CFDA 66.460: Nonpoint Source Implementation Grants
Award Number: C9975474-01 C9975474-02 C9975474-03 C9975474-04 C9975474-05 C9975474-06 C9975474-07	Award Period: 10/01/2000 - 09/30/2006 10/01/2001 - 09/30/2006 10/01/2002 - 09/30/2007 10/01/2003 - 09/30/2008 10/01/2004 - 09/30/2009 10/01/2005 - 09/30/2010 10/01/2006 - 09/30/2011
	Questioned Costs: \$77,339

DEQ's internal control over the NPS Program did not ensure compliance with federal laws and regulations regarding allowable costs/cost principles; matching, level of effort, and earmarking; and subrecipient monitoring.

Internal control that does not ensure compliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of NPS Program awards.

Federal expenditures for the NPS Program totaled \$11.4 million for the two-year period ended September 30, 2007. We identified known questioned costs of \$77,339.

Our exceptions, by compliance area, are as follows:

a. Allowable Costs/Cost Principles

DEQ's internal control did not ensure that NPS Program expenditures met the allowable cost principles of federal regulation 2 *CFR* 225.

Appendix B, section 8(h) of federal regulation 2 *CFR* 225 requires DEQ to adjust costs charged to federal awards to reflect activity actually performed. DEQ allocated administrative payroll costs to the NPS Program based on the estimated percentage of direct staff hours charged to the grants rather than the actual percentage of direct hours charged. Our review disclosed:

- (1) DEQ did not adjust its administrative payroll costs to reflect the actual percentage of direct staff time charged. DEQ informed us that it did not make the required adjustments because it misinterpreted federal regulation 2 *CFR* 225 to exclude it from adjusting budgeted costs if they are within 10% of actual costs. However, federal regulation 2 *CFR* 225 provides that the adjustments must be made at least annually if the differences between budgeted and actual costs are within 10%. As a result, we identified known questioned costs of \$32,324.
- (2) DEQ directly charged the payroll costs of field office supervisors and secretaries to various funding sources, including the NPS Program; however, DEQ did not identify the administrative activities of field office supervisors and secretaries to include in its administrative cost pool. As a result, DEQ did not allocate all administrative costs to the NPS Program. DEQ's payroll costs for field office supervisors and secretaries were \$491,444 and \$474,747 during fiscal years 2005-06 and 2006-07, respectively. DEQ informed us that the field office supervisors and secretaries are primarily direct program staff, but they have some

administrative responsibilities. We could not determine if the amount of administrative costs for these field office supervisors and secretaries would have resulted in additional questioned costs for the NPS Program.

b. Matching, Level of Effort, and Earmarking

DEQ's internal control did not ensure compliance with federal laws and regulations regarding matching and earmarking. Our review disclosed:

- (1) DEQ needs to improve its internal control over matching expenditures to help ensure that only eligible projects are used to meet the matching requirements for the NPS Program.

Federal regulation 40 *CFR* 31.24 states that a matching requirement may be satisfied by allowable costs incurred by the grantee, subgrantee, or a cost-type contractor. The EPA does not permit DEQ to use funds from Section 319(h) of the Clean Water Act to implement specific requirements of draft or final National Pollutant Discharge Elimination System (NPDES) storm water permits or to implement permit application requirements of the EPA's storm water regulations.

Our review of reported matching expenditures noted that DEQ claimed \$348,686 of matching expenditures for a project that required a storm water permit. However, subsequent to informing DEQ of this condition, DEQ identified other eligible costs from projects, funded by the Clean Michigan Initiative, that were eligible to replace the storm water permit project.

- (2) DEQ did not ensure that it earmarked expenditures in accordance with federal laws and regulations.

Title III, section 1329(h)(12) of the *United States Code* states that administrative costs in the form of salaries, overhead, or indirect costs for services shall not exceed in any fiscal year 10% of the amount of the grant in such year. Federal regulation 40 *CFR* 31.22 states that grant funds

may only be used for allowable costs of DEQ or its subrecipients. Our review disclosed:

- (a) DEQ did not have a process to ensure that it did not exceed the 10% statutory limitation. DEQ charged administrative costs to the NPS Program that exceeded the 10% statutory limitation by \$26,616 and \$18,399 for fiscal years 2005-06 and 2006-07, respectively. As a result, we identified known questioned costs of \$45,015.
- (b) DEQ did not have a process to identify the administrative costs related to field office supervisors and secretaries as described in part a.(2) of this finding. As a result, DEQ did not allocate all administrative costs to the NPS Program.

c. Subrecipient Monitoring

DEQ's internal control did not ensure compliance with the pass-through entity responsibilities as established by OMB Circular A-133.

OMB Circular A-133 establishes the responsibilities for state entities that provide federal funds to subrecipients that carry out federal programs. DEQ is considered a pass-through entity in these cases.

We reviewed 38 subrecipients, of which 6 received NPS Program funding. Our review of DEQ's subrecipient monitoring efforts disclosed:

- (1) DEQ did not receive an A-133 audit report for 1 (17%) of the 6 NPS Program subrecipients we reviewed. OMB Circular A-133, Section 400(d) requires DEQ to ensure that subrecipients expending \$500,000 or more in federal awards meet the A-133 audit requirements for a fiscal year. After we informed DEQ of the 1 subrecipient that did not have an A-133 audit report, DEQ obtained and reviewed the subrecipient's A-133 audit report. This audit report disclosed issues that required DEQ to issue a management decision. We reported a similar condition in our prior Single Audit. DEQ indicated in its May 2006 corrective action plan that it would implement procedures to obtain and review 100% of the required A-133 audit reports.

- (2) DEQ did not document the receipt date of an A-133 audit report for 1 (20%) of the 5 NPS Program subrecipients we reviewed that submitted an A-133 report. OMB Circular A-133, Section 400(d) requires DEQ to issue a management decision on audit findings within six months after receipt of a subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action. Despite the lack of documentation of the receipt date of the A-133 audit report, we were able to determine compliance because the subrecipient's audit report did not require DEQ to issue a management decision.

RECOMMENDATIONS

We recommend that DEQ improve its internal control over the NPS Program to ensure compliance with federal laws and regulations regarding allowable costs/cost principles and matching, level of effort, and earmarking.

WE AGAIN RECOMMEND THAT DEQ IMPROVE INTERNAL CONTROL OVER THE NPS PROGRAM TO ENSURE COMPLIANCE WITH FEDERAL LAWS AND REGULATIONS REGARDING SUBRECIPIENT MONITORING.

FINDING (7610804)

4. Capitalization Grants for Drinking Water State Revolving Funds (DWSRF), CFDA 66.468

U.S. Environmental Protection Agency	CFDA 66.468: Capitalization Grants for Drinking Water State Revolving Funds
Award Number: FS975487-02 FS975487-03 FS975487-04 FS975487-05 FS975487-06 FS975487-07	Award Period: 10/01/2001 - 09/30/2005 (extended to 09/30/2006) 10/01/2002 - 09/30/2007 10/01/2003 - 09/30/2008 10/01/2004 - 09/30/2006 10/01/2005 - 09/30/2008 10/01/2006 - 09/30/2009
	Questioned Costs: \$36,102

DEQ's internal control over the DWSRF Program* did not ensure compliance with federal laws and regulations regarding allowable costs/cost principles and subrecipient monitoring.

* See glossary at end of report for definition.

Internal control that does not ensure compliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of DWSRF Program awards.

Federal expenditures for the DWSRF Program totaled \$42.1 million for the two-year period ended September 30, 2007. We identified known questioned costs of \$36,102 and known and likely questioned costs totaling \$724,683.

Our exceptions, by compliance area, are as follows:

a. Allowable Costs/Cost Principles

DEQ's internal control did not ensure that DWSRF Program expenditures met the allowable cost principles of federal regulation 2 *CFR* 225. Our review disclosed:

- (1) DEQ overcharged administrative payroll costs to DWSRF Program awards. Appendix B, section 8(h) of federal regulation 2 *CFR* 225 requires DEQ to adjust costs charged to federal awards to reflect activity actually performed. Our review disclosed that DEQ allocated administrative payroll costs to DWSRF Program awards based on the estimated percentage of direct staff hours charged to the awards rather than the actual percentage of direct hours charged. As a result, we identified known questioned costs of \$33,522.
- (2) DEQ did not maintain the required payroll certifications to support payroll costs charged to the DWSRF Program for 1 (8%) of 12 employees reviewed. Appendix B, section 8(h) of federal regulation 2 *CFR* 225 requires employees who are expected to work solely on a single federal award to semiannually certify that they worked solely on that program. Because DEQ did not document that this employee worked solely on the DWSRF Program, it could not verify that the payroll costs charged to the Program were appropriate. As a result, we identified known questioned costs of \$2,580 and known and likely questioned costs totaling \$691,161.
- (3) DEQ's internal control did not ensure that payroll costs charged to the DWSRF Program were reasonable costs for 1 (8%) of 12 employees reviewed. Appendix A, section C(2) of federal regulation 2 *CFR* 225 defines reasonable costs as costs generally recognized as ordinary and

necessary for the operation of the governmental unit or the performance of the federal award. Our review disclosed that an employee improperly charged 100% of her payroll costs to the DWSRF Program for a six-month period when the work performed did not relate to the DWSRF Program. The error was not detected during the standard review and approval of the employee time sheet. DEQ informed us that it identified the error upon the employee's transfer to another DEQ district office and subsequently made the appropriate corrections.

b. Subrecipient Monitoring

DEQ's internal control did not ensure compliance with OMB Circular A-133 requirements regarding subrecipient monitoring.

DEQ monitors subrecipients at the program and departmental levels. DEQ's program staff are responsible for informing subrecipients of *CFDA* and federal award information. Also, program staff are responsible for monitoring subrecipients' activities to ensure that they used federal awards for authorized purposes. DEQ's Financial and Business Services Division is responsible for obtaining and reviewing DEQ's subrecipients' A-133 audit reports and issuing management decisions.

We reviewed 13 supplemental agreements and related projects at the program level to assess DEQ's efforts to inform subrecipients of the required *CFDA* and federal award information and to monitor subrecipients' activities. Also, we reviewed 38 subrecipients, of which 19 received DWSRF funding, at the departmental level to assess DEQ's efforts to obtain and review subrecipients' A-133 audit reports and to issue management decisions.

Our review of DEQ's subrecipient monitoring efforts for the DWSRF Program disclosed:

- (1) DEQ did not consistently inform subrecipients of *CFDA* and federal award information as required by federal laws and regulations. OMB Circular A-133, Section 400(d) requires DEQ to inform subrecipients of the *CFDA* title and number, award name and number, award year, and name of the federal agency and if the award is for research and development. Also, OMB Circular A-133 states that if some of the required information is not available, DEQ shall provide the best information available to describe the

federal award. We reviewed 13 supplemental agreements that included 5 agreements established during our audit period. Our review disclosed that DEQ did not inform the subrecipient of the information required by OMB Circular A-133 in any of the 5 supplemental agreements established during our audit period. We reported a similar condition in our prior Single Audit. DEQ indicated in its May 2006 corrective action plan that it would develop standardized supplemental agreement language that will include the required award information.

- (2) DEQ did not consistently monitor the activities of subrecipients to ensure that they used federal awards for authorized purposes. OMB Circular A-133, Section 400(d) requires DEQ to monitor the activities of subrecipients to ensure that they used federal awards in compliance with federal laws and regulations. Our review of 13 supplemental agreements for projects under construction disclosed that DEQ did not maintain evidence that it monitored 8 (62%) of the 13 projects. Effective monitoring of subrecipients by DEQ can be accomplished through regular discussions with the subrecipients and on-site inspections. The EPA also recommended, in its fiscal year 2005-06 State Revolving Fund Program Evaluation Report, that DEQ institute an on-site inspection program to monitor projects that are under construction to protect the significant capital invested in the DWSRF Program.
- (3) DEQ did not receive an A-133 audit report for 1 (5%) of the 19 subrecipients we reviewed. OMB Circular A-133, Section 400(d) requires DEQ to ensure that subrecipients expending \$500,000 or more in federal awards meet the A-133 audit requirements for a fiscal year. DEQ informed us that it requested the audit report from the subrecipient, but the subrecipient's auditors replied that the audit requirements were not applicable. This subrecipient received approximately \$1.9 million during its fiscal year; therefore, the audit requirements were applicable. DEQ did not make any additional attempts to obtain the audit report and did not perform any other follow-up procedures, such as imposing sanctions with the subrecipient. We reported a similar condition in our prior Single Audit. DEQ indicated in its May 2006 corrective action plan that it would implement procedures to obtain and review 100% of the required A-133 audit reports.

- (4) DEQ did not document the receipt date of A-133 audit reports for 8 (44%) of the 18 subrecipients we reviewed that submitted an A-133 audit report. OMB Circular A-133, Section 400(d) requires DEQ to issue a management decision on audit findings within six months after receipt of a subrecipient's audit report and to ensure that the subrecipient takes appropriate and timely corrective action. Without documentation of the receipt date of the A-133 audit reports, we could not test compliance for 3 of these subrecipients. In the remaining 5 instances, we were able to determine compliance using the date of the subrecipient's audit report or the subrecipient's audit report did not require DEQ to issue a management decision.

RECOMMENDATIONS

We recommend that DEQ improve its internal control over the DWSRF Program to ensure compliance with federal laws and regulations regarding allowable costs/cost principles.

WE AGAIN RECOMMEND THAT DEQ IMPROVE ITS INTERNAL CONTROL OVER THE DWSRF PROGRAM TO ENSURE COMPLIANCE WITH FEDERAL LAWS AND REGULATIONS REGARDING SUBRECIPIENT MONITORING.

FINDING (7610805)

5. Performance Partnership Grants (PPG), CFDA 66.605

U.S. Environmental Protection Agency	CFDA 66.605: Performance Partnership Grants
Award Number: BG985023-06 BG985023-07	Award Period: 10/01/2005 - 09/30/2006 10/01/1006 - 09/30/2007
	Questioned Costs: \$271,335

DEQ's internal control over the PPG Program did not ensure compliance with federal laws and regulations regarding allowable costs/cost principles. We consider this to be a material weakness in internal control and material noncompliance with federal requirements. As a result, we issued a qualified opinion on compliance with federal laws and regulations for the PPG Program.

Internal control that does not ensure compliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of PPG awards.

Federal expenditures for the PPG Program totaled \$25.1 million for the two-year period ended September 30, 2007. We identified known questioned costs of \$271,335 and known and likely questioned costs totaling \$1,361,433.

DEQ's internal control did not ensure that PPG program expenditures met the allowable cost principles of federal regulation 2 *CFR* 225. Our review disclosed:

a. DEQ overcharged administrative payroll costs to the PPG Program. Appendix B, section 8(h) of federal regulation 2 *CFR* 225 requires DEQ to adjust costs charged to federal awards to reflect activity actually performed. DEQ allocated administrative payroll costs to the PPG Program based on the estimated percentage of direct staff hours charged to the grants rather than the actual percentage of direct hours charged. Our review disclosed:

(1) DEQ did not make adjustments to its administrative payroll costs to reflect the actual percentage of direct staff time charged. As a result, we identified known questioned costs of \$271,049.

(2) DEQ directly charged the payroll costs of field office supervisors and secretaries to various funding sources, including the PPG Program; however, DEQ did not identify the administrative activities of field office supervisors and secretaries to include in its administrative cost pool. As a result, DEQ did not allocate all administrative costs to the PPG Program. DEQ's payroll costs for field office supervisors and secretaries were \$1,678,703 and \$1,755,389 during fiscal years 2005-06 and 2006-07, respectively. DEQ informed us that the field office supervisors and secretaries are primarily direct program staff, but they have some administrative responsibilities. We could not determine if the amount of administrative costs for field office supervisors and secretaries would have resulted in additional questioned costs for the PPG Program.

b. DEQ did not maintain the required payroll certifications to support payroll costs charged to the PPG Program for 3 (14%) of 22 employees reviewed. Appendix B, section 8(h) of federal regulation 2 *CFR* 225 requires employees who are expected to work solely on a single federal award to semiannually

certify that they worked solely on that program. Because DEQ did not document that these employees worked solely on the PPG Program, it could not verify that the payroll costs charged to the Program were appropriate. As a result, we identified known questioned costs of \$286 and known and likely questioned costs totaling \$1,090,384.

RECOMMENDATION

We recommend that DEQ improve its internal control over the PPG Program to ensure compliance with federal laws and regulations regarding allowable costs/cost principles.

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

OTHER SCHEDULES

DEPARTMENT OF ENVIRONMENTAL QUALITY
Summary Schedule of Prior Audit Findings
As of June 16, 2008

PRIOR AUDIT FINDINGS RELATED TO THE FINANCIAL STATEMENTS AND FINANCIAL SCHEDULES

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

PRIOR AUDIT FINDINGS RELATED TO FEDERAL AWARDS

Audit Findings Not Fully Corrected or Partially Corrected:

Audit Period: October 1, 2003 through September 30, 2005

Finding Number: 760601

Finding Title: Suspension and Debarment

Finding: The Department of Environmental Quality (DEQ) had not established internal control in its Coastal Zone Management Administration Awards (CZM) Program to ensure that it did not contract with or make grant awards to parties that had been suspended or debarred.

Comments: DEQ formed a departmentwide workgroup known as the Grants Facilitation Team (GFT) to develop standards for grant-related issues. The GFT has developed grant contract boilerplate language to be used by all DEQ grant-making programs. This boilerplate contains a section which specifies that, by signing the contract, the grantee certifies that it is not currently disbarred, suspended, or declared ineligible. In addition, workgroup members (including the CZM Program) have been instructed to consult the Excluded Parties List System on the Internet to verify that potential grantees are not on the Excluded Parties List.

Audit Period: October 1, 2003 through September 30, 2005
Finding Number: 760602
Finding Title: Subrecipient Monitoring

Finding: DEQ should establish additional internal control to ensure that it complies with the pass-through entity responsibilities as established by U.S. Office of Management and Budget (OMB) Circular A-133.

Comments: DEQ's GFT developed the "Federal Funding Requirements" section of the standard grant contract boilerplate language which requires program managers of federally funded programs to supply this required information.

DEQ transferred responsibility for the OMB Circular A-133 subrecipient monitoring process to the Federal Aid Section of the Financial and Business Services Division. Federal Aid Section staff have completed review of the fiscal year 2002-03 and fiscal year 2003-04 audits. It was determined that three of the entities had findings that warranted a management decision and management decision letters were issued to these entities.

For fiscal year 2004-05, 256 subrecipients were identified and it was determined that 102 had federal expenditures in excess of \$500,000 during their fiscal year 2004-05. Audits have been secured from all except 2 entities. Letters that identified minor issues were sent to 42 subrecipients. No additional high-risk subgrantees were identified during this review.

For fiscal year 2005-06, 234 subrecipients were identified, 93 had federal expenditures in excess of \$500,000, and audits have been secured from all but 13 entities. Federal Aid Section staff are in contact with these subrecipients and have requested their audits. The audits received were reviewed and letters identifying minor issues were sent to 33 subrecipients. Six potential high-risk grantees have been identified. DEQ continues to determine whether the designation is appropriate.

DEPARTMENT OF ENVIRONMENTAL QUALITY

Corrective Action Plan

As of June 19, 2008

FINDINGS RELATED TO THE FINANCIAL STATEMENTS AND FINANCIAL SCHEDULES

There were no findings related to the financial statements and financial schedules for fiscal years 2005-06 and 2006-07.

FINDINGS RELATED TO FEDERAL AWARDS

Finding Number: 7610801

Finding Title: Coastal Zone Management Administration Awards (CZM), *CFDA* 11.419

Management Views: Part a.: The Department of Environmental Quality (DEQ) agrees.

Part b.(1): DEQ agrees in part with this finding. DEQ has been performing administrative cost justifications on a quarterly basis. Unfortunately, the procedure used did not agree with the auditor's interpretation. DEQ believes this program is a continuing program, with multiple grants open every fiscal year, and, in terms of administrative costs, should be regarded in total, and not by individual grants. Looking at the program as a whole, the questioned costs should be \$21,029.

Part b.(2): DEQ agrees.

Parts c.(1) and c.(2): DEQ agrees in part with these findings. DEQ began implementation of a new process of A-133 subrecipient monitoring during this audit period and made great strides toward obtaining all of the audits and issuing management decisions.

The majority of the missing audits were from other State departments, and DEQ has now incorporated them into its process.

Part c.(3): DEQ agrees. Issuance of management decisions was a new procedure for DEQ and it was necessary to work through the process. Now that the process is established, management decisions will be issued more timely in the future.

Part d.: DEQ agrees.

Corrective Action:

Part a.: Grant coding will be removed from the Data Collection and Distribution System (DCDS) default coding for these employees and they will cost-account their hours in DCDS, entering time worked on the grant by coding block.

Part b.(1): DEQ will seek clarification from the federal awarding agency on the acceptability of regarding these grants as a total program, in terms of administrative costs. The amount of administrative time charged to the grant will be minimized. The procedure for allocating these costs to federal grants will be posted on the DEQ intranet.

Part b.(2): DEQ will continue to work to ensure certification of all employees who work 100% of their time on federal grants, giving greater scrutiny to grants that are shared across divisions.

Part c.(1): DEQ will continue its effort to obtain 100% of the required audit reports and has established additional procedures to help determine whether an audit report is required.

Part c.(2): The receipt date will be noted when an audit is printed from a Web site.

Part c.(3): If it appears that a management decision may be necessary, the due date of the decision will be indicated on the audit and any correspondence that must be reviewed by DEQ management.

Part d.: DEQ will post a procedure on the intranet for verifying the suspension and debarment status of potential grantees. Program managers will obtain and print the status of each potential grantee found on the federal Web site and retain it in the program file.

Anticipated Completion Date: September 30, 2009

Responsible Individuals: Karen Jurgensen, Catherine Cunningham, Karen Best, Kathy Tetzlaff, and Sharon Maher

Finding Number: 7610802

Finding Title: Capitalization Grants for Clean Water State Revolving Funds (SRF), *CFDA* 66.458

Management Views: Part a.: DEQ agrees in part with this finding. The Single Audit Act requirement and *Catalog of Federal Domestic Assistance (CFDA)* numbers are posted on the Internet and subrecipients are informed of the percentage of federal funding at the time of each draw.

Part b.: DEQ agrees in part with this finding. While it feels that sufficient monitoring is conducted, it will work to improve consistency and documentation of monitoring.

Part c.: DEQ agrees in part with this finding. DEQ began implementation of a new process of A-133 subrecipient monitoring during this audit period and

made great strides toward obtaining all of the audits and issuing management decisions.

Part d.: DEQ agrees.

Corrective Action:

Part a.: DEQ will revise the SRF Supplemental Agreement boilerplate to insert the information required by U.S. Office of Management and Budget (OMB) Circular A-133. Because the fiscal year and grant number of the federal award are not known at the time of signing of the agreements, this information will be provided at the time of each payment.

Part b.: DEQ will perform an evaluation and develop a plan to improve consistency and documentation of monitoring.

Part c.: DEQ will continue its effort to obtain 100% of the required audit reports and has established additional procedures to help determine whether an audit report is required.

Part d.: The receipt date will be noted when an audit is printed from a Web site.

Anticipated Completion Date: September 30, 2009

Responsible Individuals: Karen Jurgensen, Chip Heckathorn, Karen Best, and Sharon Maher

Finding Number: 7610803

Finding Title: Nonpoint Source Implementation Grants (NPS),
CFDA 66.460

Management Views: Part a.(1): DEQ agrees in part with this finding. DEQ has been performing administrative cost justifications on a quarterly basis. Unfortunately, the procedure used did not agree with the auditor's interpretation.

DEQ believes this program is a continuing program, with multiple grants open every fiscal year, and, in terms of administrative costs, should be regarded in total, and not by individual grants. Looking at the grants as a total program, there should be no questioned costs.

Part a.(2): DEQ agrees.

Part b.(1): DEQ agrees.

Part b.(2)(a): DEQ agrees in part with this finding. It did not have a procedure to ensure that administrative costs did not exceed the 10% statutory limitation. However, DEQ believes this program is a continuing program, with multiple grants open every fiscal year, and, in terms of administrative costs, should be regarded in total, and not by individual grants. Looking at the program as a whole, there should be no questioned costs.

Part b.(2)(b): DEQ agrees.

Parts c.(1) and c.(2): DEQ agrees in part with these findings. DEQ began implementation of a new process of A-133 subrecipient monitoring during this audit period and made great strides toward obtaining all of the audits and issuing management decisions. The majority of the missing audits were from other State departments, and DEQ has now incorporated them into its process.

Corrective Action:

Part a.(1): DEQ will seek clarification from the federal awarding agency on the acceptability of regarding these grants as a total program, in terms of administrative costs. The amount of administrative time charged to the grant will be minimized. The

procedure for allocating these costs to federal grants will be posted on the DEQ intranet.

Part a.(2): No administrative time, including field office staff, will be charged to the federal grants, dependent on the availability of nonfederal funds.

Part b.(1): This error was corrected and the correct totals were reported to the federal awarding agency.

Part b.(2)(a): A process has been developed to ensure that the 10% statutory limitation has not been exceeded at the program level. DEQ will seek clarification from the federal awarding agency on the acceptability of regarding these grants as a total program, in terms of administrative costs.

Part b.(2)(b): No administrative time, including field office staff, will be charged to the federal grants, dependent on the availability of nonfederal funds.

Part c.(1): DEQ will continue its effort to obtain 100% of the required audit reports and has established additional procedures to help determine whether an audit report is required.

Part c.(2): The receipt date will be noted when an audit is printed from a Web site.

Anticipated Completion Date: September 30, 2009

Responsible Individuals: Karen Jurgensen, Cindy Emmons, and Sharon Maher

Finding Number: 7610804

Finding Title: Capitalization Grants for Drinking Water State Revolving Funds (DWSRF), *CFDA* 66.468

Management Views:

Part a.(1): DEQ agrees in part with this finding. DEQ has been performing administrative cost justifications on a quarterly basis. Unfortunately, the procedure used did not agree with the auditor's interpretation. DEQ believes this program is a continuing program, with multiple grants open every fiscal year, and, in terms of administrative costs, should be regarded in total, and not by individual grants. Looking at the program as a whole, there should be no questioned costs.

Part a.(2): DEQ agrees that the certification was not done. The auditors were provided with a position description indicating that the employee worked solely on the On-Site Water and Wastewater Management Program and that the charges to the Source Water Protection Set-Aside of the DWSRF grants are appropriate. The employee's supervisor does not have the authority or funding to assign activities outside of this program. This should not be a questioned cost.

Part a.(3): DEQ agrees in part with this finding. DEQ's internal control ensured that the error was identified and corrected before the Single Audit began.

Part b.(1): DEQ agrees in part with this finding. The Single Audit Act requirement and *CFDA* numbers are posted on the Internet and subrecipients are informed of the percentage of federal funding at the time of each draw.

Part b.(2): DEQ agrees in part with this finding. While it feels that sufficient monitoring is conducted, it will work to improve consistency and documentation of monitoring.

Part b.(3): DEQ agrees in part with this finding. DEQ began implementation of a new process of A-133 subrecipient monitoring during this audit period and made great strides toward obtaining all of the audits and issuing management decisions.

Part b.(4): DEQ agrees.

Corrective Action:

Part a.(1): DEQ will seek clarification from the federal awarding agency on the acceptability of regarding these grants as a total program, in terms of administrative costs. The amount of administrative time charged to the grant will be minimized. The procedure for allocating these costs to federal grants will be posted on the DEQ intranet.

Part a.(2): DEQ will continue to work to ensure certification of all employees who work 100% of their time on federal grants.

Part a.(3): This correction was made before the Single Audit began.

Part b.(1): DEQ will revise the DWSRF Supplemental Agreement boilerplate to insert the information required by OMB Circular A-133. Because the fiscal year and grant number of the federal award are not known at the time of signing of the agreements, this information will be provided at the time of each payment.

Part b.(2): DEQ will perform an evaluation and develop a plan to improve consistency and documentation of monitoring.

Part b.(3): DEQ will continue its effort to obtain 100% of the required audit reports and has established

additional procedures to help determine whether an audit report is required.

Part b.(4): The receipt date will be noted when an audit is printed from a Web site.

Anticipated Completion Date: September 30, 2009

Responsible Individuals: Karen Jurgensen, Chip Heckathorn, Karen Duling, and Sharon Maher

Finding Number: 7610805

Finding Title: Performance Partnership Grants (PPG), *CFDA* 66.605

Management Views: Part a.(1): DEQ agrees that the administrative charges to the grant were not in proper proportion to the staff charges to the grant. However, DEQ does not agree that these are questioned costs. Federal funding is not adequate to fund all PPG activities in the Water Bureau. Consequently, a variety of State General Fund/general purpose dollars and State restricted fund sources have been used for staff payroll charges. When State-funded, grant-eligible staff payroll charges are added to the federal grant staff payroll charges, the administrative payroll charges are well below the allowable level and thus should not be considered questioned costs.

Part a.(2): DEQ agrees.

Part b.: DEQ agrees that these three certifications were not done. However, one of these employees works in a dedicated function (toxicology laboratory) where all activities are PPG grant-eligible. Another of these employees enters his/her time by coding block into DCDS, which is certified biweekly by his supervisor. The third employee works under a

memorandum of understanding, which funds all of his/her work (stream flow analysis and hydrological studies). His/her work duties spelled out in the position description are completely in line with the memorandum of understanding. In all cases, these supervisors are not authorized to assign the employees to work outside of the assigned program. These should not be questioned costs.

Corrective Action:

Part a.(1): DEQ will reallocate its PPG grant funding so that all PPG funds are spent on programmatic staff and none on administrative functions. This will not result in any change in programmatic effort or any change in overall funding.

Part a.(2): No administrative time, including field office staff, will be charged to the federal grants, dependent on the availability of nonfederal funds.

Part b.: DEQ will continue to work to ensure certification of all employees who work 100% of their time on federal grants, giving greater scrutiny to grants that are shared across divisions.

Anticipated Completion Date: September 30, 2009

Responsible Individuals: Karen Jurgensen, Karen Duling, Kathy Tetzlaff, and Sharon Maher

GLOSSARY

Glossary of Acronyms and Terms

Capitalization Grants for Clean Water State Revolving Funds (SRF) Program

The federal grant program that provides capitalization grants to states for establishing revolving funds to be used for the construction of municipal wastewater treatment projects or for the development and implementation of nonpoint source or estuary conservation management programs and plans in compliance with the Clean Water Act.

Capitalization Grants for Drinking Water State Revolving Funds (DWSRF) Program

The federal grant program that provides capitalization grants to states for establishing revolving funds to be used to assist public water suppliers in financing the costs of infrastructure needed to achieve or maintain compliance with Safe Drinking Water Act requirements. States may also set aside certain percentages of their capitalization grant for various activities that promote source water protection and enhanced water systems management.

CFDA

Catalog of Federal Domestic Assistance.

control deficiency in internal control over federal program compliance

The design or operation of a control that does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect on a timely basis noncompliance with a type of compliance requirement of a federal program.

control deficiency in internal control over financial reporting

The design or operation of a control that does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

CRF

Cleanup and Redevelopment Subfund.

CRTF

Cleanup and Redevelopment Trust Subfund.

CZM

Coastal Zone Management Administration Awards.

DCDS	Data Collection and Distribution System.
DEQ	Department of Environmental Quality.
Drinking Water State Revolving Fund	A fund established within the Michigan Municipal Bond Authority, a discretely presented component unit of the State of Michigan, to provide low-interest loans to public water suppliers to finance the costs of infrastructure needed to comply with requirements of the Safe Drinking Water Act.
EPA	U.S. Environmental Protection Agency.
EPF	Environmental Protection Fund.
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 presented fairly in all material respects in conformity with the disclosed basis of accounting.
GAAP	accounting principles generally accepted in the United States of America.
GFT	Grants Facilitation Team.
internal control	A process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
low-risk auditee	As provided for in OMB Circular A-133, an auditee that may qualify for reduced federal audit coverage if it receives an annual Single Audit and it meets other criteria related to prior audit results. In accordance with State statute, this Single

Audit was conducted on a biennial basis; consequently, this auditee is not considered a low-risk auditee.

material misstatement	A misstatement in the financial schedules and/or financial statements that causes the schedules and/or statements to not present fairly the financial position or the changes in financial position or cash flows in conformity with the disclosed basis of accounting.
material noncompliance	Violations of laws, regulations, contracts, and grants that could have a direct and material effect on major federal programs or on financial schedule and/or financial statement amounts.
material weakness in internal control over federal program compliance	A significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected.
material weakness in internal control over financial reporting	A significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial schedules and/or financial statements will not be prevented or detected.
MSP	Michigan Department of State Police.
NPS	Nonpoint Source Implementation Grants.
OMB	U.S. Office of Management and Budget.
OMB Circular A-87	Guidance regarding "Cost Principles for State, Local, and Indian Tribal Governments," which has been incorporated into the <i>Code of Federal Regulations</i> as Title 2, Part 225 (i.e., federal regulation 2 <i>CFR</i> 225).

pass-through entity	A nonfederal entity that provides a federal award to a subrecipient to carry out a federal program.
PPG	Performance Partnership Grants.
qualified opinion	<p>An auditor's opinion in which the auditor:</p> <ol style="list-style-type: none"> a. Identifies a scope limitation or one or more instances or misstatements that impact the fair presentation of the financial schedules and/or financial statements presenting the basic financial information of the audited agency in conformity with the disclosed basis of accounting or the financial schedules and/or financial statements presenting supplemental financial information in relation to the basic financial schedules and/or financial statements. In issuing an "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules and/or financial statements 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 and/or financial statements taken by themselves; or b. Expresses reservations about the audited agency's compliance, in all material respects, with the cited requirements that are applicable to each major federal program. In issuing an "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules and/or financial statements 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 and/or financial statements taken by themselves.

questioned cost A cost that is questioned by the auditor because of an audit finding: (1) which resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds; (2) where the costs, at the time of the audit, are not supported by adequate documentation; or (3) where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

significant deficiency in internal control over federal program compliance A control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected.

significant deficiency in internal control over financial reporting A control deficiency, or a combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial schedules and/or financial statements that is more than inconsequential will not be prevented or detected.

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

a direct and material effect on a major federal program and the consideration of internal control over compliance in accordance with OMB Circular A-133.

SOMCAFR

State of Michigan Comprehensive Annual Financial Report.

State Revolving Fund

A fund established within the Michigan Municipal Bond Authority, a discretely presented component unit of the State of Michigan, to provide low-interest loans to municipalities for the construction of publicly owned water pollution control facilities.

subrecipient

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

TCE

trichloroethylene.

unqualified opinion

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

- a. The financial schedules and/or financial statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting; or
- b. The financial schedules and/or financial statements presenting supplemental financial information are fairly stated in relation to the basic financial schedules and/or financial statements. In issuing an "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules and/or financial statements 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 and/or financial statements taken by themselves; or

- c. The audited agency complied, in all material respects, with the cited requirements that are applicable to each major federal program.

