STATE OF ILLINOIS
ENVIRONMENTAL PROTECTION AGENCY

FINANCIAL AUDIT
FUND 270 – WATER REVOLVING FUND
For the Year Ended June 30, 2012

Performed as Special Assistant Auditors
for the Auditor General, State of Illinois

STATE OF ILLINOIS
ENVIRONMENTAL PROTECTION AGENCY
FUND 270 – WATER REVOLVING FUND

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STATE OF ILLINOIS
ENVIRONMENTAL PROTECTION AGENCY
FUND 270 – WATER REVOLVING FUND

AGENCY OFFICIALS

Director	John Kim (01/02/13 to present)
Interim Director	John Kim (10/25/11 to 01/01/13)
	Lisa Bonnett (03/03/11 to 10/24/11)
Director	Douglas Scott (through 03/02/11)
Deputy Director	Lisa Bonnett (11/08/11 to Present)
Acting Deputy Director	Lisa Bonnett (through 11/07/11)
Acting Chief Legal Counsel	Julie Armitage (10/25/11 to Present)
Chief Legal Counsel	John Kim (through 10/24/11)
Fiscal Services Manager	Willa Barger (through 12/31/12)
Chief Internal Auditor	Rusti Cummings (02/01/11 to Present)

Agency Headquarter offices are located at:

1021 North Grand Avenue East
Springfield, Illinois 62794

STATE OF ILLINOIS
ENVIRONMENTAL PROTECTION AGENCY
FUND 270 – WATER REVOLVING FUND

FINANCIAL STATEMENT REPORT

SUMMARY

The audit of the accompanying individual nonshared proprietary financial statements of the Water Revolving Fund of the State of Illinois, Environmental Protection Agency (Agency) was performed by E.C. Ortiz and Co., LLP.

Based on their audit, the auditors expressed an unqualified opinion on the Agency's individual nonshared proprietary financial statements of the Water Revolving Fund.

SUMMARY OF FINDINGS

The auditors identified a matter involving the Agency's internal control over financial reporting that they considered to be a significant deficiency. The significant deficiency is described in the accompanying Schedule of Findings listed in the table of contents as finding 12-1, *Inadequate Controls Over Financial Reporting*.

EXIT CONFERENCE

The Agency waived having an exit conference in a letter dated January 23, 2013, from the Agency's Chief Internal Auditor, Ms. Rusti Cummings.

The response to the recommendation was provided by Ms. Rusti Cummings in a letter dated February 6, 2013.

E.C. ORTIZ & CO., LLP
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITORS' REPORT

Honorable William G. Holland
Auditor General
State of Illinois

As Special Assistant Auditors for the Auditor General, we have audited the accompanying financial statements of the Water Revolving Fund of the State of Illinois, Environmental Protection Agency, as of and for the year ended June 30, 2012, as listed in the table of contents. These financial statements are the responsibility of the State of Illinois, Environmental Protection Agency'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, 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 discussed in Note 2, the financial statements present only the Water Revolving Fund and do not purport to, and do not, present fairly the financial position of the State of Illinois, Environmental Protection Agency as of June 30, 2012, and its changes in financial position and cash flows, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Water Revolving Fund of the State of Illinois, Environmental Protection Agency, as of June 30, 2012, and the changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated February 27, 2013 on our consideration of the State of Illinois, Environmental Protection Agency's internal control over financial reporting of the Water Revolving Fund and on our tests of the State of Illinois, Environmental Protection Agency's 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

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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.

Management has omitted a management's discussion and analysis and budgetary comparison information for the Water Revolving Fund that accounting principles generally accepted in the United States of America require to be presented to supplement the fund financial statements. Such missing information, although not a part of the fund financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of the financial reporting for placing the fund financial statements in an appropriate operational, economic, or historical context. Our opinion on the fund financial statements is not affected by this missing information.

This report is intended solely for the information and use of the Auditor General, the General Assembly, the Legislative Audit Commission, the Governor, the Comptroller, and Agency management, and is not intended to be and should not be used by anyone other than these specified parties.

E.C. Ortiz & Co., LLP

Chicago, Illinois
February 27, 2013

STATE OF ILLINOIS
ENVIRONMENTAL PROTECTION AGENCY
FUND 270 - WATER REVOLVING FUND
INDIVIDUAL NONSHARED PROPRIETARY FUND

STATEMENT OF NET ASSETS

JUNE 30, 2012
(amounts in $000's)

	Water Revolving Fund (270 Fund)
ASSETS	
Current assets	
Cash and cash equivalents	$ 192,504
Securities lending collateral equity with State Treasurer	80,163
Loans and notes receivable	160,115
Other receivables	13,113
Due from federal government	20,577
Due from component unit	134
Other current assets	78
Restricted assets - accrued interest receivable	1,321
Restricted assets - loans receivable	27,521
Total current assets	495,526
Noncurrent assets	
Loans and notes receivable, net of current portion	1,968,272
Restricted assets - loans receivable, net of current portion	172,038
Capital assets, net of accumulated depreciation	56
Other noncurrent assets	261
Total noncurrent assets	2,140,627
TOTAL ASSETS	2,636,153
LIABILITIES	
Current liabilities	
Accounts payable and accrued liabilities	40
Due to component units	53
Due to federal governments	22
Due to local governments	15
Due to other funds	5,076
Obligations under securities lending of State Treasurer	80,163
Compensated absences	101
Total current liabilities	85,470
Noncurrent liabilities	
Long-term obligations	49,137
Compensated absences	1,489
Total noncurrent liabilities	50,626
TOTAL LIABILITIES	136,096
NET ASSETS	
Invested in capital assets, net of related debt	56
Restricted for:	
Debt service	200,880
Other purposes	2,000,344
Unrestricted	298,777
TOTAL NET ASSETS	$ 2,500,057

See accompanying notes to the basic financial statements.

STATE OF ILLINOIS
ENVIRONMENTAL PROTECTION AGENCY
FUND 270 - WATER REVOLVING FUND
INDIVIDUAL NONSHARED PROPRIETARY FUND

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

FOR THE YEAR ENDED JUNE 30, 2012
(amounts in $000's)

	Water Revolving Fund (270 Fund)
OPERATING REVENUES	
Interest income on loans - unpledged	$ 40,571
Interest income on loans - pledged	2,387
Total operating revenues	42,958
OPERATING EXPENSES	
General and administrative	18,525
Principal forgiveness	62,341
Depreciation	59
Total operating expenses	80,925
OPERATING LOSS	(37,967)
NONOPERATING REVENUES	
Interest and investment income	1,194
Other nonoperating revenues	71,970
Total nonoperating revenues	73,164
NONOPERATING EXPENSES	
Interest	3,440
Other nonoperating expenses	1,005
Total nonoperating expenses	4,445
INCREASE IN NET ASSETS	30,752
Transfers-in	2,532
CHANGE IN NET ASSETS	33,284
NET ASSETS, BEGINNING OF YEAR	2,466,773
NET ASSETS, END OF YEAR	$ 2,500,057

See accompanying notes to the basic financial statements.

STATE OF ILLINOIS
ENVIRONMENTAL PROTECTION AGENCY
FUND 270 - WATER REVOLVING FUND
INDIVIDUAL NONSHARED PROPRIETARY FUND

STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED JUNE 30, 2012
(amounts in $000's)

	Water Revolving Fund (270 Fund)
CASH FLOWS FROM OPERATING ACTIVITIES	
Cash payments to employees for services	$ (13,567)
Other payments	(4,751)
Net cash used in operating activities	(18,318)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
Operating grants received	65,008
Interest and principal paid on borrowing	(18,672)
Transfers-in from other funds	8,400
Reimbursement for arbitrage	(1,000)
Net cash provided by noncapital financing activities	53,736
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES	
Principal paid on capital lease	(4)
Acquisition of capital assets	(21)
Net cash used in capital and related financing activities	(25)
CASH FLOWS FROM INVESTING ACTIVITIES	
Interest and investment income	45,610
Loans disbursed to governmental units	(396,213)
Loans repaid by governmental units	172,977
Net cash used in investing activities	(177,626)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(142,233)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	334,737
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 192,504
Reconciliation of operating loss to net cash used in operating activities:	
Operating loss	$ (37,967)
Adjustments to reconcile operating loss to net cash used in operating activities:	
Depreciation expense	59
Principal forgiveness	62,341
Interest income on loans	(42,958)
Change in assets and liabilities:	
Increase in accounts payable and accrued liabilities	8
Increase in due to component units	53
Increase in intergovernmental payables	29
Increase in due to other funds	(69)
Increase in compensated absences	186
Net cash used in operating activities	$ (18,318)

See accompanying notes to the basic financial statements.

NOTES TO THE BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2012
(amounts in $000's)

1. Description of Funds

The State of Illinois, Environmental Protection Agency (Agency) administers the nonshared proprietary fund - Water Revolving Fund. A nonshared fund is a fund in which a single State agency is responsible for administering substantially all financial transactions of the fund.

The Water Revolving Fund held by the State Treasurer consists of the Water Pollution Control Loan Program ("Clean Water Program") established under authority granted in the Water Quality Act of 1987, which amended the Clean Water Act of 1972 and the Public Water Supply Loan Program ("Drinking Water Program") established under authority granted in the Federal Safe Drinking Water Act Amendments of 1996.

The Clean Water Program is administered by the Agency pursuant to the Illinois Environmental Protection Act, as supplemented and amended. The Clean Water Program was established as a revolving fund to accept federal capitalization grants, the required 20% State match and any proceeds of revenue bonds for the purpose of making low interest loans to units of local government to finance the construction of wastewater treatment works.

The Drinking Water Program is administered by the Agency pursuant to the Illinois Environmental Protection Act to accept federal capitalization grants, the required 20% State match and any proceeds of revenue bonds for the purpose of making low interest loans to units of local government and certain private community water supplies to finance the construction of public water facilities.

2. Summary of Significant Accounting Policies

The financial statements of the individual nonshared proprietary fund administered by the Agency have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP), as prescribed by the Governmental Accounting Standards Board (GASB). To facilitate the understanding of data included in the financial statements, summarized below are the more significant accounting policies.

2. Summary of Significant Accounting Policies (Continued)

Reporting Entity: As defined by GAAP, the financial reporting entity consists of a primary government, as well as its component units, which are legally separate organizations for which the elected officials of the primary government are financially accountable. Financial accountability is defined as:

(1) Appointment of a voting majority of the component unit's board and either (a) the primary government's ability to impose its will, or (b) the possibility that the component unit will provide a financial benefit to or impose a financial burden on the primary government; or

(2) Fiscal dependency on the primary government.

Based upon the required criteria, the individual nonshared proprietary fund does not have component units, nor is it a component unit of any other entity. However, because the individual nonshared proprietary fund is not legally separate from the State of Illinois (State), it is included in the financial statements of the State as a proprietary fund. The State of Illinois' Comprehensive Annual Financial Report may be obtained by writing to the State Comptroller's Office, Financial Reporting Department, 325 West Adams Street, Springfield, Illinois, 62704-1871.

The financial statements present only the Water Revolving Fund (270) administered by the State of Illinois, Environmental Protection Agency and do not purport to, and do not, present fairly the financial position of the Illinois Environmental Protection Agency as of June 30, 2012, and the changes in its financial position and cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Basis of Presentation: In government, the basic accounting and reporting entity is a fund. A fund is defined as an independent fiscal and accounting entity with a self-balancing set of accounts recording cash and/or other resources together with all related liabilities, obligations, reserves, and equities which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations. A statement of net assets, statement of revenues, expenses, and changes in net assets and statement of cash flows have been presented for the individual nonshared proprietary fund administered by the Agency.

2. Summary of Significant Accounting Policies (Continued)

Operating revenues, such as charges for services, result from exchange transactions associated with the principal activity of the fund. Exchange transactions are those in which each party receives and gives up essentially equal values. Nonoperating revenues, such as subsidies and investment earnings, result from nonexchange transactions or ancillary activities.

<u>Basis of Accounting</u>: The individual nonshared proprietary fund is reported using the economic resources measurement focus and the accrual basis of accounting.

Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flow takes place. Nonexchange transactions, in which the Agency gives (or receives) value without directly receiving (or giving) equal value in exchange, include grants and entitlements. Revenue from grants, entitlements, and similar items is recognized in the fiscal year in which all eligibility requirements imposed by the provider have been met.

Private-sector standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed in the individual nonshared proprietary fund financial statements to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board. The State also has the option of following subsequent private-sector guidance for their business-type activities and enterprise funds, subject to this same limitation. The State has elected not to follow subsequent private-sector guidance as for the individual nonshared proprietary fund administered by the Agency.

<u>Cash and Cash Equivalents</u>: Cash and cash equivalents consist principally of deposits held in the State Treasury. Cash and cash equivalents also include cash in banks for locally-held funds.

<u>Interfund Transactions</u>: The individual nonshared proprietary fund has the following types of interfund transactions with other funds of the State:

Loans - amounts provided with a requirement for repayment. Interfund loans are reported as interfund receivables (i.e. due from other funds) in lender funds and interfund payables (i.e. due to other funds) in borrower funds.

2. Summary of Significant Accounting Policies (Continued)

Services Provided and Used - sales and purchases of goods and services between funds for a price approximating their external exchange value. Interfund services provided and used are reported as revenues in seller funds and expenditures or expenses in purchaser funds. Unpaid amounts are reported as interfund receivables and payables in the fund statement of net assets.

Reimbursements - repayments from the funds responsible for particular expenditures or expenses to the funds that initially paid for them. Reimbursements are reported as expenditures in the reimbursing fund and as a reduction of expenditures in the reimbursed fund.

Transfers - flows of assets (such as cash or goods) without equivalent flows of assets in return and without a requirement for repayment. Transfers are reported after nonoperating revenues and expenses.

Restricted Assets - Loans Receivable: Under the bond agreements, the repayments of certain loans to municipalities and water districts are pledged against the bond payments. The repayments of those loans are collected in a separate trust account and are used to make bond payments.

Capital Assets: Capital assets, which include equipment, are reported at cost. Contributed assets are reported at estimated fair value at the time received. Capital assets are depreciated using the straight-line method.

The capitalization threshold and the estimated useful lives are as follows:

Capital Asset Category	Capitalization Threshold	Estimated Useful Life
Equipment	$ 5	3-25

2. Summary of Significant Accounting Policies (Continued)

Compensated Absences: The liability for compensated absences reported in the individual nonshared proprietary fund consists of unpaid, accumulated vacation and sick leave balances for Agency employees. The liability has been calculated using the vesting method, in which leave amounts for employees who are currently eligible to receive termination payments and other employees who are expected to become eligible in the future to receive such payments upon termination are included. The liability has been calculated based on the employees' current salary level and includes salary-related costs (e.g. social security and Medicare tax).

Legislation that became effective January 1, 1998, capped the paid sick leave for all State Employees' Retirement System members at December 31, 1997. Employees continue to accrue 12 sick days per year but will not receive monetary compensation for any additional time earned after December 31, 1997. Sick days earned between 1984 and December 31, 1997, (with a 50% cash value) would only be used after all days with no cash value are depleted. Any sick days earned and unused after December 31, 1997, will be converted to service time for purposes of calculating employee pension benefits.

Net Assets: Equity is displayed in three components as follows:

Invested in Capital Assets, Net of Related Debt - this consists of capital assets, net of accumulated depreciation and related debt.

Restricted - this consists of net assets that are legally restricted by outside parties or by law through constitutional provisions or enabling legislation. When both restricted and unrestricted resources are available for use, generally it is the State's policy to use restricted resources first, and then unrestricted resources when they are needed.

Unrestricted - this consists of net assets that do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

Use of Estimates: The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

3. Cash and Cash Equivalents

The State Treasurer is the custodian of the State's cash and cash equivalents for funds maintained in the State Treasury. The Agency independently manages cash and cash equivalents maintained outside the State Treasury.

Deposits in the custody of the State Treasurer (or in transit) at June 30, 2012, were $167,819. Deposits in the custody of the State Treasurer are pooled and invested with other State funds in accordance with the Deposit of State Moneys Act of the Illinois Compiled Statutes (15 ILCS 520/11).

Funds held by the State Treasurer have not been categorized as to credit risk because the Agency does not own individual securities. Details on the nature of these investments are available within the State of Illinois' Comprehensive Annual Financial Report.

Custodial credit risk is the risk that, in the event of a bank failure, the Agency's deposits might not be recovered. The Agency does not have a deposit policy for custodial credit risk. As of June 30, 2012, none of the bank balances of $24,686 held outside the State Treasury was exposed to custodial credit risk.

4. Securities Lending Transaction

The State Treasurer lends securities to broker-dealers and other entities for collateral that will be returned for the same securities in the future. The State Treasurer has, through a Securities Lending Agreement, authorized Deutsche Bank Group to lend the State Treasurer's securities to broker-dealers and banks pursuant to a form of loan agreement.

During fiscal year 2012, Deutsche Bank Group lent U.S. Treasury and U.S. agency securities and received as collateral U.S. dollar denominated cash. Borrowers were required to deliver collateral for each loan equal to at least 100% of the aggregate market value of the loaned securities. Loans are marked to market daily. If the market value of collateral falls below 100%, the borrower must provide additional collateral to raise the market value to 100%.

The State Treasurer did not impose any restrictions during the fiscal year on the amount of the loans of available or the eligible securities. In the event of borrower default, Deutsche Bank Group provides the State Treasurer with counterparty default indemnification. In addition, Deutsche Bank Group is obligated to indemnify the State Treasurer if Deutsche Bank Group loses any securities, collateral or investments of the State Treasurer in Deutsche Bank Group's custody. Moreover, there were no losses during the fiscal year resulting from a default of the borrowers or Deutsche Bank Group.

4. Securities Lending Transaction (Continued)

During the fiscal year, the State Treasurer and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested in repurchase agreements with approved counterparties collateralized with securities approved by Deutsche Bank Group and marked to market daily at no less than 102%. Because the loans are terminable at will, their duration did not generally match the duration of the investments made with the cash collateral. The State Treasurer had no credit risk as a result of its securities lending program as the collateral held exceeded the fair value of the securities lent.

In accordance with GASB Statement No. 28, paragraph 9, the State Treasurer has allocated the assets and obligations at June 30, 2012, arising from securities lending agreements to the various funds of the State. The securities lending collateral invested in repurchase agreements allocated to the Water Revolving Fund was $80,163 as of June 30, 2012.

5. Loans and Notes Receivable

Loans and notes receivable consist of loans made to local governments for infrastructure programs.

Each loan to a participant for an eligible project from funds in the Clean Water Program or the Drinking Water Program is evidenced by a Loan Agreement. In each Loan Agreement, the Agency agrees to make a loan in an amount up to the maximum amount provided in the Loan Agreement. Funds are disbursed to a participant only to pay eligible project costs that actually have been incurred by the participant, and the amount of a loan is generally equal to the aggregate of such disbursed amounts, although in certain instances such amount may also include capitalized interest. The actual amounts loaned to participants will generally depend upon the actual progress of construction on the related projects.

5. Loans and Notes Receivable (Continued)

Each Loan Agreement specifies a date as of which the Project is required to initiate operation ("Operation Initiation Date"). Amortization of each Loan is required to begin no later than one year from the earlier of the Operation Initiation Date or the date identified in the Loan Agreement as the initiation of loan repayment date ("Initiation of Loan Repayment Date"). The final maturity of each loan is not later than 20 years from the earlier of the Operation Initiation Date or the Initiation of Loan Repayment Date. Each Loan Agreement permits prepayment of all or a portion of the balance of the loan, without premium. Most of the Loan Agreements provide for semi-annual principal and interest payments, with the actual dates of repayment varying from Loan Agreement to Loan Agreement, with a few Loan Agreements providing for quarterly or annual principal and interest payments.

Fixed Loan Rate: The Agency assigns to each loan a fixed loan rate at the time a loan is made to the participant. For loans financed prior to the inception of the American Recovery and Reinvestment Act (ARRA), the fixed loan rate is comprised of an interest portion and a loan support portion and is computed by using the mean interest rate of the 20-year Tax-Exempt Bonds General Obligation Bond Buyer Index, as published weekly by The Bond Buyer, from July 1 to June 30 of the preceding fiscal year rounded to the nearest 100th of a percent and multiplied by 50%. There is no maximum, but the minimum fixed loan rate is 2.5% per annum. Those loans financed with ARRA funds bear an interest rate of 0.0%. The interest rates on the loans currently outstanding are between 0.0% to 3.75%.

Security for Loans: Generally, the repayment obligations of each participant will either be (i) secured by the revenues generated by its wastewater or drinking water system or (ii) a general obligation of the participant. The Agency conducts an analysis as part of its loan review process to determine the appropriate security for a loan and upon making such determination, the participant evidences its obligation under the loan agreement and grants the security determined by the Agency by adopting a bond ordinance or resolution or similar authorization in accordance with State law. In certain instances, a participant may issue revenue bonds, general obligation bonds or other obligations, as applicable, to evidence its repayment obligations.

(amounts in $000's)

5. Loans and Notes Receivable (Continued)

Estimated minimum repayments of the loans receivable and interest thereon, are as follows:

Year ending June 30	
2013	$ 187,636
2014	181,212
2015	175,708
2016	170,570
2017	167,105
2018-2022	723,628
2023-2027	485,346
2028-2032	183,865
	$ 2,275,070

In addition, outstanding loans of $885,042 have not been scheduled for repayment.

Restricted Loans Receivable

At June 30, 2012, $199,559 of loans receivable were pledged as security for the revenue bonds outstanding (see Note 8). The principal and interest received during the fiscal year from these loans is to be used to make the annual debt service payments on the revenue bonds. During the year ended June 30, 2012, the Fund received $43,346 and $2,795 of principal and interest, respectively, on these loans. Any excess of the principal and interest received over the debt service payments required and the required debt service reserve accounts is released from restriction at the time of a bond payment.

5. Loans and Notes Receivable (Continued)

Loan Commitments and Concentrations

Per the Department of Central Management Services Procedures and Requirements for Determining Loan Priorities (35 Illinois Administrative Code, Section 366.105: Funding Allocations), loan funds available from State and Federal appropriations during the capitalization period authorized by the Clean Water Act to capitalize the Clean Water portion of the fund will be subject to an equal division between the service area of the Metropolitan Water Reclamation District of Greater Chicago (MWRDGC) and the area which is comprised of the geographical balance of the State of Illinois, to the extent that projects in either area in any fiscal year have qualified to receive loan assistance and are ready to proceed in accordance with the criteria for loan award. The service area of MWRDGC also includes several municipalities that may receive loans directly from the fund. Any imbalance in the division of the total loan funds shall be carried forward from year to year and shall be applied as projects are able to complete a loan application to achieve an accumulatively equal distribution. Currently, 39.5% of loan funds made under the Clean Water Program have been made to MWRDGC and municipalities in its service area.

As of June 30, 2012, the outstanding balance of loans to MWRDGC amounted to $649,933 which exceeds 5% of total loans receivable of the fund. This represents approximately 28% of total loans receivable.

Principal Forgiveness

As of June 30, 2012, the Federal loan commitments included ARRA federal funds of $256,781, of which $129,077 will be forgiven. ARRA principal forgiveness loans are forgiven as disbursed, but must be repaid if the recipient fails to meet ARRA requirements.

NOTES TO THE BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2012
(amounts in $000's)

5. Loans and Notes Receivable (Continued)

Federal grants awarded post-ARRA required additional loan principal forgiveness with the minimum and maximum requirements depending on the program. The total minimum principal forgiveness amount is $56,352 and the total maximum amount is $168,904. The 2012 Federal grants for both the Clean Water and Drinking Water programs had not been received as of June 30, 2012. However, the principal forgiveness issued for loans in this program year is conditional based upon the Agency receiving the grant awards. The Clean Water Program exceeded the maximum principal forgiveness allowed after the 2011 grant. As a result, the amount exceeded of $11,903 will be paid from the Clean Water Loan Support Program. The Drinking Water minimum has been met and no issues have resulted from the maximum amount for the Drinking Water Program. Following is a summary of Post-ARRA loan principal forgiveness:

	Clean Water Program		
	Minimum	Maximum	Actual
2010 Grant	$ 13,801	$ 46,003	$ 46,002
2011 Grant	6,189	20,629	20,625
2012 Grant (to be issued)	3,552	5,329	1,104
Principal forgiveness to be charged to Loan Support Program	-	-	11,903
Total Principal Forgiveness Post ARRA	$ 23,542	$ 71,961	$ 79,634

	Drinking Water Program		
	Minimum	Maximum	Actual
2010 Grant	$ 15,369	$ 51,230	$ 15,605
2011 Grant	10,665	35,549	11,202
2012 Grant (to be issued)	6,776	10,164	3,193
Total Principal Forgiveness Post ARRA	$ 32,810	$ 96,943	$ 30,000

NOTES TO THE BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2012
(amounts in $000's)

5. Loans and Notes Receivable (Continued)

	Total		
	Minimum	Maximum	Actual
2010 Grant	$ 29,170	$ 97,233	$ 61,607
2011 Grant	16,854	56,178	31,827
2012 Grant (to be issued)	10,328	15,493	4,297
Principal forgiveness to be charged to Loan Support Program	-	-	11,903
Total Principal Forgiveness Post ARRA	$ 56,352	$ 168,904	$ 109,634

6. Interfund Balances and Transfers

Balances Due to Other Funds: The following balances at June 30, 2012, represent amounts due to other Agency and State of Illinois funds:

Due to Central Management Services for:	
Facilities management revolving payments	$ 7
Communications revolving payments	8
Group insurance premium payments	4
	19
Due to Office of the Auditor General	78
Total Due to Other Funds	$ 97

Transfers from Other Funds: During the year ended June 30, 2012, $2,532 was transferred from the Anti-Pollution Fund to meet State Match requirements for Federal Capitalization Grants (see Note 9).

(amounts in $000's)

7. Capital Assets

Capital asset activities for the year ended June 30, 2012, were as follows:

	Balance July 1, 2011	Additions	Deletions/ Transfers	Balance June 30, 2012
Capital assets being depreciated:				
Equipment	$ 398	$ 21	$ 5	$ 414
Capital lease – equipment	10	-	10	-
	408	21	15	414
Less: accumulated depreciation	309	59	10	358
Total capital assets being depreciated	$ 99	$ (38)	$ 5	$ 56

8. Long-Term Obligations

Changes in Long-Term Obligations: Changes in long-term obligations for the year ended June 30, 2012, were as follows:

	Balance July 1, 2011	Additions	Deletions/ Transfers	Balance June 30, 2012	Amounts Due Within One Year
Due to Illinois Finance Authority	$ 64,460	$ 3,349	$ 18,672	$ 49,137	$ -
Compensated absences	1,404	767	581	1,590	101
Capital leases	4	-	4	-	-
	$ 65,868	$ 4,116	$ 19,257	$ 50,727	$ 101

Due to Illinois Finance Authority: The Illinois Finance Authority (IFA), a nonmajor component unit of the State of Illinois, issued $280,000 State of Illinois Revolving Fund Revenue Bonds (Bonds), Series 2002 and 2004. The proceeds (including bond premiums of $16,400) were deposited in the Water Revolving Fund for the purpose of making loans pursuant to the Clean Water Program and the Drinking Water Program. Prior to the issuance of these revenue bonds, the Agency sold and assigned certain loans outstanding related to the Clean Water Program and the Drinking Water Program to the IFA and pledged the loans to secure payment of the bonds. Of the total outstanding loans at June 30, 2012, $199,559 has been pledged for repayment of the Bonds. The bond trustee is entitled to receive all principal and interest due on these pledged loans. Any loans funded with the proceeds from the bonds are not pledged to the bond trustee and are not deemed to be pledged loans.

NOTES TO THE BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2012
(amounts in $000's)

8. Long-Term Obligations (Continued)

The Bonds are to be repaid from a) payments made pursuant to the pledged loans, b) the income derived from the investment of moneys held in funds and accounts established under the bond indentures and c) moneys held in the debt service fund, the reserve fund and other funds and accounts held by the trustee under the bond indentures and available for payment. The reserve accounts are in the name of the IFA. The reserve accounts are required to contain an amount equal to one-half the amount of the outstanding balance of the bonds. As a result, the Water Revolving Fund has recorded an obligation to repay the remaining one-half of the outstanding balance of the bonds, adjusted for excess amounts held by IFA, and for bond premium. Total principal remaining on the bonds as of June 30, 2012, is $126,325 payable through 2024. The balance of the unamortized premium on the bonds at June 30, 2012, is $3,145. The Agency has also committed to paying approximately one-half the interest on the bonds, with interest rates ranging from 3.25% to 5.50%.

The amounts required to repay the obligation due to IFA are as follows:

Year Ending June 30	Obligation	Interest
2013	$ -	$ 3,204
2014	557	2,730
2015	7,800	2,296
2016	7,588	1,882
2017	7,487	1,477
2018-2022	21,705	2,509
2023-2024	855	31
	$ 45,992	$ 14,129

9. Net Assets

Net assets at June 30, 2012, are restricted for:

United States Environmental Protection Agency (U.S. EPA) Capitalization Grants	$ 1,540,789
U.S. EPA ARRA Capitalization Grants	127,704
	1,668,493
State match	331,851
Subtotal net assets restricted for other purposes	2,000,344
Debt service	200,880
Total restricted net assets	$ 2,201,224

(amounts in $000's)

9. Net Assets (Continued)

U.S. EPA Capitalization Grants and State Match: The Water Revolving Fund was created pursuant to the Clean Water Act and Safe Drinking Water Act and established to provide financial assistance in the form of loans. In order to qualify for Federal Capitalization Grants, the state must pay into the Revolving Fund a matching amount equal to at least 20% of the amount of such grants (State Match). These funds are restricted for the purpose of making low interest loans from the Fund.

Debt Service: The amount restricted for debt service consists of loans receivable pledged and related interest receivable pursuant to the sale of revenue bonds in 2002 and 2004 (see Note 8).

10. Capitalization Grants

The Agency has entered into Capitalization Grant Agreements with the U.S. EPA to administer the Waste Water and Drinking Water Loan Programs, jointly the Water Revolving Fund (270). Pursuant to these Capitalization Grant Agreements, $1,570,250 for Waste Water and $564,870 for Drinking Water have been made available to be drawn (pursuant to state matching requirements being met) on the Capital Grant facility at June 30, 2012, with respect to costs in connection with loans made under the Waste Water and Drinking Water Loan Programs.

The remaining Capital Grant Facility as of June 30, 2012, is summarized below:

	Waste Water	Drinking Water	Total
Total Capital Grants	$ 1,570,250	$ 564,870	$ 2,135,120
Less: Cumulative drawdowns	(1,411,498)	(488,331)	(1,899,829)
Capital Grant Facility	$ 158,752	$ 76,539	$ 235,291

Included in the above table are the following amounts awarded under the ARRA:

	Waste Water	Drinking Water	Total
Total ARRA grants	$ 177,243	$ 79,538	$ 256,781
Less: Cumulative drawdowns	(177,243)	(79,538)	(256,781)
Remaining ARRA amounts to be drawn	$ -	$ -	$ -

NOTES TO THE BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2012
(amounts in $000's)

11. General and Administrative Costs

The Agency is authorized to utilize up to 4% of the total Clean Water Capitalization Grants received for administration of the loan program. In order to allow the maximum amount of grant dollars for loan disbursements, the Agency currently funds administrative costs for the Clean Water Program from sources other than the grant. The Drinking Water Grant Program sets aside and restricts 4% of each grant for the administrative costs of running the program. As of June 30, 2012, the Agency had $3,519 to fund future administration costs of the Drinking Water Program.

The Agency also charges a loan support fee. This loan support fee is used to defray program expenses and for state match on federal grants. Loan support fees are collected, deposited and held in the Water Revolving Fund. This fee cannot exceed 50% of the fixed loan rate.

The Agency is also authorized to use a portion of each capitalization for specific set-asides authorized under Federal Statutes.

The Administrative Revenues and Expenses reported in the Water Revolving Fund for the year ended June 30, 2012, are as follows:

Revenues	
Administrative grants	$ 1,544
Loan Support	20,638
	22,182
Expenses	
Payroll and insurance	14,124
Other general expenses	4,401
	18,525
Excess of revenues over expenses	$ 3,657

12. Pension Plan

Substantially all of the Agency's full-time employees who are not eligible for participation in another state-sponsored retirement plan participate in the State Employees' Retirement System (SERS), which is a pension trust fund in the State of Illinois reporting entity. The SERS is a single-employer defined benefit public employee retirement system (PERS) in which State employees participate, except those covered by the State Universities, Teachers', General Assembly, and Judges' Retirement Systems. The financial position and results of operations of the SERS for fiscal year 2012 are included in the State of Illinois' Comprehensive Annual Financial Report (CAFR) for the year ended June 30, 2012. The SERS issues a separate CAFR that may be obtained by writing to the SERS, 2101 South Veterans Parkway, Springfield, Illinois, 62794-9255.

A summary of SERS benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established are included as an integral part of the SERS' CAFR. Also included is a discussion of employer and employee obligations to contribute and the authority under which those obligations are established.

The Agency pays employer retirement contributions in the individual nonshared proprietary funds based upon an actuarially determined percentage of their payrolls. For fiscal year 2012, the employer contribution rate was 34.190%. Effective for pay periods beginning after December 31, 1991, the State opted to pay the employee portion of retirement for most State agencies (including the Agency) with employees covered by the State Employees' and Teachers' Retirement Systems. However, effective with the fiscal year 2004 budget, the State opted to stop paying the portion or a part of the portion of retirement for many State agencies (including the Agency) for certain classes of employees covered by the State Employees' and Teachers' Retirement Systems. The pick-up, when applicable, is subject to sufficient annual appropriations and those employees covered may vary across employee groups and State agencies.

13. Post-employment Benefits

The State provides health, dental, vision, and life insurance benefits for retirees and their dependents in a program administered by the Department of Healthcare and Family Services (DHFS) along with the Department of Central Management Services. Substantially all State employees become eligible for post-employment benefits if they eventually become annuitants of one of the State sponsored pension plans. Health, dental, and vision benefits include basic benefits for annuitants and dependents under the State's self-insurance plan and insurance contracts currently in force. Annuitants may be required to contribute towards health, dental, and vision benefits with the amount based on factors such as date of retirement, years of credited service with the State, whether the annuitant is covered by Medicare, and whether the annuitant has chosen a managed health care plan. Annuitants who retired prior to January 1, 1998, and who are vested in the State Employee's Retirement System do not contribute towards health, dental, and vision benefits. For annuitants who retired on or after January 1, 1998, the annuitant's contribution amount is reduced five percent for each year of credited service with the State allowing those annuitants with twenty or more years of credited service to not have to contribute towards health, dental, and vision benefits. Annuitants also receive life insurance coverage equal to the annual salary of the last day of employment until age 60, at which time the benefit becomes five thousand dollars.

The total cost of the State's portion of health, dental, vision, and life insurance benefits of all members, including post-employment health, dental, vision, and life insurance benefits, is recognized as an expenditure by the State in the Illinois Comprehensive Annual Financial Report. The State finances the costs on a pay-as-you-go basis. The total costs incurred for health, dental, vision, and life insurance benefits are not separated by department or component unit for annuitants and their dependents nor active employees and their dependents. A summary of post-employment benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established are included as an integral part of the financial statements of the DHFS. A copy of the financial statements of the DHFS may be obtained by writing to the DHFS, 201 South Grand Avenue, Springfield, Illinois, 62763-3838.

14. Contingencies

The Agency is involved in a number of legal proceedings and claims covering a wide range of matters. The ultimate results of these lawsuits and other proceedings against the Agency cannot be predicted with certainty; however, the Agency does not expect such matters to have a material effect on the financial position of the Agency.

15. Subsequent Event

On October 18, 2012, the State of Illinois announced the Clean Water Initiative. This Initiative will use the assets of both the Clean Water and Drinking Water Loan Programs in future leveraged bond sales to increase the size of these programs over the next several fiscal years.

E.C. ORTIZ & CO., LLP
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Honorable William G. Holland
Auditor General
State of Illinois

As Special Assistant Auditors for the Auditor General, we have audited the financial statements of the Water Revolving Fund of the State of Illinois, Environmental Protection Agency, as of and for the year ended June 30, 2012, and have issued our report thereon dated February 27, 2013. 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

Management of the State of Illinois, Environmental Protection Agency is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the State of Illinois, Environmental Protection Agency'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, but not for the purpose of expressing an opinion on the effectiveness of the State of Illinois, Environmental Protection Agency's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State of Illinois, Environmental Protection Agency's internal control over financial reporting.

A *deficiency in internal control* 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 and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, 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 above. However, we identified a certain deficiency in internal control over financial reporting, described in the accompanying schedule of findings as item 12-1 that we consider to be a significant deficiency in internal control over financial reporting. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

333 SOUTH DES PLAINES STREET, SUITE 2-N CHICAGO, IL 60661 tel: 312.876.1900 fax: 312.876.1911

Compliance and Other Matters

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

The State of Illinois, Environmental Protection Agency's response to the finding identified in our audit is described in the accompanying schedule of findings. We did not audit the State of Illinois, Environmental Protection Agency's response and, accordingly, we express no opinion on the response.

This report is intended solely for the information and use of the Auditor General, the General Assembly, the Legislative Audit Commission, the Governor, and agency management and is not intended to be and should not be used by anyone other than these specified parties.

E. C. Ortiz & Co., LLP

Chicago, Illinois
February 27, 2013

CURRENT FINDINGS – *GOVERNMENT AUDITING STANDARDS*

12-1 **<u>FINDING</u>** (Inadequate Controls Over Financial Reporting)

The Illinois Environmental Protection Agency (Agency) did not exercise adequate internal control over financial reporting.

During our testing, we noted the following:

- The Agency did not develop a basis or prepare any calculation for the estimated arbitrage rebate of $1,000,000 within the rebate fund of the State of Illinois Revolving Fund, Series 2004. During 2009, the Agency paid $323,000 rebate on Bond Series 2004. In anticipation for a substantially higher rebate to be paid in May, 2014, the Agency transferred $500,000 on both bond payment dates, September, 2011 and March, 2012.

  Agency management is responsible under generally accepted accounting principles for establishing a process for preparing reasonable accounting estimates based upon an accumulation of relevant, sufficient and reliable data.

  Management stated that the Agency recorded the accrual based upon a conversation between the Agency, bond counsel and bond trustee concerning the potential for a higher arbitrage tax liability.

- The Agency did not accrue interest income totaling $388,909 from March 2012 through June 2012 on investments of the debt service fund under the Debt Service Forward Delivery Agreement for the State of Illinois Revolving Fund, Series 2004 issuance. This resulted in an overstatement of Due to Component Units by the same amount. This was not adjusted by the Agency since the amount was determined to be immaterial in relation to the financial statements.

  The Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires the Agency establish and maintain a system, or systems, of internal fiscal and administrative controls to provide assurance that revenues or funds applicable to operations are properly recorded and accounted for to permit the preparation of reliable financial reports.

  Agency management stated that interest income was not accrued due to oversight.

CURRENT FINDINGS – *GOVERNMENT AUDITING STANDARDS* *(Continued)*

Failure to document the calculation of estimated arbitrage liability based upon an accumulation of relevant, sufficient and reliable data and properly record interest accruals reduces the reliability of Statewide financial reporting and increases the risk of material misstatement within the Agency's financial statements.

Recommendation

We recommend the Agency document the calculation of estimated arbitrage liability based upon an accumulation of relevant, sufficient and reliable data and properly record interest accruals.

Agency Response

Accepted. Although the Agency believed its past transfers were a reasonable estimation of the future arbitrage tax liability, the Agency has established a formal process to document the relevant, sufficient and reliable data used for this accounting estimate. The Agency has also developed procedures to ensure interest income earned between March and June on investments of debt service funds is recorded in the financial statements.