SOUTH DAKOTA BOARD OF WATER AND NATURAL RESOURCES DRINKING WATER STATE REVOLVING FUND

AUDIT REPORT

Fiscal Year Ended June 30, 2010

SOUTH DAKOTA BOARD OF WATER AND NATURAL RESOURCES
DRINKING WATER STATE REVOLVING FUND
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DEPARTMENT OF LEGISLATIVE AUDIT

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MARTIN L. GUINDON, CPA
AUDITOR GENERAL

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*

The Honorable Dennis Daugaard
Governor of South Dakota

and

South Dakota Board of Water and Natural Resources

We have audited the financial statements of the Drinking Water State Revolving Fund as of and for the fiscal year ended June 30, 2010 and have issued our report thereon dated January 28, 2011. 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 Board of Water and Natural Resources' 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 Board of Water and Natural Resources' internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Board of Water and Natural Resources' 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 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.

Compliance and Other Matters

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

This report is intended solely for the information and use of management and members of the South Dakota Legislature and is not intended to be and should not be used by anyone other than those specified. However, this report is a matter of public record and its distribution is not limited.

Martin L. Guindon, CPA
Auditor General

January 28, 2011

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MARTIN L. GUINDON, CPA
AUDITOR GENERAL

INDEPENDENT AUDITOR'S REPORT

The Honorable Dennis Daugaard
Governor of South Dakota

and

South Dakota Board of Water and Natural Resources

We have audited the accompanying financial statements of the Drinking Water State Revolving Fund, as of and for the fiscal year ended June 30, 2010, as listed in the Table of Contents. These financial statements are the responsibility of the South Dakota Board of Water and Natural Resources' 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.

The financial statements of the Drinking Water State Revolving Fund are intended to present the financial position, and changes in financial position and cash flows, of the business type activities of the State that is attributable to the transactions of the Drinking Water State Revolving Fund. They do not purport to, and do not, present fairly the financial position of the State of South Dakota as of June 30, 2010, and the changes in its financial position and its cash flows, where applicable, for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Drinking Water State Revolving Fund as of June 30, 2010, and the respective changes in financial position and cash flows thereof for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards,* we have also issued our report dated January 28 2011, on our consideration of the Board of Water and Natural Resources' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, 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.

Martin L. Guindon, CPA
Auditor General

January 28, 2011

SOUTH DAKOTA BOARD OF WATER
AND NATURAL RESOURCES
DRINKING WATER STATE REVOLVING FUND
STATEMENT OF NET ASSETS
June 30, 2010

Assets	
Current Assets:	
Cash and Cash Equivalents	$ 35,748,267.04
Restricted Cash and Cash Equivalents	526,381.48
Total Cash and Cash Equivalents	36,274,648.52
Due from Federal Government	305,478.10
Due from Other Governments	167,308.90
Deferred Charges	41,920.70
Accrued Interest Receivable	1,299,055.07
Loans Receivable	11,003,289.08
Total Current Assets	49,091,700.37
Noncurrent Assets:	
Investments	35,103,975.11
Restricted Investments	419,250.00
Deferred Charges	497,958.94
Loans Receivable	124,535,864.04
Total Noncurrent Assets	160,557,048.09
Total Assets	209,648,748.46
Liabilities	
Current Liabilities:	
Accounts Payable	179,004.29
Accrued Liabilities	11,179.78
Compensated Absences Payable	25,641.87
Accrued Interest Payable	913,356.92
Notes Payable	18,000,000.00
Bonds Payable - net of unamortized premium and discount	2,538,820.77
Total Current Liabilities	21,668,003.63
Noncurrent Liabilities:	
Compensated Absences Payable	22,968.31
Bonds Payable - net of unamortized premium and discount	54,925,829.82
Total Noncurrent Liabilities	54,948,798.13
Total Liabilities	76,616,801.76
Net Assets	
Restricted For Debt Service	945,631.48
Unrestricted	132,086,315.22
Total Net Assets	$ 133,031,946.70

The notes to the financial statements are an integral part of this statement.

SOUTH DAKOTA BOARD OF WATER
AND NATURAL RESOURCES
DRINKING WATER STATE REVOLVING FUND
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN FUND NET ASSETS
For the Fiscal Year Ended June 30, 2010

Operating Revenues:		
Loan Interest Income		$ 2,847,119.96
Federal Capitalization Grants		16,556,851.88
Other Income		886,286.39
Bond Premium		264,240.00
Total Operating Revenue		20,554,498.23
Operating Expenses:		
Administrative Expenses		
Personal Services	172,139.63	
Employee Benefits	47,131.50	
Travel	12,219.34	
Contractual	531,120.08	
Supplies	1,008.24	
Grants	78,700.00	
Other	571.50	
Total Administrative Expenses		842,890.29
Grant Expense		1,862,000.00
Interest Expense		2,237,170.11
Servicer Expense		35,703.13
Bond Issuance Expense		88,286.92
Total Operating Expenses		5,066,050.45
Operating Income (Loss)		15,488,447.78
Nonoperating Revenue (Expenses):		
Investment Income		1,681,054.68
Income (Loss) Before Transfers		17,169,502.46
Transfers:		
Transfer Out		(29,388.59)
Change in Net Assets		17,140,113.87
Net Assets at Beginning of Year		115,891,832.83
Net Assets at End of Year		$ 133,031,946.70

The notes to the financial statements are an integral part of this statement.

SOUTH DAKOTA BOARD OF WATER
AND NATURAL RESOURCES
DRINKING WATER STATE REVOLVING FUND
STATEMENT OF CASH FLOWS
For the Fiscal Year Ended June 30, 2010

Cash Flows from Operating Activities:		
Receipts for Loan Repayments	$ 11,140,084.52	
Receipts for Interest Income on Loans	2,694,345.47	
Receipts for Surcharge Interest on Loans	846,998.03	
Receipts for Administering Program	16,439,568.00	
Receipts for BAN's Premium	264,240.00	
Payments to Loan Recipients	(31,737,550.00)	
Servicing Payments	(35,703.13)	
Ban's Issuance Costs Paid	(46,366.22)	
Payments for Employee Services	(214,102.85)	
Payments for Contractual Services	(525,653.11)	
Payment for Grants	(1,928,700.00)	
Other Payments	(12,750.52)	
Net Cash Provided (Used) by Operating Activities		(3,115,589.81)
Cash Flows from Noncapital Financing Activities:		
BAN's Receipts	18,000,000.00	
Transfers Out	(29,388.59)	
Principal Payments on Bonds	(1,815,000.00)	
Interest Payments on Bonds and Notes	(2,249,410.31)	
Net Cash Provided (Used) by Noncapital Financing Activities		13,906,201.10
Cash Flows from Investing Activities:		
Interest on Investments	1,554,756.80	
Proceeds from Sale of Investment Securities	3,447,954.13	
Purchase of Investment Securities	(9,830,910.76)	
Net Cash Provided (Used) by Investing Activities		(4,828,199.83)
Net Increase (Decrease) in Cash and Cash Equivalents		5,962,411.46
Cash and Cash Equivalents at Beginning of Year		30,312,237.06
Cash and Cash Equivalents at End of Year		$ 36,274,648.52
Reconciliation of Operating Income to Net Cash Provided (Used) by Operating Activities		
Operating Income (Loss)		$ 15,488,447.78
Adjustments to Reconcile Net Income to Net Cash Provided (Used) by Operating Activities:		
Interest Expense	2,237,170.11	
Amortization of Bond Issuance Cost	41,920.70	
Assets: (Increase)/Decrease		
Loans Receivable	(20,597,465.48)	
Accrued Interest Receivable on Loans	(152,774.49)	
Due from Federal Government	(117,283.88)	
Due from Other Governments	(39,288.36)	
Liabilities: Increase/(Decrease)		
Accounts Payable	18,515.53	
Accrued Employee Benefits	6,007.14	
Accrued Liabilities	(838.86)	
Total Adjustments		(18,604,037.59)
Net Cash Provided by Operations		$ (3,115,589.81)

The notes to the financial statements are an integral part of this statement.

SOUTH DAKOTA BOARD OF WATER
AND NATURAL RESOURCES
DRINKING WATER STATE REVOLVING FUND
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2010

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Authorizing Legislation

The Drinking Water State Revolving Fund (DWSRF) Loan Program was federally authorized by the Safe Drinking Water Act Amendments of 1996. The state authorized the loan program in 1994 in anticipation of federal action. The Environmental Protection Agency (EPA) developed final guidance for the Drinking Water State Revolving Fund on February 28, 1997. The South Dakota Conservancy District, acting in its capacity as the Board of Water and Natural Resources, conducted a public hearing on April 15, 1997 to adopt formal administrative rules for the program. The Department of Environment and Natural Resources performs all of the functions of the South Dakota Conservancy District, except for quasi-legislative, quasi-judicial, advisory, and special budgetary functions, which are performed by the District acting in its capacity as the Board of Water and Natural Resources. The DWSRF is a low interest loan program to finance drinking water projects. Funds are provided to the states in the form of capitalization grants awarded annually through the United States Environmental Protection Agency. The federal capitalization grants are matched by state funds at a ratio of 5:1. The Drinking Water State Revolving Fund is a part of the State of South Dakota and, as such, the accompanying financial statements are included in the Comprehensive Annual Financial Report of the State of South Dakota.

B. Fund Accounting

The DWSRF is accounted for as an enterprise fund. An enterprise fund is a proprietary fund type used to report an activity for which a fee is charged to external users for goods or services.

C. Basis of Accounting

The DWSRF follows the accrual basis of accounting. This method of accounting recognizes the financial effect of transactions, events, and interfund activities when they occur, regardless of the timing of related cash flows. The DWSRF follows all Governmental Accounting Standards Board (GASB) pronouncements and those Financial Accounting Standards Boards Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins that were issued on or before November 30, 1989, except those that conflict with a GASB pronouncement.

D. Cash and Cash Equivalents

For purposes of the accompanying statement of net assets and statement of cash flows all highly liquid investments with original maturities of 90 days or less are considered cash equivalents.

E. Investments

Investments are reported at fair value. Unrealized gains and losses due to fluctuations in market value are included in investment income.

F. Deferred Charges

Issuance costs, discounts, and premiums on bonds are amortized using the straight line method over the life of the bonds to which they relate.

G. Reserves

The bond indentures provide that certain reserve accounts be established. The reserves as of June 30, 2010 consist of an Investment Agreement at 5.07% with AIG Matched Funding Corp due August 1, 2025 totaling $419,250. The reserves are reported as restricted assets in the financial statements.

In addition, $526,381 is invested in a Money Market Fund described in note 2 below.

H. Restricted Resources

When both restricted and unrestricted resources are available for use, it is the DWSRF's policy to use restricted resources first, and then unrestricted resources as they are needed.

I. Revenue and Expense Recognition

Enterprise funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering items in connection with an enterprise fund's principal ongoing operations. The DWSRF records all revenues derived from interest on loans, and federal capitalization grants as operating revenues since these revenues are generated from the DWSRF's daily operations needed to carry out its purpose. Operating expenses include interest expense on bonds, grants and subsidies, and contractual service expenses related to the administration of the DWSRF program.

J. Federal Capitalization Grant

Federal capitalization grants reported as operating income in the statement of revenues, expenses, and changes in fund net assets is a federally funded loan program. Information about the program is as follows:

CFDA Number:	66.468
Federal Agency:	Water Management Division
Program:	Drinking Water State Revolving Fund
State Agency:	Environment & Natural Resources
Expenditures:	$136,172,067
Outstanding Loans:	$135,539,153
Current Year	
Administrative Expense:	$632,914
Loan Disbursement:	$31,737,550

2. CASH AND INVESTMENTS

Cash and Cash Equivalents consisted of a Goldman Sachs Financial Square Treasury Obligation Fund (mutual fund). It was rated "AAAm" by Standard and Poor's Rating Group. The fund paid .04% for the period 7/01/2009 – 8/31/2009, .03% for the month of September 2009, and .01% for the period 10/01/2009 – 6/30/2010. A Money Market Taxable of Trust Institutional Now Account held since the previous year was sold on 12/30/2009. The fund paid a constant 0.5%. This fund was not rated, but it is FDIC insured.

Series 2004			
Leveraged Serial Bonds	3.0%-5.25%	2025	19,060,000
St. Match Serial Bonds	3.0%-5.25%	2025	4,235,000
Series 2005			
Leveraged Serial Bonds	3.25%-5.0%	2026	6,115,000
St. Match Serial Bonds	3.25%-5.0%	2026	1,465,000
Series 2008			
Leveraged Term Bonds	2.35% (a)	2029	13,110,000
St Match Term Bonds	2.35% (a)	2029	4,930,000
Total			56,795,000
Less: Unamortized Original Issue Discount			(60,241)
Add: Unamortized Premium			729,892
Total Net of Amortization			$ 57,464,651

a) Variable rates are adjusted at any favorable interval. The rate is determined and reset by Wachovia Bank, National Association as Remarketing Agent.
The initial rate was set in March 2008 at 2.35%
For the period 8/1/2008 – 1/31/2009 the rate was 1.9%
For the period 2/1/2009 – 7/31/2009 the rate was 1.0%
For the period 8/1/2008 – 1/31/2010 the rate was .70%
For the period 2/1/2010 – 7/31/2010 the rate was .34%

Future bond payments and future interest payments remaining as of June 30, 2010 are as follows:

Year Ended June 30,	Principal	Interest	Total Principal and Interest
2011	2,495,000	2,534,065	5,029,065
2012	2,595,000	2,431,941	5,026,941
2013	2,720,000	2,322,188	5,042,188
2014	2,830,000	2,206,145	5,036,145
2015	2,945,000	2,083,676	5,028,676
2016-2020	16,715,000	8,221,577	24,936,577
2021-2025	17,400,000	4,075,581	21,475,581
2026-2030	9,095,000	725,403	9,820,403
TOTAL	$ 56,795,000	$ 24,600,576	$ 81,395,576

Interest for the Series 2008 bond issue is a variable rate, so the future bond interest payments are an estimate due to the fact that we do not know what the future 2008 interest payments will be.

Changes in long-term liabilities

	Beginning Balance	Additions	Reductions	Ending Balance	Due Within One Year
Revenue Bonds	$ 59,323,471	$ 6,858	$ 1,865,678	$ 57,464,651	$ 2,538,821
Compensated Absences	42,603	13,591	7,584	48,610	25,642
Long-Term Liabilities	$ 59,366,074	$ 20,449	$ 1,873,262	$ 57,513,261	$ 2,564,463

Custodial Credit Risk: Custodial credit risk is the risk that in the event of a bank failure, the Drinking Water State Revolving Fund's investments may not be returned. At June 30, 2010, $35,523,225 of guaranteed investment contracts were uninsured and unregistered, with the securities held by its trust department, but not in the DWSRF's name.

Interest Rate Risk: Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The maturities of the investments are listed below.

Investment	Maturities	Fair Value
Guaranteed Investment Contract	8/01/2025	$ 30,315,283
Guaranteed Investment Contract	8/01/2026	$ 5,207,942
		$ 35,523,225

Credit Risk: Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations to the DWSRF. The South Dakota State Revolving Fund Master Trust Indenture requires any investment agreement to be with a guarantor whose long-term rating category is no lower than the two highest long-term rating categories. The investment is rated by Moody's Investors Service.

Moody's Rating	Fair Value
A3	$ 35,523,225

This guarantor's rating is below the acceptable rating category (i.e., below Moody's Aa3). This investment has been fully collateralized with government securities in accordance with the provisions of Guaranteed Investment Contracts. These fully collateralized investments have a fair value that equates to contract value.

3. LOANS RECEIVABLE

Loans receivable consists of loans made to local governments through a loan agreement. In order for a local government to receive a loan, evidence must be shown that the principal and interest of the loan will be repaid. Loans made from the DWSRF may be made at or below market interest rates and shall be fully amortized within twenty years, unless the loan is to a Disadvantaged Community, in which case the loan must be amortized within 30 years. Interest rates are reduced for those loans with shorter amortization periods.

4. LONG-TERM DEBT

Revenue Bonds

The bond issues outstanding as of June 30, 2010 are as follows:

Issue	Interest Rate	Maturity Through	Principal Balance
Series 1998A			
Serial Bonds	4.5%-4.9%	2012	$ 990,000
Term Bonds	5.0%	2019	2,960,000
Series 2001			
Serial Bonds	4% - 5%	2014	1,230,000
Term Bonds	5.0%	2022	2,700,000

5. BOND ANTICIPATION NOTES (BANS)

Bond Anticipation Notes (BANS) with a par amount of $18 million were issued with a closing date of 8/26/2009. They were sold at a premium of $264,240 making the total BANS proceeds $18,264,240. The maturity date on the BANS was 9/30/2010 with an interest rate of 2.0%.

6. COMMITMENTS

As of June 30, 2010, the DWSRF had loan commitments with political subdivisions worth $66,288,335.

7. RETIREMENT PLAN

The Department of Environment and Natural Resources participates in the South Dakota Retirement System (SDRS), a cost-sharing, multiple-employer defined benefit pension plan established to provide retirement, disability, and survivor benefits for employees of the State and its political subdivisions. Authority for establishing, administering and amending plan provisions is found in SDCL 3-12. The SDRS issues a publicly available financial report that includes financial statements, footnote disclosures, and required supplementary information. That report may be obtained by writing to the SDRS, P.O. Box 1098, Pierre, SD 57501-1098 or by calling (605) 773-3731.

Employees are required by state statute to contribute 6 percent of their salary to the plan. State statute also requires the employer to contribute an amount equal to the employee's contribution. The right to receive retirement benefits vests after three years of credited service. The DWSRF contributions to the SDRS for the fiscal years ended June 30, 2010, 2009, and 2008, were $11,979.46, $10,322.14, and $11,075.87, respectively, equal to the required contributions each year.

8. ANNUAL AND SICK LEAVE ACCRUAL

All employees earn annual leave. Upon termination, employees are eligible to receive compensation for their accrued annual leave balances. At June 30, 2010, a liability existed for accumulated annual leave calculated at the employee's June 30, 2010 pay rate in the amount of $21,109. Employees who have been continuously employed by the State of South Dakota for at least seven years prior to the date of their retirement, voluntary resignation or death will receive payment for one-fourth of their accumulated sick leave balance. This payment is not to exceed the sum of twelve weeks of employee's annual compensation. At June 30, 2010, a liability existed for accumulated sick leave, calculated at each employee's June 30, 2010, pay rate in the amount of $27,501. The total leave liability of $48,610 at June 30, 2010 is shown as a liability on the balance sheet.

9. PUBLIC ENTITY POOL FOR LIABILITY

The Department of Environment and Natural Resources is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assts; errors and omissions; injuries to employees; and natural disasters. The Department is uninsured for property loss. The Department participates in the various programs administered by the State of South Dakota. These risk management programs are funded through assessments charged to participating entities. The risk management programs include; 1) coverage for risks associated with automobile liability and general tort liability (including public officials' errors and omissions liability, medical malpractice liability, law enforcement liability, and products liability) through the State's Public Entity Pool for Liability Fund,

2) coverage of employee medical claims through the State's health insurance program, 3) coverage for unemployment benefits through the State's Unemployment Insurance Fund, and, 4) coverage for workers' compensation benefits through the State's Workers' Compensation Fund. Financial information relative to the self-insurance funds administered by the State is presented in the State of South Dakota Comprehensive Annual Financial Report.

10. SUBSEQUENT EVENTS

State Revolving Fund (SRF) Bond Anticipation Notes, Series 2010

The Conservancy District issued $54,330,000 in State Revolving Fund Program Bond Anticipation Notes Series 2010 through a competitive sale process in September 2010. Proceeds of the Series 2010 Bond Anticipation Notes, together with other available funds, were used to pay the redemption price of the $18 million 2009 Bond Anticipation Notes on 9/10/2010. The closing date for the 2010 BANS was 9/8/2010 with a maturity date of 9/30/2011.

State Revolving Fund (SRF) Program Bonds, Series 2010AB

The South Dakota Conservancy District priced and sold $92,380,000 of Series 2010 Bonds during the week of December 13, 2010, to refinance prior SRF bond debt incurred by the District. The refinancing involved $54,330,000 of Series 2010 Bond Anticipation Notes, $3,635,000 of Bonds issued in 1998, and $38,625,000 of Bonds issued in 2008. The Series 2010 Bond issue was closed on December 28, 2010.

The 2010 bonds consisted of $38,695,000 of Taxable Revenue Bonds (Series 2010A) and $53,685,000 of Tax-exempt Revenue Bonds (Series 2010B). The taxable bonds were Build America Bonds (BABs) - taxable bonds for which the bondholder may receive a tax credit or the issuer may receive a direct subsidy of 35% of the interest payable which were created under the American Recovery and Reinvestment Act of 2009. The District elected to receive the direct subsidy for its BABs. The BABs series had an all-in true interest cost of 3.414 percent, and the tax-exempt series had an all-in true interest cost of 3.610 percent.