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STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

September 30, 2004

Mr. Thomas J. Kelly
President
Environmental Facilities Corporation
625 Broadway
Albany, NY 12207

Re: Internal Controls Over Major
Financial Operations
Report 2004-S-4

Dear Mr. Kelly:

Pursuant to the State Comptroller's authority as set forth in Article X, Section 5 of the State Constitution and Section 2803 of the Public Authorities Law, we audited the Environmental Facilities Corporation's internal controls over its major financial management functions for the period April 1, 2002 through March 31, 2004.

A. Background

The New York State Environmental Facilities Corporation (Corporation) is a public benefit corporation formed pursuant to the New York State Environmental Facilities Corporation Act (Chapter 744 of the Laws of the State of New York of 1970). The Corporation's mission is to promote environmental quality by providing low-cost capital funding and expert technical assistance to municipalities, businesses and State agencies for environmental projects in New York State. The Corporation helps both public and private entities comply with federal and State environmental requirements.

The Corporation is governed by a seven-member Board of Directors (Board) that serves without compensation. Board members include the Commissioner of Environmental Conservation (the Chairman), the Commissioner of Health, the Secretary of State, and four directors nominated by the Governor. The Corporation is operated by a President, who is appointed by the Board, and it employs 133 people, including seven Department of Environmental Conservation (DEC) staff who is assigned to the Corporation. The Corporation's main functions include administering the Clean Water State Revolving Fund (CWSRF) and the Drinking Water State Revolving Fund (DWSRF). The CWSRF was created by law in 1989 to provide low-interest financing for water pollution control projects and is administered by both the Corporation and DEC. As of June 30, 2003 the CWSRF had made 1,123 loans, totaling about $9.1 billion, to 422 recipients throughout the State. The DWSRF was created by law in 1996 to provide low-interest financing for construction of drinking water projects for publicly and privately owned water supply systems. The DWSRF is

administered by the Corporation and the Department of Health. As of June 30, 2003, the DWSRF has made 282 loans and 103 grants, totaling about $1.1 billion, to 219 recipients throughout the State.

The Corporation also assists businesses to finance environmental projects through the Industrial Finance Program (IFP). The IFP has provided businesses with $1.2 billion in low-interest loans and $208 million in loan refinancing since its creation in 1976. Projects that qualify for loans through the IFP include solid waste management, hazardous waste management, clean water and waste-water projects. In addition, the Corporation helps municipalities, state agencies and businesses comply with environmental laws and regulations through its Technical Advisory Services (TAS) program. Other Corporation programs include the Financial Assistance to Business Program (FAB) and the Pipeline for Jobs State Revolving Fund Program. As of June 30, 2003, a total of $18.6 million had been provided for FAB air projects, and an additional $8.9 million had been committed to FAB water projects. There has been $11.9 million committed to the Pipeline for Jobs projects since its creation.

The operations of the Corporation are funded by financing fees and annual fees charged to municipalities that receive loans and grants and user fees paid by businesses, municipalities and industrial clients for the Corporation's technical and financial services. For the fiscal year ended March 31, 2003, the Corporation had assets totaling $8.2 billion and liabilities of $4.8 billion.

In 1987 the Legislature enacted the Governmental Accountability, Audit and Internal Control Act to require state agencies and public benefit corporations to have a comprehensive system of internal controls to: promote efficient and effective operations; safeguard resources; ensure adherence to laws, regulations and directives; and develop and maintain reliable financial and management data that is presented in timely reports. Agency heads and corporation boards are responsible for the implementation of effective internal control systems in their entities.

B. Audit Scope, Objectives and Methodology

We audited the design and implementation of the internal controls established by the Corporation over its major financial management functions for the period April 1, 2002 through March 31, 2004. The objective of our performance audit was to determine if the Corporation has established and implemented an adequate system of internal controls to: ensure that funds and resources are used efficiently and effectively; give reasonable assurance that assets and resources are appropriately protected and managed; laws, regulations and directives are adhered to; and reliable data is maintained and presented in timely reports.

To accomplish our objectives, we reviewed Article 9 of the Public Authorities Law (Law) and Title 2 of the New York Code of Rules and Regulations, Part 201 (Regulation). We interviewed Corporation officials and reviewed documentation, logs and reports pertaining to the Corporation's major financial management functions. Specifically, we tested internal controls over the collection of revenues, cash and investments, payroll, procurement and contracting, assets and equipment, budgeting and expenditures, and accounting and information systems.

We conducted our audit according to Generally Accepted Government Auditing Standards. Such standards require that we plan and perform our audit to adequately assess those operations of the Corporation which are included within our audit scope. Further, these standards require that we understand the Corporation's internal control structure and its compliance with those laws, rules and regulations that are relevant to the operations which are included in our audit scope. An audit includes examining, on a test basis, evidence-supporting transactions recorded in the accounting and operating records and applying such other auditing procedures, as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State, several of which are performed by the Division of State Services. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds, and other payments. In addition, the Comptroller appoints members to certain boards, commissions and public authorities, some of who have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under Generally Accepted Government Auditing Standards. In our opinion, these management functions do not affect our ability to conduct independent audits of program performance.

C. Systems of Internal Control

We concluded that EFC has established an adequate system of internal controls over its major financial management functions and that the control system functioned as intended. Internal control is the integration of the activities, plans, attitudes, policies, and efforts of the people of an organization to provide reasonable assurance that the organization will achieve its objectives and mission. Specifically, internal controls should:

- promote orderly economical, efficient and effective operations;
- safeguard resources against loss due to waste, abuse, mismanagement, errors and fraud;
- ensure adherence to laws, regulations, contracts and management directives; and
- develop and maintain reliable financial and management data, and accurately present that data in timely reports.

An effective system of internal controls has five major components that are essential to achieving the objectives and mission of an organization. These components include: the Control Environment, Communication, Risk Assessment, Control Activities and Monitoring.

1. Control Environment

The Corporation's management and Board have established and maintain a positive control environment. The mission and structure of the Corporation are clearly defined and communicated to all employees. The Board has appointed an Internal Control Officer to implement and review internal control responsibilities pursuant to the Law. An Ethics Officer oversees compliance with

the Public Officers Law, the Executive Law and the regulations of the State Ethics Commission. A Procurement Integrity Officer ensures consistent and effective compliance with procurement policies. The Corporation also annually submits an Internal Control Certification and Summary Report to the State Division of Budget (DOB) to help ensure that internal controls are in place and is followed by employees.

The Corporation has established policies and procedures for all key areas of their operations, and they are available to all employees. Human Resource policies and practices ensure that employees possess the knowledge, skills and ability to perform their jobs. Key employees contacted throughout the audit demonstrated commitment to helping the Corporation achieve its mission. Further, low staff turnover at the Corporation is an indication of positive employee morale.

2. Communication

Communication is the exchange of useful information between and among people and organizations to support decisions and coordinate activities. We noted no weaknesses in the Corporation's internal communication functions. Internal information is timely, accurate, sufficient, appropriate and readily available to users. The Board meets regularly and is apprised of all material occurrences at the Corporation. Management emphasizes the importance of internal controls and communicates this by providing internal control information to all staff.

However, the Corporation did not fully comply with external reporting requirements of the Law and Regulation. Specifically, audited financial statements, prepared in accordance with Generally Accepted Accounting Principals (GAAP), transmittal and management letters, and approved procurement and investment reports were not submitted to the Office of the State Comptroller (OSC) and various other oversight agencies within 90 days of the end of the fiscal year ended March 31, 2003, as required.

3. Risk Assessment

We determined that the Corporation's risk assessment activities were effective. In 2001, a detailed vulnerability assessment was conducted for key functions within each division. Each function was classified as high, moderate or low risk. High-risk, moderate-risk and low-risk functions are reviewed annually, every two years and every three years, respectively. Corrective action plans were implemented in 2002 for 23 functions that were identified as high-risk. For the 2002-03 year, the Corporation did not identify any high-risk functions that required improvement. For 2004, a total of 47 moderate-risk functions were identified and scheduled for internal control reviews. Further, forty lower-risk functions are scheduled for internal control review in 2005.

4. Control Activities

We determined that the Corporation's control activities were effective. Specifically, we reviewed control activities over cash and investments, revenues and collections, payroll, procurement and contracting, equipment and assets, budget and expenditures, accounting and information systems and bond issuances. We determined that Corporation personnel use documentation, formal authorizations, and verifications to ensure compliance with policies and

directives. The Corporation's internal controls provide assurances that cash and investments are safeguarded and that billing and collection procedures are appropriate. Based on our tests of payroll records, procurement contracts and travel expenses, we concluded that applicable Corporation policies were adhered to. To test payroll records, we utilized the State Payroll System to determine if any duplicate payments were made to EFC employees by any other State agency. We also compared the dates of eleven additions and eight deletions from the Corporation's payroll to the State payroll System for a period of one year. To test contract procurement, for 2 contracts we verified that the Corporation followed its procedures to verify that potential contractors supplied all required information, including qualifications, in their contract proposals. To test travel expenses, we reviewed ten travel vouchers for appropriate receipts and proper authorization according to Corporation policy. In all of the tests we conducted, no exceptions were found. Controls over office and computer equipment provided adequate assurance that they were properly secured and used as intended. Adequate general and application controls have been established over the Corporation's computer systems. All bond issuances were approved by the Corporation's Board. The financial advisor, bond counsel and underwriters were selected using a competitive process, including requests for proposals.

5. Monitoring

We determined that the Corporation's monitoring practices were functioning effectively. Specifically, activities and transactions are properly supervised, and reviews of financial transactions are performed daily. In addition, a report of budgeted versus actual expenditures is prepared monthly and forwarded to DOB. Accounts receivable are reviewed on a daily basis. Accounting staff review all transactions posted to the Corporation's accounts and refer past due accounts to management for follow-up. Furthermore, as noted previously, the Corporation has a formal vulnerability assessment program which includes periodic reviews of many Corporation functions.

D. Financial Reporting

The Corporation is required by the Law and Regulation to prepare a number of specific status activity, and financial reports. Further, the Corporation must submit these reports to various State agencies and officials to enable them to fulfill their reporting and oversight responsibilities. These reports include a budget report (due 60 days before the start of the fiscal year) and an annual report (due 90 days after the end of the Corporation's fiscal year) to the Governor, the Comptroller, and the chairpersons and ranking minority members of the Senate Finance and the Assembly Ways and Means Committees. In addition, other reports (addressing, for example, personnel, prompt payment policy, and investments) must be submitted each year, by dates established by Law, to the Comptroller, DOB, and the chairpersons of the legislative fiscal committees.

In addition, the Regulations of the State Comptroller require the following to be submitted to OSC's Bureau of Financial Reporting: a transmittal letter from the Chairman of the Board or Chief Executive Officer representing that the annual report is complete and conforms with the Regulations; financial statements prepared in accordance with GAAP; a management letter from the authority's independent auditor in connection with the most recent annual audit; an annual investment audit report providing assurance the authority complied with OSC's Investment Guidelines for Public Authorities; the completed annual public authority data request; and any other supplementary

information requested by OSC. Per the Regulation, the Corporation is required to submit its reports within 90 days after the end of its fiscal year (or June 29 of each year). These items must be received on time by OSC because OSC is required by the State Finance Law to prepare GAAP-based financial statements for the State within 120 days of the State's fiscal year end. These statements include financial data for all State agencies and certain public benefit corporations, including the Corporation. Thus, OSC depends on each such public benefit corporation (including the Corporation) to submit the required GAAP financial statements and other supplemental information in a time frame sufficient to prepare and issue the State's financial statements by July 29 of each year.

In 2003, the Corporation submitted some of the required reports on time. For example, the Corporation submitted its personnel, budget, and prompt payment policy reports to all required agencies and officials within the prescribed timeframes. The Corporation's submissions of other reports and information for 2003 were not, however, fully consistent with the Law and the Regulation. Specifically, the Corporation submitted a draft copy of its financial statements, for the year ended March 31, 2003, with the annual data request information submitted to OSC on June 30, 2003. This was consistent with the Corporation's traditional practices. However, the draft financial statements were not sufficient because it did not include the required Management Discussion and Analysis letter, Statements of Cash Flow, and a signed opinion from the Corporation's independent auditors. Thus, the draft financial statements were not sufficient for the State's GAAP reporting requirements. The Corporation did not submit copies of their audited GAAP financial statements to OSC and other State oversight agencies until October 21, 2003, more than three months after the prescribed due date.

Also, other required documents were not submitted (or were not submitted timely). For example, the Corporation did not submit copies of its management comment and transmittal letters and a copy of its report on internal controls over financial reporting (which was supplemental information requested by OSC). Furthermore, the approved procurement and investment reports were submitted to OSC about three months late. The Corporation also did not submit its annual report to the Governor and other required recipients within 90 days of its fiscal year end, as required by Law.

Corporation officials told us that they submitted incomplete draft copies of their financial statements in response to OSC's annual public authority data request, in 2003, because their independent auditors had not issued a final opinion on the Corporation's financial statements by June 29. Officials also told us that their independent auditors could not issue a final opinion by June 29 because the Corporation had not yet provided the auditors with the required letter of representation and a legal confirmation letter. In addition, the independent auditors had not presented the audit's conclusions and findings to the Corporation's Board (specifically, the Audit Committee) by June 29. This presentation took place on July 29, 2003. Corporation officials further noted that approval of the Corporation's financial statements, procurement report and investment report usually did not take place until the Board's major annual meeting, which was normally scheduled for September.

Therefore, the Corporation could not meet the June 29 deadline for submitting all the required reports and documents for 2003. Corporation officials stated that their submissions for

2003 were consistent with those from prior years, and consequently, officials believed that they had complied adequately with the Law and Regulation. Officials also indicated that the date of OSC's 2003 data request did not provide Corporation staff with sufficient time to meet the prescribed deadlines for submission of the information requested, given the Corporation's established practices at that time.

The Corporation's financial condition has changed significantly in recent years, with considerable growth in both assets and liabilities. As noted previously, the Corporation had assets totaling $8.2 billion and liabilities totaling $4.8 billion as of March 31, 2003. These represent increases in assets of about $3.8 billion (87.5 percent) and liabilities of about $1.9 billion (67.3 percent) since March 31, 1997. As such, the Corporation has become a more significant component of the State's overall financial reporting entity, and therefore, it has become more important for the Corporation to comply fully with the State's financial reporting requirements. Furthermore, we believe that the timely submission of the required documents and reports to all of the aforementioned State oversight authorities will better enable those authorities to carry out their monitoring and assessment functions.

In response to our preliminary observations, Corporation officials stated that they would take steps to help ensure that the required reports and documents were submitted to OSC and other oversight agencies by the prescribed dates. Further, the Corporation submitted the reports and documents required by OSC for the fiscal year ended March 31, 2004 on time. Corporation officials anticipate that the steps they have taken to address this issue will help to ensure that reporting deadlines are met consistently in the future.

(In their response to our draft report, Corporation officials disagree with our conclusion that their submission of financial information was not fully consistent with the Law and the Regulations. They state that it remains their position that based upon a review of the laws, rules and regulations, together with discussions with OSC that they have complied with all of the reporting requirements. Corporation officials say they have always advised OSC of the status of the financial statements and provided the procurement and investment reports as required by the Law. They further state that OSC, in turn, never advised the Corporation that they were not in full compliance. Thus, they conclude that the Corporation met the standards, measures and expectations criteria as required by law and regulation.)

Auditors' Comments: The requirements in the Law and Regulations have not changed during the audit period and the Corporation is expected to be cognizant of these legal requirements. In order to be fully consistent with the Law, the Regulation and the State Finance Law, the Corporation must submit audited GAAP financial statements to OSC and other State oversight agencies. As stated in our report, on June 30, 2003, the Corporation submitted draft financial statement that did not include the required Management Discussion and Analysis letter, Statement of Cash Flow, and a signed opinion from the Corporation's independent auditors. Thus, the Corporation did not fully meet all of its reporting requirements until October 21, 2003, when such additional material was provided to OSC.

Recommendations

1. *Submit all required reports to OSC's Bureau of Financial Reporting and other oversight agencies within the timeframes required by the Law and the Regulation.*

2. *Take action to ensure that all requirements are met for the independent auditors to issue a timely opinion on the Corporation's annual financial statements. These actions should include (but not be limited to): the independent auditor's timely presentation of audit results to the Board's Audit Committee; and the timely provision of all of the representations required by the independent auditors to complete their audit work.*

We provided draft copies of this report to Corporation officials for their review and comment. Their comments have been considered in the preparation of this report and are included in Appendix A. Corporation officials disagreed with the report's conclusion that the Corporation's submission of financial information was not fully consistent with the Law, the Regulation and the State Finance Law. Corporation officials agreed with our recommendations and state that they have implemented the necessary changes to accommodate OSC's needs for the current State fiscal year and in the future.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the President of the Corporation shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons why.

Major contributors to this report were Jessica Feltman, Melissa Clayton, Cynthia Herubin, Karen Bogucki and Brian Mason.

We thank the management and staff of the Environmental Facilities Corporation for the courtesies and cooperation extended to our auditors during this audit.

Very truly yours,

Steven E. Sossei
Audit Director

cc: Ms. Erin M. Crotty, DEC
Mr. Robert Barnes, DOB

New York State
ENVIRONMENTAL FACILITIES CORPORATION

Thomas J. Kelly, *President*

September 22, 2004

Mr. Steven Sossei
Audit Director
Office of the State Comptroller
State Audit Bureau
110 State Street, 11th Floor
Albany, NY 12236

Dear Mr. Sossei:

This letter is in response to the Office of the State Comptroller's (OSC) draft audit report (2004-S-4) which summarizes the recent audit of internal controls over major financial management functions at the New York State Environmental Facilities Corporation (EFC).

As detailed in the draft audit report, the system of internal controls at EFC, including the control environment, communication, risk assessment, control activities and monitoring were all determined by OSC to be effective. OSC's determination is a direct result of the policies of the members of the EFC Board of Directors and the efforts of dedicated EFC staff to administer the policies and procedures that have been adopted to ensure that both the mission of the EFC is achieved and the public trust is maintained. The members of the Board of Directors and all EFC employees should be commended for their efforts in this regard.

Although the draft audit report concluded that EFC's submission of financial information was not fully consistent with the Public Authorities Law (PAL) and the New York Code of Rules and Regulations (NYCRR), it remains our position that, based upon a review of the laws, rules and regulations, together with discussions between EFC and OSC that we have complied with all of the reporting requirements. Our position is further supported when the one matter raised in the draft audit report is reviewed against the long standing past practice and the facts and circumstances regarding the submission of the adopted annual audited financial statements of EFC.

EFC has always advised OSC of the status of the financial statements, and provided the procurement and investment reports as required by the PAL. OSC has repeatedly advised EFC that what was submitted was sufficient and that EFC staff was very responsive to requests made by OSC for information. We were never advised by OSC that

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we were not in full compliance. As such, it is our position that EFC had met the standards, measures and expectations criteria as established by and discussed with OSC and as required by law and regulation.

We can appreciate that the growth of EFC in recent years may have raised concern as to the effect EFC's financial statements may have upon the State's financial reporting. However, OSC failed to communicate its need for, or request that EFC adjust its schedule to provide for, the earlier submission of audited financial statements or other reports. While it is true that EFC has grown, it should also be noted that the majority of such growth is non-State supported debt. The State Revolving Funds Program financings are revenue based bond issues supported by recipient repayments. These financings are not obligations of the State of New York.

While EFC has at all times been in full compliance, we have implemented the necessary changes to accommodate the needs of OSC for the current State fiscal year and in the future. As you noted in the audit report, EFC was able to accelerate our schedule for the 2003/2004 State fiscal year so that our Board of Directors was able to consider and approve many of the items that, in the past, were normally approved at our annual board meeting in September.

We look forward to a continued, cooperative working relationship between EFC and OSC in the future.

Sincerely,

Thomas J. Kelly
President

Cc: David Sterman – EFC Executive Vice President
James Levine – EFC General Counsel
Barbara D. Wayman – EFC Director of Corporate Operations
Michael Malinoski – EFC Controller
Brian Mason, OSC Audit Manager
Karen Bogucki, OSC Audit Supervisor