

STATE OF MINNESOTA

Office of the State Auditor



Rebecca Otto
State Auditor

MANAGEMENT AND COMPLIANCE REPORT FOR

WESTERN LAKE SUPERIOR SANITARY DISTRICT
DULUTH, MINNESOTA

FOR THE YEAR ENDED DECEMBER 31, 2007

Description of the Office of the State Auditor

The mission of the Office of the State Auditor is to oversee local government finances for Minnesota taxpayers by helping to ensure financial integrity and accountability in local governmental financial activities.

Through financial, compliance, and special audits, the State Auditor oversees and ensures that local government funds are used for the purposes intended by law and that local governments hold themselves to the highest standards of financial accountability.

The State Auditor performs approximately 160 financial and compliance audits per year and has oversight responsibilities for over 3,300 local units of government throughout the state. The office currently maintains five divisions:

Audit Practice - conducts financial and legal compliance audits of local governments;

Government Information - collects and analyzes financial information for cities, towns, counties, and special districts;

Legal/Special Investigations - provides legal analysis and counsel to the Office and responds to outside inquiries about Minnesota local government law; as well as investigates allegations of misfeasance, malfeasance, and nonfeasance in local government;

Pension - monitors investment, financial, and actuarial reporting for approximately 730 public pension funds; and

Tax Increment Financing - promotes compliance and accountability in local governments' use of tax increment financing through financial and compliance audits.

The State Auditor serves on the State Executive Council, State Board of Investment, Land Exchange Board, Public Employees Retirement Association Board, Minnesota Housing Finance Agency, and the Rural Finance Authority Board.

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**WESTERN LAKE SUPERIOR SANITARY DISTRICT
DULUTH, MINNESOTA**

For the Year Ended December 31, 2007



Management and Compliance Report

**Audit Practice Division
Office of the State Auditor
State of Minnesota**

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**WESTERN LAKE SUPERIOR SANITARY DISTRICT
DULUTH, MINNESOTA**

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**WESTERN LAKE SUPERIOR SANITARY DISTRICT
DULUTH, MINNESOTA**

Schedule 1

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED DECEMBER 31, 2007**

I. SUMMARY OF AUDITOR'S RESULTS

- A. Our report expresses an unqualified opinion on the basic financial statements of the Western Lake Superior Sanitary District.
- B. A significant deficiency in internal control was disclosed by the audit of financial statements of the Western Lake Superior Sanitary District and is reported in the "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 significant deficiency is considered to be a material weakness.
- C. No instances of noncompliance material to the financial statements of the Western Lake Superior Sanitary District were disclosed during the audit.
- D. No matters involving internal control over compliance relating to the audit of the major federal award program were reported in the "Report on Compliance with Requirements Applicable to Each Major Program and Internal Control Over Compliance in Accordance with OMB Circular A-133."
- E. The Auditor's Report on Compliance for the major federal award program for the Western Lake Superior Sanitary District expresses an unqualified opinion.
- F. No findings were disclosed that are required to be reported in accordance with Section 510(a) of OMB Circular A-133.
- G. The major program is:
 - Capitalization Grants for State Revolving Funds CFDA #66.458
- H. The threshold for distinguishing between Types A and B programs was \$300,000.
- I. The Western Lake Superior Sanitary District was not determined to be a low-risk auditee.

II. FINDINGS RELATED TO FINANCIAL STATEMENTS AUDITED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

INTERNAL CONTROL

PREVIOUSLY REPORTED ITEM NOT RESOLVED

06-4 Audit Adjustments

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements of the financial statements on a timely basis. Statement on Auditing Standards (SAS) No. 112 states that one control deficiency that shall be regarded as at least a significant deficiency is identification by the auditor of a material misstatement in the financial statements that was not initially identified by the entity's internal controls, even if management subsequently corrects the misstatement.

During our audit, we proposed material adjustments that resulted in significant changes to the District's financial statements. The adjustments were to record additional receivables and payables, to correct a prior period error in accumulated depreciation, and to correct for over-accrual of accounts payable. The audit adjustments were caused in part because new accounting staff is still becoming familiar with governmental accounting principles. The inability to detect a material misstatement in the financial statements increases the likelihood that the financial statements would not be fairly presented.

We recommend that the District implement internal controls over financial reporting to detect misstatements in the financial statements. The controls should include preparation and review of all work papers necessary to adjust the financial statements in accordance with generally accepted accounting principles. Work papers should be carefully reviewed to detect errors, especially in the area of spreadsheet formulas. The draft financial statements should be reviewed by a qualified individual to identify potential misstatements.

Client's Response:

The current WLSSD staff is continuing to obtain the training and expertise to better implement internal controls over financial reporting which will ensure detection of misstatements in the financial statements. This process will involve the Director of Finance reviewing all of the work papers and ensuring posting of all necessary adjusting entries prior to the start of the audit.

PREVIOUSLY REPORTED ITEMS RESOLVED

Operating Cash Checking Account Reconciliation (06-1)

During our prior audit, we noted the operating cash checking account had not been reconciled for approximately 11 months at the time of our audit. We recommended the District have someone with limited duties in the cash receipts and cash disbursements areas reconcile all bank accounts on a monthly basis. We also recommended the reconciliations be reviewed by management.

Resolution

All bank account reconciliations were found to be up to date during our current audit. The reconciliations are performed by someone with limited duties in the cash receipts and disbursements areas and are reviewed by the Director of Finance.

Journal Entries (06-2)

In the prior audit, journal entries were made on the general ledger system by the Director of Finance and the Senior Accountant, but were not reviewed or approved by anyone else. Also, other Finance Department staff members have access to the journal entry function but are not authorized to make journal entries. We recommended that access to the journal entry function be reviewed and limited, if possible, to those with a logical need for that access; that a procedure be established to require review and approval of journal entries by someone other than the person making the journal entries; and that the journal entries be supported by documentation and explanations.

Resolution

In the current audit, the District established a procedure for journal entry review and approval. Journal entries are made by the Accountant and the Senior Accountant. Supporting documentation is attached to the journal entries, and they are submitted to the Director of Finance for review. The Director of Finance prints a journal entry report from the general ledger system which lists all journal entries made during the period under review. She compares the report to the journal entries to determine that no unauthorized entries have been made. She also reviews and approves the journal entries and supporting documentation.

Preparation of Financial Statements (06-3)

In prior audits, the District has relied on its independent external auditors to assist in the preparation of the basic financial statements, including notes to the financial statements, as part of its external financial reporting process.

Resolution

During the current audit, the District prepared all of the financial statements and notes.

III. FINDINGS AND QUESTIONED COSTS FOR FEDERAL AWARD PROGRAMS

None.

IV. OTHER FINDINGS AND RECOMMENDATIONS

A. MINNESOTA LEGAL COMPLIANCE

PREVIOUSLY REPORTED ITEM NOT RESOLVED

05-2 Bidding

Minn. Stat. § 471.345 requires that certain contracts estimated to exceed \$50,000 be solicited by a sealed bid process. In our prior audit, we noted two instances where the District had purchased equipment which exceeded \$50,000 without soliciting sealed bids as required by the statute.

During the current audit, we noted one purchase which exceeded \$50,000 not solicited by sealed bids. The contract was for the purchase of a specialized equipment part for \$61,070. This item was purchased directly from the vendor because it was the only known supplier for the part.

Minn. Stat. § 471.36 allows for the purchase of noncompetitive types and kinds of supplies and equipment. This provision of the statute however, only exempts the District from the provisions of Minn. Stat. § 471.35, which is the provision that requires that specifications not be prepared so restrictively that only one type or kind of equipment will meet the specifications. It does not exempt the District from having to solicit bids.

We recommend the District solicit bids for all contracts requiring bids which are expected to exceed \$50,000.

Client's Response:

The referenced non-bid purchase was for specialized equipment totaling \$61,070. This purchase was not bid due to the nature of the equipment and the single supplier from which this equipment could be procured.

In a review of Minn. Stat. § 471.35 and the amendments to this statute adopted in 1969, it appears that the legislature inadvertently deleted key language from the original legislation which did not require bidding if the supplies and equipment could only be procured from a sole source. It is our belief that the situation cited did not require bidding; however, because the auditor disagrees, we will bid similar purchases of supplies and equipment above the \$50,000 threshold regardless of the sole source reality.

ITEM ARISING THIS YEAR

07-1 Collateral to Secure Deposits

Minn. Stat. § 118A.03 requires governmental entities to obtain collateral to secure deposits to the extent that funds on deposit exceed available federal deposit insurance at the close of the financial institution's banking day. The market value of the collateral should be at least ten percent more than the uninsured amount on deposit.

The District's deposits at Park State Bank were not properly collateralized at December 31, 2007. The amount of collateral required to secure the deposits on that date was \$4,390. No collateral was pledged at year-end at Park State Bank because the collateral had matured on December 20 and was not replaced because the District was changing banks. The amount of the bank balance at Park State Bank which exceeded the FDIC coverage of \$100,000 for the time period between December 20 and December 31 would also have been unsecured.

We recommend the Finance Director monitor all District deposits to determine that adequate collateral has been pledged to secure deposits in accordance with Minn. Stat. § 118A.03.

Client's Response:

This situation arose primarily from the change in banking institutions. The Director of Finance will monitor the deposits on hand in the financial institutions to ensure the funds are fully collateralized and institute internal controls that ensure compliance with Minn. Stat. § 118A.03.

PREVIOUSLY REPORTED ITEM RESOLVED

Prompt Payment (06-5)

Minn. Stat. § 471.425 requires governmental units to pay their vendors according to the terms of the contract, or if no contract terms apply, within the standard payment period, which for the District, would be within 35 days of the receipt of the invoice. For 11 of 26 vendor invoices we reviewed during the prior audit, payment was not made within this standard payment period.

Resolution

In the current audit, we noted great improvement in this area. Only 2 of 40 invoices we reviewed were not paid within 35 days of the receipt of the invoice.

B. MANAGEMENT PRACTICES

PREVIOUSLY REPORTED ITEM NOT RESOLVED

06-6

Investment Policy

The District's investment policy has diversification limits which restrict the amount of commercial paper which can be held to 50 percent of the investment portfolio and the amount of money market mutual funds to 10 percent of the portfolio. The policy also limits the amount of commercial paper that can be held with any one issuer to 10 percent of the portfolio.

At December 31, 2007, the District held 56 percent of the investment portfolio in commercial paper and 27 percent in money market mutual funds. Also, the District had 11 percent of its investment portfolio invested with each of two single issuers. These investments exceeded the limits set by the investment policy.

We recommend the District comply with its investment policy and limit its investments to the maximum percentages allowed by the policy. If the District has changed its diversification goals, the policy should be revised.

Client's Response:

The District has reviewed and updated the investment policy and the investment and portfolio guidelines as of May 16, 2008. Controls have been put in place to ensure the diversification of investments is consistent with the investment policy and guidelines.

C. OTHER ITEMS FOR CONSIDERATION

Other Postemployment Benefits (OPEB)

The Governmental Accounting Standards Board (GASB) issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, which governs employer accounting and financial reporting for OPEB. This standard, similar to what GASB Statement 27 did for government employee pension benefits, provides the accounting and reporting standards for the various other postemployment benefits many local governments offer to their employees. OPEB can include many different benefits offered to retirees such as health, dental, life, and long-term care insurance coverage.

If retirees are included in an insurance plan and pay a rate similar to that paid for younger active employees, this implicit subsidy is considered OPEB. In fact, local governments may be required to continue medical insurance coverage pursuant to Minn. Stat. § 471.61, subd. 2b. This benefit is common when accumulated sick leave is used to pay for retiree medical insurance. Under the new GASB statement, accounting for OPEB is now similar to the accounting used by governments for pension plans.

This year the legislature enacted a new law, Minn. Stat. § 471.6175, intended to help local governments address their OPEB liability in at least three important ways:

- it allows governments to create both irrevocable and revocable OPEB trusts;
- it authorizes the use of a different list of permissible investments for both irrevocable and revocable OPEB trusts; and
- it also permits governments to invest OPEB trust assets with the State Board of Investment (SBI) bank trust departments, and certain insurance companies.

Some of the issues that the District Board will need to address in order to comply with the Statement are:

- determine if employees are provided OPEB;
- if OPEB are being provided, the Board will have to determine whether it will advance fund the benefits or pay for them on a pay-as-you-go basis;

Schedule 1
(Continued)

- if OPEB are being provided, and the Board determines that the establishment of a trust is desirable in order to fund the OPEB, the Board will have to comply with the new legislation enacted authorizing the creation of an OPEB trust and establishing an applicable investment standard;
- if an OPEB trust will be established, the District will have to decide whether to establish an irrevocable or a revocable trust, and report that trust appropriately in the financial statements; and
- in order to determine annual costs and liabilities that need to be recognized, the Board will have to decide whether to hire an actuary.

GASB Statement 45 would be applicable to the Western Lake Superior Sanitary District for the year ending December 31, 2008.

Pollution Remediation Obligations

The Governmental Accounting Standards Board (GASB) Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, becomes effective for the District beginning with the year ending December 31, 2008. This statement addresses accounting and financial reporting standards for pollution remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and cleanups.

The Western Lake Superior Sanitary District is negotiating a consent decree to settle an enforcement action of the Environmental Protection Agency for sewage overflows in the past that have violated the Clean Water Act. The proposed consent decree requires the District to make improvements to prevent future sewage overflows. These improvements will be made over a number of years.

GASB Statement 49 may require the District to accrue a liability for future expenditures if certain obligating events have occurred. The District should evaluate the possible effect this accounting standard will have on the District's financial statements.



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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*

Board of Directors
Western Lake Superior Sanitary District

We have audited the basic financial statements of the Western Lake Superior Sanitary District as of and for the year ended December 31, 2007, and have issued our report thereon dated June 9, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Western Lake Superior Sanitary District'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 Western Lake Superior Sanitary District's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the District's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph of this section and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified a deficiency in internal control over financial reporting that we consider to be a significant deficiency.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination

of control deficiencies, that adversely affects the District's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the District's financial statements that is more than inconsequential will not be prevented or detected by the District's internal control. We consider the deficiency described in the accompanying Schedule of Findings and Questioned Costs as item 06-4 to be a significant deficiency in internal control over financial reporting.

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

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe the significant deficiency described above as item 06-4 to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Western Lake Superior Sanitary District'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*.

Minnesota Legal Compliance

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the provisions of the *Minnesota Legal Compliance Audit Guide for Local Government*, promulgated by the State Auditor pursuant to Minn. Stat. § 6.65. Accordingly, the audit included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The *Minnesota Legal Compliance Audit Guide for Local Government* contains six categories of compliance to be tested: contracting and bidding, deposits and investments, conflicts of interest, public indebtedness, claims and disbursements, and miscellaneous provisions. Our study included all of the listed categories.

The results of our tests indicate that, for the items tested, the Western Lake Superior Sanitary District complied with the material terms and conditions of applicable legal provisions, except as described in the Schedule of Findings and Questioned Costs as items 05-2 and 07-1.

Also included in the Schedule of Findings and Questioned Costs are management practices comments and other items for consideration. We believe these recommendations and information to be of benefit to the Western Lake Superior Sanitary District, and they are reported for that purpose.

The Western Lake Superior Sanitary District's written responses to the material weakness, legal compliance, and management practice findings identified in our audit have been included in the Schedule of Findings and Questioned Costs. We did not audit the District's responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the Board of Directors, management, others within the Western Lake Superior Sanitary District, and federal awarding agencies and pass-through entities and is not intended to be, and should not be, used by anyone other than those specified parties.

/s/Rebecca Otto

REBECCA OTTO
STATE AUDITOR

/s/Greg Hierlinger

GREG HIERLINGER, CPA
DEPUTY STATE AUDITOR

June 9, 2008

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REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO EACH MAJOR PROGRAM AND INTERNAL CONTROL OVER COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133

Board of Directors
Western Lake Superior Sanitary District

Compliance

We have audited the compliance of the Western Lake Superior Sanitary District with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to its major federal program for the year ended December 31, 2007. Western Lake Superior Sanitary District's major federal program is identified in the Summary of Auditor's Results section of the accompanying Schedule of Findings and Questioned Costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of the District's management. Our responsibility is to express an opinion on the District's compliance based on our audit.

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

In our opinion, the Western Lake Superior Sanitary District complied, in all material respects, with the requirements referred to above that are applicable to its major federal program for the year ended December 31, 2007.

Internal Control Over Compliance

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

A control deficiency in internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the District's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the District's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the Western Lake Superior Sanitary District's internal control.

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

Schedule of Expenditures of Federal Awards

We have audited the financial statements of the Western Lake Superior Sanitary District as of and for the year ended December 31, 2007, and have issued our report thereon dated June 9, 2008. Our audit was performed for the purpose of forming an opinion on the Western Lake Superior Sanitary District's basic financial statements. The accompanying Schedule of Expenditures of Federal Awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. Such

information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

This report is intended solely for the information and use of the Board of Directors, management, others within the Western Lake Superior Sanitary District, and federal awarding agencies and pass-through entities and is not intended to be, and should not be, used by anyone other than those specified parties.

/s/Rebecca Otto

REBECCA OTTO
STATE AUDITOR

/s/Greg Hierlinger

GREG HIERLINGER, CPA
DEPUTY STATE AUDITOR

June 9, 2008

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**WESTERN LAKE SUPERIOR SANITARY DISTRICT
DULUTH, MINNESOTA**

Schedule 2

**SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED DECEMBER 31, 2007**

Federal Grantor Pass-Through Agency Grant Program Title	Federal CFDA Number	Pass-Through Grant Number	Expenses
U.S. Environmental Protection Agency			
Passed Through Minnesota Department of Employment and Economic Development			
Capitalization Grants for State Revolving Funds	66.458		
Flocculation Tanks Project		MPFA-05-0072-R-FY06	\$ 2,960,471
Multi-Media Filters Project		MPFA-07-0031-R-FY08	766,933
Direct			
Congressionally Mandated Projects			
Oneota Pump Station	66.202	XP00E39101-0	477,900
Surveys, Studies, Investigations, and Special Projects			
Generator Project	66.606	XP-96578701-0	19,631
Total Federal Awards			<u>\$ 4,224,935</u>

Notes to Schedule of Expenditures of Federal Awards

1. The Schedule of Expenditures of Federal Awards presents the activity of federal award programs expended by the Western Lake Superior Sanitary District. The awards include amounts spent or accrued on projects through December 31, 2007. These amounts are capitalized in capital assets on the financial statements.
2. The expenditures on this schedule are on the accrual basis of accounting used by the Western Lake Superior Sanitary District.
3. During 2007, the District did not pass any federal money to subrecipients.