

PUBLIC SERVICE COMMISSION
ANNUAL REPORT BRANCH
MAR 19 2012
RECEIVED
EXAMINED BY _____

GALLATIN COUNTY WATER DISTRICT
BASIC FINANCIAL STATEMENTS,
SUPPLEMENTARY INFORMATION,
AND INDEPENDENT AUDITORS' REPORTS
At December 31, 2011 and 2010

**GALLATIN COUNTY WATER DISTRICT
BASIC FINANCIAL STATEMENTS
SUPPLEMENTARY INFORMATION
AND INDEPENDENT AUDITORS' REPORTS**

Years Ended December 31, 2011 and 2010

TABLE OF CONTENTS

Independent Auditors' Report	1
Management's Discussion and Analysis	2-5
Basic Financial Statements:	
Statement of Net Assets	6
Statement of Revenues, Expenses, and Changes in Fund Net Assets	7
Statement of Cash Flows	8-9
Notes to Basic Financial Statements	10-20
Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With <u>Government Auditing Standards</u>	21-22
Schedule of Findings and Responses	23-24
Rural Development Compliance Letter	25-26

To the Commissioners of the
Gallatin County Water District
Sparta, Kentucky 41086

INDEPENDENT AUDITORS' REPORT

We have audited the accompanying financial statements of Gallatin County Water District as of and for the years ended December 31, 2011 and 2010, as listed in the table of contents. These financial statements are the responsibility of Gallatin County Water District's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Gallatin County Water District as of December 31, 2011 and 2010, and the changes in financial position, and cash flows thereof for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued our report dated March 6, 2012, on our consideration of the Gallatin County Water District's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on 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.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 2 through 5 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Raisor, Zapp & Woods, PSC

RAISOR, ZAPP & WOODS, PSC
Certified Public Accountants

March 6, 2012

**GALLATIN COUNTY WATER DISTRICT
MANAGEMENT'S DISCUSSION AND ANALYSIS
December 31, 2011**

Our discussion and analysis of the Gallatin County Water District's financial performance provides an overview of the District's financial activities for the year ended December 31, 2011. Please read it in conjunction with the District's financial statements, which begin on page 6.

REQUIRED FINANCIAL STATEMENTS

The financial statements of the District report information about the District's use of accounting methods which are similar to those used by private sector companies. These statements offer short and long-term financial information about its activities.

The balance sheet includes all of the District's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and obligations to District creditors (liabilities). It also provides the basis for evaluating the capital of the District and assessing its liquidity and financial flexibility.

All of the current year's revenues and expenses are accounted for in the statement of revenues, expenses, and changes in net assets. This statement measures the success of the District's operations over the past year and can be used to determine whether the District has successfully recovered all its costs through its water rates and other fees.

The final required financial statement is its statement of cash flows. The primary purpose of this statement is to provide information about the District's cash receipts and cash payments during the reported period. The statement reports cash receipts, cash payments, and net changes in cash resulting from operations, investing, and financing activities, and the change in cash during the reporting period.

The notes to the financial statements provide required disclosures and other information that are essential to a full understanding of material data provided in the statements. The notes present information about the District's accounting policies, significant account balances and activities, material risks, obligations, commitments, contingencies and subsequent events, if any.

FINANCIAL HIGHLIGHTS

The following are key financial highlights:

- Total assets at year-end were \$7,842,163 and exceeded liabilities in the amount of \$3,931,164 (i.e. net assets). Of the total net assets, \$941,277 was unrestricted and was available to support short-term operations. Total net assets decreased from year end 2010 to 2011 in the amount of \$120,254.
- Water charges increased \$29,251 during the year.
- Operating expenses increased by \$15,244, attributable mainly to an increase in utilities- pumping, retirement expenses and increased sampling requirements.
- The District was in compliance with all debt covenants required by borrowing agreements.

Balance Sheet, Statement of Net Assets

Utility Plant decreased by \$254,651, net of depreciation, in 2011. (See diagram below.)

**GALLATIN COUNTY WATER DISTRICT
MANAGEMENT'S DISCUSSION AND ANALYSIS
December 31, 2011**

Condensed Assets

	<u>2011</u>	<u>2010</u>	<u>Difference</u>
Utility Plant	\$ 6,458,648	\$ 6,713,299	\$ (254,651)
Current Assets	780,435	768,373	12,062
Other Non-current Assets	603,080	566,719	36,361
Total Net Assets	<u>\$ 7,842,163</u>	<u>\$ 8,048,391</u>	<u>\$ (206,228)</u>

At the end of December 31, 2011, the District had \$6,458,648 invested in capital assets (net of depreciation) including buildings, equipment, and water lines. (See table below.)

	<u>2011</u>	<u>2010</u>
Land & Rights	\$ 226,229	\$ 226,229
Structures & Improvements	266,479	275,451
Distribution System	5,605,618	5,860,988
Wells	264,914	273,257
Machinery & Equipment	78,441	77,374
Construction in Process	<u>16,967</u>	<u>-</u>
Totals	<u>\$ 6,458,648</u>	<u>\$ 6,713,299</u>

This year's major additions included:

- Distribution system improvements included pump upgrades to increase pumping capacity.
- Distribution system additions included the installation of four new fire protection hydrants.

Long-term debt decreased by normal principal payments made during the year. The decrease in current and accrued liabilities is attributed to the decrease in obligations due on capital projects at December 31, 2011.

Condensed Liabilities

	<u>2011</u>	<u>2010</u>	<u>Difference</u>
Long Term Debt	\$ 3,721,515	\$ 3,802,680	\$ (81,165)
Current & Accrued Liabilities	189,484	194,293	(4,809)
Total Liabilities	<u>\$ 3,910,999</u>	<u>\$ 3,996,973</u>	<u>\$ (85,974)</u>

**GALLATIN COUNTY WATER DISTRICT
MANAGEMENT'S DISCUSSION AND ANALYSIS
December 31, 2011**

Net Assets

At December 31, 2011, net assets decreased \$120,254, as a result of contributions in aid of construction of \$12,190 offset by the District's loss from operations (before contributions) of \$132,444..

Condensed Net Assets

	<u>2011</u>	<u>2010</u>	<u>Difference</u>
Invested in Capital Assets, Net of Related Debt	\$ 2,716,436	\$ 2,893,694	\$ (177,258)
Restricted for Capital Projects	-	20,000	(20,000)
Restricted for Debt Service	273,451	250,518	22,933
Unrestricted	941,277	887,206	54,071
Total	<u><u>\$ 3,931,164</u></u>	<u><u>\$ 4,051,418</u></u>	<u><u>\$ (120,254)</u></u>

Income Statement

Operating Revenues for 2011 increased by \$38,366 (1%). Operating expenses increased in 2011 due mainly to increases in utilities-pumping, required sampling requirements, retirement expenses and professional services. Depreciation also decreased.

Condensed Statement of Revenues and Expenses

	<u>2011</u>	<u>2010</u>	<u>Difference</u>
Operating Revenues	\$ 924,385	\$ 886,019	\$ 38,366
Operating Expenses	914,587	899,343	(15,244)
Net-Operating Revenue	\$ 9,798	\$ (13,324)	\$ 23,122
Non-Operating Income (Expenses)	(142,242)	(141,297)	(945)
Net Income Before Contributions	<u><u>\$ (132,444)</u></u>	<u><u>\$ (154,621)</u></u>	<u><u>\$ 22,177</u></u>

Statement of Cash Flows

Cash from Operating Activities was down \$16,316 in 2011. Cash from capital and related financing activities in 2011 reflect grant monies received and used to finance capital improvements equipment. Cash used in investing activities reflects the District's investment in additional certificates of deposit. Cash is consistent with expectations for the year.

Condensed Statement of Cash Flows

Cash from Operating Activities	\$ 319,283	\$ 335,599	\$ (16,316)
Cash from Capital & Related Financing Activities	(297,304)	(266,229)	(31,075)
Cash from Investing Activities	(97,486)	(147,564)	50,078
Change in Cash	\$ (75,507)	\$ (78,194)	\$ 2,687
Cash Balance, Beginning of Year	657,296	735,490	(78,194)
Cash Balance, End of Year	<u><u>\$ 581,789</u></u>	<u><u>\$ 657,296</u></u>	<u><u>\$ (75,507)</u></u>

**GALLATIN COUNTY WATER DISTRICT
MANAGEMENT'S DISCUSSION AND ANALYSIS
December 31, 2011**

Debt

At year-end, the District had \$3,783,820 in notes payable and bonds payable compared to \$3,862,643 last year as shown below. The decrease is attributable to the payment of scheduled principal and interest payments.

	<u>2011</u>	<u>2010</u>
Notes Payable	\$ 516,320	\$ 539,443
Bonds Payable	<u>3,267,500</u>	<u>3,323,200</u>
Totals	<u>\$ 3,783,820</u>	<u>\$ 3,862,643</u>

ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS AND RATES

The District anticipates some minor system upgrades in 2012.

The District anticipates operating income in 2012 to increase in accordance with pending rate case approval.

CONTACTING THE DISTRICT'S FINANCIAL MANAGEMENT

This financial report is designed to provide our customers and creditors with a general overview of the District's finances and to show the District's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the District's office at 4500 Highway 455, Sparta, KY 41086.

Tammy Hendren
Office Manager

GALLATIN COUNTY WATER DISTRICT
STATEMENT OF NET ASSETS
December 31, 2011 and 2010

	2011	2010
ASSETS		
Current Assets:		
Cash, Including Time Deposits	\$ 630,802	\$ 633,400
Accounts Receivable Trade (Net)	104,009	98,346
Interest Receivable	2,567	2,513
Inventory	33,491	24,382
Prepaid Expense	9,566	9,732
Total Current Assets	\$ 780,435	\$ 768,373
Noncurrent Assets:		
Restricted Assets:		
Cash, Including Time Deposits	\$ 560,919	\$ 523,146
Interest Receivable	553	535
Bond Issuance Costs, (Net)	41,608	43,038
Capital Assets (Net)	6,458,648	6,713,299
Total Noncurrent Assets	\$ 7,061,728	\$ 7,280,018
Total Assets	\$ 7,842,163	\$ 8,048,391
LIABILITIES		
Current Liabilities:		
Accounts Payable	\$ 15,062	\$ 11,195
Accrued Wages	4,846	4,331
Accrued Compensated Absences	-	9,936
Accrued Payroll Taxes/Employee Withholding	11,817	12,630
Utility Tax Payable	2,151	2,008
Sales Tax Payable	678	335
Current Liabilities Payable from Restricted Assets:		
Accrued Interest Payable	73,705	75,035
Revenue Bonds Payable	57,800	55,700
Note Payable - Kentucky Infrastructure Authority	23,425	23,123
Total Current Liabilities	\$ 189,484	\$ 194,293
Noncurrent Liabilities:		
Revenue Bonds Payable	\$ 3,209,700	\$ 3,267,500
Note Payable - Kentucky Infrastructure Authority	492,895	516,320
Escrow - Customer Construction Deposits	350	350
Noncurrent Liabilities Payable from Restricted Assets:		
Customer Deposits Payable	18,570	18,510
Total Noncurrent Liabilities	\$ 3,721,515	\$ 3,802,680
Total Liabilities	\$ 3,910,999	\$ 3,996,973
NET ASSETS		
Invested in Capital Assets, Net of Related Debt	\$ 2,716,436	\$ 2,893,694
Restricted for Capital Projects	-	20,000
Restricted for Debt Service	273,451	250,518
Unrestricted	941,277	887,206
Total Net Assets	\$ 3,931,164	\$ 4,051,418

GALLATIN COUNTY WATER DISTRICT
 STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN FUND NET ASSETS
 For the Years Ended December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Operating Revenues:		
Charges for Services:		
Water Charges (Net of Estimated Bad Debts)	\$ 860,024	\$ 830,773
Total Charges for Services	<u>\$ 860,024</u>	<u>\$ 830,773</u>
Other Charges and Miscellaneous:		
Billing Service Charges	\$ 41,324	\$ 31,820
Reconnect and Disconnect Charges	20,582	21,160
Miscellaneous	2,455	2,266
Total Other Charges and Miscellaneous	<u>\$ 64,361</u>	<u>\$ 55,246</u>
Total Operating Revenues	<u>\$ 924,385</u>	<u>\$ 886,019</u>
Operating Expenses:		
Bank Charges	\$ 4,448	\$ 7,027
Commissioner Fees	6,300	5,800
Contractual Service - Sampling	14,961	3,480
Dues	1,003	1,228
Health Insurance	69,984	74,141
Insurance	20,150	22,469
Labor	211,709	217,728
Maintenance of Mains	37,507	38,656
Office Supplies and Expense	29,672	22,495
Other Interest Expense	169	177
Payroll Taxes	16,223	15,567
Professional Services	17,914	13,737
Purchased Water	8,307	7,073
Regulatory Fees	1,370	1,385
Retirement Expense	39,402	35,869
Travel/Transportation Expense	20,885	18,461
Uniforms	1,835	1,845
Utilities - Office	11,021	11,476
Utilities - Pumping	68,036	57,128
Depreciation Expense	333,691	343,601
Total Operating Expenses	<u>\$ 914,587</u>	<u>\$ 899,343</u>
Net Operating Income (Loss)	<u>\$ 9,798</u>	<u>\$ (13,324)</u>
Nonoperating Revenue (Expense):		
Investment Income	\$ 13,268	\$ 10,158
Interest Expense	(154,079)	(157,027)
Amortization of Bond Issuance Costs	(1,431)	(1,428)
Gain (Loss) on Equipment Sold/Abandoned	-	7,000
Total Nonoperating Revenues (Expense)	<u>\$ (142,242)</u>	<u>\$ (141,297)</u>
Net Income (Loss) Before Contributions	<u>\$ (132,444)</u>	<u>\$ (154,621)</u>
Capital Contributions	<u>12,190</u>	<u>27,950</u>
Net Income	<u>\$ (120,254)</u>	<u>\$ (126,671)</u>
Net Assets--Beginning of Year	<u>4,051,418</u>	<u>4,178,089</u>
Net Assets--End of Year	<u>\$ 3,931,164</u>	<u>\$ 4,051,418</u>

**GALLATIN COUNTY WATER DISTRICT
STATEMENT OF CASH FLOWS**
For the Years Ended December 31, 2011 and 2010

	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from Customers	\$ 919,268	\$ 885,362
Payments to Suppliers	(54,670)	(41,909)
Payments to Employees	(227,430)	(221,827)
Other Receipts (Payments)	(317,885)	(286,027)
Net Cash Provided (Used) by Operating Activities	\$ 319,283	\$ 335,599
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Capital Contributions	\$ 12,190	\$ 7,950
Fiscal Court Capital Contribution	-	20,000
Purchases of Capital Assets	(75,262)	(66,373)
Proceeds from Sales of Assets	-	7,000
Principal Paid on Capital Debt	(78,823)	(76,526)
Interest Paid on Capital Debt (including capitalized interest)	(155,409)	(158,280)
Net Cash Provided (Used) by Capital and Related Financing Activities	\$ (297,304)	\$ (266,229)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of Investments	\$ (110,682)	\$ (158,271)
Interest on Investments	13,196	10,707
Net Cash Provided (Used) by Investing Activities	\$ (97,486)	\$ (147,564)
Net Increase (Decrease) in Cash and Cash Equivalents	\$ (75,507)	\$ (78,194)
Balances-Beginning of the Year	657,296	735,490
Balances-End of the Year	\$ 581,789	\$ 657,296

	Balances Per December 31, 2011 Statement of Net Assets	Balances Per December 31, 2011 Statement of Cash Flows
Cash	\$ 93,388	\$ 93,388
Time Deposits	537,414	-
Restricted Cash	488,401	488,401
Restricted Time Deposits	72,518	-
Total Cash and Cash Equivalents, End of Year	\$ 1,191,721	\$ 581,789
	Balances Per December 31, 2010 Statement of Net Assets	Balances Per December 31, 2010 Statement of Cash Flows
Cash	\$ 205,106	\$ 205,106
Time Deposits	428,294	-
Restricted Cash	452,190	452,190
Restricted Time Deposits	70,956	-
Total Cash and Cash Equivalents, End of Year	\$ 1,156,546	\$ 657,296

(Continued)

**GALLATIN COUNTY WATER DISTRICT
STATEMENT OF CASH FLOWS
For the Years Ended December 31, 2011 and 2010**

	2011	2010
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES		
Operating Income (Loss)	\$ 9,798	\$ (13,324)
Adjustments to Reconcile Operating Income to Net Cash Provided (Used) by Operating Activities:		
Cash Flows Reported in Other Categories:		
Depreciation Expense	333,692	343,601
Change in Assets and Liabilities:		
Receivables, Net	(5,663)	(1,170)
Accounts Receivable - Other	-	207
Inventories	(9,109)	2,006
Prepaid Expenses	166	2,030
Accounts and Other Payables	87	(216)
Accrued Expenses	(9,748)	2,137
Customer Meter Deposits Payable	60	328
Net Cash Provided by Operating Activities	\$ 319,283	\$ 335,599

SCHEDULE OF NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

At December 31, 2011 and 2010, Gallatin County Water District had not incurred any noncash transactions.

GALLATIN COUNTY WATER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS
December 31, 2011 and 2010

NOTE 1 – DESCRIPTION OF ENTITY AND SIGNIFICANT ACCOUNTING POLICIES

The Gallatin County Water District is a rural water company serving approximately 1,890 customers in Gallatin, Grant and Boone Counties of Kentucky, and regulated by the Public Service Commission of the Commonwealth of Kentucky. The Water District was formed under the laws of Gallatin County in September 1960 through the Fiscal Court (reaffirmed in 1985) and began operations in July 1989.

In evaluating how to define Gallatin County Water District for financial reporting purposes, management has considered all potential component units. The decision to include a potential component unit in the reporting entity was made by applying the criteria set forth in GAAP. The basic -- but not the only -- criterion for including a potential component unit within the reporting entity is the governing body's ability to exercise oversight responsibility. The most significant manifestation of this ability is financial interdependency. Other manifestations of the ability to exercise oversight responsibility include, but are not limited to, the selection of governing authority, the designation of management, the ability to significantly influence operations and accountability for fiscal matters. The other criterion used to evaluate potential component units for inclusion or exclusion from the reporting entity is the existence of special financing relationships, regardless of whether the District is able to exercise oversight responsibilities. Based upon the application of these criteria, the District has no component units.

A summary of the District's significant accounting policies follows:

Basis of presentation and accounting: As stated in Kentucky Revised Statutes (KRS) 278.015, "any water district shall be a public utility and shall be subject to the jurisdiction of the Public Service Commission." In KRS 278.220, it is outlined that the Public Service Commission may establish a system of accounts to be kept by the utilities subject to its jurisdiction, and may prescribe the manner in which such accounts shall be kept. The financial statements of the District are prepared in accordance with generally accepted accounting principles (GAAP). The District applies all relevant Governmental Accounting Standards Board (GASB) pronouncements and applicable Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless they conflict with GASB pronouncements.

All activities of the District are accounted for within a single proprietary (enterprise) fund. Proprietary funds are used to account for operations that are (a) financed and operated in a manner similar to private business enterprises where the intent of the governing body is that the cost (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges; or (b) where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

Proprietary funds utilize the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recorded when the liability is incurred or economic asset used.

The accounting and financial reporting treatment applied to the District is determined by its measurement focus. The transactions of the District are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities associated with the operations are included on the statement of net assets. Net assets (i.e., total assets net of total liabilities) are segregated into invested in capital assets, net of related debt; restricted; and unrestricted components.

Revenues and expenses: Operating revenues and expenses consist of those revenues and expenses that result from the ongoing principal operations of the District. Operating revenues consist primarily of charges for services. Non-operating revenues and expenses consist of those revenues and expenses that are related to financing and investing types of activities and result from nonexchange transactions or ancillary activities.

The District adheres to the use restrictions established by Bond Agreements when expenses are incurred for which both restricted and unrestricted net assets are available. The District has no policy defining which resources (restricted or unrestricted) to use first.

GALLATIN COUNTY WATER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)
December 31, 2011 and 2010

NOTE 1 – DESCRIPTION OF ENTITY AND SIGNIFICANT ACCOUNTING POLICIES (Continued)

Property and equipment: Property and equipment purchased or constructed is stated at cost. Interest related to costs, and major improvements, renewals and replacements is capitalized as a cost of the project. Costs associated with hook-up fees are capitalized as meters, installations, and services. Depreciation is computed on the straight-line basis over the estimated useful lives of the related assets. The range of estimated useful lives by type of asset is as follows:

- Structures & Improvements	40 years
- Distribution System	30-50 years
- Wells	35 years
- Machinery & Equipment	5-20 years

Inventory: Inventories are stated at latest cost.

Compensated Absences: See Note 9 for the District's policy on vacation and personal days.

Income Taxes: The Gallatin County Water District is not subject to income taxes.

Contributed capital: Under the Governmental Accounting Standards Board's (GASB) Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, the District recognizes capital contributions as revenues in the statement of revenues, expenses and changes in fund net assets. No grant monies were received in the years ended December 31, 2011 and 2010. Tap-on fees of \$12,190 and \$7,950 were received by the District for the years ended December 31, 2011 and 2010. In 2010 the Gallatin County Fiscal Court contributed \$20,000 for hydrant installations.

Net assets: Net assets comprise the various net earnings from operating and non-operating revenues, expenses and contributions of capital. Net assets are classified in the following three components: invested in capital assets, net of related debt; restricted; and unrestricted net assets. Invested in capital assets, net of related debt, consists of all capital assets, net of accumulated depreciation and reduced by outstanding debt that is attributable to the acquisition, construction and improvement of those assets; debt related to unspent proceeds or other restricted cash and investments is excluded from the determination. Restricted net assets consists of net assets for which constraints are placed thereon by external parties, such as lenders, grantors, contributors, laws, regulations and enabling legislation, including self-imposed legal mandates. Unrestricted net assets consist of all other net assets not included in the above categories.

Estimates: The preparation of financial statements 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.

Statement of Cash Flows: For the purpose of the Statement of Cash Flows, Gallatin County Water District considers all highly liquid investments (including restricted assets) with a maturity of three months or less when purchased to be cash equivalents.

NOTE 2 – DEBT RESTRICTIONS AND COVENANTS

The Bond and Interest Sinking Account was established with the original RECD bond issue, and is to be continued to be maintained as long as any of the 1988, 1993, 1996, 2000, 2002 or 2006 issues are outstanding. Under the bond resolution which established this account, it was provided that a minimum balance be maintained in this account as security to the bondholders. In order to attain the minimum balance, a monthly transfer must be made as follows:

	one sixth (1/6) of the next semiannual interest payment
+	<u>one twelfth (1/12) of next annual principal payment</u>
=	monthly transfer

GALLATIN COUNTY WATER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)
December 31, 2011 and 2010

NOTE 2 – DEBT RESTRICTIONS AND COVENANTS (Continued)

Transfers sufficient to meet the total obligation outstanding on all issues were made timely during the years ended December 31, 2011 and 2010.

A funded depreciation reserve account was required in accordance with the original RECD Bond issue and was continued with the District's subsequent issues. The cumulative requirement of these issues was a monthly transfer of \$547 into this account until the balance accumulated to \$71,600. The 2000 Bond Resolution required \$240 to be deposited monthly to the depreciation reserve account as long as any bonds payable remain outstanding, until an additional \$28,800 is accumulated. The 2002 Bond Resolution requires an additional transfer of \$65 per month until \$7,800 (additional) is accumulated. The 2006 Bond Resolution requires an additional transfer of \$865 per month until an additional \$103,800 is accumulated in the reserve. This additional transfer began in January, 2008. The deposits must be resumed any time the account(s) fall below the balance indicated.

A funded Maintenance and Replacement Reserve is required by the District's Assistance Agreement (B99-02) with the Kentucky Infrastructure Authority. Under the agreement, the District must deposit into this account an amount equal to 10% of the amount of the loan payment until the amount accumulated on deposit is equal to 5% of the original principal amount of the loan. Assuming all payments are made as required, the account will be fully funded in June, 2013.

Transfers were made as required in 2011 and 2010.

A funded short lived asset account is required under the letter of conditions establishing funding for the 2006 system improvement project. Under this agreement, the District must deposit \$5,535 monthly into the account. This account may be used as needed to replace or add short lived assets in the District's water system. Transfers began in January, 2008. During 2011, \$31,664 was used to finance the acquisition of a new service vehicle and line improvements on Highway 127.

NOTE 3 – CASH AND INVESTMENTS

KRS 66.480 authorizes the District to invest in obligations of the United States and its agencies and instrumentalities including repurchase agreements, through sources including national and state banks chartered in Kentucky, obligations and contracts for future delivery backed by the full faith of the United States or its Agency, certificates of deposit and interest bearing accounts in institutions insured by the Federal Depository Insurance Corporation and other investments described therein provided that approved securities are pledged to secure those funds on deposit in an amount equal to the amount of those funds. The District may also invest in mutual funds meeting the requirements of the statute.

Gallatin County Water District's policies regarding deposits of cash are discussed above. The table presented below is designed to disclose the level of custody credit risk assumed by the District based upon how its deposits were insured or secured with collateral at December 31, 2011 and 2010. The categories of credit risk are defined as follows:

Category 1 – Insured by FDIC Insurance or collateralized with a depository surety bond or securities held by the District (public trust) or by its agent in its name.

Category 2 – Uninsured but collateralized with securities held by the pledging financial institution's trust department or agent in the District's name.

Category 3 – Uninsured and uncollateralized; or collateralized with securities held by the pledging financial institution, or by its trust department or agent but not in the District's name; or collateralized with no written or approved collateral agreement.

GALLATIN COUNTY WATER DISTRICT
 NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)
 December 31, 2011 and 2010

NOTE 3 – CASH AND INVESTMENTS (Continued)

December 31, 2011

Type of Deposits	Total Bank Balance	Custody Credit Risk Category			Total Carrying Value
		1	2	3	
Demand Deposits	\$ 101,972	\$ 101,972	\$ -	\$ -	\$ 93,318
Time and Savings Deposits	1,098,333	917,860	180,473	-	1,098,333
Total Deposits	\$ 1,200,305	\$ 1,019,832	\$ 180,473	\$ -	\$ 1,191,651

December 31, 2010

Type of Deposits	Total Bank Balance	Custody Credit Risk Category			Total Carrying Value
		1	2	3	
Demand Deposits	\$ 224,580	\$ 224,580	\$ -	\$ -	\$ 225,036
Time and Savings Deposits	931,440	881,088	50,352	-	931,440
Total Deposits	\$ 1,156,020	\$ 1,105,668	\$ 50,352	\$ -	\$ 1,156,476

Reconciliation to Statement of Net Assets:

	December 31, 2011	December 31, 2010
Unrestricted Cash	\$ 630,802	\$ 633,400
Restricted Cash, Including Time Deposits	560,919	523,146
Less Cash on Hand	(70)	(70)
	<u>\$ 1,191,651</u>	<u>\$ 1,156,476</u>

NOTE 4 – RESTRICTED ASSETS

Restricted cash and investments consist of the following:

	December 31, 2011	December 31, 2010
Bond and Interest Sinking Account	\$ 132,860	\$ 131,088
Depreciation Account	175,519	159,197
Customer Deposits	23,285	22,737
Speedway Maintenance and Replacement Reserve	38,224	34,733
Short Lived Assets Account	191,031	155,391
Hydrant Construction	-	20,000
Total	<u>\$ 560,919</u>	<u>\$ 523,146</u>

Restricted receivables consist of the following:

	December 31, 2011	December 31, 2010
Interest Receivable	\$ 553	\$ 535
Total	<u>\$ 553</u>	<u>\$ 535</u>

NOTE 5 – CUSTOMER ACCOUNTS RECEIVABLE

Customer Accounts Receivable has been netted with an Allowance for Bad Debts of \$15,863 and \$11,750 at December 31, 2011 and 2010, respectively. The amount provided for bad debts represents the portion of the total amounts for which collection is unlikely, based on historical collection data.

GALLATIN COUNTY WATER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)
December 31, 2011 and 2010

NOTE 6 – CAPITAL ASSETS

Capital asset activity for the years ended December 31, 2011 and 2010, was as follows:

	Balance at January 1, 2011	Additions	Disposals	Balance at December 31, 2011
Land & Land Rights	\$ 226,229	\$ -	\$ -	\$ 226,229
Organizational Fees	31,926	-	-	31,926
Structures & Improvements	344,910	-	-	344,910
Distribution System	8,429,375	33,384	-	8,462,759
Wells	366,887	5,300	-	372,187
Machinery & Equipment	262,931	23,389	-	286,320
Construction in Process	-	16,967	-	16,967
Totals at Historical Cost	\$ 9,662,258	\$ 79,040	\$ -	\$ 9,741,298
Less: Accumulated Depreciation				
Organizational Fees	\$ (31,926)	\$ -	\$ -	\$ (31,926)
Structures & Improvements	(69,459)	(8,972)	-	(78,431)
Distribution System	(2,568,387)	(288,754)	-	(2,857,141)
Wells	(93,630)	(13,643)	-	(107,273)
Machinery & Equipment	(185,557)	(22,322)	-	(207,879)
Total Accumulated Depreciation	\$ (2,948,959)	\$ (333,691)	\$ -	\$ (3,282,650)
Capital Assets, Net	\$ 6,713,299	\$ (254,651)	\$ -	\$ 6,458,648

	Balance at January 1, 2010	Additions	Disposals	Balance at December 31, 2010
Land & Land Rights	\$ 226,229	\$ -	\$ -	\$ 226,229
Organizational Fees	31,926	-	-	31,926
Structures & Improvements	344,910	-	-	344,910
Distribution System	8,363,002	66,373	-	8,429,375
Wells	366,887	-	-	366,887
Machinery & Equipment	283,186	-	(20,255)	262,931
Totals at Historical Cost	\$ 9,616,140	\$ 66,373	\$ (20,255)	\$ 9,662,258
Less: Accumulated Depreciation				
Organizational Fees	\$ (31,926)	\$ -	\$ -	\$ (31,926)
Structures & Improvements	(60,486)	(8,973)	-	(69,459)
Distribution System	(2,272,669)	(295,718)	-	(2,568,387)
Wells	(80,252)	(13,378)	-	(93,630)
Machinery & Equipment	(180,280)	(25,532)	20,255	(185,557)
Total Accumulated Depreciation	\$ (2,625,613)	\$ (343,601)	\$ 20,255	\$ (2,948,959)
Capital Assets, Net	\$ 6,990,527	\$ (277,228)	\$ -	\$ 6,713,299

Land and land rights are capital assets not being depreciated. Included under the District's Plant Assets were \$327,936 and \$273,959 of fully depreciated assets, at December 31, 2011 and 2010, respectively.

Depreciation expense aggregated \$333,691 and \$343,601 in 2011 and 2010, respectively.

GALLATIN COUNTY WATER DISTRICT
 NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)
 December 31, 2011 and 2010

NOTE 7 – CUSTOMER DEPOSITS/ESCROW

Customer deposits are collected upon installation of water service. This amount is to be refunded to the customer upon discontinuation of service (after the customer's bill has been paid in full) or one year pending a satisfactory payment record. Deposits received from customers are held in an interest bearing account (which is included in the financial statements as restricted cash). Records are maintained which detail the accrued interest on each customer's deposit based on the current annual rate. Accrued interest is paid annually and when the deposit is refunded.

Customer construction deposits represent amounts collected for hookups on future line extensions.

NOTE 8 – LONG-TERM DEBT

As of December 31, 2011 and 2010, the long-term debt payable consisted of the following:

Notes Payable:

	December 31, 2011	December 31, 2010
Kentucky Infrastructure Authority note payable represents a thirty year loan secured by water revenues. Interest is charged at 1.3% per annum. The original principal balance was \$744,796. Payments of principal, interest, and servicing fees are due semiannually.	\$ 516,320	\$ 539,443
Total Notes Payable	\$ 516,320	\$ 539,443
Current Portion	\$ 23,425	\$ 23,123
Noncurrent Portion	492,895	516,320
Total Notes Payable	\$ 516,320	\$ 539,443

Bonds Payable:

RECD Revenue Bonds of 1988 Series A, original issue amount of \$290,000, secured by water revenues. Interest is charged at the rate of 5.0% per annum. Final maturity is January 1, 2028.	\$ 194,000	\$ 201,000
RECD Revenue Bonds of 1988 Series B, original issue amount of \$108,000, secured by water revenues. Interest is charged at the rate of 5.0% per annum. Final maturity is January 1, 2028.	74,000	77,000
RECD Revenue Bonds of 1993, original issue amount of \$420,000, secured by water revenues. Interest is charged at the rate of 5.0% per annum. Final maturity is January 1, 2032.	318,000	327,000
RECD Revenue Bonds of 1996, original issue amount of \$371,000, secured by water revenues. Interest is charged at the rate of 4.875% per annum. Final maturity is January 1, 2035.	306,100	312,400

GALLATIN COUNTY WATER DISTRICT
 NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)
 December 31, 2011 and 2010

NOTE 8 – LONG-TERM DEBT (Continued)

Bonds Payable: (Continued)

	December 31, 2011	December 31, 2010
RECD Revenue Bonds of 2000 Series A, original issue amount of \$370,000, secured by water revenues. Interest is charged at the rate of 4.875% per annum. Final maturity is January 1, 2039.	325,800	331,200
RECD Revenue Bonds of 2000 Series B, original issue amount of \$112,000, secured by water revenues. Interest is charged at the rate of 5.0% per annum. Final maturity is January 1, 2039.	99,200	100,800
RECD Revenue Bonds of 2002, original issue amount of \$130,000, secured by water revenues. Interest is charged at the rate of 4.625% per annum. Final maturity is January 1, 2042.	119,700	121,400
RECD Revenue Bonds of 2006, Series A, original issue amount of \$1,394,000, secured by water revenues. Interest is charged at the rate of 4.125% per annum. Final maturity is January 1, 2046.	1,347,000	1,363,000
RECD Revenue Bonds of 2006, Series B original issue amount of \$500,000, secured by water revenues. Interest is charged at the rate of 4.125% per annum. Final maturity is January 1, 2046.	483,700	489,400
Total Bonds Payable	\$ 3,267,500	\$ 3,323,200
Current Portion	\$ 57,800	\$ 55,700
Noncurrent Portion	3,209,700	3,267,500
Total Bonds Payable	\$ 3,267,500	\$ 3,323,200

Accrued Compensated Absences:

Current Accrued Compensated Absences	\$ -	\$ 9,936
--------------------------------------	------	----------

Changes in Long-term Debt

The following is a summary of changes in long-term debt for the years ended December 31, 2011 and 2010.

December 31, 2011

	Balance at January 1, 2011	Additions	Repayments	Balance at December 31, 2011	Current Portion
Notes Payable	\$ 539,443	\$ -	\$ (23,123)	\$ 516,320	\$ 23,425
Bonds Payable	3,323,200	-	(55,700)	3,267,500	57,800
Accrued Compensated Absences	9,936	-	(9,936)	-	-
Total Enterprise Fund Debt	\$ 3,872,579	\$ -	\$ (88,759)	\$ 3,783,820	\$ 81,225

**GALLATIN COUNTY WATER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)
December 31, 2011 and 2010**

NOTE 8 – LONG-TERM DEBT (Continued)

December 31, 2010

	Balance at January 1, 2010	Additions	Repayments	Balance at December 31, 2010	Current Portion
Notes Payable	\$ 562,269	\$ -	\$ (22,826)	\$ 539,443	\$ 23,123
Bonds Payable	3,376,900	-	(53,700)	3,323,200	55,700
Accrued Compensated Absences	8,640	1,296	-	9,936	9,936
Total Enterprise Fund Debt	\$ 3,947,809	\$ 1,296	\$ (76,526)	\$ 3,872,579	\$ 88,759

The annual requirements for all long-term debt outstanding at December 31, 2011, are as follows:

Due	Bonds	Bond Interest	KIA Note	Note Interest	Note Servicing Fee	Total Payments Due
2012	\$ 57,800	\$ 143,450	\$ 23,425	\$ 6,636	\$ 1,021	\$ 232,332
2013	60,800	140,645	23,730	6,331	974	232,480
2014	63,900	137,698	24,040	6,021	926	232,585
2015	66,100	134,644	24,353	5,708	878	231,683
2016	69,400	131,438	24,671	5,390	829	231,728
2017-2021	403,900	602,840	128,267	22,039	3,391	1,160,437
2022-2026	509,400	495,280	136,852	13,454	2,070	1,157,056
2027-2031	569,600	366,314	130,982	4,294	661	1,071,851
2032-2036	529,000	242,139	-	-	-	771,139
2037-2041	476,600	133,838	-	-	-	610,438
2042-2046	461,000	38,998	-	-	-	499,998
	\$ 3,267,500	\$ 2,567,284	\$ 516,320	\$ 69,873	\$ 10,750	\$ 6,431,727

The annual requirements for all long-term debt outstanding at December 31, 2010, are as follows:

Due	Bonds	Bond Interest	KIA Note	Note Interest	Note Servicing Fee	Total Payments Due
2011	\$ 55,700	\$ 146,118	\$ 23,123	\$ 6,938	\$ 1,067	\$ 232,946
2012	57,800	143,450	23,425	6,636	1,021	232,332
2013	60,800	140,645	23,730	6,331	974	232,480
2014	63,900	137,698	24,040	6,021	926	232,585
2015	66,100	134,644	24,353	5,708	878	231,683
2016-2020	385,000	621,520	126,615	23,691	3,645	1,160,471
2021-2025	485,200	518,869	135,090	15,216	2,341	1,156,716
2026-2030	567,100	392,451	144,132	6,173	950	1,110,806
2031-2035	551,200	265,702	14,935	97	15	831,949
2036-2040	482,300	154,254	-	-	-	636,554
2041-2045	449,500	58,051	-	-	-	507,551
2046 and thereafter	98,600	-	-	-	-	98,600
	\$ 3,323,200	\$ 2,713,402	\$ 539,443	\$ 76,811	\$ 11,817	\$ 6,664,673

GALLATIN COUNTY WATER DISTRICT
 NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)
 December 31, 2011 and 2010

NOTE 9 – COMPENSATED ABSENCES

Vacation days accumulate as follows:

At the end of 1 st year	1 week of vacation
At the end of 2 nd year	2 weeks of vacation
At the end of 5 th year	3 weeks of vacation

Vacation, if not taken in the calendar year due, is lost, unless specifically approved by the Commissioners. In 2001, the District approved a policy under which employees accrue 5 days of personal leave per year. In 2009, the District approved a policy under which an employee may accumulate up to 60 days (previously it was 30 days) personal leave. The District accrues a liability for compensated absences, which meet the following criteria:

1. The District's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered.
2. The obligation relates to rights that vest or accumulate.
3. Payment of the compensation is probable.
4. The amount can be reasonably estimated.

In accordance with the above criteria, the District accrues a liability for compensated absences. No accrued compensated absences were payable at December 31, 2011. \$9,936 of compensated absences were accrued at December 31, 2010.

NOTE 10 – INTEREST EXPENSE

Interest expense incurred and charged to expense for the years ended December 31, 2011 and 2010 was \$154,248 and \$157,204, respectively. No interest was capitalized in 2011 or 2010.

NOTE 11 – FUND EQUITY – RESTRICTED NET ASSETS

	December 31, 2011	December 31, 2010
Restricted Capital Projects:		
Monies Restricted for Future Projects	\$ -	\$ 20,000
Total Restricted for Capital Projects	\$ -	\$ 20,000
Restricted for Debt Service:		
RECD Revenue Bonds of 1988, 1993, 1996, 2000, 2002 and 2006		
Kentucky Infrastructure Authority Note		
Cash	\$ 346,603	\$ 325,018
Add: Accrued Interest Receivable	553	535
Less: Accrued Interest Payable	(73,705)	(75,035)
Total Restricted for Debt Service	\$ 273,451	\$ 250,518

NOTE 12 – BAD DEBT EXPENSE

Water revenue charges have been netted with estimated bad debt expense of \$10,821 and \$10,267 at December 31, 2011 and 2010, respectively.

NOTE 13 – INSURANCE AND RELATED ACTIVITIES

The District is exposed to various forms of loss of assets associated with the risks of fire, personal liability, theft, vehicular accidents, errors and omissions, fiduciary responsibility, etc. Each of these risks is covered through the contributions, premiums and assessments to the Kentucky Association of All Lines Fund (KALF). The District is also subject to the risks associated with employee injury. These risks are covered through premiums paid to the Kentucky Association of Counties, Workers' Compensation Self-insurance Fund. Such coverage is retrospectively rated and premiums may be adjusted based on experience.

GALLATIN COUNTY WATER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)
December 31, 2011 and 2010

NOTE 14 – THE COUNTY EMPLOYEES’ RETIREMENT SYSTEM

Entry into the Commonwealth of Kentucky’s County Employees’ Retirement System (CERS) was authorized by the Commissioners in November 1999. Beginning December 1, 1999, electing employees and all new employees of the District may participate in the System. The most recent financial report on CERS is included in the Kentucky Retirement System’s annual report, June 30, 2011 and 2010. Copies of this report will be distributed to each participating employer in the Kentucky Employees Retirement System, County Employees Retirement System, and State Police Retirement System. Copies will also be available to Legislative personnel and state libraries.

Plan Description – CERS is a cost-sharing multiple-employer defined benefit pension plan that covers substantially all regular full-time members employed in non-hazardous duty positions of each participating county, city, and school board, and any additional eligible local agencies electing to participate in CERS. The plan provides for retirement, disability, and death benefits to plan members. Retirement benefits under the plan will vary based on final compensation, years of service and other factors as fully described in the plan documents. Retirement benefits may be extended to beneficiaries of plan members under circumstances. Cost-of-living (COLA) adjustments are provided at the discretion of the State legislature.

Contributions – For the years ended June 30, 2011, and 2010, plan members were required to contribute 5% of their annual creditable compensation. Participating employers were required to contribute at an actuarially determined rate. Per Kentucky Revised Statute Section 61.565 (3), normal contribution and past service contribution rates shall be determined by the Board of Trustees of the Kentucky Retirement Systems (Board) on the basis of an annual valuation last preceding the July 1 of a new biennium. The Board may amend contribution rates as of the first day of July of the second year of a biennium, if it is determined on the basis of a subsequent actuarial valuation that amended contribution rates are necessary to satisfy requirements determined in accordance with actuarial bases adopted by the Board. For the fiscal years ended June 30, 2011 and 2010, participating employers contributed 16.93% and 16.16% respectively, of each employee’s creditable compensation (17.93% and 17.16% for new members after September 1, 2008). The actuarially determined rates set by the Board for the fiscal years ended June 30, 2011 and 2010 were 16.93% and 20.91%, respectively. Administrative costs of Kentucky Retirement System are financed through employer contributions and investment earnings.

In accordance with House Bill 1, signed by the Governor on June 27, 2008, plan members who began participating on, or after, September 1, 2008, were required to contribute a total of 6% of their annual creditable compensation. Five percent of the contribution was deposited to the member’s account while the 1% was deposited to an account created under 26 USC Section 401(h) in the Pension Fund (see Kentucky Administrative Regulation 105 KAR 1:420E). Interest is paid each June 30 on members’ accounts at a rate of 2.5%. If a member terminates employment and applies to take a refund, the member is entitled to a full refund of contributions and interest; however, the 1% contribution to the 401(h) account is non-refundable and is forfeited. For plan members who began participating prior to September 1, 2008, their contributions remain at 5% of their annual creditable compensation.

The District’s total payroll for the year ended December 31, 2011, was \$235,633. Contributions were based on \$224,750 (eligible gross wages). The total pension expense for the fiscal year ended December 31, 2011, was \$40,438 and \$11,422 for the employer and employees, respectively. All contributions were made as required during the year ending December 31, 2011.

The District’s total payroll for the year ended December 31, 2010, was \$223,875. Contributions were based on \$218,075 (eligible gross wages). The total pension expense for the fiscal year ended December 31, 2010, was \$36,107 and \$10,904 for the employer and employees, respectively. All contributions were made as required during the year ending December 31, 2010.

The District’s contribution for the years ended June 30, 2011 and 2010, was .0104% and .0104%, respectively, of the System’s total contribution requirements for all employers.

GALLATIN COUNTY WATER DISTRICT
 NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)
 December 31, 2011 and 2010

NOTE 14 – THE COUNTY EMPLOYEES’ RETIREMENT SYSTEM

For non-hazardous duty, the required contributions to the plan were as follows:

	Annual Required Contributions	Actual Contributions	Retiree Drug Subsidy Contributions	Percentage Contributions
June 30, 2011	432,414,052	435,404,150	-	100.7%
June 30, 2010	453,055,709	373,682,939	9,156,991	84.5%
June 30, 2009	425,830,683	303,046,162	7,623,628	73.0%

The Kentucky Retirement Systems Insurance Fund (Fund) was established to provide hospital and medical insurance for members receiving benefits from CERS. The Fund pays a prescribed contribution for whole or partial payment of required premiums to purchase hospital and medical insurance for current beneficiaries.

NOTE 15 – RESALE AGREEMENT

The District has entered into a water resale agreement with the Kentucky American Water District under which agreement, Gallatin County Water District will sell its water to Kentucky American Water at a price of \$1.46 per thousand gallons. A minimum of 559,567 is required to be purchased monthly. The agreement is for a term of 20 years with automatic one year extensions unless terminated by either party upon written notice as specified. Rates may be modified by providing 180 days notice, or by regulatory authority action.

NOTE 16 - PURCHASED WATER CONTRACT

Gallatin County Water District has a long-term contract with the City of Warsaw for the purchase of treated water. The original contract for water became effective July 28, 1986, and extended for a period of forty-five (45) years. On June 13, 2007 the contract was amended. Under the agreement, Gallatin County Water District will be charged \$1.25 per 1,000 gallons purchased, with a minimum of 500,000 gallons to be purchased monthly. Additionally, the District agreed to transfer ownership of its 8” Smith Avenue line to the City.

NOTE 17 – WATER SUPPLY AGREEMENT – ECONOMIC DEPENDENCY

The District has entered into a water-supply agreement with Kentucky Speedway, LLC. Under the terms of the agreement, Kentucky Speedway, LLC is assessed an annual minimum charge of \$35,000 for annual usage up to 8,500,000 gallons. The Speedway is billed monthly the minimum installment plus sales tax and school tax. When accumulated usage exceeds the annual maximum, the Speedway is charged the current rates in effect for that usage. 10.0% and 4.4% of total water revenue was received from Kentucky Speedway, LLC for the years ended December 31, 2011 and 2010, respectively.

NOTE 18 – COMMITMENTS AND CONTINGENCIES

The District has motions before the Public Service Commission and Franklin and Gallatin Courts regarding its service area and the provision of services within that area.

The District has entered into contracts for relocation and/or improvements to its distribution system at Kentucky Speedway. The District is relocating and increasing the size of some of its lines and adding an extension along Kentucky 35. The District will be reimbursed for the costs associated with the relocation. The rest of the costs of these improvements will be paid with District funds.

The line upgrades and extension are estimated to cost \$95,017, of which \$7,419 will be reimbursed to the District by the Kentucky Transportation Cabinet.

To the Commissioners of the
Gallatin County Water District
Sparta, KY 41086

**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**

We have audited the financial statements of Gallatin County Water District, as of and for the year ended December 31, 2011, and have issued our report thereon dated March 6, 2012. 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 Gallatin County Water 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 Gallatin County Water District's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of Gallatin County Water 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 and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying schedule of findings and responses, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses.

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. We consider the deficiencies described in the accompanying schedule of findings and responses to be material weaknesses (Items 11-1 and 11-2).

COMPLIANCE AND OTHER MATTERS

As part of obtaining reasonable assurance about whether Gallatin County Water 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.

Commissioners of the
Gallatin County Water District
Page Two

We noted certain matters that we reported to management of Gallatin County Water District in a separate letter dated March 6, 2012.

Gallatin County Water District's response to the findings identified in our audit is described in the accompanying schedule of findings and responses. We did not audit Gallatin County Water District's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, the Rural Economic Community Development Service, Kentucky Infrastructure Authority, other lending agencies, and the Public Service Commission, and is not intended to be and should not be used by anyone other than these specified parties.

Raisor, Zapp & Woods, P.S.C.

RAISOR, ZAPP, & WOODS P.S.C
Certified Public Accountants

March 6, 2012

GALLATIN COUNTY WATER DISTRICT
SCHEDULE OF FINDINGS AND RESPONSES
For the Year Ended December 31, 2011

A. SUMMARY OF AUDIT RESULTS

1. The auditors' report expresses an unqualified opinion on the financial statements of the Gallatin County Water District.
2. Two deficiencies in internal control related to the audit of the financial statements are 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. Items 11-1 and 11-2 were reported as material weaknesses.
3. No instances of noncompliance material to the financial statements of Gallatin County Water District, which would be required to be reported in accordance with Government Auditing Standards, were disclosed during the audit.

B. FINDINGS – FINANCIAL STATEMENTS AUDIT

GOVERNMENT AUDITING STANDARDS

DEFICIENCIES IN INTERNAL CONTROL

11-1 SIZE OF ENTITY, CROSS-TRAINING AND CHECKING PROCEDURES

CONDITION:

Due to the size of the entity, cross-training and checking procedures are not in place for certain administrative positions. This limits internal control. This condition was also cited as a material weakness in the schedule of findings and responses for the year ended December 31, 2010 as 10-1.

CRITERIA:

Internal controls should be in place to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and allow timely preparation of financial data consistent with management assertions.

CAUSE:

Responsibilities associated with individual positions limit the availability of individuals to rotate duties and implement checking procedures.

EFFECT:

This limitation may affect the ability to timely record, process, summarize and report financial data.

RECOMMENDATION:

Management should strive to provide cross-training for administrative staff and implement checking processes.

RESPONSE:

We concur with the recommendation. Management believes adequate resources have been expended and control procedures implemented, that are commensurate with the staff size and responsibility of financial personnel.

**GALLATIN COUNTY WATER DISTRICT
SCHEDULE OF FINDINGS AND RESPONSES (Continued)
For the Year Ended December 31, 2011**

B. FINDINGS – FINANCIAL STATEMENTS AUDIT (Continued)

GOVERNMENT AUDITING STANDARDS (Continued)

DEFICIENCIES IN INTERNAL CONTROL (Continued)

11-2 FAILURE TO PREPARE COMPLETE SET OF FINANCIAL STATEMENTS INCLUDING REQUIRED NOTE DISCLOSURES

CONDITION:

District financial statements, including the required disclosures, are prepared as part of the annual audit. This condition was also cited as a material weakness in the schedule of findings and responses for the year ended December 31, 2010 as 10-2.

CRITERIA:

Internal controls should be in place to provide management with reasonable, but not absolute, assurance that financial statements and required notes are prepared in accordance with generally accepted accounting principles.

CAUSE:

The draft accrual basis financial statements and disclosures are prepared during the audit process. The entries are entered into the District's general ledger/financial reports.

EFFECT:

Management engaged the auditor to prepare the draft of the financial statements, including the related notes to the financial statements. Management reviewed, approved, and accepted responsibility for the financial statements prior to their issuance.

RECOMMENDATION:

District management should continue to enhance its knowledge of reporting requirements in providing oversight of this service.

RESPONSE:

The outsourcing of this service is a result of management's cost benefit decision to use others' accounting expertise rather than incur internal resource costs. We concur with the recommendation and will continue to improve our overall accounting knowledge in performing our oversight responsibilities.

COMPLIANCE AND OTHER MATTERS

NONE

To the Commissioners of the
Gallatin County Water District
Sparta, KY 41086

RURAL DEVELOPMENT COMPLIANCE LETTER

We have audited the financial statements of Gallatin County Water District as of December 31, 2011, and have issued our report thereon dated March 6, 2012. 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.

In planning and performing our audit of the financial statements of Gallatin County Water District for the year ended December 31, 2011, we considered its 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 Gallatin County Water District's internal control over financial reporting. After obtaining an understanding of the control environment and the flow of transactions through the accounting system, we did not rely on the system of internal accounting controls because of the size of the entity. Our review identified material weaknesses in the internal accounting control system as disclosed in the Schedule of Findings and Responses.

The following information is presented as supplemental information in accordance with USDA Rural Development's requirements.

1. The accounting records of Gallatin County Water District appear adequate.
2. Control over fixed assets is adequate. A supply inventory has been taken.
3. USDA Rural Development loan agreements for the 1988, 1993, 1996, 2000, 2002 and 2006 issues require transfers to be made monthly to the Bond and Interest Sinking Account and Depreciation Account. All accounts are properly funded as of December 31, 2011. Transfers required under the 2006 issues to the Depreciation Account and those required in the establishment of a short lived asset account began in January, 2008.
4. The general accounting records were kept on forms and in the manner suggested by Rural Development.
5. All bank accounts were confirmed directly by the depositories and reconciled to the cash balances as shown in these financial statements. The accounts are insured up to \$250,000 by the Federal Deposit Insurance Corporation. Additionally the Bond and Interest Sinking Fund of the District is secured by FDIC Insurance (\$132,860). Deposits in excess of FDIC coverage at First Farmers Bank are secured by two Federal Home Loan Bank letters of credit for \$535,000 and pledged securities with a market value of \$430,342.

6. Insurance coverage may be summarized as follows:

<u>General and Public Officials Liability</u>	\$	3,000,000	
<u>Vehicles & Equipment</u>	\$	1,000,000	Liability/Each Accident
<u>Property, Buildings, Tanks & Equipment</u>	\$	3,802,455	
<u>Employee Dishonesty</u>	\$	100,000	
<u>Fidelity Bond (Position)</u>			
Commissioner (2 Positions)	\$	211,000	
Secretary/Bookkeeper		211,000	
Office Manager		211,000	
<u>Position Bond</u>			
Commissioner(s) & Office Manager	\$	100,000	each
<u>Workmen's Compensation</u>			
All employees			Statutory

7. Gallatin County Water District is a governmental unit and thus exempt from income taxes.

8. Accounts receivable as of December 31, 2011, may be aged as follows.

<u>Total Accounts Receivable</u>	<u>1-30 Days</u>	<u>31-60 Days</u>	<u>Over 60</u>
\$ 119,872	\$ 96,938	\$ 3,819	\$ 19,115

<u>Total Accounts Receivable</u>	<u>Allowance for Uncollectibles</u>	<u>Net Accounts Receivable</u>
\$ 119,872	\$ 15,863	\$ 104,009

Respectfully submitted,

Raisor, Zapp & Woods, PSC

RAISOR, ZAPP & WOODS, PSC
 Certified Public Accountants

March 6, 2012