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Report

of

**Muhlenberg County Water District #3
Bremen, Kentucky**

For The Years Ended December 31, 2013 and 2012

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INDEPENDENT AUDITORS' REPORT

To the Commissioners
Muhlenberg County Water District Number 3
Bremen, Kentucky

Report on the Financial Statements

We have audited the accompanying financial statements of Muhlenberg County Water District Number 3 as of and for the years ended December 31, 2013 and 2012, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Muhlenberg County Water District Number 3 as of December 31, 2013 and 2012, and the changes in financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3-7 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.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated February 13, 2014, on our consideration of Muhlenberg County Water District Number 3'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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Muhlenberg County Water District Number 3's internal control over financial reporting and compliance.

Alexander, Iney & Knight PLLC

Madisonville, Kentucky
February 13, 2014

MUHLENBERG COUNTY WATER DISTRICT NUMBER 3
Management's Discussion and Analysis
December 31, 2013 and 2012

The discussion and analysis of the Muhlenberg County Water District Number 3's financial performance provides an overview and analysis of the District's financial activities for the years ended December 31, 2013 and 2012. It should be read in conjunction with the accompanying basic financial statements.

Financial Highlights for the Year 2013

- * The District's net position increased \$88.3 thousand or 3.1% from \$2.816 million to \$2.905 million.
- * Income before capital contributions was \$48.5 thousand for the year ended December 31, 2013.

Overview Of The Financial Statements

This report consists of this management's discussion and analysis, basic financial statements, and notes to the financial statements. The basic financial statements are reported using the full accrual basis of accounting.

Basic financial statements:

The Statements of Net Position include information on the District's assets and liabilities and provide information about the nature and amounts of investments in resources (assets) and the obligations to District creditors (liabilities). In simple terms, this statement presents a snap-shot view of the assets the District owns, the liabilities it owes and the net difference. The net difference is further separated into amounts restricted for specific purposes and unrestricted amounts.

The Statements of Revenues, Expenses, and Changes in Fund Net Assets include the District's revenues and expenses for the years ended December 31, 2013 and 2012. This statement provides information on the District's operations and can be used to determine whether the District has recovered all of its actual and projected costs through user fees and other charges.

The Statements of Cash Flows include information on the District's cash receipts and payments and the changes in cash balances resulting from operating activities, investing activities, and financing activities.

The notes to the financial statements provide additional disclosures required by governmental accounting standards and provide information to assist the reader in understanding the District's financial condition.

Muhlenberg County Water District Number 3
Statement of Cash Flows
Years Ended December 31, 2013 and 2012

	<u>2013</u>	<u>2012</u>
<u>Cash flows from operating activities</u>		
Cash received from customers	\$1,182,899	\$ 963,390
Cash payments to suppliers for goods and services	(859,125)	(658,046)
Cash payments to employees for services	(238,654)	(220,790)
Other operating revenues	<u>37,546</u>	<u>34,171</u>
Net cash provided (used) by operating activities	122,666	118,725
<u>Cash flows from capital and related financing activities</u>		
Acquisition and construction of capital assets	(132,674)	(69,289)
Interest paid on customer deposits	(6)	(9)
Customer deposits collected	6,056	5,810
Customer deposits refunded	(5,671)	(4,585)
Capital contributions received from customers	6,950	7,748
Capital contributions from state	32,886	0
Proceeds received on disposition of capital assets	<u>3,054</u>	<u>2,227</u>
Net cash provided (used) for capital and related financing activities	(89,405)	(58,098)
<u>Cash flows from investing activities</u>		
Interest earned on bank deposits	<u>5,393</u>	<u>8,957</u>
Net cash provided (used) for investing activities	5,393	8,957
Net increase (decrease) in cash and cash equivalents	38,654	69,584
Cash and cash equivalents at beginning of year	<u>827,419</u>	<u>757,835</u>
Cash and cash equivalents at end of year	<u>\$ 866,073</u>	<u>\$ 827,419</u>
	=====	=====
<u>Reconciliation of operating income to net cash provided (used) by operating activities</u>		
Operating income (loss)	\$ 43,517	\$ 49,446
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	85,503	87,796
Change in assets and liabilities:		
(Increase) decrease in accounts receivable	(29,441)	(13,952)
(Increase) decrease in other receivables	9,272	(9,272)
(Increase) decrease in inventory	(7,183)	6,304
(Increase) decrease in prepaid expenses	(1,172)	(119)
Increase (decrease) in accounts payable	21,680	(270)
Increase (decrease) in accrued expenses	307	85
Increase (decrease) in compensated absences	<u>183</u>	<u>(1,293)</u>
Total adjustments	<u>79,149</u>	<u>69,279</u>
Net cash provided by operating activities	<u>\$ 122,666</u>	<u>\$ 118,725</u>
	=====	=====

The accompanying notes are an integral part of these statements.

Muhlenberg County Water District Number 3
Notes to Financial Statements
December 31, 2013 and 2012

NOTE A - SUMMARY OF ACCOUNTING POLICIES

The accounting policies of the Muhlenberg County Water District Number 3 conform to Generally Accepted Accounting Principles (GAAP) as applicable to governments. The District applies Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989 unless those pronouncements conflict with or contradict Governmental Accounting Standards Board (GASB) pronouncements, in which case, GASB prevails. The following is a summary of the more significant policies:

1. The Financial Reporting Entity

Muhlenberg County Water District Number 3 (the "District") was created on April 24, 1967, under the provisions of Chapter 74 of the Kentucky Revised Statutes of the Commonwealth of Kentucky. The principal office of the District is located at Bremen, Kentucky. The District is composed of three commissioners who are appointed by the Muhlenberg County Judge Executive and provides water to its members in and around Muhlenberg County, Kentucky.

In evaluating how to define the government, 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 GASB Statement No. 14 - *The Financial Reporting Entity*.

2. Basis of Presentation, Measurement Focus, and Basis of Accounting

The accounts of the District are organized in accordance with the uniform system of accounts adopted by the Public Service Commission of Kentucky. Those accounts are organized on the basis of a proprietary fund type, specifically an enterprise fund. The activities of this fund are accounted for with a separate set of self-balancing accounts that comprise the District's assets, liabilities, net position, revenues, and expenses. Enterprise Funds account for activities 1) that are financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity; or 2) that are required by laws or regulations that the activities costs of providing services, including capital costs (such as depreciation or debt service), be recovered with fees and charges, rather than with taxes or similar revenues; or 3) that the pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs (such as depreciation or debt service).

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 are included on the statements of net position. Net position is required to be displayed in three components: 1) invested in capital assets, net of related debt, 2) restricted, and 3) unrestricted. Invested in capital assets, net of related debt is capital assets net of accumulated depreciation and reduced by outstanding balances of any bonds, mortgages, notes or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. Restricted net position are those with constraints placed on their use by either: 1) externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments, or 2) imposed by law through constitutional provisions or enabling legislation. Net position not otherwise classified as restricted, are shown as unrestricted. The statements of revenue, expenses, and changes in net position present increases (revenues) and decreases (expenses) in net position.

Muhlenberg County Water District Number 3
Notes to Financial Statements
December 31, 2013 and 2012

NOTE A - SUMMARY OF ACCOUNTING POLICIES continued

Basis of accounting refers to when revenues and expenses are recognized in the accounts and reported in the financial statements. The accounts of the District are maintained on the accrual basis of accounting. Its revenues are recognized when they are earned, and its expenses are recognized when they are incurred.

Proprietary funds distinguish operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. The principal operating revenues and expenses of the District's enterprise fund are charges to customers for sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

Unbilled water receivables for utility services provided through December 31 are included in the financial statements.

When both restricted and unrestricted resources are available for use, the District generally first uses restricted resources, then unrestricted resources as they are needed.

3. Cash and Cash Equivalents

All cash except for a small amount kept "on hand" is deposited in financial institutions. Deposits are interest bearing checking accounts and certificates of deposit. Unrestricted cash is available to be expended for normal operating expenses. Restricted cash is limited to payments of bond principal and interest, emergency capital improvements, and other designated purposes. Cash and cash equivalents are defined as being all monies on deposit in banks and investments with a maturity of 90 days or less.

4. Inventory

Inventory consists primarily of replacement parts and supplies. Inventory is stated at the lower of cost or market. Cost is determined primarily by the first-in, first-out method.

5. Capital Assets

Capital assets, which include property, plant, and equipment, are recorded at historical cost or estimated historical cost if actual historical cost is not available. Donated capital assets are recorded at estimated fair market value at the date of donation. The cost of normal maintenance and repairs that do not add to the value of the asset or materially extend asset lives are not capitalized.

Major outlays for capital assets and improvements are capitalized as projects are constructed. Interest incurred during the construction phase of capital assets is included as part of the capitalized value of the assets constructed. No interest was capitalized during the years ended December 31, 2013 and 2012.

Muhlenberg County Water District Number 3
 Notes to Financial Statements
December 31, 2013 and 2012

NOTE A - SUMMARY OF ACCOUNTING POLICIES continued

Capital assets of the District are depreciated using a straight-line method over the following estimated useful lives:

Structures, improvements and water system	10 to 65 years
Furniture, machinery and equipment	2 to 10 years
Vehicles	5 years

6. Restricted Net Position

Restricted net position is cash set aside for the repayment of debt in compliance with bond covenants and cash restricted for future operations in compliance with escrow reserve agreements. The District currently doesn't have any restricted net position.

7. Long-Term Liabilities

Long-term debt is reported as liabilities in the statement of net position. Long-term debt is reported at face value.

8. Uncollectible Accounts

All accounts receivable are considered by management to be collectible, therefore no provision for uncollectible accounts has been established. Uncollectible accounts are expensed using the direct write-off method.

9. Use of Estimates

The preparation of financial statements in accordance with accounting principals generally accepted in the United States requires management to make estimates that affect amounts reported in the financial statements during the reporting period. Actual results could differ from those estimates.

NOTE B - DEPOSITS

The District maintains deposits with depository institutions insured by the Federal Deposit Insurance Corporation (FDIC). According to law, the depository institution should pledge sufficient securities as collateral which, together with FDIC insurance, equals or exceeds the amount on deposit at all times. In order to be valid against the FDIC in the event of failure or insolvency of the depository institution, this pledge of securities should be evidenced by an agreement that is (1) in writing, (2) approved by the board of directors of the depository institution or its loan committee, which approval must be reflected in the minutes of the board or committee, and (3) an official record of the depository institution. This agreement, signed by both parties, must be sufficient to create an enforceable and perfected security interest in the collateral under Kentucky law.

Deposits are categorized to give an indication of risk assumed by the District at the end of the year. Category 1 includes deposits that are insured, Category 2 includes collateralized deposits held by the pledging institution's trust department or agent in the District's name, and Category 3 includes uncollateralized and uninsured deposits.

Muhlenberg County Water District Number 3
 Notes to Financial Statements
December 31, 2013 and 2012

NOTE B - DEPOSITS continued

On December 31, 2013, the reconciled balance of the District's deposits totaled \$866,073 and the bank balances were \$876,462. Of the bank balances \$573,349 was covered by federal depository insurance (category 1). Also of the bank balances, \$303,113 was collateralized by additional securities held by the pledging depository institution's trust department or agent in the District's name (category 2).

On December 31, 2012, the reconciled balance of the District's deposits totaled \$827,279 and the bank balances were \$836,881. Of the bank balances \$553,190 was covered by federal depository insurance (category 1). Also of the bank balances, \$283,691 was collateralized by additional securities held by the pledging depository institution's trust department or agent in the District's name (category 2).

NOTE C - PREPAID EXPENSES

Prepaid expenses include prepaid insurance, which represents the amount of unexpired insurance, which the District had previously paid for at the balance sheet date.

At December 31, 2013, the District's prepaid expenses consisted of \$8,988 of insurance. At December 31, 2012, the District's prepaid expenses consisted of \$7,816 of insurance.

NOTE D - RESTRICTED CASH AND CASH EQUIVALENTS

The District has cash set aside for the repayment of debt (which has been fully paid), cash restricted for future operations, cash set aside for future capital assets, and cash set aside for repayment of customer deposits.

Restricted balances as of December 31 are as follows:

	<u>2013</u>	<u>2012</u>
Bond and interest redemption fund	\$ 73,332	\$ 72,831
Bond depreciation fund	291,668	289,111
Customer meter deposit fund	23,156	22,798
Construction fund	<u>19,483</u>	<u>3,575</u>
Totals	<u>\$ 407,639</u>	<u>\$ 388,315</u>

Muhlenberg County Water District Number 3
Notes to Financial Statements
December 31, 2013 and 2012

NOTE E - CAPITAL ASSETS

Capital asset activities for the years ended December 31, 2013 and 2012, were as follows:

	Balances 12/31/11	Transfers/ Additions	Transfers/ Retirements	Balances 12/31/12	Transfers/ Additions	Transfers/ Retirements	Balances 12/31/13
Business-type activities:							
Capital assets not being depreciated							
Land & land rights	\$ 22,281	\$ 0	\$ 0	\$ 22,281	\$ 669	\$ 0	\$ 22,950
Construction in progress	0	51,404	0	51,404	36,067	68,491	18,980
Total	22,281	51,404	0	73,685	36,736	68,491	41,930
Capital assets being depreciated							
Structures, improvements, & water system	3,105,862	66,099	16,965	3,154,996	117,648	21,908	3,250,736
Office furniture & equipment	46,084	1,805	0	47,889	3,049	618	50,320
Vehicles & equipment	79,548	0	0	79,548	0	0	79,548
Machinery & equipment	398,050	3,507	0	401,557	1,730	0	403,287
Total	3,629,544	71,411	16,965	3,683,990	122,427	22,526	3,783,891
Total capital assets	3,651,825	122,815	16,965	3,757,675	159,163	91,017	3,825,821
Less accumulated depreciation for:							
Structures, improvements, & water system	1,525,138	58,850	16,965	1,567,023	60,210	18,409	1,608,824
Office furniture & equipment	36,181	3,043	0	39,224	3,086	618	41,692
Vehicles & equipment	72,349	5,388	0	77,737	1,752	0	79,489
Machinery & equipment	127,091	20,515	0	147,606	20,455	0	168,061
Total accumulated depreciation	1,760,759	87,796	16,965	1,831,590	85,503	19,027	1,898,066
Total business-type activities capital assets, net	\$1,891,066	\$ 35,019	\$ 0	\$1,926,085	\$ 73,660	\$ 71,990	\$1,927,755

Muhlenberg County Water District Number 3
 Notes to Financial Statements
December 31, 2013 and 2012

NOTE F - LONG-TERM LIABILITIES

Long-term liability activity

Long-term liability activity for the years ended December 31, 2013 and 2012, were as follows:

	Balances			Balances			Balances			Amounts
	<u>12/31/11</u>	<u>Additions</u>	<u>Reductions</u>	<u>12/31/12</u>	<u>Additions</u>	<u>Reductions</u>	<u>12/31/13</u>		<u>Due Within</u>	
									<u>One Year</u>	
Customer Deposits	17,360	5,810	4,585	18,585	6,056	5,671	18,970		5,204	
Business-type Activities Long- Term Liabilities	\$ 17,360	\$ 5,810	\$ 4,585	\$ 18,585	\$ 6,056	\$ 5,671	\$ 18,970	\$	\$ 5,204	

NOTE G - ACCUMULATED COMPENSATED ABSENCES

Effective March 2011 employees are no longer permitted to accumulate earned but unused vacation days beyond one year. The employees must use or cash out their yearly allotment of vacation time earned by the annual anniversary date of their employment.

NOTE H - EMPLOYEES' PENSION PLAN

Plan description

The District and covered employees contribute to the County Employers Retirement System (CERS), a cost-sharing, multiple-employer defined benefit plan administered by the Board of Trustees of the Kentucky Retirement Systems.

The plan provides for retirement, disability, and death benefits to plan members. Retirement benefits may be extended to beneficiaries of plan members under circumstances. Cost-of-living adjustments are provided at the discretion of the State legislature. Kentucky Revised Statute Section 61.645 assigns the authority to establish and amend benefit provisions to the Board of Trustees of the Kentucky Retirement Systems.

The CERS financial statements and other supplementary information are contained in the publicly available annual financial report of the Kentucky Retirement Systems. Copies of the report are sent to each participating employer as well as distributed to legislative personnel, state libraries and other interested parties. Copies may be obtained by writing to Kentucky Retirement Systems, Perimeter Park West 1260 Louisville Road, Frankfort, Kentucky 40601 or by calling 1-502-928-4646 or on the internet at www.kyret.com.

Muhlenberg County Water District Number 3
Notes to Financial Statements
December 31, 2013 and 2012

NOTE H - EMPLOYEES' PENSION PLAN continued

Funding policy

Per Kentucky Revised Statute 61.565, normal contribution and past service contribution rates shall be determined by the Board of Trustees of the Kentucky Retirement Systems 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 year ended December 31, 2013, plan members hired prior to September 1, 2008 were required to contribute 5% of their annual creditable compensation. Plan members hired subsequent to September 1, 2008 were required to contribute 6% of their annual creditable compensation.

The District is required to contribute at an actuarially determined rate. The District was required to contribute 18.89% of each employee's creditable compensation for the final six months of the year ended December 31, 2013. The District was required to contribute 19.55% of each employee's creditable compensation for the first six months of the year ended December 31, 2013 and for the final six months of the year ended December 31, 2012. The District was required to contribute 18.96% of each employee's creditable compensation for the first six months of the year ended December 31, 2012 and for the final six months of the year ended December 31, 2011. The District was required to contribute 16.93% of each employee's creditable compensation for the first six months of the year ended December 31, 2011. The District's contributions to CERS for the years ended December 31, 2013, 2012, and 2011 were \$40,375, \$35,971, and \$36,920, respectively.

NOTE I - RISK MANAGEMENT

The District is exposed to various risks of losses related to torts; theft of, damage to, and destruction of assets; errors and omissions; and injuries to employees. The District purchases commercial insurance for all risks of losses. Settlements resulting from these risks have not exceeded commercial insurance coverage in any of the past three fiscal years.

Muhlenberg County Water District Number 3
Notes to Financial Statements
December 31, 2013 and 2012

NOTE J - CONSTRUCTION IN PROGRESS AND CONSTRUCTION PROJECTS PAYABLE

During 2013, the District incurred an additional \$17,087 of cost related to the HWY 431 Water Line Relocation project. This project was completed and \$26,659 was capitalized. Also, the District incurred \$18,980 in engineering services related to the Clark Street Line Replacement project. These costs are considered construction in progress until the line replacement is completed. The District also owes an additional \$300 in engineering costs for services performed during December 2013. Also during 2013, 249 radio read meters was placed into service and \$41,832 was capitalized.

During 2012, the District incurred \$9,272 of cost related to the HWY 431 Water Line Relocation project. Engineering services have been performed and are estimated to be completed during 2013. These costs are considered construction in progress until the line relocation is completed. The District also owes an additional \$300 in engineering costs for services performed during December 2012. These costs are also included in construction in progress. During December 2012 the District received an order of 250 radio read meters with a cost of \$42,000. One of the meters was placed in service during December 2012 while the other 249 meters were not in service. \$42,000 of cost incurred with the purchase of the radio read meters is still payable at year end and \$41,832 of costs are in construction in progress.

NOTE K – CAPITAL CONTRIBUTIONS-STATE AND OTHER RECEIVABLES

The District has entered into an utility relocation contract with the Kentucky Transportation Cabinet, Department of Highways in regards to the HWY 431 Water Line Relocation project that has been completed. The District incurred and paid for \$26,659 of engineering costs during 2012 and 2013 and this amount was reimbursed during and subsequent to year end. Also, The District has entered into an utility replacement contract with the Commonwealth of Kentucky, Kentucky Infrastructure Authority in regards to the Clark Street Line Replacement project. The District incurred and paid for \$18,980 of engineering costs during 2013 and \$18,555 has been reimbursed during and subsequent to year end.

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

To The Commissioners
Muhlenberg County Water District Number 3
Bremen, Kentucky

We have audited, 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, the financial statements of Muhlenberg County Water District Number 3 as of and for the years ended December 31, 2013 and 2012, and the related notes to the financial statements, and have issued our report thereon dated February 13, 2014.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered Muhlenberg County Water District Number 3's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Muhlenberg County Water District Number 3's internal control. Accordingly, we do not express an opinion on the effectiveness of Muhlenberg County Water District Number 3's internal control.

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. *A significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify certain deficiencies in internal control, as discussed below, that we consider to be significant deficiencies.

2013-1 Segregation of Duties

Condition: The internal control relating to receipts and disbursements is inadequate due to a lack of segregation of duties.

Criteria: Adequate segregation of duties is essential to an adequate internal control over financial reporting by allocating various duties among employees.

Effect: The lack of proper segregation of duties may permit errors or irregularities to go undetected.

Cause: There is a small number of accounting personnel. The cost versus benefit relationship prevents the District from hiring enough accounting personnel to properly segregate key accounting functions.

Recommendation: While the small number of employees that exist will never provide proper segregation of duties, the District should continually review job responsibilities for better accounting controls.

Response: The District concurs with the recommendation and will continually review job responsibilities to improve accounting controls when possible.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Muhlenberg County Water District Number 3'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*.

Muhlenberg County Water District Number 3's Response to Findings

Muhlenberg County Water District Number 3's response to the findings identified in our audit is described above. Muhlenberg County Water District Number 3's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purposes.

Alexander, Toney & Knight PLLC

Madisonville, Kentucky

February 13, 2014