

Report

of

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

For The Years Ended December 31, 2017 and 2016

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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, 2017 and 2016, 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, 2017 and 2016, 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 and pension schedules on pages 23-24 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 June 21, 2018, 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 effectiveness of Muhlenberg County Water District Number 3's 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 Toney & Knight PLLC

Madisonville, Kentucky

June 21, 2018

MUHLENBERG COUNTY WATER DISTRICT NUMBER 3
Management's Discussion and Analysis
December 31, 2017 and 2016

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, 2017 and 2016. It should be read in conjunction with the accompanying basic financial statements.

Financial Highlights for the Year 2017

- The District's net position decreased \$107.1 thousand from \$2.785 million to \$2.678 million.
- The District purchased a new office building during 2017 without incurring new debt.

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, deferred outflows of resources, liabilities, and deferred inflows of resources 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 Position include the District's revenues and expenses for the years ended December 31, 2017 and 2016. 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.

District Financial Analysis

A summary of the District's Statements of Net Position is presented below.

Table 1
Condensed Statements of Net Position
(in thousands)

	<u>2017</u>	<u>2016</u>	dollar change	percent change	<u>2015</u>	dollar change	percent change
Current assets	\$ 884.5	\$ 976.7	(\$ 92.2)	(9.4%)	\$1,033.8	(\$ 57.1)	(5.5%)
Capital assets	2,189.4	2,087.5	101.9	4.9%	1,995.9	91.6	4.6%
Other noncurrent assets	<u>146.0</u>	<u>198.5</u>	(52.5)	(26.4%)	<u>199.9</u>	(1.4)	(0.7%)
Total assets	<u>3,219.9</u>	<u>3,262.7</u>	(42.8)	(1.3%)	<u>3,229.6</u>	33.1	1.0%
Total deferred outflows of resources	<u>175.4</u>	<u>108.4</u>	67.0	61.8%	<u>65.9</u>	42.5	64.5%
Current liabilities	76.5	79.2	(2.7)	(3.4%)	84.8	(5.6)	(6.6%)
Long-term liabilities	<u>578.4</u>	<u>506.9</u>	71.5	14.1%	<u>418.2</u>	88.7	21.2%
Total liabilities	<u>654.9</u>	<u>586.1</u>	68.8	11.7%	<u>503.0</u>	83.1	16.5%
Total deferred inflows of resources	<u>62.5</u>	<u>0.0</u>	62.5	0.0%	<u>0.0</u>	0.0	0.0%
Net assets invested in capital assets, net of related debt	2,189.4	2,087.5	101.9	4.9%	1,986.8	100.7	5.1%
Unrestricted net position	<u>488.5</u>	<u>697.5</u>	(209.0)	(30.0%)	<u>805.7</u>	(108.2)	(13.4%)
Total net position	<u>\$2,677.9</u>	<u>\$2,785.0</u>	(\$ 107.1)	(3.8%)	<u>\$2,792.5</u>	(\$ 7.5)	(0.3%)

Net assets may serve over time as a useful indicator of a government's financial position. In the case of the District, assets and deferred outflows of resources exceeded liabilities and deferred inflows of resources by \$2.6779 million at the close of the current year.

2016 to 2017

As shown in table 1, the District's total assets decreased by \$42,800 from \$3,262,700 to \$3,219,900. Current assets decreased \$92,200. This was due to decreases in cash and cash equivalents which decreased \$83,700. The District used cash reserves to fund purchases of capital assets primarily the new office building. Water sales also fell during the year although water purchases remained similar. Capital assets increased \$101,900 as capital asset acquisitions out paced depreciation expense. Other noncurrent assets decreased \$52,500 as restricted construction funds were also used to fund purchases of capital assets.

Deferred outflows of resources-pensions increased \$67,000 due to changes in the District's proportional share of the County Employee Retirement System (CERS) valuation measurements.

The District's long-term liabilities increased \$71,500. Net pension liability increased \$71,600, also due to the District's proportional share of CERS valuation measurements. Changes in actuarial assumptions from the prior year increased the net pension liability as well as pension expense.

2015 to 2016

As shown in table 1, the District's total assets increased by \$33,100 from \$3,229,600 to \$3,262,700. Current assets decreased \$57,100. This was due to decreases in cash and cash equivalents which decreased \$56,600. The District used cash reserves to fund purchases of capital assets. Water sales also fell during the year although water purchases remained similar. Capital assets increased \$91,600 as capital asset acquisitions out paced depreciation expense.

Deferred outflows of resources-pensions increased \$42,500 due to changes in the District's proportional share of the County Employee Retirement System (CERS) valuation measurements.

The District's long-term liabilities increased \$88,700. Net pension liability increased \$88,000, also due to the District's proportional share of CERS valuation measurements.

A summary of the District's Statements of Revenues, Expenses and Changes in Net Position is presented below.

Table 2
Condensed Statements of Revenues, Expenses and Changes in Net Position
(in thousands)

	<u>2017</u>	<u>2016</u>	<u>dollar change</u>	<u>percent change</u>	<u>2015</u>	<u>dollar change</u>	<u>percent change</u>
Operating revenues	\$1,327.3	\$1,348.5	(\$ 21.2)	(1.6%)	\$1,411.2	(\$ 62.7)	(4.4%)
Nonoperating revenues	<u>11.3</u>	<u>4.2</u>	7.1	169.0%	<u>7.5</u>	(3.3)	(44.0%)
Total revenues	<u>1,338.6</u>	<u>1,352.7</u>	(14.1)	(1.0%)	<u>1,418.7</u>	(66.0)	(4.7%)
Operating expenses	1,446.6	1,376.0	70.6	5.1%	1,342.7	33.3	2.5%
Nonoperating expenses	<u>7.1</u>	<u>0.1</u>	7.0	7000.0%	<u>0.3</u>	(0.2)	(66.7%)
Total expenses	<u>1,453.7</u>	<u>1,376.1</u>	77.6	5.6%	<u>1,343.0</u>	33.1	2.5%
Income (loss) before capital contributions	(115.1)	(23.4)	(91.7)	(391.9%)	75.7	(99.1)	(130.9%)
Capital contributions	<u>8.0</u>	<u>15.9</u>	(7.9)	(49.7%)	<u>3.3</u>	12.6	381.8%
Changes in net position	(107.1)	(7.5)	(99.6)	(1328.0%)	79.0	(86.5)	(109.5%)
Beginning net position	<u>2,785.0</u>	<u>2,792.5</u>	(7.5)	(0.3%)	<u>2,713.6</u>	78.9	2.9%
Ending net position	<u>\$2,677.9</u>	<u>\$2,785.0</u>	(\$ 107.1)	(3.8%)	<u>\$2,792.6</u>	(\$ 7.6)	(0.3%)

2016 to 2017

As shown in table 2, the District's operating revenues decreased \$21,200. Residential water sales increased \$6,600, commercial water sales decreased \$19,300, and resale water sales decreased \$12,300.

The District's operating expenses increased \$70,600 from the prior year. Purchased water remained similar to the prior year while water sales decreased indicating an increase in water loss. Employee benefits increased \$24,600, the effect of increasing proportional share of CERS pension expense. Wages increased \$13,300 primarily as catch-up pay for two employees. Contract services increased \$17,000 primarily due to hardware/software areas and increased repairs.

Capital contributions decreased \$7,900 due to an decrease in customer funding of small construction projects.

Changes in net position decreased \$107,100 due to the net effect of the above changes.

2015 to 2016

As shown in table 2, the District's operating revenues decreased \$62,700. Residential water sales decreased \$13,400, commercial water sales decreased \$30,500, and resale water sales decreased \$12,700.

The District's total expenses increased \$33,100 from the prior year. Purchased water remained similar to the prior year while water sales decreased indicating an increase in water loss. Employee benefits increased \$41,270, the effect of increasing proportional share of CERS pension expense.

Capital contributions increased \$12,600 due to an increase in customer funding of small construction projects.

Changes in net position decreased \$7,600 due to the net effect of the above changes.

Capital Assets and Debt Administration

Capital Assets

At December 31, 2017 the District had \$2,189,386 invested in capital assets, net of accumulated depreciation, including land, structures, improvements and water system, and office furniture and equipment. This amount represents a net increase (additions, retirements, depreciation) of \$101,939 from the prior year.

Significant expenditures during the year included expenditures on new and old buildings for \$165,427, tank improvements for \$19,999, meters placed in service for \$88,113, and a new truck for \$23,485.

At December 31, 2016 the District had \$2,087,447 invested in capital assets, net of accumulated depreciation, including land, structures, improvements and water system, and office furniture and equipment. This amount represents a net increase (additions, retirements, depreciation) of \$91,504 from the prior year.

Significant expenditures during the year included expenditures on meters for \$89,340, SCADA radio system for \$15,800, and completion of the Clark Street line replacement project of which \$108,732 was capitalized.

A comparison of the District's capital assets over the past three years is presented in Note E of the financial statements.

Long-Term Debt

At December 31, 2017, the District had \$19,635, net additions of \$140, in long-term liabilities which consisted of customer deposits. There were no new borrowings.

At December 31, 2016, the District had \$19,495, net reductions of \$8,655, in long-term liabilities which included customer deposits and a capital lease. There were no new borrowings.

Additional information on the District's long-term debt can be found in Note F of the financial statements.

Currently Known Facts, Decisions, or Conditions

There are no currently known facts, decisions, or conditions that District management expects to have a significant effect on financial position or results of operations.

Requests For Information

This financial report is designed to provide a general overview of the District's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional information should be addressed to the Muhlenberg County Water District Number 3, 4815 Main Street, Bremen, Kentucky 42325.

Muhlenberg County Water District Number 3
Statement of Net Position
December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
<u>Assets</u>		
Current assets		
Cash and cash equivalents	\$ 699,865	\$ 783,608
Accounts receivable	153,295	156,826
Material and parts inventory	20,831	25,769
Prepaid expenses	<u>10,469</u>	<u>10,505</u>
Total current assets	<u>884,460</u>	<u>976,708</u>
Noncurrent assets		
Restricted cash and cash equivalents	146,024	198,538
Capital assets:		
Nondepreciable	22,950	125,336
Depreciable, net of accumulated depreciation	<u>2,166,436</u>	<u>1,962,116</u>
Total noncurrent assets	<u>2,335,410</u>	<u>2,285,990</u>
Total assets	<u>3,219,870</u>	<u>3,262,698</u>
<u>Deferred outflows of resources</u>		
Deferred outflows of resources-pensions	<u>175,541</u>	<u>108,355</u>
Total deferred outflows of resources	<u>175,541</u>	<u>108,355</u>
<u>Liabilities</u>		
Current liabilities payable from current assets		
Accounts payable	63,357	64,359
Accrued taxes and other payables	1,973	2,059
Accrued interest payable	5	6
Accumulated compensated absences	<u>5,862</u>	<u>7,607</u>
	<u>71,197</u>	<u>74,031</u>
Current liabilities payable from restricted assets		
Customer deposits	<u>5,333</u>	<u>5,134</u>
	<u>5,333</u>	<u>5,134</u>
Total current liabilities	<u>76,530</u>	<u>79,165</u>
Long-term liabilities		
Net pension liability	564,142	492,576
Customer deposits	<u>14,302</u>	<u>14,361</u>
Total noncurrent liabilities	<u>578,444</u>	<u>506,937</u>
Total liabilities	<u>654,974</u>	<u>586,102</u>
<u>Deferred inflows of resources</u>		
Deferred inflows of resources-pensions	<u>62,538</u>	<u>0</u>
Total deferred inflows of resources	<u>62,538</u>	<u>0</u>
<u>Net Position</u>		
Invested in capital assets, net of related debt	2,189,386	2,087,452
Unrestricted	<u>488,513</u>	<u>697,499</u>
Total net position	<u>\$2,677,899</u>	<u>\$2,784,951</u>

The accompanying notes are an integral part of these statements.

Muhlenberg County Water District Number 3
Statement of Revenues, Expenses and Changes in Fund Net Position
Years Ended December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Operating revenues		
Water sales	\$1,281,814	\$1,306,851
Other operating revenues	<u>45,500</u>	<u>41,634</u>
Total operating revenues	<u>1,327,314</u>	<u>1,348,485</u>
Operating expenses		
Purchased water	705,483	701,170
Salaries and wages	267,348	254,047
Depreciation	102,378	96,929
Employee benefits	151,655	127,044
Transportation	11,737	11,325
Contract services	44,920	27,718
Taxes	20,987	19,439
Purchased power	29,561	29,643
Materials and supplies	45,974	46,046
Insurance	21,189	20,634
Miscellaneous	39,203	35,911
Regulatory commission expense	2,692	2,739
Uncollectible accounts	<u>3,497</u>	<u>3,437</u>
Total operating expenses	<u>1,446,624</u>	<u>1,376,082</u>
Operating income (loss)	(119,310)	(27,597)
Nonoperating revenues (expenses)		
Interest income	3,850	4,146
Interest expense	(20)	(60)
Gain (loss) on abandonment of project	(7,035)	0
Gains (losses) on disposition of capital assets	<u>7,464</u>	<u>0</u>
Total nonoperating revenues (expenses)	<u>4,259</u>	<u>4,086</u>
Income (loss) before contributions	(115,051)	(23,511)
Capital contributions-tap fees	6,550	6,500
Capital contributions-customers	<u>1,449</u>	<u>9,449</u>
Change in net position	(107,052)	(7,562)
Net position beginning of year	<u>2,784,951</u>	<u>2,792,513</u>
Net position end of year	<u><u>\$2,677,899</u></u>	<u><u>\$2,784,951</u></u>

The accompanying notes are an integral part of these statements.

Muhlenberg County Water District Number 3
Statement of Cash Flows
Years Ended December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
<u>Cash flows from operating activities</u>		
Cash received from customers	\$1,281,848	\$1,305,392
Cash payments to suppliers for goods and services	(1,004,202)	(973,420)
Cash payments to employees for services	(267,348)	(254,047)
Other operating revenues	<u>42,500</u>	<u>41,634</u>
Net cash provided (used) by operating activities	55,798	119,559
<u>Cash flows from capital and related financing activities</u>		
Acquisition and construction of capital assets	(211,519)	(188,437)
Interest paid on customer deposits	(21)	(21)
Interest paid on capital lease	0	(45)
Principal paid on capital lease	0	(9,180)
Capital contributions received from customers	7,999	15,949
Proceeds received on disposition of capital assets	<u>7,636</u>	<u>0</u>
Net cash provided (used) for capital and related financing activities	(195,905)	(181,734)
<u>Cash flows from investing activities</u>		
Interest earned on bank deposits	<u>3,850</u>	<u>4,146</u>
Net cash provided (used) for investing activities	3,850	4,146
Net increase (decrease) in cash and cash equivalents	(136,257)	(58,029)
Cash and cash equivalents at beginning of year	<u>982,146</u>	<u>1,040,175</u>
Cash and cash equivalents at end of year	<u>\$ 845,889</u>	<u>\$ 982,146</u>
	=====	=====
<u>Reconciliation of operating income to net cash provided (used) by operating activities</u>		
Operating income (loss)	(\$ 119,310)	(\$ 27,597)
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	102,378	96,929
Change in assets and liabilities:		
(Increase) decrease in accounts receivable	3,531	1,978
(Increase) decrease in inventory	4,938	(1,439)
(Increase) decrease in prepaid expenses	36	(84)
(Increase) decrease in deferred outflows-pensions	(67,186)	(42,502)
Increase (decrease) in accounts payable	(1,002)	2,592
Increase (decrease) in accrued expenses	(86)	(161)
Increase (decrease) in net pension liability	71,566	88,071
Increase (decrease) in customer deposits	140	525
Increase (decrease) in accumulated compensated absences	(1,745)	1,247
Increase (decrease) in deferred inflows-pensions	<u>62,538</u>	<u>0</u>
Total adjustments	<u>175,108</u>	<u>147,156</u>
Net cash provided by operating activities	<u>\$ 55,798</u>	<u>\$ 119,559</u>
	=====	=====

The accompanying notes are an integral part of these statements.

Muhlenberg County Water District Number 3
 Notes to Financial Statements
December 31, 2017 and 2016

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of the Muhlenberg County Water District Number 3 (the "District") conform to Generally Accepted Accounting Principles (GAAP) as applicable to governments. The District's reporting entity applies all relevant Governmental Accounting Standards Board (GASB) pronouncements. The following is a summary of the more significant policies:

The Financial Reporting Entity

Muhlenberg County Water District Number 3 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 Statements No. 14 and 61. The District has no component units.

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. 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 statement 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.

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.

Muhlenberg County Water District Number 3
 Notes to Financial Statements
December 31, 2017 and 2016

NOTE A - SUMMARY OF ACCOUNTING POLICIES continued

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.

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. The District does not have a formal deposit and investment policy for credit risk, custodial credit risk, or limitations on deposits and investments.

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.

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, 2017 and 2016.

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

Muhlenberg County Water District Number 3
Notes to Financial Statements
December 31, 2017 and 2016

NOTE A - SUMMARY OF ACCOUNTING POLICIES continued

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.

Long-Term Liabilities

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

Deferred Outflows/Inflows of Resources

In addition to assets, the statement of net position will sometimes report a separate section for deferred outflows of resources. This separate financial statement element, *deferred outflows of resources*, represents a consumption of net position that applies to a future period(s) and so will not be recognized as an outflow of resources (expense) until then.

In addition to liabilities, the statement of net position will sometimes report a separate section for deferred inflows of resources. This separate financial statement element, *deferred inflows of resources*, represents an acquisition of net position that applies to a future period(s) and so will not be recognized as an inflow of resources (revenue) until that time.

Pensions

For purposes of measuring the net pension liability, deferred outflows of resources and deferred inflows of resources, and pension expense, information about the fiduciary net position of the County Employees Retirement System Non-Hazardous (CERS) and additions to/deductions from CERS's fiduciary net position have been determined on the same basis as they are reported by CERS. For this purpose, benefit payments (including refunds of employee contributions) are recognized when due and payable in accordance with the benefit terms. Investments are reported at fair value.

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.

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.

Muhlenberg County Water District Number 3
Notes to Financial Statements
December 31, 2017 and 2016

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.

Also by Kentucky law, the District is allowed to invest as specified in KRS 66.480 which includes U. S. Treasury and its Obligations, certain federal investments, repurchase agreements, commercial banks' certificates of deposit, and savings and loan deposits.

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.

On December 31, 2017, the reconciled balance of the District's deposits totaled \$845,889 and the bank balances were \$855,184. Of the bank balances \$500,000 was covered by federal depository insurance (category 1). Also of the bank balances, \$355,184 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, 2016, the reconciled balance of the District's deposits totaled \$981,646 and the bank balances were \$992,704. Of the bank balances \$533,483 was covered by federal depository insurance (category 1). Also of the bank balances, \$459,221 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, 2017, the District's prepaid expenses consisted of \$10,469 of insurance. At December 31, 2016, the District's prepaid expenses consisted of \$10,505 of insurance.

Muhlenberg County Water District Number 3
Notes to Financial Statements
December 31, 2017 and 2016

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>2017</u>	<u>2016</u>
Customer meter deposit fund	\$ 23,871	\$ 23,783
Construction fund	<u>122,153</u>	<u>174,755</u>
Totals	<u>\$ 146,024</u>	<u>\$ 198,538</u>

NOTE E - CAPITAL ASSETS

Capital asset activities for the years ended December 31, 2017 and 2016, were as follows:

	<u>Balances</u> <u>12/31/15</u>	<u>Transfers/</u> <u>Additions</u>	<u>Transfers/</u> <u>Retirements</u>	<u>Balances</u> <u>12/31/16</u>	<u>Transfers/</u> <u>Additions</u>	<u>Transfers/</u> <u>Retirements</u>	<u>Balances</u> <u>12/31/17</u>
Business-type activities:							
Capital assets not being depreciated							
Land & land rights	\$ 22,950	\$ 0	\$ 0	\$ 22,950	\$ 0	\$ 0	\$ 22,950
Construction in progress	<u>130,076</u>	<u>81,042</u>	<u>108,732</u>	<u>102,386</u>	<u>12,300</u>	<u>114,686</u>	<u>0</u>
Total	<u>153,026</u>	<u>81,042</u>	<u>108,732</u>	<u>125,336</u>	<u>12,300</u>	<u>114,686</u>	<u>22,950</u>
Capital assets being depreciated							
Structures, improvements, & water system	3,272,473	199,524	23,445	3,448,552	273,544	23,445	3,698,651
Office furniture & equipment	56,380	0	0	56,380	7,514	600	63,294
Vehicles & equipment	120,318	0	0	120,318	23,485	26,549	117,254
Machinery & equipment	<u>454,868</u>	<u>16,599</u>	<u>1,516</u>	<u>469,951</u>	<u>2,482</u>	<u>0</u>	<u>472,433</u>
Total	<u>3,904,039</u>	<u>216,123</u>	<u>24,961</u>	<u>4,095,201</u>	<u>307,025</u>	<u>50,594</u>	<u>4,351,632</u>
Total capital assets	<u>4,057,065</u>	<u>297,165</u>	<u>133,693</u>	<u>4,220,537</u>	<u>319,325</u>	<u>165,280</u>	<u>4,374,582</u>
Less accumulated depreciation for:							
Structures, improvements, & water system	1,738,882	60,237	23,445	1,775,674	64,665	23,273	1,817,066
Office furniture & equipment	38,773	3,347	0	42,120	3,810	450	45,480
Vehicles & equipment	65,480	11,130	0	76,610	13,367	26,549	63,428
Machinery & equipment	<u>217,987</u>	<u>22,215</u>	<u>1,516</u>	<u>238,686</u>	<u>20,536</u>	<u>0</u>	<u>259,222</u>
Total accumulated depreciation	<u>2,061,122</u>	<u>96,929</u>	<u>24,961</u>	<u>2,133,090</u>	<u>102,378</u>	<u>50,272</u>	<u>2,185,196</u>
Total business-type activities capital assets, net	<u>\$1,995,943</u>	<u>\$ 200,236</u>	<u>\$ 108,732</u>	<u>\$2,087,447</u>	<u>\$ 216,947</u>	<u>\$ 115,008</u>	<u>\$2,189,386</u>

Muhlenberg County Water District Number 3
 Notes to Financial Statements
 December 31, 2017 and 2016

NOTE F – LONG-TERM LIABILITIES

During 2014, the District entered into an agreement with a financial institution to finance the leasing of equipment. The lease agreement qualifies as a capital lease for accounting purposes. The equipment had an original cost of \$42,527. Monthly payments of \$1,772, including interest at a rate of 2.1038% began in June 2014 and continued through May 2016. The debt service requirements to maturity were met during 2016.

Amortization expense associated with capital leases is presented with depreciation expense. The gross amount of equipment leased under capital leases is \$42,527 with accumulated depreciation of \$14,884 as of December 31, 2017 and of \$10,632 as of December 31, 2016.

Long-term liability activity

Long-term liability activity for the years ended December 31, 2017 and 2016, were as follows:

	Balances			Balances			Balances		Amounts
	<u>12/31/15</u>	<u>Additions</u>	<u>Reductions</u>	<u>12/31/16</u>	<u>Additions</u>	<u>Reductions</u>	<u>12/31/17</u>		<u>Due Within</u>
									<u>One Year</u>
Capital Lease	\$ 9,180	\$ 0	\$ 9,180	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Customer Deposits	18,970	5,671	5,146	19,495	6,127	5,987	19,635		5,333
Business-type Activities Long- Term Liabilities	<u>\$ 28,150</u>	<u>\$ 5,671</u>	<u>\$ 14,326</u>	<u>\$ 19,495</u>	<u>\$ 6,127</u>	<u>\$ 5,987</u>	<u>\$ 19,635</u>		<u>\$ 5,333</u>

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

General Information about the 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 (KRS). 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 1-502-564-4646.

Muhlenberg County Water District Number 3
Notes to Financial Statements
December 31, 2017 and 2016

NOTE H - EMPLOYEES' PENSION PLAN continued

Benefits provided. Kentucky Revised Statute Section 61.645 establishes the benefit terms and can be amended only by the Kentucky General Assembly. 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. There are currently three benefit tiers. Tier 1 members are those participating in the plan before 9/1/2008, Tier 2 members are those that began participation 9/1/2008 through 12/31/2013, and Tier 3 are those members that began participation on or after 1/1/2014.

Benefits provided-non hazardous. Tier 1 non-hazardous members are eligible to retire with an unreduced benefit at age 65 with four years of service credit or after 27 years of service credit regardless of age. Benefits are determined by a formula using the member's highest five consecutive year average compensation, which must contain at least 48 months. Reduced benefits for early retirement are available at age 55 and vested or 25 years of service credit. Members vest with five years of service credit. Service related disability benefits are provided after five years of service. Tier 2 non-hazardous members are eligible to retire based on the rule of 87: the member must be at least age 57 and age + earned service must equal 87 years at retirement or at age 65 with five years of service credit. Benefits are determined by a formula using the member's highest five consecutive year average compensation, which must be 60 months. Reduced benefits for early retirement are available at age 60 with 10 years of service. Tier 3 non-hazardous members are also eligible to retire based on the rule of 87. Benefits are determined by a life annuity calculated in accordance with actuarial assumptions and methods adopted by the board based on a member's accumulated account balance. Tier 3 members are not eligible for reduced retirement benefits.

Contributions. 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, 2017, plan members 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 actuarial determined rate. The District was required to contribute 19.18%, 14.48% for pensions and 4.70% for insurance, of each employee's creditable compensation for the last six months of the year ended December 31, 2017. The District was required to contribute 18.68%, 13.95% for pensions and 4.73% for insurance, of each employee's creditable compensation for the first six months of the year ended December 31, 2017 and for the final six months of the year ended December 31, 2016. The District was required to contribute 17.06%, 12.42% for pensions and 4.64% for insurance, of each employee's creditable compensation for the first six months of the year ended December 31, 2016 and for the final six months of the year ended December 31, 2015. The District was required to contribute 17.67%, 12.75% for pensions and 4.92% for insurance, of each employee's creditable compensation for the first six months of the year ended December 31, 2015. The District's contributions to CERS for the years ended December 31, 2017, 2016 and 2015 were \$43,433, \$40,952, and \$42,341, respectively. The District's payable to the plan at December 31, 2017 and 2016 was \$0 and \$0, respectively, which consisted of employees' withholdings and legally required contributions for the month of December.

Muhlenberg County Water District Number 3
Notes to Financial Statements
December 31, 2017 and 2016

NOTE H - EMPLOYEES' PENSION PLAN continued

Pension Liabilities, Pension Expense, and Deferred Outflows of Resources and Deferred Inflows of Resources Related to Pensions

At December 31, 2017, the District reported a liability of \$564,142 for its proportionate share of the net pension liability. The District's net pension liability was measured as of June 30, 2017, and the total pension liability used to calculate net pension liability was determined by an actuarial valuation as of June 30, 2016 and rolled forward from the valuation date to the plan's fiscal year ended June 30, 2017. At December 31, 2016, the District reported a liability of \$492,576 for its proportionate share of the net pension liability. The District's net pension liability was measured as of June 30, 2016, and the total pension liability used to calculate net pension liability was determined by an actuarial valuation as of that date.

For the year ended December 31, 2017, the District recognized pension expense of \$99,527. For the year ended December 31, 2016, the District recognized pension expense of \$74,731. At December 31, 2017 and 2016, the District reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

	<u>12/31/2017</u>		<u>12/31/2016</u>	
	<u>Deferred Outflows of Resources</u>	<u>Deferred Inflows of Resources</u>	<u>Deferred Outflows of Resources</u>	<u>Deferred Inflows of Resources</u>
Net difference between projected and actual earnings on pension plan investments	\$ 44,679	\$ 37,702	\$ 46,307	\$ -
Net difference between expected and actual experience	700	14,320	2,150	-
Changes in proportional and differences between employer contributions and proportional share of contributions	9,852	10,516	17,469	-
Change of assumptions	104,099	-	26,094	-
District contributions subsequent to the measurement date	<u>16,211</u>	<u>-</u>	<u>16,335</u>	<u>-</u>
Total	<u>\$ 175,541</u>	<u>\$ 62,538</u>	<u>\$ 108,355</u>	<u>\$ -</u>

\$16,211 reported as deferred outflows of resources related to pensions resulting from District contributions subsequent to the measurement date will be recognized as a reduction of the net pension liability in the year ended December 31, 2018. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to pensions will be recognized in pension expense as follows:

Year ended December 31:	
2018	\$ 46,047
2019	41,168
2020	16,822
2021	(7,244)

Actuarial assumptions.

The total pension liability in the June 30, 2017 and 2016 actuarial valuations using standard roll-forward techniques, was determined using the following actuarial assumptions, applied to all periods included in the measurement:

2017

Inflation	2.30%
Salary increases	3.05%, average, including inflation
Investment rate of return	6.25%, net of pension plan investment expense, including inflation

Muhlenberg County Water District Number 3
Notes to Financial Statements
December 31, 2017 and 2016

NOTE H - EMPLOYEES' PENSION PLAN continued

2016

Inflation	3.25%
Salary increases	4.00%, average, including inflation
Investment rate of return	7.50%, net of pension plan investment expense, including inflation

The mortality table used for active members is RP-2000 Combined Mortality Table projected with Scale BB to 2013 (multiplied by 50% for males and 30% for females). For healthy retired members and beneficiaries, the mortality table used is the RP-2000 Combined Mortality Table projected with Scale BB to 2013 (set back 1 year for females). For disabled members, the RP-2000 Combined Disabled Mortality Table projected with Scale BB to 2013 (set back 4 years for males) is used for the period after disability retirement.

The actuarial assumption used in the June 30, 2016 valuation and rolled forward to June 30, 2017 were based on the results of an actuarial experience study for the period July 1, 2008 – June 30, 2013.

The long-term expected return on plan assets is reviewed as part of the regular experience studies prepared every five years for KRS. The most recent analysis, performed for the period covering fiscal years 2008 through 2013, is outlined in a report dated April 30, 2014. Several factors are considered in evaluating the long-term rate of return assumption including long term historical data, estimates inherent in current market data, and a log-normal distribution analysis in which best-estimate ranges of expected future real rates of return (expected return, net of investment expense and inflation) were developed by the investment consultant for each major asset class. These ranges were combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and then adding expected inflation. The capital market assumptions developed by the investment consultant are intended for use over a 10-year horizon and may not be useful in setting the long-term rate of return for funding pension plans which covers a longer timeframe. The assumption is intended to be a long term assumption and is not expected to change absent a significant change in the asset allocation, a change in the inflation assumption, or a fundamental change in the market that alters expected returns in future years.

The target asset allocation and best estimates of arithmetic real rates of return for each major asset class are summarized in the following table:

<u>Asset Class</u>	<u>Target Allocation</u>	<u>Long-Term Expected Real Rate of Return</u>
Combined Equity	44%	5.40%
Combined Fixed Income	19	1.50
Real Return (Diversified Inflation Strategies)	10	3.50
Real Estate	5	4.50
Absolute Return (Diversified Hedge Funds)	10	4.25
Private Equity	10	8.50
Cash Equivalent	2	(0.25)
Total	<u>100%</u>	

Discount rate. For CERS, the discount rate used to measure the total pension liability was 6.25%. The projection of cash flows used to determine the discount rate assumed that local employers would contribute the actuarially determined contribution rate of projected compensation over the remaining 26 year amortization period of the unfunded actuarial accrued liability. The discount rate does not use a municipal bond rate.

Muhlenberg County Water District Number 3
 Notes to Financial Statements
December 31, 2017 and 2016

NOTE H - EMPLOYEES' PENSION PLAN continued

Sensitivity of the District's proportionate share of the net pension liability to changes in the discount rate. The following presents the District's proportionate share of the net pension liability calculated using the discount rate of 6.25% for June 30, 2017 and 7.50% for June 30, 2016, as well as what the District's proportionate share of the net pension liability would be if it were calculated using a discount rate that is 1-percentage-point lower (5.25% and 6.50%) or 1-percentage-point higher (7.25% and 8.50%) than the current rate.

	<u>1% Decrease</u> <u>(5.25%)</u>	<u>Discount Rate</u> <u>(6.25%)</u>	<u>1% Increase</u> <u>(7.25%)</u>
District's 2017 proportionate share of the net pension liability	\$ 711,505	\$ 564,142	\$ 440,874
	<u>1% Decrease</u> <u>(6.50%)</u>	<u>Discount Rate</u> <u>(7.50%)</u>	<u>1% Increase</u> <u>(8.50%)</u>
District's 2016 proportionate share of the net pension liability	\$ 613,563	\$ 492,576	\$ 388,469

2017

Change in assumptions. Since the prior measurement date, the demographic and economic assumptions that affect the measurement of the total pension liability have been updated. The changes are noted below:

- The assumed investment rate of return was decreased from 7.50% to 6.25%.
- The assumed rate of inflation was reduced from 3.25% to 2.30%.
- Payroll growth assumption was reduced from 4.00% to 3.05%.
- The mortality table used for active members is RP-2000 Combined Mortality Table projected with Scale BB to 2013 (multiplied by 50% for males and 30% for females).

For healthy retired members and beneficiaries, the mortality table used is the RP-2000 Combined Mortality Table projected with Scale BB to 2013 (set back 1 year for females). For disabled members, the RP-2000 Combined Disabled Mortality Table projected with Scale BB to 2013 (set back 4 years for males) is used for the period after disability retirement. There is some margin in the current mortality tables for possible future improvement in mortality rates and that margin will be reviewed again when the next experience investigation is conducted.

Pension plan fiduciary net position. Detailed information about the pension plan's fiduciary net position is available in the separately issued financial report of CERS.

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.

NOTE J - CONSTRUCTION IN PROGRESS AND CONSTRUCTION PROJECTS PAYABLE

During 2016 and 2015, the District incurred costs related to building a new office building. Project costs included a \$16,000 purchase of land and additional preliminary costs of \$7,035 consisting of engineering and plan designs. During 2017, the District purchased an existing office building instead of building. The previously purchased land was sold for the same amount as the purchase cost. The other costs of \$7,035 was abandoned and is reflected as a loss.

During 2016, the District incurred \$1,151 in materials cost related to the Clark Street Line Replacement project. These costs are considered construction in progress until the line replacement is complete and in service. The project was completed in 2016 and \$108,732 related costs of the project were capitalized. Also, during 2016, the District purchased a large volume of meters of which \$77,824 cost is awaiting to be placed in service at year end.

Required Supplementary Information

Muhlenberg County Water District District Number 3
 Schedule of Proportionate Share of the Net Pension Liability
 December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>	<u>2015</u>
Total net pension liability for County Employees' Retirement System	\$ 8,090,585,976	\$ 6,639,559,678	\$ 5,834,631,445
District's proportion of the net pension liability (asset)	0.009638%	0.01000%	0.00941%
District's proportionate share of the net pension liability (asset)	\$ 564,142	\$ 492,576	\$ 404,505
District's covered-employer payroll	\$ 229,516	\$ 237,399	\$ 219,505
District's proportionate share of the net pension liability (asset) as a percentage of its covered-employer payroll	245.80%	207.49%	184.28%
Total pension plan's fiduciary net position	\$ 8,905,233,231	\$ 8,151,568,466	\$ 8,519,001,523
Total pension plan's pension liability	\$16,995,819,207	\$14,791,128,144	\$14,353,632,968
Total Pension Plan's fiduciary net position as a percentage of the total pension liability	52.40%	55.11%	59.35%

Note: This schedule is intended to present a 10-year trend per GASB 68. Additional years will be reported as incurred

Muhlenberg County Water District Number 3
 Schedule of District Contributions
December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>	<u>2015</u>
Actuarially determined contribution	\$ 43,433	\$ 40,500	\$ 38,786
Contributions in relation to the actuarially determined contribution	<u>43,433</u>	<u>40,500</u>	<u>38,786</u>
Contribution deficiency (excess)	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>
 District's covered-employee payroll	 \$ 229,516	 \$ 237,399	 \$ 219,505
 Contributions as a percentage of covered- employee payroll	 18.92%	 17.06%	 17.67%

Note: This schedule is intended to present a 10-year trend per GASB 68. Additional years will be reported as incurred

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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, 2017 and 2016, and the related notes to the financial statements, and have issued our report thereon dated June 21, 2018.

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. We did identify certain deficiencies in internal control, as discussed below, that we consider to be significant deficiencies.

2017-1 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.

2017-2 Lack of Financial Reporting Expertise

Condition: The District lacks personnel with the expertise to apply generally accepted accounting principles in preparing its financial statements including note disclosures. Management engaged the auditor to prepare draft financial statements, including the related notes to the financial statements. Management reviewed, approved and accepted responsibility for the financial statements prior to their issuance.

Criteria: The District is required to have internal controls in place that enable it to prepare complete financial statements, including note disclosures, in compliance with generally accepted accounting principles.

Effect: The absence of such controls may allow errors to go undetected.

Cause: There is a lack of personnel who possess the required knowledge.

Recommendation: We recommend management review the costs and benefits involved to retain a consultant with the required expertise to prepare the financial statements or review the financial statements as prepared by the auditor for compliance with generally accepted accounting principles.

Response: Management has determined that it is more cost effective to continue to engage the auditor to draft the financial statements and related notes.

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, Tokey & Knight, PLLC

Madisonville, Kentucky

June 21, 2018