FLEMING COUNTY
WATER ASSOCIATION, INC.

AUDIT OF FINANCIAL STATEMENTS

For The Year Ended December 31, 2013

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Independent Auditors' Report

To the Board of Directors of
Fleming County Water Association, Inc.

Report on the Financial Statements

We have audited the accompanying financial statements of Fleming County Water Association, Inc. (a nonprofit organization), which comprise the statement of financial position as of December 31, 2013, and the related statements of activities and cash flows for the year then ended, and the related notes to the financial statements.

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.

Auditors' Responsibility

Our responsibility is to express an opinion 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 auditors' 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 auditors consider 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.

To the Board of Directors of
Fleming County Water Association, Inc.

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 opinion.

Basis for Qualified Opinion

We did not observe the taking of the physical inventories at December 31, 2013 (stated at $60,012). We were unable to obtain sufficient appropriate audit evidence regarding the amounts at which inventory is recorded in the accompanying statement of financial position at December 31, 2013.

Qualified Opinion

In our opinion, except for the possible effects of the matter discussed in the Basis for Qualified Opinion paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Fleming County Water Association, Inc., as of December 31, 2013, and the changes in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated April 24, 2014, on our consideration of the Association's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Association's internal control over financial reporting and compliance.

Morgan - Franklin, LLC

Morgan-Franklin, LLC
West Liberty, Kentucky

April 24, 2014

FLEMING COUNTY WATER ASSOCIATION, INC.
STATEMENT OF FINANCIAL POSITION
December 31, 2013

ASSETS	
CURRENT ASSETS	
Cash - Unrestricted	$ 456,101
Cash - Restricted	226,725
Accounts Receivable	132,189
Unbilled Receivables	82,007
Inventory	60,012
Prepaid Expenses	9,965
Total Current Assets	966,999
NONCURRENT ASSETS	
Cash - Restricted	203,070
Total Noncurrent Assets	203,070
PROPERTY AND EQUIPMENT	
(Net of Accumulated Depreciation)	
Land	54,273
Construction In Progress	1,063
Land Improvements	48,424
Buildings and Building Improvements	143,350
Machinery and Equipment	90,873
Vehicles	49,938
Tools, Shop and Garage Equipment	2,233
Communication Equipment	137
Office Furniture and Equipment	12,768
Water Lines	7,358,048
Tanks and Pumping Equipment	492,195
Total Property and Equipment	8,253,302
TOTAL ASSETS	$ 9,423,371

The accompanying notes are an integral part of the financial statements.

FLEMING COUNTY WATER ASSOCIATION, INC.
STATEMENT OF FINANCIAL POSITION
December 31, 2013

LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accrued Payroll Taxes	$	2,879
Accrued Salaries		3,015
Accounts Payable		69,221
Unearned Revenues		6,457
Accrued School and Sales Tax		5,293
Accrued Interest		47,014
Notes Payable		68,800
Total Current Liabilities		202,679
LONG-TERM LIABILITIES		
Compensated Absences		77,615
Notes Payable		2,635,179
Total Long-Term Liabilities		2,712,794
OTHER LIABILITIES		
Customer Deposits		56,053
TOTAL LIABILITIES		2,971,526
NET ASSETS		
Temporarily Restricted		429,795
Unrestricted		6,022,050
TOTAL NET ASSETS		6,451,845
TOTAL LIABILITIES AND NET ASSETS	$	9,423,371

The accompanying notes are an integral part of the financial statements.

FLEMING COUNTY WATER ASSOCIATION, INC.
STATEMENT OF ACTIVITIES
For The Year Ended December 31, 2013

CHANGE IN UNRESTRICTED NET ASSETS:

OPERATING REVENUES	
Water Collection	$ 1,678,985
Utility Relocation Proceeds	111,613
Late Penalties	36,196
Member Dues	2,900
Tap-On Fees	34,355
Miscellaneous Services	43,877
Net Operating Revenues	1,907,926
OPERATING EXPENSES	
Salaries and Wages - Employees	336,466
Salaries and Wages - Directors	13,400
Employee Benefits	120,438
Purchased Water	612,856
Purchased Power	17,013
Taxes Other Than Income	26,637
Materials and Supplies	63,739
Contracted Services	49,427
Transportation Expense	42,663
Insurance	21,024
Advertising	493
Depreciation	266,918
Waterline Relocation Expenses	121,106
Miscellaneous Expenses	23,915
Total Operating Expenses	1,716,095
NET OPERATING INCOME	191,831

The accompanying notes are an integral part of the financial statements.

FLEMING COUNTY WATER ASSOCIATION, INC.
STATEMENT OF ACTIVITIES
For The Year Ended December 31, 2013

NON OPERATING REVENUES (EXPENSES)		
Interest Expense		(128,675)
Interest Income		720
Total Non Operating Revenues (Expenses)		(127,955)
Change in Unrestricted Net Assets:		63,876
CHANGE IN TEMPORARILY RESTRICTED NET ASSETS:		
REVENUE		
Investment Income		1,284
Change in Temporarily Restricted Net Assets:		1,284
Net Assets- Beginning		6,386,685
Total Net Assets - Ending	$	6,451,845

The accompanying notes are an integral part of the financial statements.

FLEMING COUNTY WATER ASSOCIATION, INC.
STATEMENT OF CASH FLOWS
For The Year Ended December 31, 2013

CASH FLOWS FROM OPERATING ACTIVITIES		
Payments from Customers	$	1,730,965
Late Penalties		36,196
Miscellaneous Services		43,877
Utility Relocation Proceeds		111,613
Member Dues		2,900
Payments to Vendors		(943,374)
Payments for Payroll and Related Expenses		(518,846)
Net Cash Provided/(Used) by Operating Activities:		463,331
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Additions to Capital Assets		(91,245)
Net (Deposits)/Withdrawals into or from Dep. Reserve Fund		(608)
Net (Deposits)/Withdrawals into or from Debt Service Fund		(678)
Net (Deposits)/Withdrawals into or from Construction Account		(505)
Interest Paid on Capital Debt		(134,549)
Reduction in Notes Payable		(174,745)
Net Cash Provided/(Used) by Capital and Related Financing Activities	$	(402,330)
CASH FLOWS FROM INVESTING ACTIVITIES		
Cash Received From Interest	$	2,006
Net Cash Provided/(Used) by Investing Activities		2,006
INCREASE/(DECREASE) IN CASH		63,007
CASH AT BEGINNING OF YEAR		393,094
CASH AT END OF YEAR	$	456,101

The accompanying notes are an integral part of the financial statements.

FLEMING COUNTY WATER ASSOCIATION, INC.
STATEMENT OF CASH FLOWS (Continued)
For The Year Ended December 31, 2013

Reconciliation of Net Operating Income to Net Cash Provided by Operating Activities:

Net Operating Income	$ 191,831
Adjustments to Reconcile Net Operating Income to	
Net Cash Provided by Operating Activities:	
Depreciation	266,918
Changes in Assets/Liabilities:	
Accounts Receivable	3,287
Inventory	30
Accounts Payable	9,460
Accrued Payroll Taxes	(207)
Compensated Absences	(21,698)
Accrued School and Sales Tax	(628)
Customer Deposits	14,338
Net Cash Provided/Used by Operating Activities	$ 463,331

Supplementary Information

Total Interest Cost	$ 128,604
Interest Paid to Customers for Deposits	71
Interest Cost Charged to Operations	$ 128,675

The accompanying notes are an integral part of the financial statements.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This summary of significant accounting policies of the Fleming County Water Association, Inc. (the Association) is presented to assist in understanding the Association's financial statements. The financial statements and notes are representations of the Association's management, who are responsible for their integrity and objectivity. These accounting policies, as applied to the aforementioned financial statements, conform to generally accepted accounting principles.

<u>Organization & Activity</u>

The Association was incorporated in the Commonwealth of Kentucky as a nonprofit corporation in 1969. The Association operates a public water distribution system serving residential, commercial and agricultural customers. As of December 31, 2013 the Association served approximately 4,000 customers. The Kentucky Public Service Commission regulates the Association.

<u>Measurement Focus, Basis of Accounting and Financial Statement Presentation</u>

The basic financial statements provide information about the Association's activities.

"Measurement Focus" is an accounting term used to describe which transaction and types of balances are recorded within the various financial statements. The expression, "Basis of Accounting", refers to when transactions or events are recorded regardless of measurement focus applied.

Because of the "businesslike" characteristics of the Association's operations, the accompanying financial statements report uses the economic resources measurement focus and the accrual basis of accounting. The accounting objective of the "economic resources" measurement focus is the determination of operating income, changes in net assets (or cost recovery), financial position, and cash flows. All assets and liabilities (whether current or noncurrent) associated with their activities are reported.

Under full accrual accounting, revenues are recorded when earned and expenses are recorded when a liability is incurred or economic asset used, regardless of the timing of the related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

As the means for delivering services to its customers, the Association utilizes an office building, infrastructure, office equipment, equipment and vehicles. To provide the resources that are necessary to pay for water services and the related support functions, the Association charges its customers monthly user fees, which are based on the specific level of services that they are receiving. Because the operations of the Association closely mirror those of a typical, commercial company, its accounting records reflect a similar approach for measuring its business activity.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Measurement Focus, Basis of Accounting and Financial Statement Presentation (Continued)

The Association distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and delivering goods in connection with the Association's ongoing operations. The principal operating revenues are charges to customers for sales and services that are provided to them. The Association also recognizes as operating revenue the portion of tap fees intended to recover the cost of connecting new customers to the water and sewer systems. Operating expenses include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

When both restricted and unrestricted resources are available for use, it is the Association's policy to use restricted resources first, and then unrestricted resources as they are needed.

The Association has presented its financial statements in accordance with generally accepted accounting principles for not-for-profit organizations. Under this guidance, the Association is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets.

A summary of the net asset categories included in the accompanying financial statements is as follows:

Unrestricted Net Assets

Unrestricted, undesignated net assets are available for the various programs and administration of the Association.

Temporarily Restricted Net Assets

The Association is required to maintain special deposit accounts for long-term debt obligations. Restricted Accounts are made up of the Debt Service Account of $226,220, the Depreciation Reserve Account in the amount of $203,070 and the Construction Account in the amount of $505 for a total of $429,795.

Permanently Restricted Net Assets

Permanently restricted net assets consist of donor-restricted contributions, which are required to be held in perpetuity, and income from the assets held is available for either general operations or specific purposes, in accordance with donor stipulations. There are no permanently restricted net assets at December 31, 2013.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Budgeting

The Association prepares annual operating budgets for the managerial control of expenditures and for the monitoring of cash flows during the fiscal year. Project-length budgets, which generally encompass more than one fiscal year, are also prepared for major construction projects. Both the operating and project-length expenditure plans are prepared on the cash basis of accounting, which significantly differs from the accrual basis of accounting that the Association uses in the preparation of its financial statements.

These managerial budgets that are prepared for operations each year or at the inception of a major construction project are not adopted by the Board as legally imposed restrictions on expenditures. Basically, the operating budgets provide management with a tool for estimating and monitoring cash flows in each fiscal period. Accordingly, budgetary comparisons are not presented in the accompanying financial statements.

Allowance for Doubtful Accounts

No allowance for doubtful accounts has been established. The Association considers all receivables to be fully collectible based on their strict cut-off policy. If amounts become uncollectible, the amounts due are offset by any customer deposit held and the balance charged to operations when that determination is made.

Accounts and Unbilled Receivables

Accounts receivable are stated at face amount. Unbilled receivables represent income earned during the current year, but not yet billed to the customer. The billing mailed on December 27, 2013 was for customer usage from approximately November 15 through December 15, 2013. The entire amount is considered accounts receivable as of December 31, 2013. The billing mailed on January 30, 2014 was for usage from approximately December 15, 2013 through January 15, 2014. Fifty percent of this billing is considered unbilled receivables at December 31, 2013.

Customer receivables are used as collateral for outstanding Rural Development debt.

Advertising Costs

The Association expenses advertising costs as incurred.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Property, Plant and Equipment

Capital assets, which include, property, plant, equipment, and infrastructure assets (e.g., water distribution systems, sewer collection systems and similar items) are reported as a component of noncurrent assets in the basic financial statement. Capital assets are generally defined by the Association as being those assets with an initial individual cost of more than $750 and an estimated useful life in excess of one year. Such assets are recorded at historical cost or estimated historical cost if purchased or constructed.

	Capitalization Threshold		Useful Life (Years)
Land Improvements	$	5,000	20-50
Buildings and Building Improvements	$	5,000	35-40
Machinery and Equipment	$	4,000	7-10
Vehicles/Trailers	$	5,000	5-7
Tools, Shop & Garage Equipment	$	750	7-10
Communication Equipment	$	1,000	10-15
Office Furniture and Equipment	$	1,000	5-10
Water Lines - Meters/Mains/System Lines/ Plant/Radio Read	$	5,000	10-50
Tanks and Pumping Equipment	$	5,000	20-50

The reported value excludes the costs of normal maintenance and repairs that are essentially amounts spent in relation to capital assets that do not increase the capacity or efficiency of the item or extend its useful life beyond the original estimate.

Depreciation is charged as an expense against operations. Capital assets of the Association are depreciated using the straight-line method over their estimated useful lives in years.

The depreciation expense during the period ended December 31, 2013 is $266,918.

Cash and Cash Equivalents

For the purpose of these financial statements, cash and cash equivalents consist of unrestricted cash on hand, demand and savings deposits and certificates of deposit.

Inventory and Prepaid Items

Included in inventory are materials and supplies to support maintenance work on the Association's infrastructure. All inventories maintained by the Association are valued at cost.

FLEMING COUNTY WATER ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS
December 31, 2013

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Inventory and Prepaid Items (Continued)

Certain payments to vendors reflect costs applicable to future accounting periods and are recorded as prepaid items. An example of a prepaid item for the Association is property and liability insurance premiums.

Federal Income Tax

Income of the Association is exempt from tax under Internal Revenue Code Section 501(c)(12). Accordingly, the financial statements include no provision for income taxes.

All significant tax positions have been considered by management. It has been determined that it is more likely than not that all tax positions would be sustained upon examination by taxing authorities. Federal tax returns are subject to examination by taxing authorities generally for three years after they are filed.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates that effect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

NOTE B – RESTRICTIONS ON CASH

Sinking Fund

Deposits into Sinking Funds are required to be made monthly in order to accumulate funds for payment of loan principle and interest. At December 31, 2013, $209,210 was required to be on deposit to meet payments of interest and principal due on loans for 2014. The balance in this account at December 31, 2013 was $226,220.

Depreciation Reserve

The Depreciation Reserve Account is being maintained as required in various loan documents. The Association was required to deposit $415 per month into the account. At December 31, 2013, $193,496 was the required balance of the Depreciation Reserve account. The Association had $203,070 in this account for the purpose of maintaining the water system.

Construction

The Construction Account is being maintained to record revenues and expenses associated with the 2012 Waterline Extension project. The balance in this account at December 31, 2013 was $505.

NOTE C – CASH DEPOSITS WITH FINANCIAL INSTITUTIONS

The Association's funds are on deposit at a local financial institution. At December 31, 2013, the carrying amount of the Association's cash was $885,896 and the bank balances were $887,178. The difference between the carrying amount and the bank balances results from deposits in transit and outstanding checks. As of December 31, 2013, the bank balances were either insured by FDIC or covered by pledged collateral.

Deposits Covered By Federal Insurance	$250,505
Deposits Collateralized	636,673
Total Bank Balance	$887,178

NOTE D – PROPERTY, PLANT AND EQUIPMENT

The Association's major classes of utility capital assets and accumulated depreciation are shown below:

	Reporting Entity			
	Beginning Balance	Increases	Decreases	Ending Balance
Capital Assets Not Being Depreciated:				
Land	$ 54,273			$ 54,273
Construction In Progress		$ 1,063		1,063
Total Capital Assets Not Being Depreciated	54,273	1,063		55,336
Capital Assets, Being Depreciated:				
Land Improvements	9,330	44,437		53,767
Buildings and Improvements	235,944			235,944
Machinery and Equipment	125,666	1,186		126,852
Vehicles	142,192	24,385		166,577
Tools, Shop & Garage Equipment	23,926			23,926
Communication Equipment	8,041			8,041
Office Furniture and Equipment	109,590			109,590
Water Lines	10,365,605	20,174		10,385,779
Tanks and Pumping Equipment	680,590			680,590
Total Capital Assets Being Depreciated	11,700,884	90,182		11,791,066

NOTE D – PROPERTY, PLANT AND EQUIPMENT (CONTINUED)

	Beginning Balance	Increases	Decreases	Ending Balance
Less Accumulated Depreciation for:				
Land Improvements	(4,230)	(1,113)		(5,343)
Buildings and Improvements	(86,695)	(5,899)		(92,594)
Machinery and Equipment	(23,944)	(12,035)		(35,979)
Vehicles	(99,467)	(17,172)		(116,639)
Tools, Shop & Garage Equipment	(21,293)	(400)		(21,693)
Communication Equipment	(7,778)	(126)		(7,904)
Office Furniture and Equipment	(90,414)	(6,408)		(96,822)
Water Lines	(2,818,213)	(209,518)		(3,027,731)
Tanks and Pumping Equipment	(174,148)	(14,247)		(188,395)
Total Accumulated Depreciation	(3,326,182)	(266,918)		(3,593,100)
Total Capital Assets, Being Depreciated, Net	8,374,702	(176,736)		8,197,966
Governmental Activities Capital Assets, Net	$ 8,428,975	$ (175,673)	$ 0	$ 8,253,302

NOTE E – LONG-TERM DEBT

1. On February 12, 1981 the Association entered into a promissory note agreement with Rural Development in the amount of $260,000 for the purpose of providing a water distribution system in Fleming County, Kentucky. Annual principal and interest payments at a rate of 5% are required on February 12. As of December 31, 2013, the principal balance was paid in full.

NOTE E – LONG-TERM DEBT (CONTINUED)

2. On December 13, 1988 the Association entered into a promissory note agreement with Rural Development in the amount of $300,000 for the purpose of providing a water distribution system in Fleming County, Kentucky. Annual principal and interest payments at a rate of 5.75% are required on December 13. As of December 31, 2013, the principal balance outstanding was $192,536. Debt service requirements for year ending December 31, 2013, and thereafter are as follows:

Year Ended December 31	Scheduled Interest	Scheduled Principal
2014	$ 11,116	$ 8,477
2015	10,629	8,964
2016	10,114	9,479
2017	9,568	10,025
2018	8,992	10,601
2019-2023	35,084	62,881
2024-2028	14,804	82,109
Totals	$ 100,307	$ 192,536

3. On July 14, 1992 the Association entered into a promissory note agreement with Rural Development in the amount of $504,000 for the purpose of providing a water distribution system in Fleming County, Kentucky. Annual principal and interest payments at a rate of 5% are required on July 14. As of December 31, 2013, the principal balance outstanding was $360,569. Debt service requirements for year ending December 31, 2013, and thereafter are as follows:

Year Ended December 31	Scheduled Interest	Scheduled Principal
2014	$ 18,049	$ 11,834
2015	17,458	12,425
2016	16,836	13,047
2017	16,184	13,699
2018	15,499	14,384
2019-2023	65,961	83,454
2024-2028	42,903	106,512
2029-2032	13,707	105,214
Totals	$ 206,597	$ 360,569

NOTE E – LONG-TERM DEBT (CONTINUED)

4. On October 13, 1994 the Association entered into a promissory note agreement with Rural Development in the amount of $185,600 for the purpose of providing a water distribution system. Annual principal and interest payments at a rate of 4.5% are required on October 13. As of December 31, 2013, the principal balance outstanding was $137,580. Debt service requirements for year ending December 31, 2013, and thereafter are as follows:

Year Ended December 31	Scheduled Interest	Scheduled Principal
2014	$ 6,200	$ 4,085
2015	6,016	4,269
2016	5,824	4,461
2017	5,623	4,662
2018	5,414	4,871
2019-2023	23,574	27,851
2024-2028	16,718	34,707
2029-2033	8,174	43,251
2034	553	9,423
Totals	$ 78,096	$ 137,580

5. On October 13, 1994 the Association entered into a promissory note agreement with Rural Development in the amount of $700,000 for the purpose of providing a water distribution system. Annual principal and interest payments at a rate of 4.5% are required on October 13. As of December 31, 2013, the principal balance outstanding was $518,976. Debt service requirements for the year ending December 31, 2013, and thereafter are as follows:

NOTE E – LONG-TERM DEBT (CONTINUED)

5. (Continued)

Year Ended December 31	Scheduled Interest	Scheduled Principal
2014	$ 23,387	$ 15,400
2015	22,694	16,093
2016	21,969	16,818
2017	21,213	17,574
2018	20,422	18,365
2019-2023	88,945	104,990
2024-2028	63,097	130,838
2029-2033	30,888	163,047
2034	2,103	35,851
Totals	$ 294,718	$ 518,976

6. On April 23, 1997 the Association entered into a promissory note agreement with Rural Development in the amount of $529,000 for the purpose of providing a water distribution system. Annual principal and interest payments at a rate of 5% are required on April 23. As of December 31, 2013, the principal balance outstanding was $432,115. Debt service requirements for year ending December 31, 2013, and thereafter are as follows:

Year Ended December 31	Scheduled Interest	Scheduled Principal
2014	$ 21,633	$ 9,732
2015	21,147	10,218
2016	20,637	10,728
2017	20,099	11,266
2018	19,537	11,828
2019-2023	88,197	68,628
2024-2028	69,236	87,589
2029-2033	45,037	111,788
2034-2037	14,172	110,338
Totals	$ 319,695	$ 432,115

NOTE E – LONG-TERM DEBT (CONTINUED)

7. On November 22, 2000 the Association entered into a promissory note agreement with Rural Development in the amount of $267,980 for the purpose of providing a water distribution system. Annual principal and interest payments at a rate of 4.5% are required on November 22. As of December 31, 2013, the principal balance outstanding was $229,197. Debt service requirements for the year ending December 31, 2013, and thereafter are as follows:

Year Ended December 31	Scheduled Interest	Scheduled Principal
2014	$ 10,321	$ 4,528
2015	10,118	4,731
2016	9,905	4,944
2017	9,682	5,167
2018	9,450	5,399
2019-2023	43,379	30,866
2024-2028	35,779	38,466
2029-2033	26,310	47,935
2034-2038	14,509	59,736
2039-2040	1,871	27,425
Totals	$ 171,324	$ 229,197

8. On August 18, 2004 the Association entered into a promissory note agreement with Rural Development in the amount of $554,000 for the purpose of providing water lines. Annual principal and interest payments at a rate of 4.5% are required on August 18. As of December 31, 2013, the principal balance outstanding was $467,658. Debt service requirements for the year ending December 31, 2013, and thereafter are as follows:

NOTE E – LONG-TERM DEBT (CONTINUED)

8. (Continued)

Year Ended December 31	Scheduled Interest	Scheduled Principal
2014	$ 21,044	$ 9,654
2015	20,610	10,088
2016	20,157	10,541
2017	19,681	11,017
2018	19,187	11,511
2019-2023	87,677	65,813
2024-2028	71,477	82,013
2029-2033	51,285	102,205
2034-2038	26,125	127,365
2039-2040	2,066	37,451
Totals	$ 339,309	$ 467,658

9. On May 28, 2009 the Association entered into a promissory note agreement with Rural Development in the amount of $375,000 for the purpose of providing potable water to rural areas of Fleming County, Kentucky. Annual principal and interest payments at a rate of 3.265% are required on May 28. As of December 31, 2013, the principal balance outstanding was $365,348. Debt service requirements for the year ending December 31, 2013, and thereafter are as follows:

Year Ended December 31	Scheduled Interest	Scheduled Principal
2014	$ 13,244	$ 5,090
2015	13,059	5,275
2016	12,868	5,466
2017	12,670	5,664
2018	12,465	5,869
2019-2023	58,973	32,697
2024-2028	52,602	39,068
2029-2033	44,988	46,682
2034-2038	35,891	55,779
2039-2043	25,021	66,649
2044-2048	12,033	79,637
2049	633	17,472
Totals	$ 294,447	$ 365,348

NOTE F – LONG TERM DEBT IN THE AGGREGATE

Year Ended December 31	Scheduled Interest	Scheduled Principal
2014	$ 124,994	$ 68,800
2015	121,731	72,063
2016	118,310	75,484
2017	114,720	79,074
2018	110,966	82,828
2019-2023	491,790	477,180
2024-2028	366,616	601,302
2029-2033	220,389	620,122
2034-2038	93,353	398,492
2039-2043	28,958	131,525
2044-2048	12,033	79,637
2049	633	17,472
Totals	$ 1,804,493	$ 2,703,979

NOTE G – CHANGES IN LONG-TERM DEBT

	Beginning Balance	Additions	Reductions	Ending Balance	Due Within One Year
Business-type Activities:					
Promissory Notes	$ 2,878,722		$ (174,743)	$ 2,703,979	$ 68,800
Business-type Activities Long-term Liabilities	$ 2,878,722	$ 0	$ (174,743)	$ 2,703,979	$ 68,800

NOTE H – RETIREMENT

401K

In July 1992, the Association elected to participate in a 457 Prototype Plan. The Association established the plan open to all eligible employees and later discovered that it was not a money purchase plan but was in fact an eligible deferred compensation plan under section 457(b) of the Code which could not include all its rank and file employees. The Association now holds all of the deferred compensation contributed by itself and its employees to the plan in trust for their exclusive benefit, in violation of the requirements of section 457(b)(6) that a plan be unfunded and that its assets remain part of the employer's general assets. To correct this violation the Association froze the plan on December 31, 2007 when it had $633,446 in assets. As of December 31, 2013 the plan had a balance of $ 784,556 including $ 30,671 in earnings for the year.

In January 2008, the Association elected to participate in a 401(K) Retirement Saving Plan. The Association contributes 10% of the employees' salary to the plan. Employees may elect to contribute a portion of their compensation to the plan. Employees are eligible to participate in the plan when they attain the age of 21 and have completed 180 days of service to the Association. Benefits generally occur at an employee's normal (age 65) or early retirement date (age 55), unless they postpone their actual retirement. Upon termination employees will only be entitled to receive the vested percentage of their account balance.

The Association's contribution for the year ended December 31, 2013 was $33,657.

NOTE I – INSURANCE COVERAGE

The Association is exposed to various risks of loss. The Association carries commercial insurance for risks of loss. As of December 31, 2013, there were no known losses for which an accrual was considered necessary and no estimated claims that have been incurred, but not reported.

NOTE J – SUBSEQUENT EVENTS

Subsequent events have been evaluated through April 24, 2014, which is the date the financial statements were available to be issued.

NOTE K – COMPENSATED ABSENCES

It is the Association's policy to permit its employees to accumulate earned but unused vacation and sick pay benefits. The unused vacation or annual leave is considered a vested employee benefit.

In recognition of the resulting obligation, the Association has accrued a liability for earned but unused vacation and sick leave, having determined that payment of such compensation is probable and having developed a reasonable estimate based upon current salary costs and annual leave balances as of December 31, 2013. The liability for compensated absences at December 31, 2013 was $77,615.

NOTE L – RELATED PARTIES

A board member is a director and chief financial officer of the depository institution where the Association's bank accounts are held.

An employee of the Association is a partner of Muse Supply; expenditures remitted to this company during 2013 were $1,928.

NOTE M – POSTRETIREMENT BENEFITS

During 2013 an employee retired. The Association agreed to pay the employee's supplemental health insurance monthly in the amount of $217. The board intends to pay future retirees' health insurance costs. The Association has not included a liability for these future costs in the financial statements. The Association funds its post-retirement benefit costs on a pay-as-you-go basis.

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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 Board of Directors of
Fleming County Water Association, Inc.

We have audited, except as discussed in the following sentence, in accordance with the 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 Fleming County Water Association (a nonprofit organization), which comprise the statement of financial position as of June 30, 2013, and the related statements of activities, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated April 24, 2014. The report on the financial statements was qualified due to the inadequacy of accounting records. We were unable to obtain sufficient, appropriate audit evidence regarding the amounts at which inventory is recorded.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Association'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 opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Association's internal control. Accordingly, we do not express an opinion on the effectiveness of the Association's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph 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. However, as described in the accompanying comments and recommendations, we identified certain deficiencies in internal control that we consider to be material weaknesses.

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*

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying comments and recommendations as items 2013-1, 2013-2, 2013-3 and 2013-4 to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Fleming County Water Association, Inc.'s financial statements are free from 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*.

Fleming County Water Association, Inc.'s Responses to Findings

Fleming County Water Association, Inc.'s responses to the findings identified in our audit are described in the accompanying comments and recommendations. The Association's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

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 results of that testing, and not to provide an opinion on the effectiveness of the organization'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 organization's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Morgan - Franklin, LLC

Morgan-Franklin, LLC
West Liberty, Kentucky
April 24, 2014

FLEMING COUNTY WATER ASSOCIATION, INC.
Comments and Recommendations
For the Year Ended December 31, 2013

MATERIAL WEAKNESSES

2013-1 The Association Should Have Adequate Controls Over The Preparation Of The Financial Statements Being Audited

Condition: The Association does not have adequate controls over the preparation of the financial statements being audited.

Criteria: SAS 112 states that an entity must have sufficient controls in place to prepare a full set of GAAP financial statements, including full disclosures.

Cause: Lack of controls over the preparation of the financial statements.

Effect: Management may not be able to identify deficiencies in reporting.

Recommendation: We recommend that the Association's management develop adequate controls over the preparation of the financial statements.

Management may engage a qualified individual with suitable skills to review the draft audit in order to advise management sufficiently for them to be able to take responsibility for the financial statements.

Or management could implement the following controls.

1. Review draft financial statements by comparing to year-end reports that were prepared by management.

2. Read footnotes accompanying the financial statement to ensure no discrepancies between footnotes and financial statements.

3. Review a disclosure checklist and compare to the footnotes for omitted or inaccurate disclosures.

These controls could be documented by initialing and dating the draft financial statement and disclosure checklist.

Response: The Association is a small utility employing eleven (11) employees and its size limits the amount of internal control that can be maintained. Management feels that all measures are taken within the associations' capacity to see that certain internal control procedures are followed in the preparation of the financial statements and that they are presented to management to review monthly as well as a present- prior year comparison and year end reports. The cost of engaging professional accountants to prepare the monthly financial statements would be a financial burden on the association resulting in higher rates for its members.

MATERIAL WEAKNESSES (CONTINUED)

2013-2 The Association Lacks Adequate Controls Over Disbursements

Condition: During our audit, we tested twenty-five disbursements and noted the following:

- The Association is not following written purchasing procedures.

While performing other procedures, we noted the following:

- Purchase requests were not completed for any purchases.
- Price quotations were not received from potential vendors.

Criteria: In accordance with the written purchasing policies, the purchasing of supplies, equipment and contractual services must allow for fair and competitive price quotations or bidding from potential vendors. A purchase request describing the type of purchase or item and quantity desired shall be completed. The purchase request shall be signed by the staff member initiating the purchase.

Cause: Lack of adequate controls over disbursements.

Effect:

- Items may not be purchased at the most competitive prices.
- Purchases may be occurring without proper approval.

Recommendation: We recommend the Association establish written controls over disbursements and determine the controls that would best address the findings listed under the condition section above. The Association may determine the controls listed above under the criteria section are adequate or may decide to implement other controls to eliminate such internal control weaknesses in the future.

Response: Monthly bills, both paid and pending, are reviewed and approved each month by the board.

- *A Monthly Check Register of all bills paid are presented for approval and attached to the minutes of each monthly board meeting.*

- *Management compares prices with various vendors on regular operating supplies and takes into account everything including shipping charges and turn-around time in which Items are received when making decisions on purchases to find the most economical price.*

- *Management will review the purchasing procedures and recommendations listed in the findings.*

MATERIAL WEAKNESSES (CONTINUED)

2013-3 The Association Lacks Adequate Internal Controls Over Inventory

Condition: The Association maintains inventory of items needed to make minor repairs to the water distribution system. The Association does not track inventory that is utilized by maintenance employees for such repairs. The Association charges materials and supplies as expenditures when acquired (purchase method). The inventory on hand at the end of the period is recorded as an asset. Each maintenance employee has a key to the storage building where inventory is maintained. Two of the five items viewed during the observation of the year-end inventory count could not be traced to the final inventory list.

As of December 31, 2013, the Association failed to take a physical inventory.

Criteria: The consumption method must be used by proprietary fund financial statements presented on the accrual basis of accounting. The Association should track all transactions involving inventory. Whenever maintenance employees use inventory they should document the part number, the dollar value of the part, the date, and their initials at a minimum. This information should be used to update the inventory balances in the accounting system. The individuals making the physical count of inventory should be trained as to the appropriate methods to be used during the annual inventory count.

A physical count of inventory should be taken at December 31 of each year.

Cause: The lack of adequate internal controls over inventory.

Effect: Misappropriations of inventory could occur and not be detected in a timely manner. A qualified auditor's opinion of the financial statements for the inadequacy of records associated with inventory was issued.

Recommendation: We recommend the Association establish adequate internal controls over inventory.

Fleming County Water Association's Response: The Association purchased Inventory software in 2012, and was in the process of setting up the system at the time of the year end count. An inventory count was taken on December 31, 2013, and reconciled so that beginning counts were correct and in 2013 Inventory was being tracked through service orders and invoices.

MATERIAL WEAKNESSES (CONTINUED)

2013-4 The Association Should Establish Adequate Controls Over Payroll

Condition: During our audit, we noted that one salaried employee does not keep a timesheet and overtime is paid to employees that do not physically work over forty hours in a week. We also noted that one employee does not keep track of his annual or sick leave hours. Maintenance employees use company vehicles to commute from home to work, but no fringe benefit is included on the employees' wage and earnings statements. An employee was paid for his annual vacation leave at the maximum amount permitted, however, the individual did not maintain time sheets or leave balance records.

Criteria: The Association's Personnel Policies and Procedures state that each *hourly* employee is required to keep a record of working hours during each payroll period by completing a time record sheet.

Per KRS 337.320 every employer shall keep a record of (a) the amount paid each pay period to each employee; (b) the hours worked each day and each week by each employee; and
(c) such other information as the commissioner requires.

The Association is only required to pay overtime wages for <u>actual hours</u> worked in excess of forty hours in one workweek. Time off with pay (sick, vacation or holiday leave) does not have to be considered as hours worked for overtime pay purposes. The Association's Personnel Policies and Procedures states that for the purposes of calculating overtime pay which is hours worked in excess of more than (10) hours in 1 day and/or more than forty (40) hours in one week, vacation days, sick days, and/or holidays are to be included in determining the forty (40) hour work week.

The Association should keep track of all employees' annual and sick leave. It is the Association's policy to pay out any accrued and unused annual and sick leave upon termination.

Pursuant to IRS Publication 15-B, all of an employee's use of a qualified nonpersonal-use vehicle is a working condition benefit.

All expenditures should have sufficient, adequate supporting documentation.

Cause: The Association's failure to establish procedures to correct prior year findings.

Effect: Documentation is not available to substantiate hours worked by a salaried employee. Paying individuals for overtime in excess of the amounts required by law may place an unnecessary financial burden on the Association. If annual and sick leave records are not accurately maintained, there is no way to know how much annual and sick leave compensation would be due to an employee upon termination. Fringe benefits required to be included on those

MATERIAL WEAKNESSES (CONTINUED)

2013-4 The Association Should Establish Adequate Controls Over Payroll (Continued)

Effect (Continued): employees' W-2s who commute from home to work using a company vehicle has been incorrectly omitted from the employees' wage and earnings statement.

Recommendation: We recommend the Association establish procedures that would best address the findings listed under the condition section above. The Association may determine the controls listed above under the criteria section are adequate or may decide to implement other controls to eliminate such internal control weaknesses in the future.

Fleming County Water Association's Response: The Association will review its current policies and recommendations listed in the findings concerning operating policies and procedures addressing , overtime and non-personal-use of vehicles.

All current employees have timesheets on file and all sick and vacation is currently being tracked. All accrued sick and vacation leave is supported by this documentation.