Fleming County Water Association

P.O. Box 327 • 2772 Morehead Road • Flemingsburg, KY 41041

Office:(606) 845-3981 • Fax: (606) 845-3982 • Toll Free: 1 (800) 845-3983

Equal Opportunity Employer and Provider *TDD: 711*

July 30, 2012

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AUG - 3 2012

PUBLIC SERVICE
COMMISSION

Linda Faulkner-Filings Director
Public Service Commission
P O Box 615
Frankfort, KY 40602-0615

Re: 2011 Audit
PSC Final Order Case No. 2009-00163

Dear Ms.Faulkner:

Please find enclosed the financial audit for year ending 12/31/2011. I hope this completes the information needed for this filing.

Sincerely,

Wilhemina P. Whisman

Wilhemina P. Whisman
FCWA/wpw

FLEMING COUNTY
WATER ASSOCIATION, INC.

AUDIT OF FINANCIAL STATEMENTS

For The Year Ended December 31, 2011

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Morgan-Franklin, LLC
Certified Public Accountants

749 Broadway Street
P.O. Box 428
West Liberty, KY 41472

Brenda K. Morgan, CPA
Jody B. Franklin, CPA

Phone: (606) 743-1884
Fax: (606) 743-1895
www.morganfranklincpa.com

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying statement of financial position of the Fleming County Water Association, Inc. (a non-profit organization) as of December 31, 2011, and the related statements of revenue, expenses and change in net assets and cash flows for the year then ended. These financial statements are the responsibility of the Fleming County Water Association, Inc.'s management. Our responsibility is to express opinions on these financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We did not observe the taking of the physical inventories at December 31, 2011 (stated at $73,132), since this date was prior to the time we were initially engaged as auditors for the Association. We were unable to satisfy ourselves about inventory quantities by means of other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to observe the physical inventories taken as of December 31, 2011, the financial statements referred to above present fairly, in all material respects, the financial position of the Fleming County Water Association, Inc., as of December 31, 2011, and the respective changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated June 28, 2012, on our consideration of the Fleming County Water Association, Inc.'s internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Respectfully Submitted

Morgan-Franklin, LLC

Morgan-Franklin, LLC

June 28, 2012

FLEMING COUNTY WATER ASSOCIATION, INC.
STATEMENT OF FINANCIAL POSITION
December 31, 2011

ASSETS

CURRENT ASSETS

Cash - Unrestricted	$	175,113
Cash - Restricted		426,183
Accounts Receivable		142,435
Unbilled Receivables		63,096
Allowance for Doubtful Accts.		(3,202)
Inventory		73,132
Prepaid Expenses		9,965
Total Current Assets		886,722

PROPERTY AND EQUIPMENT

Land		54,273
Construction in Progress		10,034
Land Improvements		9,330
Buildings and Building Improvements		214,904
Machinery and Equipment		118,908
Vehicles		147,692
Tools, Shop and Garage Equipment		23,926
Communication Equipment		8,041
Office Furniture and Equipment		107,962
Water Lines		10,356,958
Tanks and Pumping Equipment		680,590
Accumulated Depreciation		(3,060,517)
Total Property and Equipment		8,672,101
TOTAL ASSETS	$	9,558,823

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

FLEMING COUNTY WATER ASSOCIATION, INC.
STATEMENT OF FINANCIAL POSITION
December 31, 2011

LIABILITIES AND NET ASSETS	
CURRENT LIABILITIES	
Accrued Payroll Taxes	$ 2,516
Accrued Salaries	3,017
Accounts Payable	62,433
Accounts Payable - Construction	3,032
Unearned Revenues	6,457
Accrued School and Sales Tax	4,421
Accrued Interest	54,327
Notes Payable	72,181
Total Current Liabilities	208,384
LONG-TERM NOTES PAYABLE	2,878,875
OTHER LIABILITIES	
Compensated Absences	84,414
Customer Deposits	37,809
TOTAL LIABILITIES	3,209,482
NET ASSETS:	
Unrestricted	6,349,341
TOTAL NET ASSETS	6,349,341
TOTAL LIABILITIES AND NET ASSETS	$ 9,558,823

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

FLEMING COUNTY WATER ASSOCIATION, INC.
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
For The Year Ended December 31, 2011

OPERATING REVENUES	
Water Collection	$ 1,617,834
Late Penalties	37,919
Member Dues	2,850
Miscellaneous Services	39,015
Net Operating Revenues	1,697,618
OPERATING EXPENSES	
Salaries and Wages - Employees	365,151
Salaries and Wages - Directors	15,600
Employee Benefits	112,358
Purchased Water	613,336
Purchased Power	14,318
Taxes Other Than Income	31,185
Materials and Supplies	86,715
Contracted Services	37,031
Transportation Expense	44,655
Insurance	19,492
Adverstising	2,870
Depreciation	258,527
Miscellaneous Expenses	21,129
Total Operating Expenses	1,622,367
NET OPERATING INCOME	75,251
NON OPERATING REVENUES (EXPENSES)	
Gain on Disposal of Fixed Assets	24,173
Interest Expense	(140,306)
Interest Income	2,770
Total Other Income (Expenses)	(113,363)

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

FLEMING COUNTY WATER ASSOCIATION, INC.
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
For The Year Ended December 31, 2011

Income/(Loss) Before Contributions In Aid of Construction	(38,112)
Contributions - Tap On Fees	30,432
Change in Net Assets	(7,680)
Net Assets - Beginning	5,979,136
Prior Period Adjustment	377,885
Total Net Assets - Ending	$ 6,349,341

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, 2011

CASH FLOWS FROM OPERATING ACTIVITIES

Payments from Customers	$ 1,611,195
Late Penalties	37,919
Miscellaneous Services	39,015
Member Dues	2,850
Payments to Vendors	(838,561)
Payments for Payroll and Related Expenses	(518,898)
Net Cash Provided/(Used) by Operating Activities:	333,520

CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:

Additions to Capital Assets	(169,805)
Gain on Disposal of Fixed Assets	24,173
Increase in Accounts Payable Construction	3,032
Contributed Capital - Tap Fees	30,432
Net (Deposits)/Withdrawals Into or From Dep. Reserve Fund	(1,127)
Net (Deposits)/Withdrawals Into or From Debt Service Fund	(1,256)
Interest Paid on Capital Debt	(142,971)
Reduction in Notes Payable	(128,676)
Net Cash Provided/(Used) by Capital and Related Financing Activities	$ (386,198)

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, 2011

CASH FLOWS FROM INVESTING ACTIVITIES

Cash Received from Interest	$ 2,770
Net Cash Provided/(Used) by Investing Activities	2,770
INCREASE/(DECREASE) IN CASH	(49,908)
CASH AT BEGINNING OF YEAR	225,021
CASH AT END OF YEAR	$ 175,113

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

Net Operating Income	$ 75,251
Adjustments to Reconcile Net Operating Income to Net Cash Provided by Operating Activities:	
Depreciation	258,527
Changes in Assets/Liabilities:	
Accounts Receivable	(2,084)
Inventory	6,211
Prepaid Expenses	1,039
Allowance for Doubtful Accounts	(645)
Accounts Payable	(5,833)
Unearned Revenues	210
Accrued Salaries	3,015
Accrued Payroll Taxes	(135)
Accrued School and Sales Tax	(431)
Compensated Absences	2,516
Customer Deposits	(4,121)
Net Cash Provided/Used by Operating Activities	$ 333,520

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, 2011

Supplementary Information

Total Interest Cost	$ 140,120
Interest Paid to Customers for Deposits	186
Interest Cost Charged to Operations	$ 140,306

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.

Organization & Activity

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, 2011 the Association served approximately 4,000 customers. The Kentucky Public Service Commission regulates the Association.

Measurement Focus, Basis of Accounting and Financial Statement Presentation

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

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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

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.

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.

Financial statement presentation follows the recommendations of the Financial Accounting Standards Board in its Statement of Financial Accounting Standard (SFAS) No. 117, *Financial Statements of Not-for-Profit Organizations*. Under SFAS No. 117, 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, if any.

Unrestricted Net Assets

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

Temporarily Restricted Net Assets

Temporarily restricted net assets consist of donor restricted contributions. Amounts restricted by the donor, grantor or other outside party for a particular purpose are deemed to be earned and are reported as temporarily restricted revenue when received and such unexpended amounts are reported as temporarily restricted net assets at year end.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Temporarily Restricted Net Assets (Continued)

Contributions received with donor-imposed restrictions that are met in the same year in which the contributions are received are classified as unrestricted contributions, if any. Restrictions on gifts of fixed assets or contributions restricted for the purchase of fixed assets expire when the asset is placed in service, unless otherwise stipulated by the donor.

When a donor restriction expires, that is, when a stipulated time or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as "net assets released from restrictions". There are no temporarily restricted net assets at December 31, 2011.

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, 2011.

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.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Allowance for Doubtful Accounts

An allowance for doubtful accounts has been established for utility accounts receivables. The Association estimates the allowance based on the following percentages of arrears:

Thirty days past due - 5% of accounts receivable,
Sixty days past due - 5% of accounts receivable, and
Ninety days or more past due - 95% of accounts receivable.

Bills are due by the tenth of each month. It is the policy of the Association to shut off water service one month after nonpayment. Customer deposits held are applied to outstanding bills. At December 31, 2011, the allowance for doubtful accounts was $3,202.

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 28, 2011 was for customer usage from approximately November 15 through December 15, 2011. The entire amount is considered accounts receivable as of December 31, 2011. The billing mailed on January 30, 2012 was for usage from approximately December 15, 2011 through January 15, 2012. Fifty percent of this billing is considered unbilled receivables at December 31, 2011.

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

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.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Property, Plant and Equipment (Continued)

	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, 2011 is $258,527.

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.

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.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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.

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, 2011, $215,436 was required to be on deposit to meet payments of interest and principal due on loans for 2012. The balance in this account at December 31, 2011 was $224,583.

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, 2011, $185,516 was the required balance of the Depreciation Reserve account. The Association had $201,601 in this account for the purpose of maintaining the water system.

Restricted Cash Accounts

The Association is required to maintain special deposit accounts for customer deposits and long-term debt obligations.. Restricted Accounts are made up of the Debt Service Account of $224,583 and the Depreciation Reserve Account in the amount of $201,601 for a total of $426,184.

NOTE C - CASH DEPOSITS WITH FINANCIAL INSTITUTIONS

The Association's funds are on deposit at a local financial institution. At December 31, 2011, the carrying amount of the Association's cash was $601,296 and the bank balances were $604,975. The difference between the carrying amount and the bank balances results from deposits in

NOTE C - CASH DEPOSITS WITH FINANCIAL INSTITUTIONS (CONTINUED)

transit and outstanding checks. As of December 31, 2011, the bank balances were either insured by FDIC or covered by pledged collateral.

Deposits Covered By Federal Insurance	$275,000
Deposits Collateralized	329,975
Total Bank Balance	$604,975

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 Restated	Increases	Decreases	Ending Balance
Capital Assets Not Being Depreciated:				
Construction in Progress	$	$ 10,034		$ 10,034
Land	54,273			54,273
Total Capital Assets Not Being Depreciated	54,273	10,034		64,307
Capital Assets, Being Depreciated:				
Land Improvements	9,330			9,330
Buildings and Improvements	163,721	51,183		214,904
Machinery and Equipment	100,302	69,406	(50,800)	118,908
Vehicles	151,889	22,871	(27,068)	147,692
Tools, Ship & Garage Equipment	23,926			23,926
Communication Equipment	8,041			8,041
Office Furniture and Equipment	105,655	2,307		107,962
Water Lines	10,342,954	14,004		10,356,958
Tanks and Pumping Equipment	680,590			680,590
Total Capital Assets Being Depreciated	11,586,408	159,771	(77,868)	11,668,311

NOTE D - PROPERTY, PLANT AND EQUIPMENT (CONTINUED)

Less Accumulated Depreciation for:				
Land Improvements	(3,856)	(187)		(4,043)
Buildings and Improvements	(76,514)	(4,413)		(80,927)
Machinery and Equipment	(58,145)	(4,977)	50,800	(12,322)
Vehicles	(89,305)	(18,451)	27,068	(80,688)
Tools, Shop & Garage Equipment	(20,493)	(400)		(20,893)
Communication Equipment	(7,526)	(126)		(7,652)
Office Furniture and Equipment	(77,765)	(7,079)		(84,844)
Water Lines	(2,400,926)	(208,587)		(2,609,355)
Tanks and Pumping Equipment	(145,329)	(14,464)		(159,793)
Total Accumulated Depreciation	(2,879,859)	(258,684)	77,868	(3,060,517)
Total Capital Assets, Being Depreciated, Net	8,706,549	(98,913)		8,607,794
Governmental Activities Capital Assets, Net	$ 8,760,822	$ (88,879)	$ 0	$ 8,672,101

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, 2011, the principal balance outstanding was $118,419. Debt service requirements for year ending December 31, 2011, and thereafter are as follows:

Year Ended December 31	Scheduled Interest	Scheduled Principal
2012	$ 5,945	$ 9,471
2013	5,471	9,945
2014	4,974	10,442
2015	4,452	10,964
2016	3,904	11,512
2017-2021	10,288	66,085
Totals	$ 35,034	$ 118,419

NOTE E – LONG-TERM DEBT (CONTINUED)

2. On July 26, 1985 the Association entered into a promissory note agreement with Rural Development in the amount of $105,000 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 26. As of December 31, 2011, the principal balance was paid in full.

3. 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, 2011, the principal balance outstanding was $208,216. Debt service requirements for year ending December 31, 2011, and thereafter are as follows:

Year Ended December 31	Scheduled Interest	Scheduled Principal
2012	$ 12,013	$ 7,580
2013	11,577	8,016
2014	11,116	8,477
2015	10,629	8,964
2016	10,114	9,479
2017-2021	41,737	56,228
2022-2026	23,603	74,362
2027-2028	3,111	35,110
Totals	$ 123,900	$ 208,216

4. 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, 2011, the principal balance outstanding was $382,611. Debt service requirements for year ending December 31, 2011, and thereafter are as follows:

NOTE E – LONG-TERM DEBT (CONTINUED)

4. (Continued)

Year Ended December 31	Scheduled Interest	Scheduled Principal
2012	$ 19,149	$ 10,734
2013	18,613	11,270
2014	18,049	11,834
2015	17,458	12,425
2016	16,836	13,047
2017-2021	73,719	75,696
2022-2026	52,806	96,609
2027-2031	26,115	123,300
2032	1,614	27,696
Totals	$ 244,359	$ 382,611

5. 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, 2011, the principal balance outstanding was $145,247. Debt service requirements for year ending December 31, 2011, and thereafter are as follows:

Year Ended December 31	Scheduled Interest	Scheduled Principal
2012	$ 6,544	3,741
2013	6,376	3,909
2014	6,200	4,085
2015	6,016	4,269
2016	5,824	4,461
2017-2021	25,921	25,504
2022-2026	19,643	31,782
2027-2031	11,819	39,606
2032-2034	2,673	27,890
Totals	$ 91,016	$ 145,247

NOTE E – LONG-TERM DEBT (CONTINUED)

6. On October13, 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, 2011, the principal balance outstanding was $547,877. Debt service requirements for the year ending December 31, 2011, and thereafter are as follows:

Year Ended December 31	Scheduled Interest	Scheduled Principal
2012	$ 24,685	$ 14,102
2013	24,050	14,737
2014	23,387	15,400
2015	22,694	16,093
2016	21,970	16,817
2017-2021	97,792	96,143
2022-2026	74,123	119,812
2027-2031	44,628	149,307
2032-2034	10,125	105,466
Totals	$ 343,454	$ 547,877

7. 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, 2011, the principal balance outstanding was $450,262. Debt service requirements for year ending December 31, 2011, and thereafter are as follows:

NOTE E – LONG-TERM DEBT (CONTINUED)

7. (Continued)

Year Ended December 31	Scheduled Interest	Scheduled Principal
2012	$ 22,538	8,827
2013	22,097	9,268
2014	21,634	9,731
2015	21,147	10,218
2016	20,636	10,729
2017-2021	94,577	62,248
2022-2026	77,379	79,446
2027-2031	55,430	101,395
2032-2036	27,416	129,409
2037	1,475	28,991
Totals	$ 364,329	$ 450,262

8. 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, 2011, the principal balance outstanding was $237,690. Debt service requirements for the year ending December 31, 2011, and thereafter are as follows:

NOTE E – LONG-TERM DEBT (CONTINUED)

8. (Continued)

Year Ended December 31	Scheduled Interest	Scheduled Principal
2012	$ 10,703	$ 4,146
2013	10,516	4,333
2014	10,321	4,528
2015	10,118	4,731
2016	9,905	4,944
2017-2021	45,979	28,266
2022-2026	39,021	35,224
2027-2031	30,349	43,896
2032-2036	19,543	54,702
2037-2040	6,087	52,920
Totals	$ 192,542	$ 237,690

9. 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, 2011, the principal balance outstanding was $485,736. Debt service requirements for the year ending December 31, 2011, and thereafter are as follows:

Year Ended December 31	Scheduled Interest	Scheduled Principal
2012	$ 21,858	8,840
2013	21,460	9,238
2014	21,045	9,653
2015	20,610	10,088
2016	20,156	10,542
2017-2021	93,224	60,266
2022-2026	78,387	75,103
2027-2031	59,899	93,591
2032-2036	36,858	116,632
2037-2040	9,130	91,783
Totals	$ 382,627	$ 485,736

NOTE E – LONG-TERM DEBT (CONTINUED)

10. 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, 2011, the principal balance outstanding was $375,000. Debt service requirements for the year ending December 31, 2011, and thereafter are as follows:

Year Ended December 31	Scheduled Interest	Scheduled Principal
2012	$ 13,594	$ 4,740
2013	13,422	4,912
2014	13,244	5,090
2015	13,059	5,275
2016	12,868	5,466
2017-2021	61,221	30,449
2022-2026	55,287	36,383
2027-2031	48,197	43,473
2032-2036	39,725	51,945
2037-2041	29,602	62,068
2042-2046	17,507	74,163
2047-2049	3,736	51,036
Totals	$ 321,462	$ 375,000

NOTE F – CHANGES IN LONG-TERM DEBT

	Beginning Balance	Additions	Reductions	Ending Balance	Due Within One Year
Business-type Activities:					
Promissory Notes	$ 3,079,733	$ 0	$ (128,676)	$ 2,951,057	$ 72,181
Business-type Activities Long-term Liabilities	$ 3,079,733	$ 0	$ (128,676)	$ 2,951,057	$ 72,181

NOTE G - 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, 2011 the plan had a balance of $738,305, including $28,396 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 FY 2011 was $35,231.

NOTE H - INSURANCE COVERAGE

The Association is exposed to various risks of loss. The Association carries commercial insurance for risks of loss. As of December 31, 2011, there were no known losses for which an accrual was considered necessary and no estimated claims that have been incurred, but not reported.

NOTE I – SUBSEQUENT EVENTS

Subsequent events have been evaluated through June 28, 2012, which is the date the financial statements were available to be issued.

NOTE J – 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.

NOTE J – COMPENSATED ABSENCES (CONTINUED)

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, 2011. The liability for compensated absences at December 31, 2011 was $84,414.

NOTE K - CONSTRUCTION IN PROGRESS

Construction in Progress represents cost accumulated for garage renovations that were not completed at fiscal year-end. The amount capitalized to construction in progress as of December 31, 2011 was $10,034.

NOTE L - PRIOR PERIOD ADJUSTMENTS

The beginning net asset balance as of December 31, 2010 has been restated. We have made adjustments to correct prior year capital asset, accounts receivable, compensated absences, and unearned revenue errors. Net Assets were increased by $377,887.

NOTE M – RELATED PARTIES

The Director of the Association is a partner of Fleming County Farm Supply and Frank Hinton and Son; expenditures remitted to these companies during 2011 were $1,264 and $260 respectively.

An employee of the Association is a partner of Muse Supply; expenditures remitted to this company during 2011 were $3,115.

Morgan-Franklin, LLC
Certified Public Accountants

749 Broadway Street
P.O. Box 428
West Liberty, KY 41472

da K. Morgan, CPA
B. Franklin, CPA

Phone: (606) 743-1884
Fax: (606) 743-1895
www.morganfranklincpa.com

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

Board of Directors
Fleming County Water Association, Inc.
Flemingsburg, KY 41041

We audited the financial statements of the Fleming County Water Association, Inc. (a non-profit organization), as of and for the year ended December 31, 2011, and have issued our report thereon dated June 28, 2012. The report on the financial statements was qualified because we did not observe the taking of the physical inventories at December 31, 2011 and were unable to satisfy ourselves about inventory quantities by means of other auditing procedures. Except as discussed in the preceding sentence, we conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the Fleming County Water Association, Inc. is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the Association's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Association's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Association's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying comments and recommendations, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses.

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* (CONTINUED)

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 2011-1 through 2011-5 to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Association'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*.

The Association's responses to the findings identified in our audit are described in the accompanying comments and recommendations. We did not audit the Association's responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of management, Directors, and the United States Department of Agriculture and is not intended to be and should not be used by anyone other than these specified parties.

Respectfully Submitted

Morgan - Franklin, LLC

Morgan-Franklin, LLC

June 28, 2012

MATERIAL WEAKNESSES

2011-1 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 ten (10) 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

MATERIAL WEAKNESSES (CONTINUED)

2011-1 The Association Should Have Adequate Controls Over The Preparation Of The Financial Statements Being Audited (Continued)

Response (Continued): management to review monthly as well as a present- prior year comparison and year end reports. The financial 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.

2011-2 The Association Lacks Adequate Controls Over Disbursements

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

- We noted that the board approves monthly bills; however, a bill listing is not attached to the minutes.
- One instance in which payment for the appointment of a committee member could not be substantiated. We viewed the appointment letter; however, there were no written policies and procedures for paying individuals to serve on committees.

While performing other procedures, we noted one check with only one signature.

Criteria:

- A monthly statement of all checks written should be prepared and attached to the minutes of the Association. The directors could document this by initialing the statement.
- Dual signatures are required on all checks. An individual independent of check signing could review all checks to determine two signatures are present before checks are mailed.
- Written policies and procedures should be established for payment of individuals that serve on committees on behalf of the Association.

Cause: Lack of adequate controls over disbursements.

Effect:

- Bills that have not been approved by the Association could be paid.
- Checks cleared the bank without dual signatures as required.

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

MATERIAL WEAKNESSES (CONTINUED)

2011-2 The Association Lacks Adequate Controls Over Disbursements (Continued)

Recommendation (Continued): 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 approved each month by the board.

- *A Monthly Check Register of all bills paid will be presented for approval and attached to the minutes of each monthly board meeting.*
- *It has always been a policy that dual signatures be required on all checks.*
- *The checks will be reviewed by another individual independent of check signing before mailing to ensure that all required signatures are contained thereon.*
- *A written policy will be established for the payment of individuals that serve on committees on behalf of the Association.*

2011-3 The Association Should Establish Adequate Controls Over Payroll

Condition: During our audit, we noted that salaried employees do 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.

Criteria: 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. To further strengthen internal controls, the timesheets should be signed by the employee and by the employee's immediate supervisor for verification and attestation of the accuracy of time reported.

The Association is only required to pay overtime wages for actual hours 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 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.

MATERIAL WEAKNESSES (CONTINUED)

2011-3 The Association Should Establish Adequate Controls Over Payroll (Continued)

Cause: The Association's failure to establish written payroll policies.

Effect: Documentation is not available to substantiate hours worked by salaried employees. 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 employees 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 written controls over payroll 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: The Association will review its current policies and establish written operating policies and procedures addressing payroll, overtime, non-personal-use of vehicles and documentation of employee's annual and sick leave for all employees, both salaried and hourly.

2011-4 The Association Should Establish Written Policies And Procedures

Condition: During our audit, we noted the Association has not established written policies and procedures.

Criteria: Written policies and procedures should be established by the Association. Written policies provide management and employees standards for ethics, accepted business practices and the control environment. Written policies should cover such topics as procurement and contract procedures, water bill adjustment procedures, fiscal management, personnel administration, etc.

Cause: The failure of the Association to establish written policies and procedures.

Effect: If written policies and procedures are not disseminated to employees, employees may not be aware of their job requirements and expectations.

Recommendation: We recommend the Association establish written policies and procedures.

MATERIAL WEAKNESSES (CONTINUED)

2011-4 The Association Should Establish Written Policies And Procedures (Continued)

Response: The Association will establish written policies and procedures for procurement and contract procedures and other operating procedures. We have already begun the process of establishing a Personnel Policy. It is currently being reviewed and will be presented to the board for approval and implementation.

2011-5 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. Each maintenance employee has a key to the storage building where inventory is maintained.

Criteria: 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.

Cause: Lack of adequate internal controls over inventory.

Effect: Misappropriations of inventory could occur and not be detected in a timely manner.

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

Response: Management is currently looking into purchasing inventory software in order to document, track and maintain inventory transactions.