

KNOTT COUNTY WATER AND SEWER DISTRICT

Basic Financial Statements,
Required Supplementary Information, And
Independent Auditor's Report

For The Year Ended December 31, 2014

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Independent Auditor's Report

To the Members of the Board
Knott County Water and Sewer District
Vicco, Kentucky

We have audited the accompanying financial statements of the business-type activities of Knott County Water and Sewer District, as of and for the year ended December 31, 2014, and the related notes to the financial statements, which collectively comprise the Knott County Water and Sewer District's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

INDEPENDENT AUDITOR'S REPORT
Knott County Water and Sewer District
(Continued)

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the business-type activities of the Knott County Water and Sewer District as of December 31, 2014, and the respective changes in financial position and cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Management has omitted the management's discussion and analysis information that the Governmental Accounting Standards Board (GASB) has determined is necessary to supplement, although not required to be part of, the basic financial statements. Accounting principles generally accepted in the United States of America require that the management's discussion and analysis be presented to supplement the basic financial statements. Our opinion on the basic financial statements is not affected by this missing information.

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

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Knott County Water and Sewer District's basic financial statements. The schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, and is also not a required part of the basic financial statements.

The schedule of expenditures of federal awards is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of expenditures of federal awards is fairly stated in all material respects in relation to the basic financial statements as a whole.

INDEPENDENT AUDITOR'S REPORT
Knott County Water and Sewer District
(Continued)

Other Reporting Required by Government Auditing Standards

In accordance with Government Auditing Standards, we have also issued our report dated July 6, 2015, on our consideration of the Knott County Water and Sewer District's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards in considering Knott County Water and Sewer District's internal control over financial reporting and compliance.

Respectfully submitted,



Ross & Company, PLLC
July 6, 2015

**KNOTT COUNTY WATER AND SEWER DISTRICT
STATEMENT OF NET POSITION
AS OF DECEMBER 31, 2014**

ASSETS

Current Assets

Cash	\$	41,838
Cash - restricted		187,769
Accounts receivable, net		637,639
Other current assets		19,181
Total Current Assets		886,427

Capital Assets

Construction in progress (Non-depreciable)		242,737
Land, Structures, and Equipment, net of depreciation		39,840,649
Total Capital Assets, Net		40,083,386

Total Assets

\$ 40,969,813

LIABILITIES AND NET POSITION

Current Liabilities

Accounts Payable	\$	194,946
Payroll Liabilities		22,392
Accrued Compensation		61,200
Other Current Liabilities		126,425
Current Maturity of Long Term Debt		56,746
Total Current Liabilities		461,709

Non-current Liabilities

Bonds, Notes, and Lease Payable		636,211
Total Liabilities		1,097,920

NET POSITION

Investments in Capital Assets, net of related debt		39,390,429
Unrestricted		293,668
Restricted		187,796
Total Net Position		39,871,893
Total Liabilities and Net Position	\$	40,969,813

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

**KNOTT COUNTY WATER AND SEWER DISTRICT
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET POSITION
FOR THE YEAR ENDED DECEMBER 31, 2014**

OPERATING REVENUES

Water Service	\$ 2,063,298
Sewer Service	37,727
Tap Fees	6,505
Penalties	13,719
Reconnection and Collection Fees	50
Total Operating Revenue	<u>2,121,299</u>

OPERATING EXPENSES

Salaries and Fringe Benefits	774,383
Commissioner Fee	27,200
Office Expense	23,669
Water Consumption	81,338
Electricity	392,998
Telephone	12,620
Travel and Training	2,768
Advertisement	1,425
Rents	12,737
Contractual Fees	136,021
Vehicle Expense	40,706
Operating Supplies and Maintenance	278,867
Licenses, Permits, Dues, and Fees	6,276
Insurance and Bonds	51,302
Depreciation	1,453,194
Total Operating Expenses	<u>3,295,504</u>

Excess (Deficiency) of Operating Revenue Over Expense	<u>(1,174,205)</u>
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NON-OPERATING REVENUES (EXPENSES)

Miscellaneous Income	29,604
Contributed Capital	3,717,343
Gain (Loss) on Asset Disposition	961
Interest Income	279
Interest Expense	(35,834)
Total Non-Operating Revenues (Expenses)	<u>3,712,353</u>

Net Income (Loss)	2,538,148
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Net Position - Beginning (Restated)	<u>37,333,745</u>
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Net Position - Ending	<u>\$ 39,871,893</u>
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The accompanying notes are an integral part of these financial statements.

KNOTT COUNTY WATER AND SEWER DISTRICT
STATEMENT OF CASH FLOWS
For the year ended December 31, 2014

CASH FLOWS FROM OPERATING ACTIVITIES	
Receipts from customers	\$ 1,798,842
Payments to suppliers	(1,040,727)
Payments to employees	(801,583)
Other receipts (Payments)	29,604
Net Cash Provided (Used) for Operating Activities	<u>(13,864)</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES	
Proceeds from capital debt	27,250
Capital Asset Expenditures	(3,720,798)
Contributed Capital	3,717,343
Principal paid on capital debt	(53,122)
Interest paid on capital debt	(35,834)
Proceeds from sale of capital assets	3,447
Net cash provided (used) by capital and related financing activities	<u>(61,714)</u>
CASH FLOWS FROM INVESTING ACTIVITIES	
Interest	279
Net cash provided (used) by investing activities	<u>279</u>
Net Cash increase (decrease) in cash and cash equivalents	(75,299)
Balances- beginning of year	<u>304,905</u>
Balances - end of year	<u>\$ 229,607</u>
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	
Operating Income (Loss)	\$ (1,174,205)
Adjustments to reconcile operating income to net cash provided by operating activities	
Depreciation Expense	1,453,194
Miscellaneous Income (Expense)	29,604
Change in Assets & Liabilities	
Receivables, net	<u>(322,457)</u>
Net cash provided (used) by operating activities	<u>\$ (13,864)</u>

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

**KNOTT COUNTY WATER AND SEWER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS
DECEMBER 31, 2014**

NOTE A: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. Reporting Entity

Knott County Water and Sewer District (the District) was created by the Knott County Fiscal Court on February 10, 1999 to be governed and operated under rules and procedures established under KRS Chapter 74, relating to water districts and KRS Chapter 220 relating to sanitation districts. The entity's plans are to expand its operating activities into parts of Knott County not presently served with water and sewer utility services.

2. Accounting Policies and Procedures

a. Deposits and Investments

The District's cash and cash equivalents are considered to be cash on hand, demand deposits, certificates of deposit, and short-term investments with original maturities of three months or less from the date of acquisition. The District's fund balance includes cash and cash equivalents and investments.

KRS 66.480 authorizes the District to invest in the following, including but not limited to, obligations of the United States and of its agencies and instrumentalities, obligations and contracts for future delivery or purchase of obligations backed by the full faith and credit of the United States, obligations of any corporation of the United States government, bonds or certificates of indebtedness of this state, and certificates of deposit issued by or other interest-bearing accounts of any bank or savings and loan institution which are insured by the Federal Deposit Insurance Corporation (FDIC) or which are collateralized, to the extent uninsured, by any obligation permitted by KRS 41.240(4).

b. Fixed Assets and Depreciation

Property, plant and equipment are stated at historical or estimated cost. Fixed assets costing over \$1,500 are recorded and depreciated using the straight-line method of accounting over the respective assets useful lives as follows:

Equipment	5-7 years
Transmission Lines	20-40 years
Water Wells, Structures and Improvements	15-40 years

c. Allowance for Doubtful Accounts

Knott County Water and Sewer District's financial statements reflect an allowance account for its customer accounts receivable based on management's estimates of probable losses. The prior year allowance of \$93,541 was deemed sufficient and no further bad debt expense was recognized for the year ended December 31, 2014.

d. Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

**KNOTT COUNTY WATER AND SEWER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2014**

2. Accounting Policies and Procedures (continued)

e. Basis of Presentation

GASB 34 creates basic financial statements for reporting on the governmental financial activities. Financial statements include government-wide financial statements prepared on an accrual basis of accounting and fund financial statements which present information for individual major funds rather than by fund type. Knott County Water and Sewer District is considered a special purpose government engaged in a business-type activity. No governmental type funds are recognized.

The accounting and reporting treatment applied to a fund is determined by its measurement focus. Proprietary funds are reported using the economic resources measurement focus. The statement of cash flows provides information about how the District finances and meets the cash flow needs of its proprietary activities.

The District has the following fund:

Proprietary Funds (Enterprise Funds)

The Water and Sewer Revenue Fund accounts for revenues and expenses related to customer utility services.

f. Basis of Accounting

Basis of accounting determines when transactions are recorded in the financial records and reported on the financial statements. For its water and sewer enterprise operations the District uses the full-accrual basis of accounting where revenues are recorded when earned and expenses are recognized when incurred.

Revenues - Exchange and Non-exchange Transactions - Revenues resulting from exchange transactions, in which each party receives essentially equal value, is recorded on the accrual basis when the exchange takes place. On a modified accrual basis, revenues are recorded in the fiscal year in which the resources are measurable and available.

Available means that the resources will be collected within the current fiscal year or are expected to be collected soon enough thereafter to be used to pay liabilities of the current fiscal year. For the District, available means expected to be received within sixty days of the fiscal year-end.

Nonexchange transactions, in which the District receives value without directly giving equal value in return, include grants, entitlements and donations. Revenue from grants, entitlements and donations are recognized in the fiscal year in which all eligibility requirements have been satisfied. Eligibility requirements include timing requirements, which specify the year when the resources are required to be used or the fiscal year when use is first permitted, matching requirements, in which the District must provide local resources to be used for a specified purpose, and expenditure requirements, in which the resources are provided to the District on a reimbursement basis. On a modified accrual basis, revenues from nonexchange transactions must also be available before it can be recognized.

**KNOTT COUNTY WATER AND SEWER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2014**

2. Accounting Policies and Procedures (continued)

f. Basis of Accounting (continued)

Deferred Revenue - Deferred revenue arises when assets are recognized before revenue recognition criteria have been satisfied. Grants and entitlements received before the eligibility requirements are met are recorded as deferred revenue.

Expenses/Expenditures - On the accrual basis of accounting, expenses are recognized at the time they are incurred.

g. Net Position

GASB 63, implemented for the year ended December 31, 2012, has changed the presentation of the District's financial statements to incorporate the concepts of net position, deferred outflows of resources and deferred inflows of resources. Net position represents the difference between assets and deferred outflows and liabilities and deferred inflows. The net position component "net investment in capital assets", consists of capital assets, net of accumulated depreciation, reduced by the outstanding balances of any borrowing used for acquisition, construction or improvement of those assets. Deferred outflows of resources and deferred inflows of resources that are attributable to the acquisition, construction or improvement of those assets or related debt also should be included in this component of net position. Net position is reported as restricted when there are limitations on its use either through enabling legislation adopted by the District or through external restrictions imposed by creditors, grantors or laws or regulations of other governments.

h. Operating Revenues and Expenses

Operating revenues are those revenues that are generated directly from the primary activity of the proprietary funds. For the District, those revenues are primarily charges for utility services provided.

i. Materials and Supplies

Inventory is currently charged to expense as incurred. Supplies are acquired on an as needed basis.

3. Deposits

The district maintained deposits of public funds with depository institutions insured by the Federal Deposit Insurance Corporation (FDIC) as required by KRS 66.480(1) (d). According to KRS 41.240(4), the depository institution should pledge or provide sufficient collateral which, together with FDIC insurance, equals or exceeds the amount of public funds on deposit at all times. In order to be valid against the FDIC in the event of failure or insolvency of the depository institution, this pledge or provision of collateral should be evidenced by an agreement between the district and the depository institution, signed by both parties, that is (a) in writing, (b) approved by the board of directors of the depository institution or its loan committee, which approval must be reflected in the minutes of the board or committee, and (c) an official record of the depository institution. These requirements were not met, as the district did not have a written agreement with the bank.

**KNOTT COUNTY WATER AND SEWER DISTRICT
 NOTES TO BASIC FINANCIAL STATEMENTS (continued)
 DECEMBER 31, 2014**

3. Deposits (continued)

Custodial Credit Risk - Deposits

Custodial credit risk is the risk that in the event of a depository institution failure, the district's deposits may not be returned. The district does not have a deposit policy for custodial credit risk but rather follows the requirements of KRS 41.240(4). On December 31, 2014, the district's bank balance was exposed to custodial credit risk as follows:

- Uncollateralized and Uninsured \$101,079

4. Other Current Assets

Other current assets consisted of the following at December 31, 2014:

Prepaid insurance	\$ 16,998
Prepaid maintenance agreement	1,202
Deposits trade and other	<u>981</u>
	<u><u>\$ 19,181</u></u>

5. Other Current Liabilities

Other current liabilities consisted of the following at December 31, 2014:

Customer deposits payable	\$ 93,674
Sales Tax payable	257
Contractor retainage	30,151
Utility tax payable	<u>2,343</u>
	<u><u>\$ 126,425</u></u>

**KNOTT COUNTY WATER AND SEWER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2014**

6. Changes in Fixed Assets

Following are changes in fixed assets for Knott County Water and Sewer District at December 31, 2014:

KNOTT COUNTY WATER AND SEWER DISTRICT				
	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
<u>Fixed Assets - Water operations</u>				
Land and land rights	\$ 117,294	\$	\$	\$ 117,294
Construction in progress (restated)	3,815,714	2,501,837	(6,074,814)	242,737
Water plant and transmission lines	40,079,755	6,913,305	(2,650)	46,990,410
Vehicles	346,099	29,250	(9,000)	366,349
Operating equipments	172,495	9,815		182,310
Office furniture and equipment	146,808	30,905		177,713
Subtotal	<u>44,678,165</u>	<u>9,485,112</u>	<u>(6,086,464)</u>	<u>48,076,813</u>
<u>Accumulated Depreciation - Water operations</u>				
Water plant and transmission lines	6,498,841	1,360,795	(486)	7,859,150
Vehicles	214,147	53,034	(9,000)	258,181
Operating equipment	115,909	9,308		125,217
Office furniture and equipment	78,755	20,352		99,107
Subtotal	<u>6,907,652</u>	<u>1,443,489</u>	<u>(9,486)</u>	<u>8,341,655</u>
<u>Total</u>	<u>37,770,513</u>	<u>8,041,623</u>	<u>(6,076,978)</u>	<u>39,735,158</u>
<u>Fixed Assets - Sewer operations</u>				
Land and land rights	2,790			2,790
WWTPs & Collections System	310,604	310,500		621,104
Operating equipment	68,811			68,811
Subtotal	<u>382,205</u>	<u>310,500</u>	<u>0</u>	<u>692,705</u>
<u>Accumulated Depreciation - Sewer operations</u>				
WWTPs & Collections System	305,292	2,246		307,538
Operating equipment	29,480	7,459		36,939
Subtotal	<u>334,772</u>	<u>9,705</u>	<u>0</u>	<u>344,477</u>
<u>Total</u>	<u>\$ 47,433</u>	<u>\$ 300,795</u>	<u>\$</u>	<u>\$ 348,228</u>

Total depreciation expense for the year ended December 31, 2014 is allocated as follows:

	<u>Depreciation</u>
Water operations	\$ 1,443,489
Sewer operations	9,705
<u>Total</u>	<u>\$ 1,453,194</u>

**KNOTT COUNTY WATER AND SEWER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2014**

7. Long Term Debt

A. A Rural Utilities Service bond, dated December 19, 2003 was issued to pay off prior debt of Knott County Water and Sewer District. The bond issue has an annual interest rate of 4.5%. The total amount of the loan was \$185,000. The bond calls for 40 annual interest and principal payments.

Following is the RUS debt service schedule for this issue:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2015	\$	\$ 3,702	\$ 3,702
2016	3,000	7,268	10,268
2017	3,000	7,133	10,133
2018	3,500	6,998	10,498
2019	3,500	6,840	10,340
2020-2024	19,000	35,072	54,072
2025-2029	24,500	27,047	51,547
2030-2034	30,500	20,994	51,494
2035-2039	37,500	13,524	51,024
2040-2043	37,000	4,276	41,276
<u>Totals</u>	<u>\$ 161,500</u>	<u>\$ 132,854</u>	<u>\$ 294,354</u>

B. Knott County Water and Sewer District entered into an assistance, agreement with the Kentucky Infrastructure Authority for KIA Fund C03-3 loan assistance dated January 1, 2004 having a maturity date of June 1, 2022 for expenditures related to the Highway 899/Mallie waterworks improvement project. The original principal balance was \$547,000. The interest rate is 4.05%. The District entered into an agreement to pay past due interest and fees of \$65,047 beginning with the March 1, 2011 due date.

Following is a debt service schedule:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Servicing Fees</u>	<u>Past Due Interest</u>	<u>Total</u>
2015	\$ 48,177	\$ 15,864	\$ 783	\$ 6,410	\$ 71,234
2016	50,165	13,876	685	6,410	71,136
2017	52,235	11,806	583		64,624
2018	54,390	9,651	477		64,518
2019	56,634	7,407	366		64,407
2020-2024	152,021	8,082	399		160,502
<u>Totals</u>	<u>\$ 413,622</u>	<u>\$ 66,686</u>	<u>\$ 3,293</u>	<u>\$ 12,820</u>	<u>\$ 496,421</u>

KNOTT COUNTY WATER AND SEWER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2014

7. Long Term Debt (continued)

C. A Rural Utilities Service bond, dated January 26, 2007 was issued to finance a portion of the Water Treatment Plant project. The bond issue has an annual interest rate of 4.125%. The total amount of the loan was \$100,000. The bond calls for 40 annual interest and principal payments.

Following is a debt service schedule:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2015	\$	\$ 2,305	\$ 2,305
2016	1,400	4,190	5,590
2017	1,400	4,127	5,527
2018	1,500	4,064	5,564
2019	1,500	3,996	5,496
2020-2024	8,800	18,883	27,683
2025-2029	11,000	16,719	27,719
2030-2034	13,700	14,014	27,714
2035-2039	17,100	10,634	27,734
2040-2044	21,200	6,428	27,628
2044-2046	15,200	1,432	16,632
<u>Totals</u>	<u>\$ 92,800</u>	<u>\$ 86,792</u>	<u>\$ 179,592</u>

D. On November 1, 2014, the district entered into a Government Obligation Contract to finance the purchase of a pickup truck. The original principal amount is \$27,250. The obligation requires 12 quarterly payments of \$2,454 with the first due on November 1, 2014.

Following is a debt service schedule:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2015	\$ 8,569	\$ 1,245	\$ 9,814
2016	9,073	741	9,814
2017	7,154	206	7,361
<u>Totals</u>	<u>\$ 24,797</u>	<u>\$ 2,192</u>	<u>\$ 26,989</u>

**KNOTT COUNTY WATER AND SEWER DISTRICT
NOTES TO BASIC FINANCIAL STATEMENTS (continued)
DECEMBER 31, 2014**

7. Long Term Debt (continued)

E. Changes in long-term debt for the District are as follows:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>	<u>Due Within One Year</u>
US Rural Development 91-11	\$ 94,200	\$	\$ (1,400)	\$ 92,800	\$
Kentucky Infrastructure Authority C03-03	459,890		(46,268)	413,622	48,177
US Rural Development 93-05	164,500		(3,000)	161,500	
Kansas Sate Bank 3347361		<u>27,250</u>	<u>(2,454)</u>	<u>24,797</u>	<u>8,569</u>
Total	<u>\$ 718,590</u>	<u>\$ 27,250</u>	<u>\$ (53,122)</u>	<u>\$ 692,719</u>	<u>\$ 56,746</u>

8. Contingencies

The district has filed suit in Knott County Circuit Court claiming the city of Hindman is indebted to it for approximately \$200,000 for wholesale water sold by the district to Hindman, but for which Hindman has not paid. The case is scheduled for trial in that court on August 17, 2015. Settlement discussions have failed to resolve the dispute. The chances of the district obtaining judgement against Hindman are reasonably probable.

9. Employee Retirement System

The Knott County Water and Sewer District has elected to participate in the County Employees Retirement System (CERS), pursuant to KRS 78.530 administered by the Board of Trustees of the Kentucky Retirement Systems. This is a cost sharing, multiple employer defined benefit pension plan, which covers all eligible full-time employees and provides for retirement, disability and death benefits to plan members. Benefit contributions and provisions are established by statute.

Nonhazardous covered employees are required to contribute 5 percent of their salary to the plan. Nonhazardous covered employees who begin participation on or after September 1, 2008 are required to contribute 6 percent of their salary to the plan. The District's contribution rate for nonhazardous employees was 18.89 percent.

The District's contribution for FY 2012 was \$25,548, FY 2013 was \$46,609, and FY 2014 was \$98,469.

Benefits fully vest on reaching five years of service for nonhazardous employees. Aspects of benefits for nonhazardous employees include retirement after 27 years of service or age 65. Nonhazardous employees who begin participation on or after September 1, 2008 must meet the rule of 87 (members age plus years of service credit must equal 87, and the member must be a minimum of 57 years of age) or the member is age 65, with a minimum of 60 months service credit.

**KNOTT COUNTY WATER AND SEWER DISTRICT
 NOTES TO BASIC FINANCIAL STATEMENTS (continued)
 DECEMBER 31, 2014**

9. Employee Retirement System (continued)

CERS also provides post retirement health care coverage as follows:

For members participating prior to July 1, 2003, years of service and respective percentages of the maximum contribution are as follows:

Years of Service	% paid by Insurance Fund	% Paid by Member through Payroll Deduction
20 or more	100%	0%
15-19	75%	25%
10-14	50%	50%
4-9	25%	75%
Less than 4	0%	100%

As a result of House Bill 290 (2004 General Assembly), medical insurance benefits are calculated differently for members who began participation on or after July 1, 2003. Once members reach a minimum vesting period of ten years, non-hazardous employees whose participation began on or after July 1, 2003, earn ten dollars per month for insurance benefits at retirement for every year of earned service without regard to a maximum dollar amount.

Historical trend information showing the CERS' progress in accumulating sufficient assets to pay benefits when due is presented in the Kentucky Retirement Systems' annual financial report. This report may be obtained by writing the Kentucky Retirement Systems, 1260 Louisville Road, Frankfort, KY 40601-6124, or by telephone at (502) 564-4646.

SUPPLEMENTARY INFORMATION

KNOTT COUNTY WATER AND SEWER DISTRICT
BUDGETARY COMPARISON SCHEDULE
For the year ended December 31, 2014

	Budgeted Amount	Actual Amount	Variance with Final Budget Favorable (Unfavorable)
OPERATING REVENUES			
Water Service	\$ 1,750,775	\$ 2,063,298	\$ 312,523
Sewer Service	71,000	37,727	(33,273)
Tap Fees		6,505	6,505
Penalties	14,655	13,719	(936)
Reconnection and Collection Fees		50	50
Total Operating Revenue	<u>\$1,836,430.00</u>	<u>2,121,299</u>	<u>284,869</u>
OPERATING EXPENSES			
Salaries and Fringe Benefits	612,945	774,383	(161,438)
Commissioner Fee	27,600	27,200	400
Office Expense	20,100	23,669	(3,569)
Water Consumption	89,150	81,338	7,812
Electricity	263,000	392,998	(129,998)
Telephone	17,010	12,620	4,390
Travel and Training	2,800	2,768	32
Advertisement	-	1,425	(1,425)
Rents	7,508	12,737	(5,229)
Vehicle Expense	49,100	40,706	8,394
Operating Supplies and Maintenance	378,900	278,867	100,033
Licenses, Permits, Dues, and Fees	15,575	6,276	9,299
Insurance and Bonds	32,050	51,302	(19,252)
Depreciation	1,230,500	1,453,194	(222,694)
Total Operating Expenses	<u>2,855,338</u>	<u>3,295,504</u>	<u>(440,166)</u>
NON-OPERATING REVENUES (EXPENSES)			
Miscellaneous Income	8,200	29,604	21,404
Capital Contributions	1,200,000	3,717,343	2,517,343
Bad Debt Expense	(1,500)		1,500
Refunds	650		(650)
Gain (Loss) on Asset Disposition		961	961
Interest Income	1,150	279	(871)
Interest Expense	(21,500)	(35,834)	(14,334)
Total Non Operating Revenues (Expenses)	<u>1,187,000</u>	<u>3,712,353</u>	<u>2,525,353</u>
Change in Net Position	<u>\$ 168,092</u>	<u>\$ 2,538,148</u>	<u>\$ 2,370,056</u>

KNOTT COUNTY WATER AND SEWER DISTRICT
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
For the Year Ended December 31, 2014

<u>Program Title</u>	<u>Federal CFDA No.</u>	<u>Program Expenditures</u>	TOTAL FOR CFDA #
U. S. DEPARTMENT OF INTERIOR			
<i>Passed Through Kentucky Natural Resources and Environmental Protection Cabinet</i>			
Abandoned Mines Land - Red Fox Project	15.252	\$ 72,230	
Abandoned Mines Land - Knott County Branch Lines Project	15.252	77,003	
Abandoned Mines Land - WTP Upgrade Project	15.252	546,017	
Abandoned Mines Land - Carr Creek Multi Site	15.252	1,492,762	2,188,012 *
TOTAL U.S. DEPARTMENT OF INTERIOR			<u>2,188,012</u>
U.S. DEPARTMENT OF DEFENSE			
<i>-Direct-</i>			
** ARRA - Southern and Eastern KY Environmental Infrastructure	12.127	215,048	215,048
TOTAL U.S. DEPARTMENT OF INTERIOR			<u>215,048</u>
TOTAL EXPENDITURES OF FEDERAL AWARDS			<u>\$ 2,403,060</u>
** ARRA Funds			Tested as Major Program *

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To the Members of the Board
Knott County Water and Sewer District
Vicco, Kentucky

<p>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</p>
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We have audited, 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 the business-type activities of Knott County Water and Sewer District, as of and for the year ended December 31, 2014, and the related notes to the financial statements, which collectively comprise Knott County Water and Sewer District's basic financial statements and have issued our report thereon dated July 6, 2015.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered Knott County Water and Sewer District's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Knott County Water and Sewer District's internal control. Accordingly, we do not express an opinion on the effectiveness of Knott County Water and Sewer District'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 schedule of findings and questioned costs we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

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 deficiency described in the accompanying schedule of findings and questioned costs to be a material weakness. See finding reference number 2014-03.

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

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)

governance. We consider the deficiency described in the accompany schedule of findings and questioned costs to be a significant deficiency. See finding reference number 2014-04.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Knott County Water and Sewer District'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 instances of noncompliance or other matters that are required to be reported under Government Auditing Standards and which are described in the accompanying schedule of findings and questioned costs as items 2014-01 and 2014-02.

Knott County Water and Sewer District's Response to Findings

Knott County Water and Sewer District's response to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. Knott County Water and Sewer District's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

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

Respectively Submitted,



Ross & Company, PLLC
July 6, 2015

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Report On Compliance With Requirements That Could Have A Direct And Material Effect On Each Major Program And On Internal Control Over Compliance In Accordance With OMB Circular A-133
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Independent Auditor's Report

Compliance

We have audited the compliance of the Knott County Water and Sewer District, with the types of compliance requirements described in the U.S. Office of Management and Budget Circular A-133 Compliance Supplement that could have a direct and material effect on each of its major federal programs for the year ended December 31, 2014. Knott County Water And Sewer District's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the entity's management.

Auditor's Responsibility

Our responsibility is to express an opinion on Knott County Water And Sewer District's compliance with the applicable compliance requirements based on our compliance audit.

We conducted our compliance audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and U.S. Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations. Those standards and Circular A-133 require that we plan and perform the compliance audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. A compliance audit includes examining, on a test basis, evidence about 2014 FC Update County's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our compliance audit provides a reasonable basis for our opinion. Our compliance audit does not provide a legal determination on Knott County Water And Sewer District's compliance with those requirements.

Opinion

In our opinion, Knott County Water And Sewer District complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended December 31, 2014.

**Report On Compliance With Requirements
That Could Have A Direct And Material Effect On Each Major Program
And On Internal Control Over Compliance In Accordance With OMB Circular A-133
(Continued)**

Internal Control over Compliance

The management of Knott County Water And Sewer District is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our compliance audit, we considered Knott County Water And Sewer District's internal control over compliance with requirements that could have a direct and material effect on a major federal program as a basis for designing our compliance auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Knott County Water And Sewer District's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct noncompliance with a type of compliance requirement of a federal program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

Restricted Use

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

Respectfully submitted,



Ross & Company, PLLC
July 6, 2015

**KNOTT COUNTY WATER AND SEWER DISTRICT
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
Fiscal Year Ended December 31, 2014**

A. Summary Of Audit Results

1. The auditor's report expresses an unmodified opinion on the financial statements of Knott County Water And Sewer District..
2. One significant deficiency and one material weakness relating to the audit of the financial statement are reported in the Independent Auditor's Report.
3. Two instances of noncompliance material to the financial statement of Knott County Water And Sewer District were disclosed during the audit.
4. No significant deficiencies or material weaknesses relating to the audit of the major federal awards program are reported in the Independent Auditor's Report
5. The auditor's report on compliance for the audit of the major federal awards programs for Knott County Water And Sewer District expresses an unmodified opinion.
6. There are no findings relative to the major federal awards programs for Knott County Water And Sewer District reported in Part C of this schedule.
7. The program tested as a major program was: Abandoned Mines Land (CFDA #15.252).
8. The threshold for distinguishing Type A and B programs was \$300,000.
9. Knott County Water And Sewer District was not determined to be a low-risk auditee.

B. Findings - Financial Statement Audit

State Laws And Regulations

2014-01 Deposits Are Not Protected By A Collateral Security Agreement

The district has not entered into a collateral security agreement with the depository institution. As the district expands its water distribution service, money held in depository institutions will exceed the protection provided by the F.D.I.C. This could result in the loss of public funds in the event of a bank failure. KRS 41.240 requires depositories with public funds to pledge collateral or provide surety bond for the balance not covered by F.D.I.C. insurance. We recommend the district enter into a collateral security agreement with the depository institution, then monitor bank balances, and communicate with the bank to ensure deposits are adequately protected.

District Manager's Response:

We have received the proper documentation from the Bank of Hindman to execute a collateral security agreement for \$1,000,000, it is pending an authorized signature which we will have at our next board meeting.

**KNOTT COUNTY WATER AND SEWER DISTRICT
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
Fiscal Year Ended December 31, 2014
(continued)**

B. Findings - Financial Statement Audit

State Laws And Regulations (Continued)

2014-02 Operating Expenses Exceed Budget

In total, operating expenses exceeded the budget by \$440,166. While revenues exceeded budget by \$284,869, the budget was not amended for unanticipated revenues. Closer analysis shows salaries, electricity expense, and depreciation expense as the major contributors. The likely cause, besides failure to amend the budget for unanticipated revenues, was a major change in management and accounting personnel after the budget was enacted, and failure to adequately anticipate electricity and depreciation expense. This could result in expenditures deemed to be unallowable. KRS 65A.080 (1) states "No moneys shall be expended from any source except as provided in the originally adopted or subsequently amended budget." We recommend a budget be adopted and disseminated as required by law and be amended when unanticipated revenues are expended.

District Manager's Response:

None.

Internal Control - Material Weakness

2014-03 Payroll Processing Lacks An Adequate Segregation Of Accounting Duties

The CFO has signature authority, authority to record transactions, prints the pay checks, and distributes the pay checks. This condition exists because the district lacks the resources to hire adequate personnel to segregate duties. The condition could result in improper or fraudulent expenditures and misstated financial reporting. Proper segregation of duties would place responsibility for custody of assets, authorization for asset use, and record keeping with different individuals. When resources do not allow the district to hire an adequate number of individuals to segregate duties, compensating controls can be implemented. We recommend implementation of compensating controls, such as having someone independent of payroll processing distribute the checks, and having the district manager or board member closely review and initial the monthly payroll account bank reconciliation.

District Manager's Response:

We have implemented a system where our billing clerk distributes payroll, as well as the manager reviewing and initialing both the weekly payroll transfer and the monthly payroll bank reconciliation.

**KNOTT COUNTY WATER AND SEWER DISTRICT
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
Fiscal Year Ended December 31, 2014
(continued)**

B. Findings - Financial Statement Audit (Continued)

Internal Control - Significant Deficiency

2014-04 The Accounting System Is Unable To Identify Individual Grant Project Awards

The district uses a contributed capital account to record capital grant revenues and a construction in progress account to record project expenditures, however, no subsidiary accounts are used to distinguish each grant and project. This results in the need to examine all supporting documentation and accumulate each project outside the computerized accounting system to produce project financial statements, assemble the Schedule of Expenditures of Federal Awards, and eventually book assets to the fixed asset account group upon project completion. This process is more prone to error. We recommend the use of subsidiary ledgers to segregate each project's revenues and expenses while the transactions are fresh.

District Manager's Response:

None.

C. Findings And Questioned Costs - Major Federal Awards Program Audit

None.

D. Summary Schedule Of Prior Audit Findings

None.