

**Mount Sterling Water and
Sewer Commission**

**Independent Auditor's Report
and Basic Financial Statements
June 30, 2014 and 2013**

Mount Sterling Water and Sewer Commission
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June 30, 2014 and 2013

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INDEPENDENT AUDITOR'S REPORT

Mount Sterling Water and
Sewer Commission and
the City Council
Mount Sterling, Kentucky 40353

Report on the Financial Statements

We have audited the accompanying financial statements of the business-type activities of Mount Sterling Water and Sewer Commission (the Commission) of the City of Mount Sterling, Kentucky, as of and for the years ended June 30, 2014 and 2013, and the related notes to the financial statements, which collectively comprise the Commission'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 audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinion

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 Mount Sterling Water and Sewer Commission (the Commission) of the City of Mount Sterling, Kentucky, as June 30, 2014 and 2013, and the respective changes in financial position, and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Change in Accounting Principle

As described in Note 1 to the financial statements, in 2013, the City adopted new accounting guidance, *GASB Statement No. 65, Items Previously Reported as Assets and Liabilities*. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Management has omitted the Management's Discussion & Analysis that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing 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. Our opinion on the basic financial statements is not affected by this missing information.

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Mount Sterling Water and Sewer Commission's basic financial statements. The Schedule of Revenues, Expenses and Changes in Net Position – Budget and Actual and the Schedule of Debt Service Requirements are presented for purposes of additional analysis and are not a required part of the basic financial statements.

The Schedule of Revenues, Expenses and Changes in Net Position – Budget and Actual and the Schedule of Debt Service Requirements are the responsibility of management and were derived from and relate 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 Revenues, Expenses and Changes in Net Position – Budget and Actual and the Schedule of Debt Service Requirements are fairly stated in all material respects in relation to the basic financial statements as a whole.

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the City Council
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Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated September 5, 2014, on our consideration of the Commission's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Commission's internal control over financial reporting and compliance.

Faulkner, King & Wenz, PSC

September 5, 2014

Mount Sterling Water and Sewer Commission
Statements of Net Position
June 30, 2014 and 2013

Assets	<u>2014</u>	<u>2013</u>
Current assets:		
Cash and investments	\$ 2,994,089	\$ 2,982,767
Accounts receivable, net	650,623	636,137
Interest receivable	499	564
Other receivables	12,311	149,296
Inventory	170,491	174,129
Prepaid expenses	175,055	170,426
Total current assets	<u>4,003,068</u>	<u>4,113,319</u>
Non-current assets:		
Restricted cash and cash equivalents	1,419,582	1,351,204
Capital Assets:		
Land and building	1,260,362	1,260,362
Water and sewer system	59,390,569	57,660,738
Equipment	979,244	819,467
Vehicles	346,571	319,672
Construction in progress	0	1,128,409
Less accumulated depreciation	<u>(28,204,020)</u>	<u>(26,390,822)</u>
Total non-current assets	<u>35,192,308</u>	<u>36,149,030</u>
 Total assets	 <u>39,195,376</u>	 <u>40,262,349</u>
 Liabilities		
Current liabilities:		
Accounts payable	56,495	246,559
Other accrued liabilities	287,627	274,214
Accrued interest on bonds	8,462	10,127
Customer deposits	565,580	514,820
Notes payable	1,229,232	1,205,583
Total current liabilities	<u>2,147,396</u>	<u>2,251,303</u>
Non-current liabilities:		
Notes payable	6,827,965	8,057,198
Total non-current liabilities	<u>6,827,965</u>	<u>8,057,198</u>
 Total liabilities	 <u>8,975,361</u>	 <u>10,308,501</u>
 Net Position		
Invested in capital assets, net of related debt	25,715,529	25,535,045
Restricted for debt service	854,002	836,384
Unrestricted	3,650,484	3,582,419
Total net position	<u>\$ 30,220,015</u>	<u>\$ 29,953,848</u>

Mount Sterling Water and Sewer Commission
Statements of Revenues, Expenses And Changes in Net Position
For the Years Ended June 30, 2014 and 2013

Operating revenues	<u>2014</u>	<u>2013</u>
Water sales	\$ 2,750,666	\$ 2,669,973
Sewer sales	2,360,447	2,312,130
Other income	<u>202,425</u>	<u>244,829</u>
Total operating revenues	<u>5,313,538</u>	<u>5,226,932</u>
Operating expenses		
Water	2,361,465	2,172,488
Sewer	1,617,155	1,561,284
General and administrative costs:		
Water	757,975	746,603
Sewer	<u>376,229</u>	<u>360,934</u>
Total operating expenses	<u>5,112,824</u>	<u>4,841,309</u>
Operating income	<u>200,714</u>	<u>385,623</u>
Nonoperating revenues (expenses)		
Interest income	15,374	18,408
Grants	3,496	63,509
Gain (Loss) on sale of fixed assets	0	650
Other expense	(34,257)	(34,298)
Interest expense	<u>(119,968)</u>	<u>(138,705)</u>
Total net nonoperating revenues (expenses)	<u>(135,355)</u>	<u>(90,436)</u>
Income before contributions	65,359	295,187
Capital contributions	<u>200,808</u>	<u>973,030</u>
Change in net position	266,167	1,268,217
Total net position, beginning of year (restated for 2013)	<u>29,953,848</u>	<u>28,685,631</u>
Total net position, end of year	<u>\$ 30,220,015</u>	<u>\$ 29,953,848</u>

Mount Sterling Water and Sewer Commission
Statements of Cash Flows
For the Years Ended June 30, 2014 and 2013

Cash Flows from Operating Activities	<u>2014</u>	<u>2013</u>
Cash received from customers	\$ 5,233,612	\$ 4,873,629
Other cash receipts	202,425	244,829
Cash payments to vendors for water services and supplies	(751,783)	(628,837)
Cash payments to vendors for sewer services and supplies	(390,903)	(359,117)
Cash payments to employees for services	(1,308,761)	(1,304,733)
Cash payments for water administrative costs	(671,541)	(482,080)
Cash payments for sewer administrative costs	(352,285)	(159,088)
Net cash provided by operating activities	<u>1,960,764</u>	<u>2,184,603</u>
Cash Flows from Capital and Related Financing Activities		
Acquisition and construction of capital assets	(589,285)	(847,894)
Proceeds from sale of assets	0	650
Interest paid on revenue bonds	(121,633)	(140,342)
Principal paid on debt	(1,205,584)	(1,187,865)
Increase in customer deposits	50,760	35,333
Other expense	(34,257)	(34,298)
Grant contributions	3,496	63,509
Net cash used in capital and related financing activities	<u>(1,896,503)</u>	<u>(2,110,907)</u>
Cash Flows from Investing Activities		
Interest income from investments	15,439	18,191
Net cash provided by investing activities	<u>15,439</u>	<u>18,191</u>
Net change in cash and cash equivalents	79,700	91,887
Cash and cash equivalents, beginning of year	<u>4,333,971</u>	<u>4,242,084</u>
Total cash and cash equivalents, end of year	<u>\$ 4,413,671</u>	<u>\$ 4,333,971</u>
Restricted cash and cash equivalents	\$ 1,419,582	\$ 1,351,204
Unrestricted cash and cash equivalents	<u>2,994,089</u>	<u>2,982,767</u>
Total cash and cash equivalents, end of year	<u>\$ 4,413,671</u>	<u>\$ 4,333,971</u>

Mount Sterling Water and Sewer Commission
Statements of Cash Flows (continued)
For the Years Ended June 30, 2014 and 2013

Reconciliation of operating income to net cash provided by operating activities:	<u>2014</u>	<u>2013</u>
Operating income	<u>\$ 200,714</u>	<u>\$ 385,623</u>
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	1,815,193	1,732,291
Provision for bad debts	14,937	12,391
Change in assets and liabilities:		
(Increase) decrease in accounts receivable	107,562	(120,866)
(Increase) decrease in inventories	3,638	(1,185)
(Increase) in prepaids	(4,629)	(6,455)
Increase in accounts payable and accrued expenses	<u>(176,651)</u>	<u>182,804</u>
Total adjustments	<u>1,760,050</u>	<u>1,798,980</u>
Net cash provided by operating activities	<u><u>\$ 1,960,764</u></u>	<u><u>\$ 2,184,603</u></u>

Mount Sterling Water and Sewer Commission
Notes to the Financial Statements
June 30, 2014 and 2013

Note 1. Summary of Significant Accounting Policies

The accounting policies of the Mount Sterling Water and Sewer Commission (the Commission) conform to accounting principles generally accepted in the United States of America (GAAP). The Commission applies Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict Governmental Accounting Standards Board (GASB) pronouncements, in which case, GASB prevails. The following is a summary of the more significant policies:

Basis of accounting

The Commission is an individual fund of the City of Mount Sterling, Kentucky and is accounted for as a governmental enterprise fund. It is financed and operated in a manner similar to a private business enterprise where the intent of the governing body is that costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis are financed primarily through user charges.

Accounts are maintained on the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred or prepaid amounts have been utilized.

Investments

Investments are carried at cost. Some of the investments are restricted as to use (Note 2). Funds of the Commission are required to be invested in accordance with the investment policy adopted by the Commission. The investment policy allows the Commission to invest in those instruments authorized by KRS 66.480. Bank deposits were substantially secured by FDIC insurance and collateral or invested in direct obligations of the United States at June 30, 2014 and 2013.

Custodial credit risks – Deposits

Custodial credit risk is the risk that in the event of a bank failure, the Commission's deposits may not be returned to it. The Commission does not have a deposit policy for custodial credit risk. As of June 30, 2014 \$3,700,191 of the Commission's bank balance of \$4,450,191 was exposed to custodial credit risk, as follows:

Insured	\$ 750,000
Collateral held by pledging bank's trust department in the Commission's name	<u>3,700,191</u>
Total bank deposits	<u>\$ 4,450,191</u>

Accounts receivable

Customer receivables are recorded as receivables and revenues at their original invoice amount. Management regularly reviews the customer receivable accounts and determines the allowance for doubtful accounts. A receivable is considered to be past due if any portion of the receivable balance is outstanding for more than 60 days. For the years ended June 30, 2014 and 2013, accounts receivable is stated less an allowance for doubtful accounts of \$132,986 and \$117,874, respectively. A schedule of allowance for doubtful accounts at June 30, 2014 and 2013, follows:

	<u>2014</u>	<u>2013</u>
Beginning balance	\$117,874	\$105,331
Provisions	14,937	12,391
Recoveries (Charge-offs)	<u>175</u>	<u>152</u>
Ending balance	<u>\$132,986</u>	<u>\$117,874</u>

Mount Sterling Water and Sewer Commission
Notes to the Financial Statements
June 30, 2014 and 2013

Note 1. Summary of Significant Accounting Policies (Continued)

Inventories

Inventories are stated at the lower of cost or market on the basis of "first-in, first-out" (FIFO) inventory method.

Budgets

In May of 2013, the Commission adopted the annual management budget in the amount of \$5,355,441 for the fiscal year ended June 30, 2014, detailed as follows:

Water	\$2,207,062
Sewer	1,633,411
General and administrative costs:	
Water	862,915
Sewer	458,379
Total operating expenses	<u>\$5,161,767</u>

Property, plant and equipment

Property, plant and equipment are stated at cost and depreciated over their estimated useful lives using the straight-line method. The range of useful lives used in computing depreciation is:

<u>Classification</u>	<u>Range of lives</u>
Buildings	20-40 years
Water plant	25-40 years
Water systems	10-30 years
Sewer system	10-40 years
Office equipment	7-10 years
Other equipment	7 years
Vehicles	5 years

Total depreciation expense was \$1,815,193 and \$1,732,291 for the years ended June 30, 2014 and 2013, respectively.

Prior period adjustment - Unamortized debt discount and expense

In prior years, these costs were being amortized as non-operating expenses over the life of the debt issue using the straight line method. Amortization expense was \$10,961 for the year ended June 30, 2013. MSWS recorded a prior period adjustment of \$61,196, effective July 1, 2012, to write off bond issuance costs which were previously capitalized. Governmental Accounting Standards Board Statement No. 65 mandated this accounting change. This adjustment is reported as an adjustment to the beginning of year net position. The impact of this retroactive accounting change on previously-reported amounts for the year ended June 30, 2013 is as follows:

	July 1, 2012 <u>Net Position</u>	2013 Change <u>in Net Position</u>	June 30, 2013 <u>Net Position</u>
Amounts as previously reported	\$28,746,827	\$1,257,256	\$30,004,083
Prior-period adjustment	<u>(61,196)</u>	<u>10,961</u>	<u>(50,235)</u>
Amounts as restated	<u>\$28,685,631</u>	<u>\$1,268,217</u>	<u>\$29,953,848</u>

Cash and cash equivalents

All cash, unrestricted and restricted, is considered cash for the purposes of the statement of cash flows.

Mount Sterling Water and Sewer Commission
Notes to the Financial Statements
June 30, 2014 and 2013

Note 1. Summary of Significant Accounting Policies (Continued)

Estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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 revenues and expenses during the reporting period. Actual results could differ from those estimates.

Capital and operating grants

Grants that are restricted to the purchase of property, plant and equipment are recorded as other income, per GASB 33. The Commission received \$3,496 and \$63,509 in grants of this type for the years ended June 30, 2014 and 2013.

Infrastructure assets constructed by outside entities then taken over by the Commission are also recorded as other income per GASB 33. The total amount of the assets taken over were \$0 and \$266,700 for the years ended June 30, 2014 and 2013, respectively. These amounts constitute noncash transactions.

Capitalized interest

The Commission follows the policy of capitalizing interest as a component of construction cost. For the year ended June 30, 2014, total interest cost incurred was \$119,968 of which \$0 was capitalized. For the year ended June 30, 2013, total interest cost incurred was \$138,705 of which \$0 was capitalized.

Note 2. Restricted Assets

The restricted assets in the accompanying financial statements are restricted as to use by ordinance (Note 5), external parties, or by board designation. A schedule of restricted assets at June 30, 2014, follows:

<u>Description</u>	<u>Cash</u>	<u>Investments at Cost</u>	<u>Total</u>
Assets restricted by grant agreement or bond ordinance:			
Customer deposits	\$ 565,580	\$ -0-	\$ 565,580
Reserve accounts	604,002	-0-	604,002
Depreciation accounts	<u>250,000</u>	<u>-0-</u>	<u>250,000</u>
	<u>\$1,419,582</u>	<u>\$ -0-</u>	<u>\$1,419,582</u>

A schedule of restricted assets at June 30, 2013, follows:

<u>Description</u>	<u>Cash</u>	<u>Investments at Cost</u>	<u>Total</u>
Assets restricted by grant agreement or bond ordinance:			
Customer deposits	\$ 514,820	\$ -0-	\$ 514,820
Reserve accounts	586,384	-0-	586,384
Depreciation accounts	<u>250,000</u>	<u>-0-</u>	<u>250,000</u>
	<u>\$1,351,204</u>	<u>\$ -0-</u>	<u>\$1,351,204</u>

Mount Sterling Water and Sewer Commission
Notes to the Financial Statements
June 30, 2014 and 2013

Note 3. Long-Term Debt

The Mount Sterling Water and Sewer Commission's bonded indebtedness and other long-term notes at June 30, 2014 and 2013, are summarized as follows:

	<u>Rate</u>	<u>Original Issue</u>	<u>2014</u>	<u>2013</u>
Kentucky Bond Corporation				
2010 Series C	2.70%	\$ 2,760,000	\$ 1,050,833	\$ 1,472,084
KIA Fund A	1.20%	1,055,969	174,942	231,875
KIA Fund B	1.50%	2,448,213	554,078	687,499
KIA Fund A Loan	1.00%	<u>13,202,540</u>	* <u>6,277,344</u>	<u>6,871,323</u>
		<u>\$ 19,466,722</u>	8,057,197	9,262,781
Less current maturities			<u>(1,229,232)</u>	<u>(1,205,583)</u>
Total long term debt			<u>\$ 6,827,965</u>	<u>\$ 8,057,198</u>

- The original issue of the KIA Fund A Loan is \$13,202,540. As of June 30, 2014, the Commission had borrowed \$11,936,783 of this amount.

The Mount Sterling Water and Sewer Commission's bonded indebtedness and other long-term notes at June 30, 2014 and 2013, are detailed as follows:

	<u>Balance</u>			<u>Balance</u>			<u>Balance</u>
	<u>June 30</u>			<u>June 30</u>			<u>June 30</u>
	<u>2012</u>	<u>Advances</u>	<u>Repayments</u>	<u>2013</u>	<u>Advances</u>	<u>Repayments</u>	<u>2014</u>
Kentucky Bond Corporation							
2010 Series C	\$ 1,884,167	\$0	\$ (412,083)	\$ 1,472,084	\$0	\$ (421,251)	\$ 1,050,833
KIA Fund A	288,131	0	(56,256)	231,875	0	(56,933)	174,942
KIA Fund B	818,942	0	(131,443)	687,499	0	(133,421)	554,078
KIA Fund A Loan	<u>7,459,406</u>	<u>0</u>	<u>(588,083)</u>	<u>6,871,323</u>	<u>0</u>	<u>(593,979)</u>	<u>6,277,344</u>
Total	<u>\$ 10,450,646</u>	<u>\$0</u>	<u>\$ (1,187,865)</u>	<u>\$ 9,262,781</u>	<u>\$0</u>	<u>(\$1,205,584)</u>	<u>\$ 8,057,197</u>

Mount Sterling Water and Sewer Commission
Notes to the Financial Statements
June 30, 2014 and 2013

Note 3. Long-Term Debt (Continued)

	Balance	
	Current	Long-Term
	June 30, 2014	
Kentucky Bond Corporation 2010 Series C	\$ 436,250	\$ 614,583
KIA Fund A	57,618	117,324
KIA Fund B	135,430	418,648
KIA Fund A Loan	599,934	5,677,410
	<u>599,934</u>	<u>5,677,410</u>
Total	<u>\$ 1,229,232</u>	<u>\$ 6,827,965</u>

The long-term debt service requirements are as follows:

<u>Fiscal Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2014-2015	\$ 1,229,232	\$ 102,534	\$ 1,331,766
2015-2016	1,134,228	80,701	1,214,929
2016-2017	987,655	61,882	1,049,537
2017-2018	864,800	47,799	912,599
2018-2019	624,355	36,856	661,211
2019-2024	<u>3,216,927</u>	<u>89,127</u>	<u>3,306,054</u>
	<u>\$ 8,057,197</u>	<u>\$ 418,899</u>	<u>\$ 8,476,096</u>

KIA Fund A and KIA Fund B

As of June 30, 2014 and 2013, the Commission had drawn on a KIA loan which was made to finance the construction of the water treatment plant sludge facilities. The loan is secured by a pledge of revenues, and has been drawn up to \$1,055,969. The loan bears an interest rate of 1.2% and has a life of 20 years and matures in 2017.

As of June 30, 2014 and 2013, the Commission had also drawn on a KIA loan which was made to finance the construction of ground storage tanks and a water strengthening main. The loan is secured by a pledge of revenues, and has been drawn up to \$2,448,213. The loan bears an interest rate of 1.5% and has a life of 20 years and matures in 2018.

Kentucky Infrastructure Authority - A02-01

The Commission had drawn \$11,936,783 as of June 30, 2014 and 2013, from the Kentucky Infrastructure Authority. The loan was made for the construction of a new trunk sewer and wastewater treatment plant. The loan is secured by a pledge of revenues and can be drawn up to \$13,202,540. The loan bears an interest rate of 1% and has a life of 20 years.

Mount Sterling Water and Sewer Commission
Notes to the Financial Statements
June 30, 2014 and 2013

Note 3. Long-Term Debt (Continued)

Kentucky Bond Corporation 2010 Series C Bonds

On November 4, 2010, the Commission borrowed the aggregate principal amount of \$2,760,000 with the Kentucky Bond Corporation 2010 Series C Bonds. The purpose of the issue was for the refunding in advance of the obligations of the City of Danville, Kentucky designated as its Multi-City Lease Revenue Bonds (City of Mount Sterling, Kentucky Water and Sewer System Revenue Refunding & Improvement Project) Series 1998-B and the Kentucky Municipal League Pooled Lease Financing Program. The bonds are secured by a pledge of revenues. The bonds are subject to optional and mandatory redemption prior to maturity.

Note 4. Net Position

GASB Statement No. 34 requires the delineation of Net Position as Invested in Property, Plant and Equipment (capital investments), Restricted and Unrestricted.

The balance of capital investments represents funds that have been used to acquire pump stations, storage facilities, meter stations, etc., constructed and operated by the Mount Sterling Water and Sewer Commission, net of outstanding debt. The balance was \$25,715,529 and \$25,535,045 at June 30, 2014 and 2013, respectively.

The Commission has the following restricted net assets that are reserved in accordance with the Commission's various bond ordinances (Note 5) or Board designations:

	<u>2014</u>	<u>2013</u>
Operation and Maintenance	\$273,527	\$ 272,300
Replacement	328,073	311,682
Depreciation	250,000	250,000
Other	<u>2,402</u>	<u>2,402</u>
Total Restricted	<u>\$854,002</u>	<u>\$ 836,384</u>

The Commission has a balance of \$3,650,484 and \$3,582,419 for unrestricted net assets at June 30, 2014 and 2013, respectively.

Note 5. Compliance with Bond Ordinance

The Kentucky Bond Corporation 2010 Series C bond ordinance requires the Commission to maintain certain reserves and restricted assets as follows:

Operation and Maintenance Fund - This reserve is required to maintain a balance equal to three month's cost of operating, maintaining, and insuring the system. The balance of this reserve at June 30, 2014 and 2013 was \$273,527 and \$272,300.

Depreciation Fund - This reserve is required for major repairs and replacements. Funds may be withdrawn only to pay the cost of making unusual or extraordinary maintenance, repairs, renewals, and/or replacements to the system not included in the annual budget of current expenses, or for the purpose of paying the cost of construction improvements. The balance of this reserve at June 30, 2014 and 2013 was \$250,000.

The Kentucky Infrastructure Authority requires the Commission to maintain certain reserves and restricted assets as follows:

Replacement Reserve - This reserve requires the Commission to deposit \$32,790 each December 1 into a separate account until the balance reaches \$327,900 and be maintained for the life of the loan. The balance of this reserve at June 30, 2014 and 2013, was \$330,475 and \$314,084, respectively.

Mount Sterling Water and Sewer Commission
Notes to the Financial Statements
June 30, 2014 and 2013

Note 6. Property, Plant and Equipment

A summary of changes in property, plant and equipment is as follows:

	Balance June 30, 2012	Additions	Disposals	Balance June 30, 2013	Additions	Reclassifications and Disposals	Balance June 30, 2014
Land and building	\$1,259,126	\$1,236	\$0	\$1,260,362	\$0	\$0	\$1,260,362
Water and sewer system	57,014,942	645,796	0	57,660,738	1,729,831	0	59,390,569
Equipment	826,467	0	(7,000)	819,467	161,772	(1,995)	979,244
Construction in progress	1,005	1,127,404	0	1,128,409	0	(1,128,409)	0
Vehicles	308,283	46,488	(35,099)	319,672	26,899	0	346,571
	59,409,823	1,820,924	(42,099)	61,188,648	1,918,502	(1,130,404)	61,976,746
Accumulated depreciation	(24,700,630)	(1,732,291)	42,099	(26,390,822)	(1,815,193)	1,995	(28,204,020)
Total net property, plant and equipment	\$34,709,193	\$88,633	\$0	\$34,797,826	\$103,309	(\$1,128,409)	\$33,772,726

Note 7. Pension Plan

The Mount Sterling Water and Sewer Commission is a participating employer of the County Employees' Retirement System (CERS) which is a multi-employer defined benefit plan that covers substantially all regular full-time employees of county, school board, municipal and other local agencies electing to participate. Upon election to participate in the CERS, each employee has the option to participate. However, all subsequent employees must participate and the employer is required to continue participation.

The Mount Sterling Water and Sewer Commission had a total of 31 and 32 employees at June 30, 2014 and 2013, respectively, covered by the CERS who contributed 5.00%-6.00% of payroll. The employer contributed 18.89% in 2014 and 19.55% in 2013. The Commission's contribution was \$243,033 and \$244,638, and the employees contributed \$62,813 and \$62,644 for the years ended June 30, 2014 and 2013, respectively.

The amount shown below as "actuarial accrued liability" is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases estimated to be payable in the future as a result of employee service to date. The measure is the actuarial present value of credited projected benefits and is intended to help users assess the System's funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due, and make comparisons among public employee retirement systems (PERS). The measure is independent of the actuarial funding method used to determine contributions to the System.

Vesting in a retirement benefit begins immediately upon entry into the System. The participant has a fully vested interest after the completion of sixty months of service, twelve of which are current service. At a minimum, terminated employees are refunded their contributions with credited interest at 3% compounded annually through June 30, 1981, 6% thereafter through June 30, 1986 and 4% thereafter. All required contributions were paid at year end or within thirty (30) days thereafter. The percentage of the Commission's contribution to total employers' contribution in the CERS for the year is not known.

The CERS total actuarial accrued liability was \$12,503,082,000 and net assets available for benefits were \$7,438,786,000 as of June 30, 2013, which is the latest information available. Also see Note 9.

Mount Sterling Water and Sewer Commission
Notes to the Financial Statements
June 30, 2014 and 2013

Note 8. Risk Management

The Mount Sterling Water and Sewer Commission is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. In addition to its general liability insurance, the Commission also carries commercial insurance for all other risks of loss such as workers' compensation and employee health and accident insurance. Settled claims resulting from these risks have not exceeded commercial insurance coverage in any of the past three fiscal years. The following is a schedule of insurance in force as of June 30, 2014:

<u>Coverage</u>	<u>Amount of Coverage</u>	<u>Premium</u>	<u>Policy Term</u>
Buildings & property	\$ 30,254,409	*	7/1/13 - 7/1/14
General & automobile liability (ea)	3,000,000	*	7/1/13 - 7/1/14
Public officials liability	3,000,000	*	7/1/13 - 7/1/14
Automobile physical	Actual Value	*	7/1/13 - 7/1/14
Crime:			
Forgery or alteration	100,000	*	7/1/13 - 7/1/14
Theft-inside & outside premises (ea)	100,000	*	7/1/13 - 7/1/14
Public dishonesty	250,000	*	7/1/13 - 7/1/14
Counterfeit paper	100,000	*	7/1/13 - 7/1/14
Workers compensation insurance:			
Waterworks	725,021	*	7/1/13 - 7/1/14
Sewage	272,228	*	7/1/13 - 7/1/14
Clerical	287,186	*	7/1/13 - 7/1/14
Health & life insurance	Various	\$ 215,485	Monthly

*Blanket coverage; total premium \$157,896.

Note 9. Subsequent Events

Subsequent events for Mount Sterling Water and Sewer Commission have been evaluated through September 5, 2014, which is the date the financial statements were available to be issued.

In June 2012 the GASB approved a pair of related Statements that reflect substantial changes to the accounting and financial reporting of state and local government employers and pension plans. Statement No. 67, *Financial Reporting for Pension Plans*, addresses financial reporting for state and local government pension plans. Statement No. 68, *Accounting and Financial Reporting for Pensions*, addresses financial reporting for state and local government employers whose employees are provided with pensions through pension plans that are covered under Statement No. 67.

The guidance contained in these Statements will change how governments calculate and report the costs and obligations associated with pensions in important ways. It is designed to improve the decision usefulness of reported pension information and to increase the transparency, consistency, and comparability of pension information across governments. Under the pension standards now in effect, cost-sharing employers have not been required to present actuarial information about pensions. Instead, information has been required to be presented in the pension plan's own financial statements for all of the participating governments combined.

Through its research, the GASB concluded that the needs of users of information regarding cost-sharing employers do not differ significantly from those interested in single and agent employers. Therefore, the GASB believes it is important to give users of the financial statements of cost-sharing employers access to better, more transparent financial information. Consequently, under the new standards the GASB is requiring that cost-sharing governments report a net pension liability, pension expense, and pension-related deferred inflows and outflows of resources based on their proportionate share of the collective mounts for all the governments in the plan.

Statement No. 68 will take effect for pension plan employers in fiscal years beginning after June 15, 2014 (that is, for years ended June 30, 2015 or later). The Commission is currently evaluating the effects of this statement on its financial statements. The Kentucky League of Cities (KLC) prepared estimates of the financial statement impact for all city governments participating in CERS. KLC estimated that the City of Mount Sterling's unfunded liability would be approximately \$5,000,000, based on the 2011 actuarial analysis, but no further breakdown of such liabilities to individual funds is currently available. The actual liability for June 30, 2015 for the Mount Sterling Water and Sewer Commission is not known, at this time.

**Mount Sterling Water and Sewer Commission
Schedule of Revenues, Expenses And Changes
in Net Assets Budget and Actual
For the Year Ended June 30, 2014**

	Enacted Budget	Actual	Favorable (Unfavorable)
Operating revenues			
Water sales	\$ 2,770,556	\$ 2,750,666	\$ (19,890)
Sewer sales	2,416,812	2,360,447	(56,365)
Other income	153,037	202,425	49,388
Total operating revenues	<u>5,340,405</u>	<u>5,313,538</u>	<u>(26,867)</u>
Operating expenses			
Water	2,207,062	2,361,465	(154,403)
Sewer	1,633,411	1,617,155	16,256
General and administrative costs:			
Water	769,292	757,975	11,317
Sewer	397,679	376,229	21,450
Total operating expenses	<u>5,007,444</u>	<u>5,112,824</u>	<u>(105,380)</u>
Operating income	<u>332,961</u>	<u>200,714</u>	<u>(132,247)</u>
Nonoperating revenues (expenses)			
Interest income	15,036	15,374	338
Grants	0	3,496	3,496
Loss on sale of fixed assets	0	0	0
Other expense	(32,923)	(34,257)	(1,334)
Interest expense	(121,400)	(119,968)	1,432
Total net nonoperating revenues (expenses)	<u>(139,287)</u>	<u>(135,355)</u>	<u>3,932</u>
Income before contributions	193,674	65,359	(128,315)
Capital contributions	<u>0</u>	<u>200,808</u>	<u>200,808</u>
Change in net assets	193,674	266,167	72,493
Total net assets, beginning of year	<u>29,953,848</u>	<u>29,953,848</u>	<u>0</u>
Total net assets, end of year	<u>\$ 30,147,522</u>	<u>\$ 30,220,015</u>	<u>\$ 72,493</u>

Mount Sterling Water and Sewer Commission
Schedule of Debt Service Requirements
Kentucky Infrastructure Authority Fund A
June 30, 2014

Fiscal Year Ending June 30	Principal Due Dec. 1 & June 1	Interest December 1	Interest June 1	Total Debt Requirements	Principal Outstanding at End of Year
2015	\$ 57,618	\$ 1,050	\$ 877	\$ 59,545	\$ 117,324
2016	58,311	704	530	59,545	59,013
2017	59,013	354	178	59,545	0
	<u>\$ 174,942</u>	<u>\$ 2,108</u>	<u>\$ 1,585</u>	<u>\$ 178,635</u>	

Mount Sterling Water and Sewer Commission
Schedule of Debt Service Requirements
Kentucky Infrastructure Authority Fund B
June 30, 2014

<u>Fiscal Year Ending June 30</u>	<u>Principal Due Dec. 1 & June 1</u>	<u>Interest</u>		<u>Total Debt Requirements</u>	<u>Principal Outstanding at End of Year</u>
		<u>December 1</u>	<u>June 1</u>		
2015	\$ 135,430	\$ 4,155	\$ 3,650	\$ 143,235	\$ 418,648
2016	137,469	3,140	2,626	143,235	281,179
2017	139,537	2,109	1,589	143,235	141,642
2018	<u>141,642</u>	<u>1,062</u>	<u>534</u>	<u>143,238</u>	<u>0</u>
	<u>\$ 554,078</u>	<u>\$ 10,466</u>	<u>\$ 8,399</u>	<u>\$ 572,943</u>	

Mount Sterling Water and Sewer Commission
Schedule of Debt Service Requirements
Kentucky Infrastructure Authority A02-01
June 30, 2014

<u>Fiscal Year Ending June 30</u>	<u>Principal Due Dec. 1 & June 1</u>	<u>Interest Due Dec. 1 & June 1</u>	<u>Admin. Fees</u>	<u>Total Debt Requirements</u>	<u>Principal Outstanding at End of Year</u>
2015	\$ 599,934	\$ 61,277	\$ 12,255	\$ 673,466	\$ 5,677,410
2016	605,948	55,263	11,053	672,264	5,071,462
2017	612,022	49,188	9,838	671,048	4,459,440
2018	618,158	43,053	8,610	669,821	3,841,282
2019	624,355	36,856	7,372	668,583	3,216,927
2020	630,614	30,597	6,119	667,330	2,586,313
2021	636,936	24,275	4,855	666,066	1,949,377
2022	643,321	17,889	3,578	664,788	1,306,056
2023	649,771	11,440	2,288	663,499	656,285
2024	656,285	4,925	985	662,195	0
	<u>\$ 6,277,344</u>	<u>\$ 334,763</u>	<u>\$ 66,953</u>	<u>\$ 6,679,060</u>	

Mount Sterling Water and Sewer Commission
Schedule of Debt Service Requirements
Kentucky Bond Corporation Financing Program Revenue Bonds 2010 First Series C
June 30, 2014

<u>Fiscal Year Ending June 30</u>	<u>Principal Payments</u>	<u>Interest</u>	<u>Admin. Fees</u>	<u>Total Debt Requirements</u>	<u>Principal Outstanding at End of Year</u>
2015	\$ 436,250	\$ 31,525	\$ 3,077	\$ 470,852	\$ 614,583
2016	332,500	18,438	1,986	352,924	282,083
2017	177,083	8,463	1,155	186,701	105,000
2018	105,000	3,150	525	108,675	0
	<u>\$ 1,050,833</u>	<u>\$ 61,576</u>	<u>\$ 6,743</u>	<u>\$ 1,119,152</u>	

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INDEPENDENT AUDITOR'S 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*

Mount Sterling Water and Sewer Commission
Mount Sterling, Kentucky

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 Mount Sterling Water and Sewer Commission (the Commission) of the City of Mount Sterling, Kentucky, as of and for the year ended June 30, 2014, and the related notes to the financial statements, which collectively comprise the Commission's basic financial statements and have issued our report, which includes an explanatory paragraph regarding the omission of Management Discussion and Analysis, thereon dated September 5, 2014.

Internal Control Over Financial Reporting

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

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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

Finding: 2014-1

- **Condition:** While management is knowledgeable in regard to the numbers reported in the financial statements, identifying and applying new authoritative guidance in regard to information reported in the notes to those statements is outside the scope of management's training and experience.
- **Management Response and Corrective Action Plan:** It does not appear that it would be economically feasible for our organization to enlarge its staff or contract an individual with appropriate skill and knowledge in applying new authoritative guidance. Thus, it is important that our Board provide oversight and independent review functions.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Commission's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Response to Findings

The Commission's response to the findings identified in our audit is described on the first page. The Commission'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.

Faulkner, King & Wenz, PSC

September 5, 2014