Examination of Certain Policies, Procedures, Controls, and Financial Activity of Sanitation District 1

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The Auditor Of Public Accounts Ensures That Public Resources Are Protected, Accurately Valued, Properly Accounted For, And Effectively Employed To Raise The Quality Of Life Of Kentuckians.

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August 17, 2011

Chuck Heilman, Board President
Sanitation District 1 Board
1045 Eaton Drive
Ft. Wright, Kentucky 41017

John R. Chamberlin, CPA, MBA
Van Gorder, Walker & Co., Inc.
3216 Dixie Highway
Erlanger, Kentucky 41018

RE: Examination of Certain Policies, Procedures, Controls, and Financial Activity of Sanitation District 1

Dear Mr. Heilman and Mr. Chamberlin:

We have completed our Examination of Certain Policies, Procedures, Controls, and Financial Activity of Sanitation District 1 (SD1). The report presents 14 findings and offers 72 recommendations to strengthen the management, oversight, and controls of SD1.

Examination procedures included interviews of current and former SD1 employees, members of the independent CPA firm auditing SD1, and others. A review of applicable SD1 policies and procedures were performed, as well as an examination of SD1 records and information for the period July 1, 2008 through December 31, 2010. In addition, pertinent project information prior to that date and policies and procedures implemented during 2011 were also reviewed. The objectives developed by the Auditor of Public Accounts for this examination include:

- Determine whether policies governing contract procurement were adequate, were consistently followed, and provided transparency;
- Determine whether appropriate financial statement adjustments were made to properly account for financial activity recorded in SD1's Construction-in-Progress (CIP) account;
- Determine compliance with policies and other official requirements associated with customer rate increases;
- Determine whether SD1's retention of reports, e-mails, and other documents complied with required retention policies and schedules;
- Review SD1 governing policies; and,
- Report findings identified and provide recommendations to strengthen SD1 oversight and management of operations.

Specific items scrutinized in the examination include:

- Accounting controls over the allocation of project labor costs, general ledger adjusting entries, and the model used to adjust sewer rates;
- Certain procurement policies, including construction in progress change orders; and,
- Policies for Board governance, including an orientation program and ethics policies.

The purpose of this examination was not to provide an opinion on financial statements, but to ensure that processes are in place to provide strong oversight of financial activity through a review of SD1 organization's policies, Board governance, certain internal controls, and other financial transactions.

The Auditor of Public Accounts requests a report from SD1 on the implementation of audit recommendations within 60 days of the completion of the final report. If you wish to discuss this report further, please contact Brian Lykins, Executive Director of the Office of Technology and Special Audits, or me.

Respectfully submitted,

Crit Luallen
Auditor of Public Accounts

Examination of Certain Policies, Procedures, Controls, and Financial Activity of Sanitation District 1

Examination Objectives

On March 16, 2011, the Auditor of Public Accounts (APA) informed Sanitation District No. 1 (SD1) of Northern Kentucky, which serves more than 30 municipalities and the unincorporated portions of Boone, Campbell and Kenton counties, that it would conduct an examination of specific issues at SD1 including a review of SD1's organizational policies, certain internal controls, and other financial transactions. This examination was in response to public reports and concerns presented to the APA regarding particular issues and financial transactions of SD1. Specifically, the Kenton County Judge/Executive expressed concerns pertaining to potential mismanagement at SD1 and requested the APA to conduct an audit of SD1's affairs.

The scope of this review included the following objectives:

- Determine whether policies governing contract procurement were adequate, were consistently followed, and provided transparency;
- Determine whether appropriate financial statement adjustments were made to properly account for financial activity recorded in SD1's Construction-in-Progress (CIP) account;
- Determine compliance with policies and other official requirements associated with customer rate increases;
- Determine whether SD1's retention of reports, e-mails, and other documents complied with required retention policies and schedules;
- Review SD1 governing policies; and,
- Report findings identified and provide recommendations to strengthen SD1 oversight and management of operations.

The scope of the examination includes records and information of SD1 for the period July 1, 2008 through December 31, 2010, although pertinent project information prior to that date, and policies and procedures implemented during 2011, also were reviewed.

SD1 Background

SD1 was established in Northern Kentucky in 1946 by the Commissioner of Sanitation Districts, Division of Sanitary Engineering of the Kentucky Department of Health, pursuant to Kentucky Revised Statutes (KRS) 220.110. KRS 220.110 authorized SD1 to prevent and correct the pollution of streams, regulate the flow of streams for sanitary purposes, clean and improve stream channels for sanitary purposes, and collect and dispose of sewage and other liquid wastes produced throughout the established service area.

The original area served by SD1 included 17 municipalities and covered 25 square miles. Each community had its own independent system for the collection and treatment of sewage. In 1954, SD1 completed its first wastewater treatment plant in the city of Bromley to serve the Northern Kentucky area of Kenton and Campbell counties.

Due to more stringent water quality regulations and the area's increasing population, in 1979, SD1 constructed the Dry Creek Wastewater Treatment Plant that included the construction of new interceptor sewers and pump stations. In 1994, in response to pending changes in environmental regulations and increased public interest in the consolidation of services, KRS 220 was amended, allowing SD1 to operate sewage and drainage systems in cities located within its jurisdictional boundaries. As a result, SD1 acquired approximately 900 additional miles of sanitary sewer lines and related pump stations.

In 1998, the Kentucky General Assembly granted SD1 the authority to regulate and finance storm water facilities within its service area. As part of Interlocal Agreements, in 2009, SD1 began the process of assuming ownership and maintenance of a portion of the publicly-owned storm water system from the local governments.

SD1 is the second largest public sewer utility in Kentucky and has ownership of all sanitary sewer systems in Northern Kentucky, with the exception of systems in Florence and Walton. SD1 operates and maintains more than 1600 miles of sanitary sewer line, 145 wastewater pumping stations, 15 flood pump stations, eight package treatment plants, two major wastewater treatment plants, and more than 400 miles of storm sewer, and over 28,800 storm sewer structures. SD1 has approximately 100,000 customer accounts. SD1 is not under the jurisdiction of the Public Service Commission.

Consent Decree

Effective April 18, 2007, the Federal Court Order "Consent Decree" negotiated between SD1 and the United States Environmental Protection Agency (EPA) established a structure for developing and implementing plans to address SD1's combined sewer overflows (CSOs) and sanitary sewer overflows (SSOs). Overflows can degrade the quality of streams and rivers and are regulated through the Federal Clean Water Act. The Consent Decree incorporates a "watershed-based" approach in the planning process that considers pollution sources in addition to sewer overflows.

Review of SD1 Policies and Procedures

The APA reviewed certain SD1 organizational policies, procedures, and other governing requirements and compared them to the APA's "Recommendations for Public and Nonprofit Boards" regarding financial oversight and internal control processes for board consideration.

Through this comparison, we found SD1 policies, procedures, and practices generally provide an effective structure for the oversight and processes that govern the operations of the organization. We make recommendations in Chapter 2, Findings and Recommendations, to further strengthen certain policies, controls and oversight procedures.

Review of Records Retention

Questions have been raised by recent court actions concerning the records retention of documents by SD1. The APA obtained and reviewed SD1 retention schedules and related policies, systems and processes being carried out to ensure proper SD1 document retention.

Auditors identified training conducted on records retention for staff and liaisons. SD1 created a liaison program to serve as a communication between the Records Coordinator and SD1 departments. SD1's retention policies appear to be applicable and in compliance with KDLA approved Local Government Retention Schedule requirements.

As a result of the APA testing of capital projects, the auditors found SD1 to be in compliance with records retention requirements for the projects tested.

Beginning in April 2009, SD1 changed its e-mail retention policy and implemented a Google e-mail and archiving system that automatically retains all e-mails indefinitely. This improvement by SD1 complements its other established retention policies and procedures.

Review of Rate and Fee Increases

The setting of sanitary sewer and storm water rates for the SD1 coverage area is a complex and challenging task for SD1. The rate setting process requires knowledgeable assessment of the impacts of financial, regulatory, economic, and demographic considerations on such decisions. The rate setting process must weigh and evaluate the impacts of projects mandated by the Consent Decree as well as the financial requirements to operate, maintain and extend existing facilities. In addition, SD1 must ensure that adequate reserves are maintained to satisfy the various debt and other reserve requirements. Funding for all these requirements is derived from a mix of operating revenues generated from the sewer and storm water rates and funding from bond issues and low cost state funding.

As part of its examination, the APA researched SD1's rate-setting policies as well as federal, state, and local laws and ordinances to determine SD1's authority and requirements for increasing rates and fees. The APA also reviewed SD1's rate-setting procedures to ascertain compliance with its stated policies, and applicable laws and regulations. In addition, a review of the rate setting model and related processes was conducted in response to an error noted in that model.

The examination revealed that SD1 was in compliance with the rate setting requirements of KRS 220 regarding Board approvals and public notices. See Finding 12 for recommendations regarding the rate setting process.

Review of Construction in Progress Projects

"Construction in progress" is an asset account wherein the cost of a construction project is accumulated until construction is completed. Upon completion, the total cost of the project is moved from CIP to a fixed capital asset account, and that amount is then depreciated over the deemed useful life of the capital asset.

As part of its audit procedures, the APA selected eight CIP projects for testing certain criteria. A review and analysis of the records of each of the eight projects was conducted to ascertain proper procedures were followed in contract selection, change order modifications, and payments to vendors. Projects also were reviewed for conflicts of interest, capitalization of expenditures, and record retention. See Findings in Chapter 2 for the results of the project testing.

Review of Capitalization versus Operations & Maintenance Expense

As part of the Examination of certain financial transactions, policies, and procedures of the SD1, the APA reviewed whether appropriate financial statement adjustments were made to properly account for financial activity in SD1's CIP and Operations and Maintenance (O & M) accounts. This review focused primarily on the 2008 financial statements given that current and former employees of SD1, as well as the CPA firm hired to conduct the 2008 audit, revealed a difference of opinion among the parties as to what types of expenses should have been included in CIP to be capitalized versus what should have been charged to current year expense. Capitalizing expenditures rather than charging them to expense in the current year understates current expenses and increases net income for the year. An overinflated net income inaccurately portrays an entity's financial stability on which bond rating agencies and other users rely to determine bond ratings, which ultimately affects rate increases.

Regulatory guidance on the types of expenditures that should be included in CIP and ultimately capitalized, rather than expensed in the current year, is not definitive. However, legal costs related only to the acquiring of the asset should be included as CIP and not other litigation related to the project. Cleaning and monitoring costs should not be capitalized and depreciated regardless of how infrequent the cleaning is, unless it can be determined that such maintenance will extend the life of the asset beyond the original depreciable life of the asset established by SD1.

Prior to fiscal year ending June 30, 2008, SD1's capitalization procedures allowed many expenditures to be included in CIP and eventually capitalized and depreciated that did not meet the criteria of a depreciable asset. SD1, at the urging of a CPA firm began implementation of a more extensive capitalization policy during fiscal year 2008-2009.

The APA's examination and review of SD1's financial statement adjustments and capitalization policies exposed several issues regarding capitalization versus expense procedures at SD1, as well as compliance issues with capitalization policies. See Findings 6, 7, and 8 in Chapter 2 detailing the results of this review.

Findings and Recommendations

Finding 1: Governance policies for the Board of Directors did not address several critical responsibilities necessary for proper and effective oversight.

Governance policies for the Board of Directors did not address several critical responsibilities necessary for proper and effective oversight of SD1. Auditors found no evidence of the following:

- An internal audit function that reports directly to the Board of Directors, or any independent process to receive, analyze, investigate, and resolve concerns related to SD1, including anonymous complaints;
- Annual or new Board member orientation regarding board member fiduciary responsibilities as board members;
- Policy requirements for annual reviews of executive staff salary increases by the Board of Directors or a designated committee with documentation in the meeting minutes;
- Review and approval of executive staff travel by the Board of Directors; and
- An audit committee of the Board during the period of review.

Recommendations: We recommend the Board of Directors strengthen its policies to include several critical responsibilities necessary for proper and effective oversight of SD1. We recommend SD1 strengthen its whistleblower reporting policies by creating and documenting an independent process whereby employees and/or customers have the option to directly make the Board aware of concerns involving matters that specifically need Board oversight. We recommend the Board establish methods that allow for concerns to be reported directly to its attention by all staff, including anonymous concerns, and any complaints against executive staff. The Board should further ensure a process exists to analyze, investigate and resolve issues brought to its attention. An internal audit function could be used to ensure that concerns brought to the Board are independently investigated. The internal auditor should report findings directly to the Board. We recommend the Board provide annual orientation training for new and returning Board members to ensure the members have at a minimum, a clear understanding of SD1's organizational structure and policies, their responsibilities as Board members, as well as their legal and fiduciary roles, and the purpose of the board on which they serve. In addition, the orientation should address ethical requirements of Board members and staff and any significant policy changes adopted by SD1 during the previous year. Material for the orientation should be written and formally presented in a manual to facilitate the orientation process and serve as a useful reference tool for Board members. We also recommend that the orientation be facilitated by a knowledgeable independent party, such as a Board attorney who can participate in and oversee the orientation training. We recommend SD1 Board of Directors adopt a policy to review and approve the salaries of the executive staff on an annual basis to ensure that the compensation paid is equitable to the responsibilities and duties of each position. The salaries should be reviewed specifically by the Board to ascertain appropriate use of funds given the mission of SD1, and such review should be documented in the minutes. We recommend SD1's newly established Board audit committee appoint and approve the compensation of the CPA firm hired to conduct the financial audit of SD1. The audit committee should have the outside auditors report directly to it. We recommend the Board, or a designated committee of the Board, pre-approve executive staff out-of-state travel, including estimated costs. The Board meeting minutes should document the review conducted by the Board. We also recommend the Board require a report of the actual travel expenses of executive staff, with Board approval, prior to expense reimbursement. The expense reports should sufficiently detail the expenses associated with meals, lodging, transportation, and entertainment of each trip, as well as the business purpose of each expense item.

Finding 2: Certain policies were not documented or sufficient to ensure accountability.
SD1 had no written policies or procedures regarding the use of credit cards, reimbursements to employees, electronic backup of financial information, and fixed asset inventory. Such policies are necessary to provide proper control and accountability required of a public agency.
Recommendations: We recommend SD1 adopt a credit card usage and oversight policy and document such policy in the employee handbook or through written documentation. The policy should detail required supporting documentation, timely review by the Board of Directors, and approval of executive staff credit card statements. If any expenses are classified as gifts or entertainment, they should be documented to include the name and title of the person making the purchase as well as the recipient and a description of why the expense was needed and how it relates to SD1. Further, we recommend SD1 develop a policy related to reimbursement for use of personal credit cards with a stated timeframe allowed for making the reimbursement. Expense reimbursements requested by executive management should be reviewed by the Board ensuring that supporting documentation exists. Documentation should be retained to avoid any duplicate payments to employees. We recommend SD1 adopt written policies that detail procedures for the backup of electronic financial information. Moreover, policies should include a process to report any lost or missing financial information or records. We recommend SD1 adopt and implement property and inventory control policies and procedures to identify and account for all furniture, equipment, or other items valued over a certain specified dollar amount (specific dollar amount to be included in policy). We further recommend such inventory policies and procedures include an annual, or periodic, physical inventory of all fixed assets. Dispositions of property should also be reflected in inventory accounting.

Finding 3: Financial reviews and caucus meetings were not documented in meeting minutes.
The nature of financial reviews conducted by the Board of Directors was not documented in SD1 Board meeting minutes. Neither were meeting minutes recorded for Board caucus sessions held prior to monthly Board meetings. The only reference to the nature of any financial reviews by the Board was that a monthly financial report, and sometimes an annual financial report, was approved.
Recommendations: We recommend the Board of Directors ensure that Board meeting minutes document the exact nature of the financial reviews conducted by the Board. At least quarterly, the Board should receive a listing of expenditures with sufficient detail to identify inappropriate, unusual or excessive expenditures, and document its review of the listing. Any issues that result from these reviews and action taken to resolve the issues should also be documented. We recommend that all discussion and actions taken during the caucus sessions held prior to the Board meetings, or at any other time, be recorded as open meeting minutes pursuant to KRS 61.835.

Finding 4: SD1 ethics policies for Board members and employees were not comprehensive.
Although some ethics policies existed for SD1 Board members and employees during the APA's period of review, no ethics policies existed pertaining to honoraria, investment/stock ownership, post employment, or acting as a representative of SD1 before a business owned by a family member. Furthermore, the policies in effect during the audit period addressing financial disclosure, acceptance of gifts, and conflicts of interest were inadequate, though SD1 made an attempt in its Ethics Policy adopted on March 22, 2011 to improve such policies. The lack of strong, enforceable ethics policies allowed the potential for, if not actual, conflicts of interest for certain SD1 Board members. A comparison of vendor payments to Board member affiliated businesses exposed three apparent conflicts of interest of current and former SD1 Board members.
Recommendations: We recommend that SD1's Board of Directors strengthen its Ethics Policy by establishing a comprehensive code of ethics, applicable to both Board members and staff members. In developing a comprehensive code of ethics for the Board and staff, the following areas of conduct that are not in the current revised SD1 Ethics Policy should be considered for inclusion: Honoraria; Investment/Stock

Ownership; Post-Employment; and Representation of SD1 Before a Family-Owned/Related Business. We recommend Board and executive staff members annually file by a specified date a financial interests disclosure statement. Required information should be expanded and disclosed on a form prescribed by the Board. Board members and employees should abstain from involvement in certain discussions and decisions. Documentation of such abstention should be in writing and placed in the employee's personnel file or recorded in the minutes of the Board meeting. We recommend Board members, employees, and any business owned by any Board member or employee be prohibited from having a contract or an agreement with SD1, or from representing a person or business privately before SD1. We recommend Board members and employees be prohibited from using their official positions to obtain a financial gain or benefit or advantage for themselves or family members. We recommend Board members and employees be prohibited from using confidential information acquired during their tenure to further personal economic interests. We recommend Board members and employees be prohibited from holding outside employment with, or accepting compensation from, any person or business with which they have involvement as part of their official duties for SD1. In order to ensure compliance with SD1's Ethics Policy, we recommend SD1 adopt policies, procedures and responsibilities for investigating reported ethical misconduct and criteria for sanctions and disciplinary procedures.

Finding 5: **Accounting controls need strengthening.**
During the course of the examination there were several instances of accounting errors and of apparent lax accounting controls noted that suggest SD1 should review and strengthen accounting controls and oversight. The specific instances noted involved a formula error in a spreadsheet allocating labor costs to projects, significant accounting entries made without proper review or documentation, and errors in the rate setting "Pro Forma" model.
Recommendations: We recommend that SD1 make a concerted effort to address not only the issues noted above but to address and formalize the nature of accounting and financial oversight and review that would help prevent such errors in the future. Specifically, we recommend that all projects that were overcharged in-house labor be considered for correction through prior period adjustments. Except for those labor charges allocated for the current fiscal year, the twelve projects that are still active and included in CIP that were overcharged in the amount of $180,122 also should be considered for correction through prior period adjustments. In addition, we recommend SD1 assure the integrity and security of the SD1 ledgers by imposing strict controls on general ledger access, by evidencing review and approval of ledger entries, and by maintaining the approved documentation supporting all entries in the SD1 ledger. As provided in Finding 6, SD1 finance and accounting staff should ensure that applicable accounting standards are followed in determinations of all capital versus expense decisions. We also recommend, as noted in Finding 12, that SD1 expand the participation and oversight of the rate setting model such that the responsibility for not only the data input but also the end product, .i.e. the revised rates, is a multi-disciplinary responsibility. Expanded participation and oversight should also ensure continuity of expertise should a change in personnel occur.

Finding 6: SD1 Construction in Progress accounts included questionable charges.
The examination of specific charges recorded in the CIP account balances raised several questions as to whether the treatment of those costs was appropriate and accurate. Certain charges were included in CIP account balances and eventually capitalized as assets, rather than expensed in the year they were incurred.
Recommendations: We recommend SD1 review and update its Capitalization Policy for CIP to provide more detailed guidance regarding the expense or capitalization of expenditures for meals, catering, furniture, and fixtures, and to ensure the policy complies with any available governing authority. SD1 accounting and finance personnel are charged with, and held responsible for, the integrity of the SD1 financial statements. As such, they must be knowledgeable of and apply appropriate guidance to all aspects of SD1's financial records, including whether to expense or capitalize a cost.

Finding 7: Year-end adjustments to financial statements were made without approvals, support documentation, or necessary prior period adjusting entries.
As stated earlier, the review of financial statements focused primarily on the fiscal year-end 2008 statements. Fiscal year-end adjusting journal entries proposed by the CPAs totaling $2.7 million were made by SD1's former controller in January of 2009 to adjust the financial statements for the fiscal year ended June 30, 2008. These adjusting entries were made to correct expenditures originally charged to CIP that should have been recorded as expenses in the year incurred. SD1 was unable to provide the APA with a breakdown of expenditures or projects that comprised the total of these adjustments. Moreover, SD1 stated that these adjustments were made without any supervisory review or approval. SD1 also indicated that prior period adjustments were not made even when costs accumulated in CIP for previous years were charged to expense in the current year. For example, SD1

accumulated charges from multiple years in CIP account balances for projects involving feasibility studies. If a specific capital project did not materialize as a result of a study, the CIP expenditures incurred to date were immediately expensed in the current period, regardless of when the costs were actually incurred.

Recommendations: We recommend SD1 implement policies that require supervisory approval for any financial statement adjustments and that require documentation be retained to support any adjustments made. Such policies must be followed to ensure proper internal control over the financial records. We also recommend SD1 implement a policy disallowing adjusting journal entries after the audit is complete for the fiscal year under audit, except for prior period adjustments. We recommend SD1 implement a policy for recording prior period adjustments, those expenditures incurred in previous years that are adjusted in a future period. Prior period adjustments should have supervisory approval before any entry is made.

Finding 8: The SD1 FY 2008 financial audit did not include a finding reporting a material financial adjustment and the lack of a capitalization policy.

The SD1 financial audit for fiscal year ended June 30, 2008 performed by a CPA firm did not include an audit finding in the audit report, although SD1 made a material audit adjustment and lacked a comprehensive capitalization policy.

Recommendations: We recommend that any future financial audit reports issued include audit findings of any material audit adjustments or related matters.

Finding 9: SD1 did not comply with its procurement guidelines when obtaining goods and services.

SD1 contracted for professional engineering services, purchased materials and supplies directly from vendors, and procured services for the construction of a major project without following its own procurement requirements.

Recommendations: We recommend that SD1 develop and implement, with Board approval, procurement guidelines that fully comply with the Model Procurement code in KRS 45A.345-45A.460, and KRS 45A.740, 45A,745, and 45A.750. Further, we recommend that SD1, through its Procurement Officer, implement procedures to ensure that SD1 complies with the provisions of its procurement guidelines. Employees responsible for procurement should be trained sufficiently on the guidelines. We recommend SD1 ensure that procurement guidelines for securing professional engineering services are followed for all projects. Time limitations due to securing federal funding should be taken into account when requesting proposals for engineering or geotechnical services involving fees expected to be in excess of $100,000, but procurement guidelines should not be circumvented. All proposals received should be reviewed by a selection committee that may include, but is not limited to, staff, consultants, and interested Board members. The selection committee should evaluate the professional, technical, financial and physical capability of the firms and make a recommendation to the Board on its selection. We recommend all purchases for nonprofessional goods or services where aggregate payments will exceed $20,000 be competitively bid, approved by the Board of Directors, and made through a written contract between SD1 and the vendor. Criteria established for vendor selection should be objective and include information such as the amount bid, qualifications of the vendor, and quality of the product. We recommend that even if a project is a joint effort with another entity, any engineering and construction services procured through such a joint agreement should comply with SD1 procurement guidelines. All decisions related to the joint agreement should be approved by the Board of Directors and documented in the Board meeting minutes.

Finding 10: Capital project change orders were not always preapproved in writing by staff, nor reviewed by the Board.

Internal controls and procedures related to capital project change orders did not provide proper oversight for increases to project totals. Several change orders for capital projects were not consistently approved in writing by SD1 staff prior to incurring expenses related to the change order. Auditors found no evidence of Board members being informed of project increases through change orders to Board approved project totals, or of the necessity for such increases. Consequently, the expenditures made under a professional engineering contract on one project reviewed by auditors totaled more than the Board approved contract amount plus change orders.

Recommendations: We recommend SD1 management, on a regular basis, provide the Board with information on all projects that are approaching the Board approved amounts including the related change orders and reasons for such increases. We also recommend SD1 review change order policy and procedures to ensure that all requested change orders are approved by SD1 staff prior to the work being done and cost incurred. Acknowledging that an unapproved change order can disrupt and delay project progress, any SD1 policy and procedures should accommodate the need for avoiding costly delays.

Finding 11: SD1 did not consistently comply with requirements to withhold amounts from vendor payments.

SD1 did not consistently withhold the proper percent when paying contractor and vendor invoices as required in the contracts and purchase orders. For its CIP projects, SD1 entered into contracts with primary contractors for the construction of capital projects. Additionally, SD1 purchased products and equipment directly from vendors for the projects. In testing a sample of eight CIP projects, two of the projects were found to include payments for invoices where SD1 did not retain the proper percentage of payment as required by the contract or purchase order.

Recommendations: We recommend SD1 engineering management review all contract payments and ensure the appropriate percent of any contract payment is withheld as specified by the contract. We further recommend that all invoices be reviewed by the Finance department to determine that an engineer has approved the proper payment amount prior to paying an invoice.

Finding 12: SD1 failed to establish a process to ensure the accuracy of projected rate increases to its customers.

The lack of review and oversight of the model followed by SD1 to project customer rates provided the opportunity for errors to occur in the rate setting process. To project future rate increases, the Director of Finance maintained an Excel spreadsheet financial model, or "Pro Forma," used to capture detailed historical financial activity of SD1. This model also enabled SD1 to input detailed projections of financial data and to conduct "what if" scenarios with various components of the financial data. Those financial projections were the basis for determining SD1's future requirements for operating funds and capital borrowings needed to ensure revenues and capital are sufficient to support daily operations, to service outstanding debt issues, and to maintain the various mandated reserves.

Recommendations: We recommend SD1 establish an internal review and oversight process of the rate setting model to include additional financial related expertise as well as operational expertise. While the model is a financial tool, the sources for the financial inputs are derived from both accounting and operational personnel. The Director of Finance and the others involved in the review of the process should document that they have independently reviewed the information and agree to the rate recommended to the Board. Establishing a consistent oversight and review process of the model would also expose other staff to the functionality of the model and provide a degree of backup for those interacting with the model. We also recommend that SD1 document the procedures followed to update the model as well as the procedures followed to produce the various scenarios or iterations that may be required during any rate setting period. Documenting those procedures of such a critical process is essential and could prove invaluable should someone less familiar with the model be required to operate it.

Finding 13: SD1 provides billing credits to school districts that participate in SD1 sponsored environmental programs.

Schools within the SD1 coverage area can qualify for a 25 percent discount on their storm water surcharge if the SD1 approved Environmental Curriculum is taught in that school. The curriculum developed by SD1 meets the Kentucky Educational Core Content standards for grades 4 and 5. This credit is part of SD1's Credit Policy for non-residential property owners that was approved by the SD1 Board of Directors on April 17, 2003. If a school chooses to discontinue the curriculum, the credit is revoked. The amount of credits given is detailed in Table 14 below. While this program appears to be a commendable service to the communities, and an appropriate method for instilling environmental awareness in the student population, the granting of discounts to participating school districts would seem to result in an inequitable allocation of rate abatement with the cost ultimately borne by the remaining customer base.

Recommendations:

Given the impact on the customer base of the ever increasing sewer rates, we recommend SD1 reconsider the practice of providing credits for school districts that participate in environment education awareness programs. We further recommend that SD1 ensure that the public, the County Judges/Executive, and the SD1 Board members are fully aware of any credits provided to customers, as well as the implications and financial impact of such a program. The Board of Directors should be fully aware of each and every credit program administered by SD1 and its value, and determine whether such programs are the best use of public monies.

Finding 14: SD1 expenditures for lobbying, sponsorships, public relations, and employee benefits are questionable uses of public funds.

While evaluating SD1 expenditures, certain expenses for lobbying efforts, public relations, sponsorships, and employee benefits were found that appear to be questionable uses of public funds.

Recommendations: We recommend SD1 and the Board review SD1's public relations, lobbying, and sponsorship efforts to ensure that all expenditures are necessary, reasonable, and an appropriate use of public funds. We also recommend that SD1 and the Board review SD1's extended employee benefits to insure that the incentive programs, Christmas gifts, and attendance rewards are all necessary and fiscally responsible expenditures.

Chapter 1

Introduction, Background, and Procedures

Scope and Objectives

On March 16, 2011, the Auditor of Public Accounts (APA) informed Sanitation District No. 1 (SD1) of Northern Kentucky, which serves more than 30 municipalities and the unincorporated portions of Boone, Campbell and Kenton counties, that it would conduct an examination of specific issues at SD1 including a review of SD1's organizational policies, certain internal controls, and other financial transactions. This examination was in response to public reports and concerns presented to the APA regarding particular issues and financial transactions of SD1. Specifically, the Kenton County Judge/Executive expressed concerns pertaining to potential mismanagement at SD1 and requested the APA to conduct an audit of SD1's affairs. The scope of this review included the following objectives:

- Determine whether policies governing contract procurement were adequate, were consistently followed, and provided transparency;
- Determine whether appropriate financial statement adjustments were made to properly account for financial activity recorded in SD1's Construction-in-Progress (CIP) account;
- Determine compliance with policies and other official requirements associated with customer rate increases;
- Determine whether SD1's retention of reports, e-mails, and other documents complied with required retention policies and schedules;
- Review SD1 governing policies; and,
- Report findings identified and provide recommendations to strengthen SD1 oversight and management of operations.

The scope of the examination includes records and information of SD1 for the period July 1, 2008 through December 31, 2010, although pertinent project information prior to that date, and policies and procedures implemented during 2011, also were reviewed. The purpose of this examination was not to provide an opinion on financial statements, but to ensure that processes, policies, and procedures were in place to provide strong oversight of financial activity. Nor was this examination intended to report on the appropriateness of SD1's actions regarding open records requests, which is under the jurisdiction of the court system. This examination does not report on the necessity or quality of sanitation services provided by SD1 or the accuracy of charges billed to customers.

Background

SD1 was established in Northern Kentucky in 1946 by the Commissioner of Sanitation Districts, Division of Sanitary Engineering of the Kentucky Department of Health, pursuant to Kentucky Revised Statutes (KRS) 220.110. KRS 220.110 authorized SD1 to prevent and correct the pollution of streams, regulate the flow of streams for sanitary purposes, clean and improve stream channels for sanitary purposes, and collect and dispose of sewage and other liquid wastes produced throughout the established service area. Statutes granted SD1 the authority to construct sewers, trunk sewers, laterals, intercepting sewers, siphons, pump stations, treatment and disposal works, and other appropriate facilities. KRS 220 also authorized SD1 to maintain and operate any applicable structures and facilities.

The original area served by SD1 included 17 municipalities and covered 25 square miles. Each community had its own independent system for the collection and treatment of sewage. SD1 was responsible for the construction of a sewage treatment plant and collections system that would convey sewage from the various municipalities to a treatment facility. In 1954, SD1 completed its first wastewater treatment plant in the city of Bromley to serve the Northern Kentucky area of Kenton and Campbell counties. The wastewater treatment plant provided primary treatment of wastewater before discharging it into the Ohio River.

Due to more stringent water quality regulations and the area's increasing population, in 1979, SD1 constructed the Dry Creek Wastewater Treatment Plant that included the construction of new interceptor sewers and pump stations. The new plant was designed to treat 30 million gallons a day. In 1993, due to the growing population of Northern Kentucky, the plant was upgraded to treat 46.5 million gallons a day. In 1994, in response to pending changes in environmental regulations and increased public interest in the consolidation of services, KRS 220 was amended, allowing SD1 to operate sewage and drainage systems in cities located within its jurisdictional boundaries. Until 1995, a vast majority of the wastewater collection system of Northern Kentucky was owned, operated, and maintained by separate political jurisdictions of the region. On July 1, 1995, 28 cities within the three county area turned over ownership of their sanitary sewer systems to SD1. On December 31, 1995, Boone County officially merged with SD1, and subsequently two other cities have transferred ownership of their sewer lines to SD1. As a result, SD1 acquired approximately 900 additional miles of sanitary sewer lines and related pump stations.

In 1998, the Kentucky General Assembly granted SD1 the authority to regulate and finance storm water facilities within its service area. SD1 developed a regional storm water management program to comply with the federal regulations, which was formalized in 2003 through the development and adoption of Interlocal Agreements to provide Kentucky Pollutant Discharge Elimination System storm water discharge permit services and other storm water-related services in Boone, Campbell and Kenton counties. As part of the Agreements, in 2009, SD1 began the process of assuming ownership and maintenance of a portion of the publicly-owned storm water system from the local governments.

SD1 is the second largest public sewer utility in Kentucky and has ownership of all sanitary sewer systems in Northern Kentucky, with the exception of systems in Florence and Walton. SD1 operates and maintains more than 1600 miles of sanitary sewer line, 145 wastewater pumping stations, 15 flood pump stations, eight package treatment plants, two major wastewater treatment plants, and more than 400 miles of storm sewer, and over 28,800 storm sewer structures. SD1 has approximately 100,000 customer accounts.

SD1 is not under the jurisdiction of the Public Service Commission.

Chapter 1
Introduction, Background, and Procedures

Board Administration and Composition

The SD1 Board of Directors was given the full power and authority granted by KRS Chapter 220 and other applicable law in administering, controlling and managing the affairs of SD1. The Judges/Executive of Boone, Campbell, and Kenton Counties, appoint members to the Board of Directors with the approval of their respective courts, as provided by KRS Chapter 220. The County Judge/Executive of Kenton County, the most populous county of the three counties, appoints four Directors to the Board, while the County Judges/Executive of Boone and Campbell counties each appoint two members to the Board for a total of eight Board Members. The Board Members must be residents of the SD1 service area, and any Director who moves out of the SD1 area may no longer serve as a Board Member. Each member of the SD1 Board of Directors is appointed to a four year term and has the power and authority to make motions, to second motions and to vote. Unless otherwise agreed by formal action of the Board of Directors, all motions properly made and seconded must be decided by the vote of a majority of the Directors present at a called meeting of the Directors at which a quorum is present.

Officers

The officers of the Board of Directors consist of the President, Vice-President, Secretary, and Treasurer. In addition to their duties prescribed by law, the officers have the duties generally described below:

President – The President serves as the spokesperson and senior officer of the Board of Directors and officiates at all meetings of the Board of Directors. The President executes all contracts, deeds, mortgages, bonds and other instruments and papers in the name of SD1 and on behalf of the Board of Directors. He also performs other duties as prescribed by formal action of the Board of Directors.

Vice-President – The Vice-President performs duties as delegated to him/her by formal action of the Board of Directors or, in the absence of formal action by the Board, by the President. In the absence or inability of the President to act, the Vice-President may perform the duties and exercise the powers of the President.

Secretary – The Secretary ensures that the minutes of all meetings of the Board of Directors are properly prepared and maintained and performs other duties prescribed by formal action of the Board of Directors.

Treasurer – The Treasurer ensures that the annual independent audit of SD1's finances is conducted appropriately and performs other duties as prescribed by formal action of the Board of Directors.

Board Members receive compensation for their service to SD1; the maximum annual amount of compensation may be no greater than $3600, except for the President who may receive an additional $600, the Treasurer who may receive an additional $900, and the Secretary who may receive an additional $300.

Selection of SD1 Officers

Each of the three counties represented on the Board of Directors must have one representative Board Member serve as an officer of the Board in each fiscal year. No officer may hold more than one office at any given time. Nominations and elections occur at the last regularly scheduled meeting of the Board of Directors in each fiscal year for the coming fiscal year. If a vacancy occurs in any office, the nominations and elections for that office occur at the next regularly scheduled meeting of the Board of Directors. A majority of the votes of the members of the Board of Directors is required to elect each respective officer. New officers take office on the first day of the first month of the succeeding fiscal year of SD1, except when an officer is elected to fill a vacancy, he/she will take office immediately.

The office of the President rotates among the three counties every two years. The term of each elected officer is for the fiscal year of SD1 or until a replacement is elected. No member of the Board of Directors may hold more than two consecutive terms in the same office. The completion of an officer's term of less than twelve months does not apply to this limitation.

Board Meetings

The Board of Directors holds regular monthly meetings on the third Tuesday of the month. Special meetings, in addition to the regular meetings, may be called by the President or by a majority of the Board of Directors. Meetings are conducted under the rules contained in Robert's Rules of Order Newly Revised, except where KRS Chapter 220 or the Bylaws provide for a different procedure. A majority of the Board of Directors constitutes a quorum.

Committees

The President, with majority approval of the Board, appoints committees deemed necessary to assist the Board in the performance of its duties and responsibilities. Each committee must have no less than two members, with each member representing a different county. Any decision of a committee requires formal action of the Board of Directors to be binding on SD1.

Role of County Judges/Executive

Pursuant to KRS 220.035, the three County Judges/Executive have the authority to:

1) Review and approve, amend, or disapprove proposed SD1 land acquisitions;
2) Review and approve, amend or disapprove proposed SD1 construction of capital improvements;
3) Except as provided under KRS 220.542, review and approve, amend or disapprove proposed SD1 service charges or user fees not more than once in a 12 month period; and,
4) Review and approve, amend or disapprove SD1's proposed budget.

The County Judges/Executive are required to meet jointly at least once each fiscal year to exercise their authority. Prior to June 8, 2011, regarding review and approval of proposed service charges or user fees, two of the three Judges/Executive votes were required to override the recommendations of SD1's Board of Directors. Effective June 8, 2011, pursuant to newly created KRS 220.542, the following procedures are required for an increase in an SD1 service charge, rate or user fee:

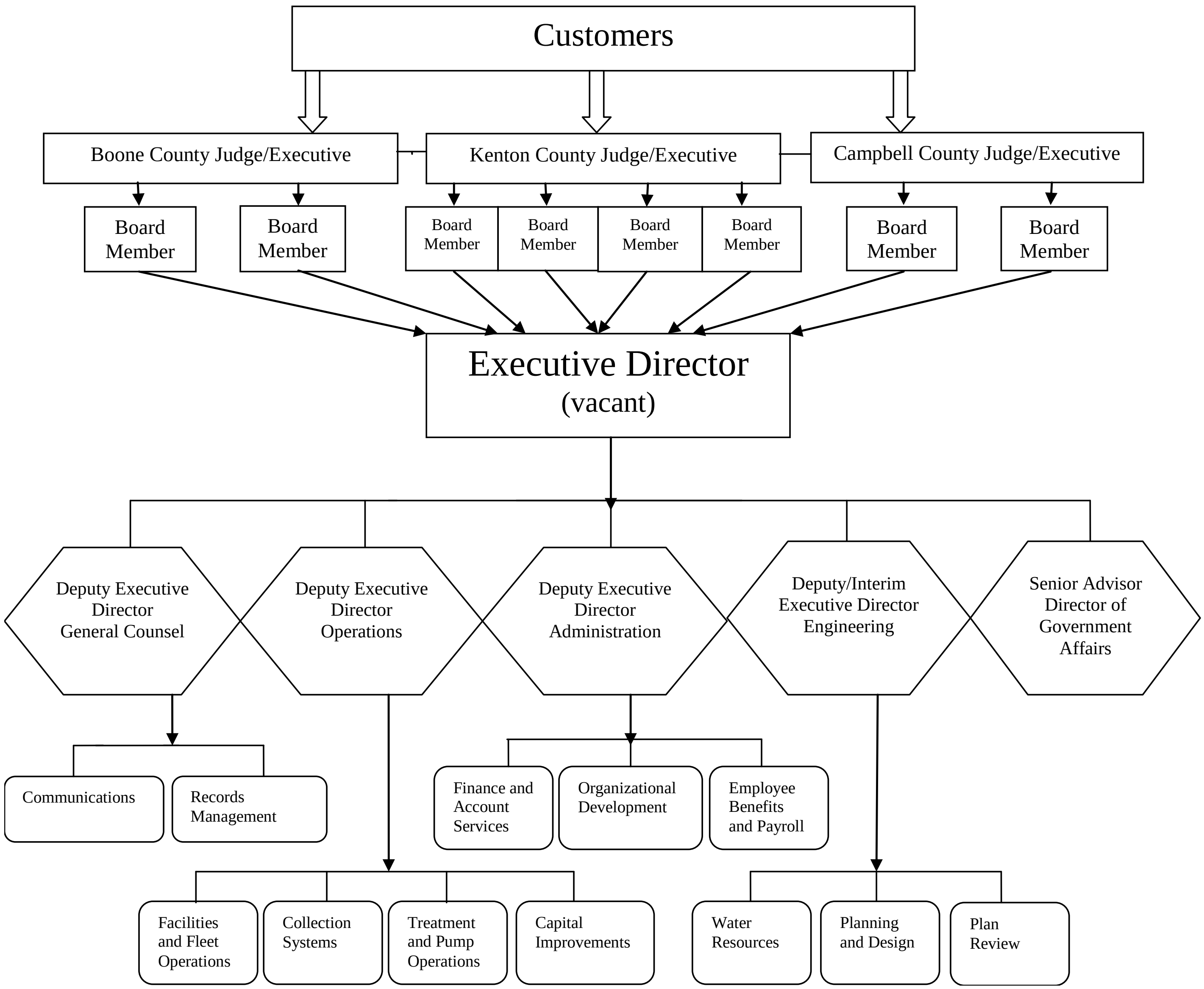
(1) Before a proposed service charge, rate, or user fee of greater than five percent (5%) of the previous charge, rate, or user fee may be adopted by the SD1 Board of Directors, it must receive the approval of a majority of the fiscal courts of the three counties having jurisdiction over a part of the district. Each approval of a fiscal court shall be equally weighted.

(2) A service charge, rate, or user fee shall not be increased more than once in a twelve (12) month period.

Management of the District

The Board of Directors is required to employ an Executive Director who acts as administrative officer and is responsible to the Board for all of SD1 operations. The Executive Director executes the policies adopted by formal action of the Board of Directors, and supervises and directs SD1's daily operations. The Executive Director's responsibilities include the employment of all SD1 personnel, preparation and submission of an annual budget, submission of monthly operating statements, and other duties as prescribed by formal action of the Board of Directors.

Executive Management Organization Chart
Northern Kentucky Sanitation District 1



Source: SD1

Consent Decree

Effective on April 18, 2007, the Federal Court Order "Consent Decree" negotiated between SD1 and the United States Environmental Protection Agency (EPA) established a structure for developing and implementing plans to address SD1's combined sewer overflows (CSOs) and sanitary sewer overflows (SSOs). Overflows can degrade the quality of streams and rivers and are regulated through the Federal Clean Water Act. The Consent Decree incorporates a "watershed-based" approach in the planning process that considers pollution sources in addition to sewer overflows.

As required by the Consent Decree, SD1 developed watershed plans for addressing overflows and other water quality issues in order to achieve the goals of the Court Order. The deadline for full implementation of the Consent Decree requirements is December 31, 2025.

Watershed-based Approach

SD1's Consent Decree allows a watershed management approach to more efficiently and cost-effectively meet federal Clean Water Act requirements for addressing CSOs and SSOs. This approach is based on the fact that sewer overflows are not the sole source of impairment for Northern Kentucky's streams and rivers. SD1's watershed approach identifies the characteristics of individual watersheds and considers CSOs and SSOs along with other sources impacting the waterways, such as runoff and dry weather sources. It considers alternative control strategies, such as green infrastructure or watershed controls, as a means to offset or delay traditional overflow controls.

- **Watershed controls** are systems and practices that can reduce pollution from sources other than sewer overflows, such as storm water runoff. Watershed control projects could include regional retention facilities or riparian buffers.

- **Green infrastructure** includes systems and practices that mimic the natural water cycle. When trees and vegetation are replaced with impervious surfaces, this cycle is impacted by a reduction in infiltration and evapotranspiration and an increase in runoff. Examples of green infrastructure include green roofs, reforestation, tree boxes, rain gardens, vegetated swales, rain water harvesting, and permeable pavements.

Green infrastructure and watershed controls also provide additional community benefits such as improved air quality, wildlife habitat, urban beautification, or economic development.

Economic Impact

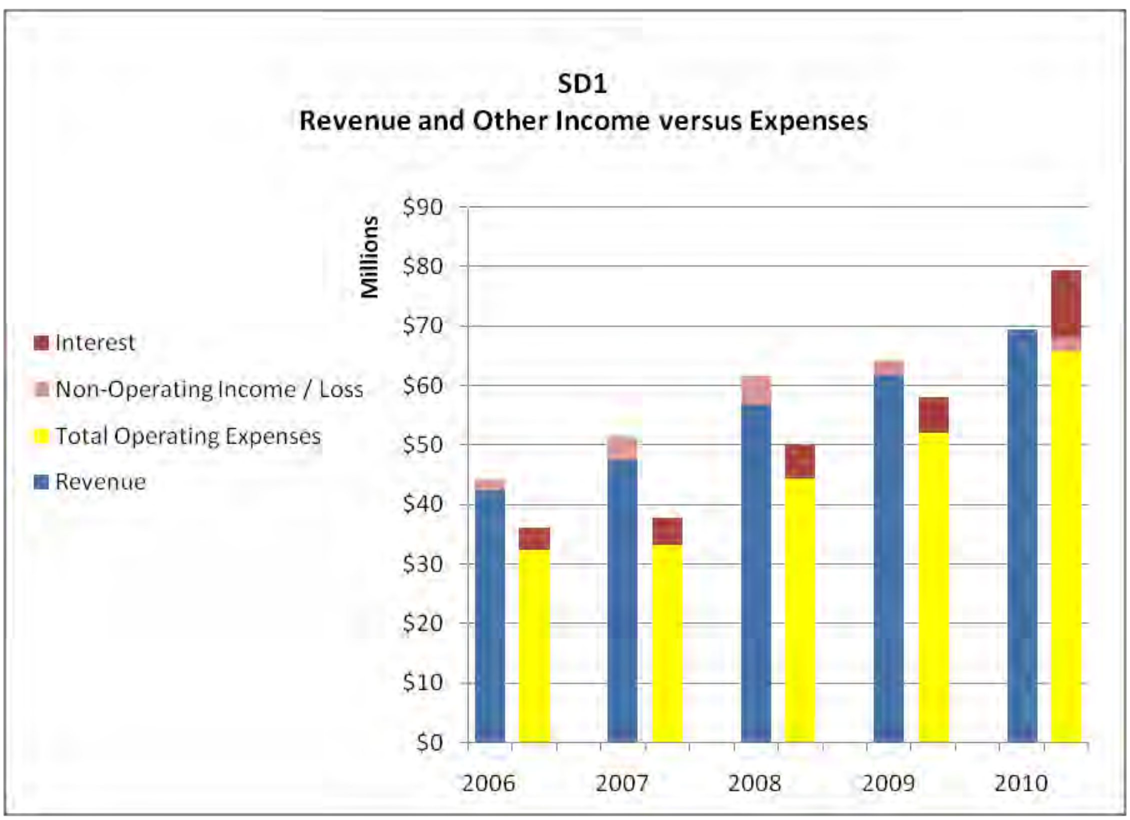
SD1 is funded primarily through a combination of sanitary and storm water utility fees, with sanitary sewer fees representing 70 percent of this revenue stream. Financing a long-term, capital intensive program including Consent Decree requirements, without placing an unreasonable burden on its customers, is a challenge for SD1. In addition to funding projects associated with the Consent Decree, SD1 has an obligation to operate and maintain current assets.

Funding scenarios and affordability implications were developed for two time frames, the full Consent Decree implementation period ending in 2025 and the watershed planning cycle for the next five years beginning in 2008. Historical revenue and related expenses are presented in Table 1.

Table 1: Revenue and Other Income versus Expenses

	2006	2007	2008	2009	2010
Revenue	$ 42,353,524	$ 47,454,087	$ 56,815,019	$ 61,670,848	$ 69,395,510
Total Operating Expenses	(32,491,323)	(33,277,879)	(44,423,973)	(51,940,860)	(65,757,265)
Non-Operating Income / Loss	1,916,995	3,887,496	4,776,949	2,465,962	(2,286,603)
Interest Expense	(3,604,483)	(4,426,387)	(5,739,650)	(6,017,122)	(11,360,883)
Change in Net Assets – Net Income (Loss)	**$ 8,174,713**	**$ 13,637,317**	**$ 11,428,345**	**$ 6,178,828**	**$ (10,009,241)**

Source: SD1 Audited Financial Statements



Policies and Procedures

The APA reviewed certain SD1 organizational policies, procedures, and other governing requirements and compared them to the APA's "Recommendations for Public and Nonprofit Boards" regarding financial oversight and internal control processes for board consideration.

When performing this comparison, the APA reviewed various documents and manuals provided by SD1, including but not limited to the following:

- Board meeting minutes;
- Board caucus agendas;
- Articles of Incorporation;
- Bylaws;
- Organizational chart;
- Kentucky Revised Statutes;
- SD1 Website;
- SD1 Consent Decree;
- Employee Handbook;
- Salary Administration Program guidelines;
- Conflict of Interest disclosure forms;
- Information Technology Acceptable Use Policy;
- Open Records Policy;
- Procurement Guidelines and Purchasing Procedures;
- Surplus Property Guidelines;
- Ethical policies;
- Travel policies;
- Whistleblower Policy; and,
- Other pertinent information provided by SD1.

Through this comparison, we found SD1 policies, procedures, and practices generally provide an effective structure for the oversight and processes that govern the operations of the organization. We make recommendations in Chapter 2, Findings and Recommendations, to further strengthen certain policies, controls and oversight procedures.

The following provides a listing of the APA's 32 "Recommendations for Public and Nonprofit Boards" with any findings as a result of the comparison to SD1 policies, procedures, and practices, referenced to Findings and Recommendations in Chapter 2.

1. The Board should have a well defined, clear mission statement to serve as a platform for policies, operational plans, and resource allocations that further the interest of its organization's members. **SD1 appears to have adequately addressed this recommendation.**

2. The Board should facilitate the development of an annual orientation program and manual for new and returning Board members to ensure an understanding of the Board's structure, operations, and their legal and fiduciary responsibilities. An explanation of the budget and accounting structure, as well as revenue and investment information should also be included. If possible, the orientation should be facilitated by a knowledgeable, independent party, such as a Board attorney or consultant. **SD1 appears to have addressed this recommendation, but further strengthening of the policy is recommended. See Finding 1.**

3. The Board should ensure that its organizational structure maintains a flexibility that allows for multiple sources of information. The Board should request reports from individuals having responsibility for various program areas rather than from just the chief executive. **SD1 appears to have adequately addressed this recommendation.**

4. The Board meeting minutes should document the exact nature of the financial reviews conducted by the Board. Any issues that result from these reviews and action taken to resolve the issues should also be documented. **The nature of financial reviews conducted by the Board of Directors was not documented in SD1 Board meeting minutes. Neither were meeting minutes recorded for Board caucus sessions held prior to monthly Board meetings. See Finding 3.**

5. For Boards which fall under the open meetings law, sessions closed to the public should be entered into in accordance with KRS 61.810. Any conclusions or decisions reached during a session closed to the public must be documented in the Board meeting minutes as stated in KRS 61.815, clarified in OAG 81-387. **Auditors were not able to determine whether closed sessions were held during caucus meetings due to the lack of meeting minutes. See Finding 3.**

6. The Board should establish an independent process to receive, analyze, investigate, and resolve concerns related to the organization including anonymous concerns. Employees, business associates, customers, or the general public may have significant, beneficial information that they are uncomfortable reporting directly to the Board. A toll-free complaint number or an advertised email and postal address for feedback would allow the transmission of this information. In addition, where applicable, the Board's policy should include a reference to Kentucky law (KRS 61.102) notifying employees, as defined in KRS 61.101, of their rights to protection against retaliation for reporting violations to certain authorities. A whistleblower policy should be adopted and distributed to employees. The policy should include reporting procedures and management's responsibility to address issues reported. **SD1 appears to have addressed this recommendation, but further strengthening of the policy is recommended. See Finding 1.**

7. An internal audit function could be used to ensure that Board concerns are independently investigated. The individual designated to perform internal audits should be given the authority to investigate and examine any area designated by the Board and the responsibility to report the audits findings directly to the Board. **Auditors found no evidence of an internal audit function that reports directly to the Board of Directors, or any independent process to receive, analyze, investigate, and resolve concerns related to SD1, including anonymous complaints. See Finding 1.**

8. A Board audit committee should appoint and compensate the audit firm and ensure the rotation of the lead audit partner and the audit partner reviewing the audit, as required by the Sarbanes Oxley Act (SOX) for companies with publicly traded stock. The Board should also consider whether rotating audit firms would be beneficial given the facts and circumstance of the organization. Further, if possible, the Board audit committee should be comprised of at least one member who has an understanding of generally accepted accounting principles and financial statements, experience with internal controls and in preparing or auditing financial statements, and an understanding of audit committee functions, as suggested in Section 407 of SOX. In addition, reviews of internal controls should be conducted to ensure that controls are functioning as designed or needed. The review of internal controls could be conducted by an internal auditor, Board designee, or included in the engagement of an auditing firm. Any concerns noted by the Board should be disclosed to the auditor and included in the audit scope for review. **SD1 appears to have rotation of audit firms, but no audit committee existed during the period of review. See Finding 1.**

9. The Board should adopt a code of ethics that includes standards of conduct for its Board members, officers, and employees related to business conduct, integrity, and ethics. The policy should include the requirement to sign a form stating that the individuals have received and understand the code of ethics. The code should include statements regarding moral and ethical standards, confidentiality, conflicts of interest, nepotism, gifts, honoraria, and assistance with applicable audits and investigations. Violations of the code of ethics should be reported to the Board or designated committee of the Board. **SD1 appears to have addressed this recommendation, but further strengthening of the policy is recommended. See Finding 4.**

10. The Board should adopt a financial disclosure policy for Board members and executive management. A policy should also be developed requiring Board members and executive management to disclose any conflicts of interests. The disclosure form should be completed by a specified date and returned to the appropriate committee of the Board. **SD1 appears to have addressed this recommendation, but further strengthening of the policy is recommended. See Finding 4.**

11. The Board should establish and approve a detailed, equitable personnel and compensation policy. The policy should include that the Board or a designated Board committee annually review the salary increases and bonus payments made to all staff. This review should be documented in the Board meeting minutes. **SD1 appears to have addressed this recommendation, but further strengthening of the policy is recommended. See Finding 1.**

12. The Board should define and document all employee benefits in a fair and equitable manner. Benefits received that result in taxable income should be properly accounted for and accrued to each applicable employee. Employee benefits should also be reviewed to ensure they provide a reasonable business purpose. Also, membership fees to organizations or associations should provide a reasonable business benefit. **SD1 appears to have adequately addressed this recommendation.**

13. The Board should approve the compensation package of the organization's primary executive and be aware of the compensation provided to other Executive Staff. In determining the compensation for the primary executive, the Board should consider the organizations financial resources, current economic conditions, employee performance, and salary data for similar positions at relevant organizations within the region. **Though no policy requirements for annual reviews of salary increases by the Board of Directors or a designated committee existed, the Board did approve the Executive Director's contract. See Finding 1.**

14. The Board should ensure a well-defined employee evaluation system is implemented within the organization to consistently assess employee performance. The results of the employee's evaluation should be used for employee advancement or salary adjustments. **SD1 appears to have adequately addressed this recommendation.**

15. The Board should adopt policies to ensure all forms of employee leave are properly approved and accurately recorded. **SD1 appears to have adequately addressed this recommendation.**

16. The Board should have sick and vacation leave policies that address the accrual, use, and the payment to employees for any unused sick, vacation, or compensatory time. **SD1 appears to have adequately addressed this recommendation.**

17. The Board policy should include a transparent, competitive selection process for the procurement of goods and services. The policy should outline the circumstances under which quotes or competitive bids are required and the process to be followed. The Board should have policies that require a formal contract for purchases over a specified amount and that all contracts over a specified dollar amount require Board approval. **SD1 appears to have addressed this recommendation, but further strengthening of the policy is recommended. See Finding 9.**

18. A review of budget to actual expenditures should be performed regularly by the Board or a designated Board Committee to monitor costs in each account. The name and number of budget categories or line items should provide transparency and sufficient detail to allow Board members to accurately identify the types of expenses being attributed to each category. If expenditures occur at an unexpected rate, additional detail should be requested to ensure that incurred expenditures are reasonable and necessary. **The nature of financial reviews conducted by the Board of Directors was not documented in SD1 Board meeting minutes. See Finding 3.**

19. At least quarterly, the Board or a designated Board committee should receive and review a listing of payments that includes, at a minimum, the payee, dollar amount, and date of each expenditure. This review would assist in identifying inappropriate, unusual, or excessive expenditures. **The nature of financial reviews conducted by the Board of Directors was not documented in SD1 Board meeting minutes. See Finding 3.**

20. Executive management traveling out of state should present their plans and estimated costs to the Board for prior approval. The approval of these activities and associated costs should be addressed at the Board meetings to ensure proper documentation in the minutes. Subsequent to attending approved conferences or activities, the amount expended should be reported to the Board. **The auditors found no evidence of review and approval of executive staff travel by the Board of Directors. See Finding 1.**

21. To minimize and control the cost of travel, a travel expense policy should be developed that specifically defines the allowable costs related to lodging, meals, entertainment, personal mileage reimbursement, rental cars, and airfare. The travel expense policy should state the invoice requirements for the reimbursement of certain expenditures such as taxi fees, tips, parking, or tolls. The policy should provide examples of expenditures that are to be paid for by the employee, such as costs incurred by family members or the attendance at events not approved by the Board. This policy should explicitly state that expenses not in compliance with the travel expense policy would not be reimbursed or paid by the Board. **SD1 appears to have adequately addressed this recommendation.**

22. In lieu of credit cards, the Board should consider the following:
    - The use of purchasing cards that would allow the Board to restrict the types of purchases that can be made on the card based on industry codes. Casinos, specialty retail outlets, and food and beverage establishments are examples of these restrictions. The amount spent on a single purchase can also be restricted through the use of a purchasing card.
    - Reimburse employees personal credit card charges when the use is necessary. Procedures and supporting documentation requirements should be developed to facilitate this type of reimbursement.

    SD1 had no written policies on the use of credit cards, purchasing cards or reimbursement of use of personal credit cards. See Finding 2.

23. If the use of credit cards is needed, the Board should implement the following oversight controls:
    - A Board member or committee of the Board should be assigned to review, at a minimum, credit card statements of Executive Staff prior to payment.
    - Credit card charges should be supported by detailed receipts, documented business purpose, and supervisory approval. The employee should be responsible for the timely payment of any unsupported credit card charges or disallowed expenses.
    - Policies established by the Board should ensure that all review procedures are performed in a timely manner to avoid late fee and finance charges.

    The review of the minutes gave no indication that any review or oversight of credit card issuance or use is conducted by the Board or a committee of the board. See Finding 2.

24. Expenses classified as gifts or entertainment should be documented to include the name and title of the person(s) involved and a description of why the expense was needed and how it relates to business operations. **SD1 appears to have addressed this recommendation, but further strengthening of the policy is recommended. See Findings 2 and 14.**

25. A policy related to reimbursements made by employees to the organization should be developed to ensure that any expenses that should be paid by an employee are monitored. This policy should include the timeframe allowed for making the reimbursement and the alternative actions that will be taken if reimbursement is not made. **SD1 appears to have addressed this recommendation, but further strengthening of the policy is recommended. See Finding 2.**

26. Business expense reimbursements requested by executive management should be reviewed by the Board or a designated Board committee to ensure supporting documentation is provided. This documentation should be retained to ensure that duplicate payments are not made to the employee. **SD1 had no written policies on reimbursement of use of personal credit cards. See Finding 2.**

27. Specific marketing goals should be developed to monitor the success of any business promotions approved by the Board. Marketing expenditures incurred should be coded to that goal so that Board members will know the expenses involved in a specific marketing promotion. Further, documentation should be maintained detailing the recipients of promotional prizes including tickets, trips, or merchandise. **As a public utility, there does not appear to be a need for marketing policies. See Finding 14 addressing expenditures that appear to be for "marketing."**

28. A Board policy should be developed to address the authorization process to purchase vehicles and the method used to dispose of vehicles. The use and assignment of vehicles owned by the organization should be addressed within this policy. In addition, the practice of providing a vehicle should be reviewed and monthly vehicle allowances considered. The policy should include following the IRS guidelines for personal use of a vehicle. **SD1 appears to have addressed this recommendation.**

29. The personal use of business equipment should be addressed within Board policy to determine when appropriate. The policy should require that equipment being used inappropriately or that is missing should be reported directly to the Board. **SD1 appears to have addressed this recommendation.**

30. The Board should establish a policy detailing the process to report lost or missing financial information or records. To avoid lost or stolen financial information, electronic images of financial records should be created and retained, if possible**. SD1 does not have a written policy concerning the reporting of missing or lost financial information. See Finding 2.**

31. A formal policy should be developed that identifies what equipment is a fixed asset and should be included as inventory. Once this designation has been made, the existing inventory listing should include the following identifying information related to each piece of equipment:

    - The name of the individual in receipt of equipment;
    - Description of equipment;
    - Vendor name;
    - Model number;
    - Serial number;

- Acquisition date; and,
- Acquisition cost.

Once the inventory listing has been validated, any acquisitions and dispositions of computer equipment that fall within the fixed asset policy should cause an appropriate update to the inventory listing. **SD1 had no written policies or procedures addressing fixed asset inventory requirements. See Finding 2.**

32. An information system policy should be developed that explicitly defines a user's responsibilities as they relate to information system resources and applications. These policies should cover, at a minimum:
    - Securing of user id and password;
    - Protection against computer virus or mal-ware infection;
    - Legal notice at logon indicating system is to be used for authorized purposes only;
    - Securing unattended workstations; and,
    - Securing portable devices, such as laptops, Blackberries, cell phones, etc.

    SD1 appears to have adequately addressed this recommendation.

Records Retention

Questions have been raised by recent court actions concerning the records retention of documents by SD1. Kentucky law requires that local agencies retain public records, including books, papers, maps, photographs, discs, software, e-mails, databases and other electronically generated records, as long as legally and operationally required. The APA obtained and reviewed SD1 retention schedules and related policies, systems and processes being carried out to ensure proper SD1 document retention.

SD1's Record Management Policy, drafted in conjunction with Kentucky Department for Libraries and Archives (KDLA), is intended to:

A. Define how SD1 will comply with Kentucky's public records management statutes KRS 171.410 – 171.748 and the rules and regulations of the KDLA for maintaining, storing, and disposing of public records. Public records are further defined below and include but are not limited to, books, papers, maps, photographs, cards, tapes, discs, diskettes, recordings, software, and other documentary materials, regardless of physical form or characteristics, which are prepared, owned, used, in the possession of or retained by the public agency. (KRS 171.410 and KRS 61.870(2)).

B. Efficiently, economically, and effectively maintain systematic control of recorded information regardless of format, from original creation to ultimate disposition.

C. Ensure that SD1 is creating and maintaining an adequate documentary record of our functions, policies, decisions, procedures, and essential daily transactions of business.

This Record Management Policy applies to all employees of SD1 who are responsible for the records they create and maintain regardless of the format of the public record.

Auditors identified training conducted on records retention for staff and liaisons, and interviewed the Records Management Team, composed of the SD1 Records Coordinator, the SD1 Official Custodian of Records, and the SD1 General Counsel, regarding retention policies and procedures to ensure employees were aware of and complying with retention requirements.

Based on the information provided, training on the records retention was conducted for staff and liaisons on the dates in Table 2:

Table 2: Records Retention Training

Date	Training Title	Attendees	Method
Presentations/Trainings			
August 8, 2007	Records Retention and Management	All SD1 staff	Presentation CD
August 8, 2007	Records Retention Schedule Training	All SD1 staff	Presentation CD
June 11, 2008	Records Management	All SD1 staff	Presentation CD
November 6, 2009	Engineering Project Files Training	Engineering staff	Presentation CD
May 26, 2011	Employee Mandatory Training	All SD1 staff	Presentation by General Counsel
Liaison Training			
September 8, 2010	What is a Retention Schedule?	Records Retention Liaisons	Presentation
October 20, 2010	Conducting a Records Inventory	Records Retention Liaisons	Presentation
November 10, 2010	Importance of Records Management	Records Retention Liaisons	Presentation
April 7, 2011	E-Discovery Class	Records Retention Liaisons	Presentation

Source: SD1

SD1 created a liaison program to serve as a communication between the Records Coordinator and SD1 departments. Liaisons work to keep departments up to date on policies, procedures, and new records retention information. Employees were required to sign acknowledgements that they had read and understood the SD1 Records Management Policy and agreed to abide by the policy.

SD1's retention policies appear to be applicable and in compliance with KDLA approved Local Government Retention Schedule requirements. As a result of the APA testing of capital projects listed in Table 3, the auditors found SD1 to be in compliance with records retention requirements for the projects tested.

Table 3: Results of Project Testing – Retention

Project Number	Project Name	In Compliance with Retention Policies?
C001	Western Regional Conveyance Tunnel Project	Yes
C424	Western Regional Wastewater Treatment Plant	Yes
C103	River's Edge Development – Manhattan Harbour	Yes
C480-8	I-75 Terraced Reforestation Project	Yes
S480-61	Green Infrastructure Modeling	Yes
S580-7	Rain Monitoring Project	Yes
S580-8	Prisoners Lake CSO Relocation	Yes

Source: APA

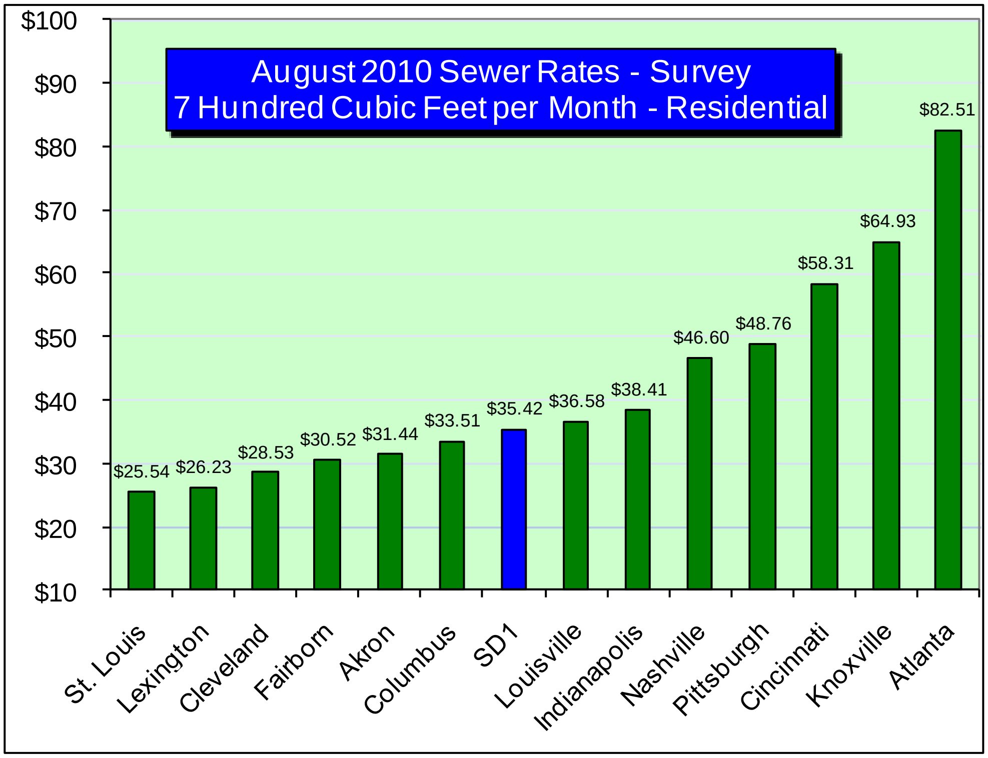
During part of the APA's period of review, SD1's policy regarding e-mail retention was to purge e-mails after 30 days unless the individual creating the e-mail printed or archived the document. Beginning in April 2009, SD1 changed its policy and implemented a Google e-mail and archiving system that automatically retains all e-mails indefinitely. Individual users no longer have the ability to determine which e-mails should be retained. This improvement by SD1 complements its other established retention policies and procedures.

Rate and Fee Increases

As previously stated, financing a long-term, capital intensive program without placing an unreasonable burden on ratepayers is one of SD1's biggest challenges. The current recession clearly affects the ability of some ratepayers to pay increased sewer rates. Continued high unemployment, tightened credit markets, and real and threatened foreclosures, are painful realities that undoubtedly affect ratepayers abilities to afford their sewer bills.

Table 4 below compares SD1 sewer rates to thirteen other metropolitan areas. As can be noted, SD1's rate of $35.42 was below the $41.95 average of the compared metropolitan areas. Eliminating the highest and lowest three areas in the survey results in an average rate of $37.66, $2.24 higher than the SD1 rates.

Table 4: Sewer Rates Survey



Source: SD1

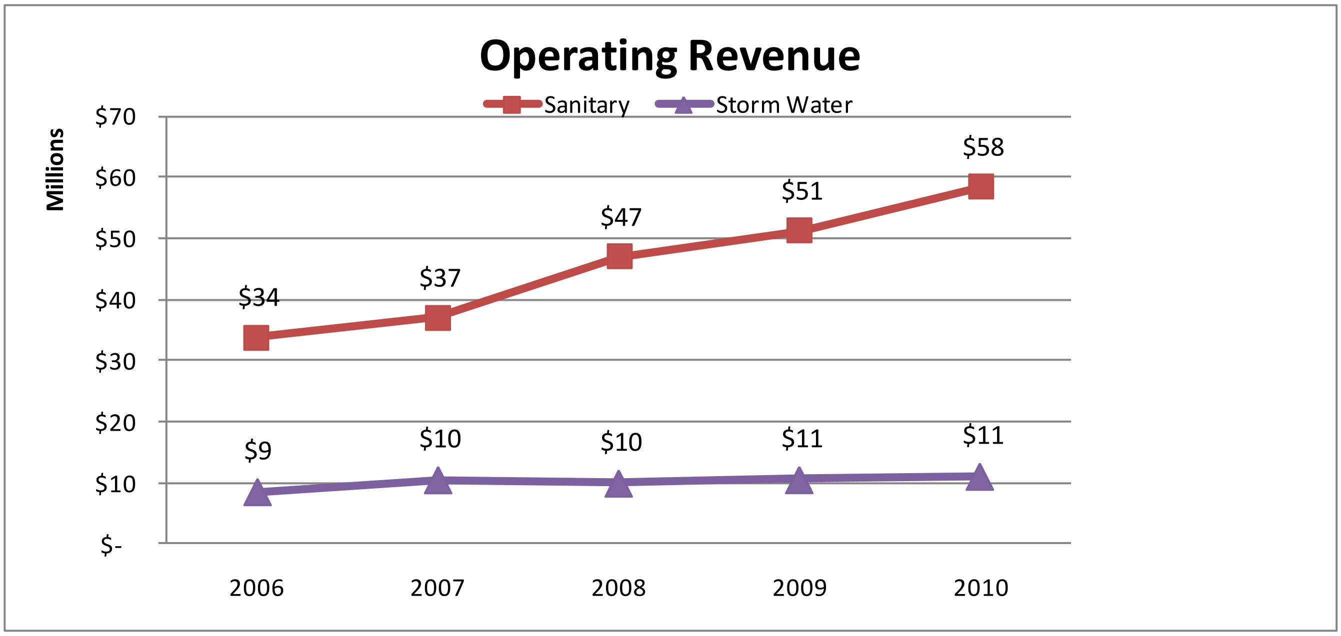
The overall impact of the current economic recession directly impacts the ability of SD1 to maintain adequate revenue, meet its bond coverage requirements, and keep a high credit rating. The setting of sanitary sewer and storm water rates for the SD1 coverage area is a complex and challenging task for SD1. The rate setting process requires knowledgeable assessment of the impacts of financial, regulatory, economic, and demographic considerations on such decisions. The rate setting process must weigh and evaluate the impacts of projects mandated by the Consent Decree as well as the financial requirements to operate, maintain and extend existing facilities. In addition, SD1 must ensure that adequate reserves are maintained to satisfy the various debt and other reserve requirements. Funding for all these requirements is derived from a mix of operating revenues generated from the sewer and storm water rates and funding from bond issues and low cost state funding.

SD1 generates operating funds through a combination of sanitary sewer and storm water utility rates and fees, with approximately 84 percent of SD1's FY 2010 revenue generated from sanitary sewer rates and fees. Table 5 displays SD1's growth in Operating Revenue from 2006 through 2010.

Table 5: SD1 Operating Revenues 2006 – 2010

Fiscal Year	2006	2007	2008	2009	2010
Sanitary	$33,816,208	$36,956,804	$46,873,991	$51,155,819	$58,325,351
Storm Water	8,537,316	10,497,283	9,941,028	10,515,029	11,070,159
Total	**$42,353,524**	**$47,454,087**	**$56,815,019**	**$61,670,848**	**$69,395,510**

Source: SD1 audited financial statements



In response to public outcry over the significant trend in rate increases, public comment by the Judges/Executive of the three Northern Kentucky counties served by SD1, and per the specific request of the members of the Northern Kentucky Legislative Caucus, on March 23 2010, SD1's Board of Directors approved "Guidelines and Procedures for Public Notification and Comment on SD1 Proposed Rate and Fee Adjustments." In addition, in June 2011, the Kentucky Legislature passed new laws stipulating that a majority of the fiscal courts of the three counties served by SD1 approve any rate increases in excess of five percent of the previous rate, and limited the frequency of rate increases to one in a 12 month period.

While there has been some public concern expressed regarding SD1's rates and lack of oversight of those rates by the Kentucky Public Service Commission (PSC), the PSC does not have any jurisdiction or approval authority over SD1's sewage and storm water rates. KRS 220 specifically addresses the formation and governance of sanitation districts. In 2000, KRS 278.010 was amended to effectively exclude a sanitation district from the definition of a public utility and as such, SD1 is not under the authority of the PSC. In addition, prior to amendments to KRS 278.010 that occurred in 2000, the PSC in 1987 and the Kentucky Supreme Court in 1997 reached the conclusion that the General Assembly did not intend for sanitation districts to be subject to PSC jurisdiction.

Table 6 summarizes SD1's actual and approved rate history from 1979 through 2012.

Table 6: Percentage Rate Increases

Year	Sewer Rate Increase	* Average Monthly Bill	Storm Water Rate Increase	** Average Monthly Bill
1979 to 1985	No rate increase	$7.20	Did not exist	n/a
1986	-5.83%	$6.78	Did not exist	n/a
1987 to 1999	No rate increase	$6.78	Did not exist	n/a
2000	35.00%	$9.18	Did not exist	n/a
2001	14.35%	$10.50	Did not exist	n/a
2002	14.35%	$12.06	Did not exist	n/a
2003	14.35%	$13.80	Storm water rates begin	$3.75
2004	No rate increase	$13.80	2.30%	$3.84
2005	No rate increase	$13.80	1.80%	$3.91
2006	15.00%	$15.90	2.89%	$4.02
2007	20.00%	$19.08	3.85%	$4.18
2008	20.00%	$22.92	2.81%	$4.30
2009	15.00%	$26.40	3.95%	$4.47
2010	15.00%	$30.36	-0.47%	$4.44
2011	15.00%	$34.92	2.06%	$4.54
2012	15.00%	$40.14	TBD	TBD

Source: SD1
* Average monthly bill based on 6 Hundred Cubic Feed (HCF) of Usage
** Average monthly bill based on 1 Equivalent Residential Unit (ERU)

Historically, SD1 sought rate increases for periods ranging from one year to four years; however, SD1 monitored and evaluate cash flows and funding requirements on a regular basis in the interim.

As stated previously, in March 2010, the SD1 Board approved the procedures "Guidelines and Procedures for Public Notification and Comment on SD1 Proposed Rate and Fee Adjustments." Prior to the adoption of those guidelines, the following procedures were followed by SD1 to implement a rate increase.

1. In January, based on financial projections and analysis prepared by the SD1 Director of Finance, SD1 management would submit a schedule of proposed rate increases to the SD1 Board of Directors at a regularly scheduled monthly Board Meeting, i.e. the "First Reading of the Proposed Rate and Fee Adjustment Schedule."

2. At the January Board Meeting, the Board would review and approve the proposed First Reading of the Proposed Rate and Fee Adjustment Schedule, contingent upon the approval of the Judges/Executive of Boone, Campbell, and Kenton counties.

3. As soon as possible after Board approval of the "First Reading…," a legal notice was published in the Kentucky Enquirer announcing the proposed rate increase(s) and noting that a copy of the proposal was available for public review at SD1's main office and would remain so for thirty days from the date of publication. The notice also indicated the time and date on which any timely filed objections would be heard by the Board. While there was no specific requirement as to how soon after Board approval the notice was to be published, SD1 attempted to ensure publication as soon as possible.

4. At the next regularly scheduled Board meeting, which was at least 30 days past the date of publication of the notice, the Board reviewed any objections or comments filed by the public and also afforded the public an opportunity to address the Board. After consideration of the public comments, the Board would adopt or reject the proposed rate schedule.

5. After the Board had adopted the proposed rate schedule, it was presented to the three elected County Judges/Executive for their consideration and approval at the next meeting of the Judges/Executive at SD1's main office. A majority vote of the three Judges/Executive was required to override the recommendations of SD1's Board of Directors.

6. The new rates would then become effective and implemented on the date as stated in the original proposal from SD1 management.

The new guidelines approved by the SD1 Board of Directors in March 2010, followed the same procedure as noted above, with the addition of two more requirements.

1. Following the first reading and approval of the proposed rate and fee adjustments by the Board, SD1 must now give public notice and hold public hearings in each of the three counties within SD1's service area on the proposed adjustments.

2. At the next Board Meeting, which shall be at least seven days following the close of the public comment period, the Board will review any objections filed or public comments received and afford the public an opportunity to address the Board.

3. The Board shall then approve, amend or disapprove the proposed rate and fee schedule, subject to final review and approval by the Judges/ Executive of the three counties served.

As part of its examination, the APA researched SD1's rate-setting policies as well as federal, state, and local laws and ordinances to determine SD1's authority and requirements for increasing rates and fees. SD1 is governed by KRS 220 regarding Sanitation Districts and, as previously stated, is not under the authority of the PSC whose authority is granted by KRS 278. The APA also reviewed SD1's rate-setting procedures to ascertain compliance with its stated policies, and applicable laws and regulations. In addition, a review of the rate setting model and related processes was conducted in response to an error noted in that model, subsequently corrected, which could have resulted in significantly higher rate increases than necessary. See Finding 12 for an explanation of the rate setting model utilization details and related process.

The examination revealed that SD1 was in compliance with the rate setting requirements of KRS 220 regarding Board approvals and public notices. As noted above, in March 2010, SD1 adopted rate setting guidelines that expanded the opportunity for public discussion and comment.

See Finding 12 for recommendations regarding the rate setting process.

Construction in Progress Projects

"Construction in progress" is an asset account wherein the cost of a construction project is accumulated until construction is completed. Upon completion, the total cost of the project is moved from CIP to a fixed capital asset account, and that amount is then depreciated over the deemed useful life of the capital asset.

In July of 2009, SD1 projected for a five year period its construction obligations for managing its capital assets, as well as improvements to be made, including the completion of 52 initial watershed control projects pursuant to the Federal Consent Decree. The benefits associated with these watershed projects include SSO elimination, CSO elimination, overflow volume reduction, increased treatment capacity, and increased conveyance capacity. Table 7 demonstrates the previous expenditures through 2009 and future financial obligations for the initial watershed projects.

Table 7: Initial Watershed Projects

Project Name	Benefit	Spending through Fiscal Year 2009	Fiscal Year 2010-2014 Budget
Western Region (11 projects)	New water reclamation facility, conveyance improvements, SSO elimination	$46,000,000	$258,000,000
Eastern Region (10 projects)	New water reclamation facility, conveyance improvements, SSO elimination	$75,000,000	$3,000,000
Pump Station and Sewer Improvements, Sewer Separation, Illicit Discharge Removal, and Overflow Studies (31 projects)	SSO elimination, CSO elimination, overflow volume reduction, increased conveyance capacity	$37,000,000	$0 (all projects completed)
	Total	**$158,000,000**	**$261,000,000**

Source: SD1 March 31, 2011 Executive Summary Watershed Plans for Northern Kentucky

The Eastern Regional and Western Regional project groups represent the largest portion of the initial watershed projects. The Eastern Regional projects were needed to eliminate the sewer overflows and resolve a 1996 sanction; these projects are nearly complete. The Western Regional projects include construction of the new Western Regional Water Reclamation Facility and significant sewer construction throughout the area tributary to that facility. The largest of these sewer projects is the $141 million conveyance tunnel project. The Western Regional projects serve as the cornerstone to the ultimate solution to SD1's sewer overflow problems.

In addition to funding projects associated with the watershed plans, SD1 has an obligation to operate and maintain current assets and meet other obligations. According to SD1, these other projects represent a total of approximately $144 million in spending over the period of fiscal years 2010 through 2014.

As part of its audit procedures, the APA selected eight CIP projects for testing certain criteria. A review and analysis of the records of each of the eight projects listed in Table 8 was conducted to ascertain proper procedures were followed in contract selection, change order modifications, and payments to vendors. Projects also were reviewed for conflicts of interest, capitalization of expenditures, and record retention. See Findings in Chapter 2 for the results of the project testing.

Table 8: Construction Projects Tested

Project Number	Project Name	Purpose of Project	Total Expenditures as of April 30, 2011
C001	Western Regional Conveyance Tunnel	To divert flows off of SD1's existing collection system and reduce sanitary sewer overflows which typically occur during heavy rainfalls by 60 million gallons and replace at least ten pump stations.	$115,812,941
C004	Western Regional South Fork Gunpowder Interceptor Sewer & Rosetta Sewer	To replace the existing sewer which will ultimately eliminate two pump stations and reduce sanitary sewer overflows as required by Federal Court Order.	$2,707,683
C103	River's Edge Development – Manhattan Harbour	To upsize from 30" to 84" and to improve a relocated sewer line for the conveyance and storage of flows necessitated by a private riverfront development that resulted in the elimination of 56 million gallons of annual combined sewer overflows.	$14,194,437
C424	Western Regional Wastewater Treatment Plant	To construct a waste water treatment plant with designed average daily capacity of 20 million gallons per day and peak of 30 million gallons per day.	$68,300,716
C480-61	Green Infrastructure Modeling Improvements	To develop and implement regional Infrastructure Program targeting CSO and SSO reduction.	$213,766
C480-8	Flow & Rain Monitoring Services	To monitor 150 flow meters and 50 rain gauges in order to supply statistical data to be used in hydraulic models to assess collection system capacity and develop watershed plans. Also included water quality sampling.	$4,896,836
S580-7	I-75 Terraced Reforestation	To reduce peak storm water runoff and improve water quality in the receiving system. Modify the grading, soil conditioning, and landscaping of the area so it generates less storm water runoff. (Storm water runoff contributes to downstream overflow.)	$869,056
S580-8	Prisoner's Lake CSO Reduction	To reduce the CSO from Prisoners Lake in Covington and reroute the overflows from Prisoners Lake to an irrigation pond at Devou Park in Covington. The rerouted overflow would then be used for irrigation purposes at the park.	$503,782
		Total	**$207,499,217**

Source: Information provided by SD1

Capitalization versus Operations & Maintenance Expense

As part of the Examination of certain financial transactions, policies, and procedures of the SD1, the APA reviewed whether appropriate financial statement adjustments were made to properly account for financial activity in SD1's CIP and Operations and Maintenance (O & M) accounts. This review focused primarily on the 2008 financial statements given that current and former employees of SD1, as well as the CPA firm hired to conduct the 2008 audit, revealed a difference of opinion among the parties as to what types of expenses should have been included in CIP to be capitalized versus what should have been charged to current year expense. Improperly capitalizing expenditures rather than charging them to expense in the current year understates current expenses and increases net income for the year. An overinflated net income inaccurately portrays an entity's financial stability on which bond rating agencies and other users rely to determine bond ratings, which ultimately affects rate increases.

Over the past four fiscal year ends, CIP has increased substantially by the following amounts:

Table 9: CIP Increases

At Fiscal Year End	Total CIP	Increase in CIP
2006	$ 58,533,869	
2007	$104,962,850	$46,428,981
2008	$144,855,250	$39,892,400
2009	$153,932,654	$ 9,077,404
2010	$197,579,699	$44,647,045
2011 (as of May 31, 2011)	$291,012,278	$93,432,579

Source: SD1 Audited Financial Statements and information provided by SD1

Capital Expenditures v. Operating Expenses Criteria

Capital expenditures are expenses creating future benefits. A capital expense is incurred when SD1 expends funds to purchase fixed assets (buildings, equipment), to add to the value of an existing fixed asset with a useful life that extends beyond the fiscal year, or to construct new assets (projects). If an expenditure is not charged to a CIP project, or isn't the result of a fixed asset purchase or adds value to an existing fixed asset, and in turn not included in capital assets, it is expensed during the year as an operating expense. Operating expenses are expenditures SD1 incurs as a result of performing its normal business operations. These expenses have an effect on the "bottom-line" or net income of that particular year. An increase in operating expenses will reduce net income and a decrease in operating expenses will increase net income.

Regulatory guidance on the types of expenditures that should be included in CIP and ultimately capitalized, rather than expensed in the current year, is not definitive. The APA contacted two authoritative bodies, the Governmental Accounting Standards Board (GASB) and the Governmental Accountability Office (GAO), during the course of the examination in an attempt to obtain definitive criteria on when an expenditure should be included in CIP versus when it should be expensed in the current year. While the auditors did receive some verbal guidance via a telephone call from the GASB, the GASB representative stated that no detailed guidance was available on this matter given that GASB has never taken up the issue of "capital assets." The representative did indicate however, that legal costs related only to the acquiring of the asset should be included as CIP and not other litigation related to the project. The representative further indicated any cleaning and monitoring costs should not be capitalized and depreciated regardless of how infrequent the cleaning is, unless it can be determined that such maintenance will extend the life of the asset beyond the original depreciable life of the asset established by SD1.

SD1 Capitalization Policy

Prior to fiscal year ending June 30, 2008, SD1's capitalization procedures allowed many expenditures to be included in CIP and eventually capitalized and depreciated that did not meet the criteria of a depreciable asset. This "liberal" capitalization procedure potentially inflated annual net income. Based on a recommendation by the CPA firm conducting the fiscal year ended June 30, 2008 audit of SD1, and other sources, SD1 addressed the issue of capitalization versus expense and implemented a new capitalization policy during the fiscal year ended June 30, 2009.

The policy used during and prior to FYE 2008 was, in part, guidance from a section of a GAAP Guide provided to SD1 by a CPA firm. The guidance, under the heading "Improvement of Depreciable Assets" stated that "expenditures that increase the capacity or operating efficiency or extend the useful life of an asset, if they are substantial, are capitalized. Minor expenditures usually are treated as period costs even though they may have the characteristics of capital expenditures." Also, under the heading "Self-Constructed Fixed Assets," the guidance provided "when a business constructs a depreciable asset for its own use, the following procedure is appropriate:

1. All direct costs are included in the total cost of the asset.
2. Fixed overhead costs are not included unless they are increased by the construction of the asset.
3. Interest costs may or may not be capitalized as part of construction cost of the fixed assets."

As stated above, SD1, at the urging of a CPA firm began implementation of a more extensive capitalization policy during fiscal year 2008-2009. This new policy, which was fully implemented in fiscal year 2009-2010, defines capital assets as "assets used in operations that have initial lives extending beyond a single reporting period." It also defines a minimum useful life for capitalizing an asset as three years and establishes a capitalization threshold of $2,500 or more for individual non information technology items or $2,000 or more for information technology. The policy goes on to state that capital assets should be reported at historical cost (actual cost) or fair market value if donated. Historical costs should also include any ancillary charges, such as freight, transportation costs, site preparation costs and professional fees that are directly attributable to asset acquisition.

SD1's new capitalization policy provides that operating expenditures are a "category of expenditure that a business incurs as a result of performing its normal business operations." SD1's goal is to match revenues to expenses during the financial period in which the transaction occurs.

Per SD1, activities pertaining to Collection Systems considered O & M expenses include:

1. Point repairs (replacement of 13 feet of pipe or less);
2. Cleaning sewer lines;
3. Raising manholes;
4. Minor repairs of infrastructure; and,
5. Television/inspection of lines, unless it results in line replacement.

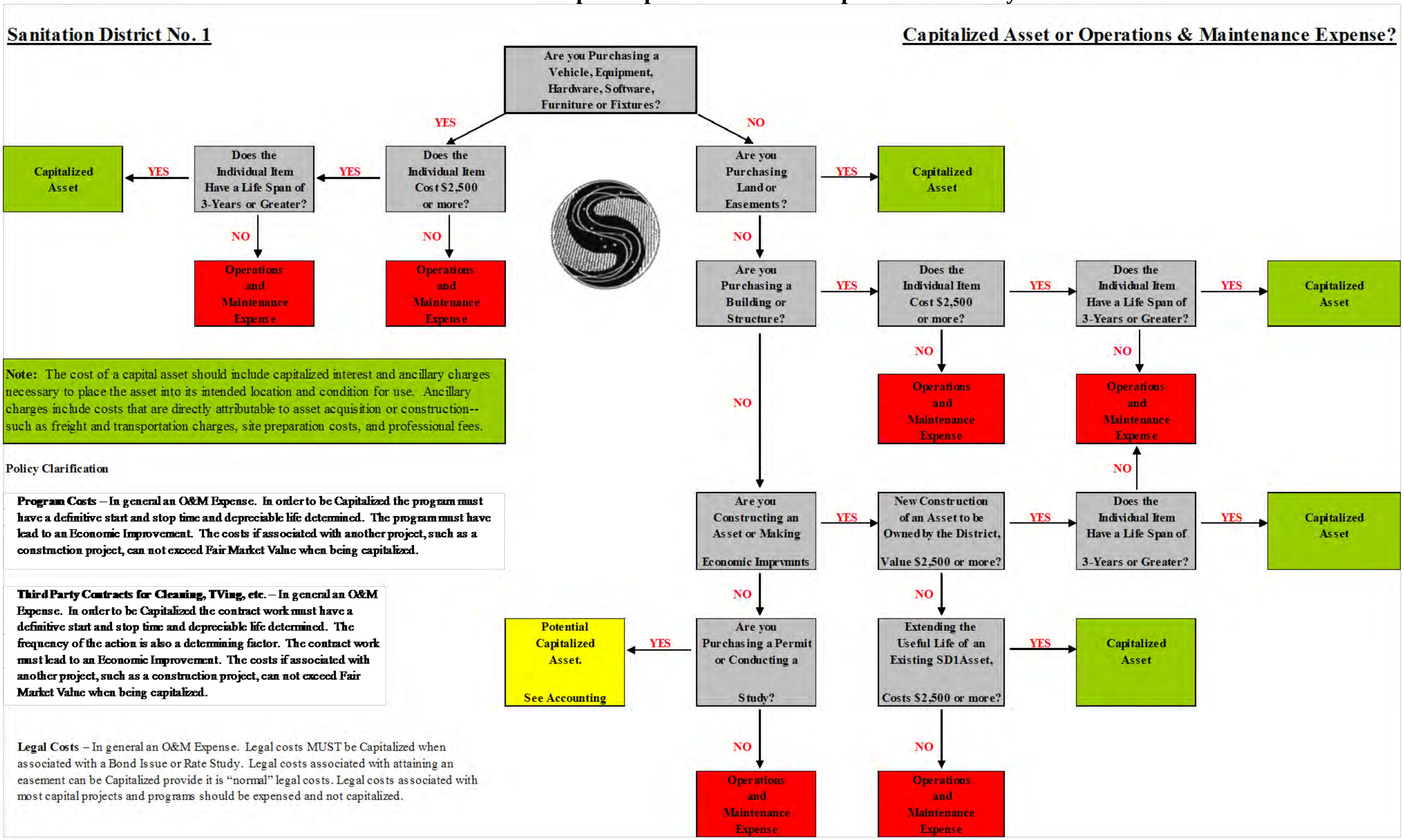
Per SD1, activities pertaining to Collection Systems that are to be capitalized and become depreciable assets include:

1. Cost to purchase or construct a new fixed asset if greater than $2,500, if the expense is necessary to make the asset ready to be used or placed in service; and,
2. Major repairs, if the repairs result in extending the useful life of the fixed asset beyond its original life expectancy and $2,500.

As part of the implementation of this new capitalization policy, SD1 created the following flow-chart entitled Capitalized Asset or Operations & Maintenance Expense.

The APA's examination and review of SD1's financial statement adjustments and capitalization policies exposed several issues regarding capitalization versus expense procedures at SD1, as well as compliance issues with capitalization policies. See Findings 6, 7, and 8 in Chapter 2 detailing the results of this review.

Flowchart Developed as part of SD1 New Capitalization Policy



Source: SD1

Chapter 2

Findings and Recommendations

Finding 1: Governance policies for the Board of Directors did not address several critical responsibilities necessary for proper and effective oversight.

Governance policies for the Board of Directors did not address several critical responsibilities necessary for proper and effective oversight of SD1. Auditors found no evidence of the following:

- An internal audit function that reports directly to the Board of Directors, or any independent process to receive, analyze, investigate, and resolve concerns related to SD1, including anonymous complaints;
- Annual or new Board member orientation regarding board member fiduciary responsibilities as board members;
- Policy requirements for annual reviews of executive staff salary increases by the Board of Directors or a designated committee with documentation in the meeting minutes;
- Review and approval of executive staff travel by the Board of Directors; and,
- An audit committee of the Board during the period of review.

SD1's Articles of Incorporation grant the Board of Directors full power and authority granted under KRS 220 to administer, control, and manage the affairs of SD1. Such authority brings with it the responsibility to ensure that the public monies SD1 receives for services provided are used in a responsible manner that serves the interests of the recipients of the services. The Board of Directors further should ensure that operating policies are consistent with, appropriate for, and supportive of the stated goals and objectives of SD1. Lack of assumption of such responsibilities weakens oversight and control over the responsible use and safeguarding of public funds by SD1.

Internal Audit Function

Although SD1 has established a detailed Whistleblower Policy, no internal audit function or process exists for employees or others to report any concerns directly to the members of the Board of Directors.

According to the SD1 Employee Handbook in Section 710, Employee Resolution, employees are encouraged to communicate problems to their immediate supervisor or higher management whenever necessary, but the auditors saw no independent process to receive, analyze, investigate, and resolve concerns related to the organization, including anonymous complaints directly to the Board of Directors.

The ethics policy in effect during the period of review, adopted in January 2009, provided for an "open door" policy for department directors and the Executive Director to welcome suggestions and concerns from employees allowing employees to feel comfortable discussing any issues and alerting executive management to concerns within the workforce. However, the policy gave no instruction on reporting of concerns directly to the Board, or processes for the Board to investigate and resolve employee or outside concerns.

An "Acknowledgement of SD1 Whistleblower Policy" form exists which is to be signed by employees acknowledging they have read and understand the policy. The auditors confirmed that the whistleblower forms were indeed signed by the employees, but they were signed in February, March, or April 2011, none prior to that time.

The open door policy above suggests employees share concerns in most cases with their supervisor. However, if an employee does not feel comfortable speaking with his or her supervisor, or if the employee is not satisfied with the supervisor's response, the employee is encouraged to speak with someone in the Human Resources Department or with anyone in management whom he or she is comfortable approaching.

"Supervisors and managers are required to report suspected violations of the Ethics Policy to SD1's Compliance Officer. For suspected fraud, or when the employee is unsatisfied with following SD1's open door policy, he or she should contact SD1's Compliance Officer directly." The Compliance Officer is SD1's General Counsel.

Without a written policy for employees or others to ensure the Board is aware of the concerns brought to management's attention, or to report potential violations of policy directly to the Board, the Board may be unaware of the environment within the organization and unable to ensure a proper follow-up to investigate reported complaints is performed. In order for the Board to be well-informed of employee and other concerns, the Board must be notified, independent of management, of certain complaints or allegations of policy violations.

Board Member Orientation

SD1's Board of Directors do not have an annual or new member orientation program regarding board member fiduciary responsibilities; however, SD1 does provide a new Board member orientation binder with SD1's rules and regulations, Board by-laws, and other information. Management asserts that staff informs the Board of current key issues and topics during the monthly Caucus and Board Meetings. Further, SD1 states that the President of the Board typically attends an orientation session.

Members of the eight person Board of Directors serve four year terms without limitations. New Board members may not be familiar with the Board's fiduciary responsibilities, or with SD1's structure, programs or personnel. New appointees may not have an understanding of their responsibilities as Board members, and absent a detailed orientation, it is difficult for a board member to effectively perform his or her duties. New Board members, without a proper understanding of the organization and their responsibilities, may not ask pertinent questions or may be hesitant to enter into discussions.

To effectively perform their responsibilities and to benefit the organization, SD1 Board members should receive a formal orientation to ensure each Board member understands the organization, his or her role and responsibility as a Board member, and the purpose of the Board and any committees on which he or she may serve.

Annual Reviews for Executive Staff Salary Increases

Personnel policies for benefits, evaluations, and salary adjustments appear to be adequately documented; however, no requirements for executive staff salary increases to be annually reviewed by the Board, or a designated committee, and documented in the minutes were found in the personnel compensation policies**.** While the Board does approve the contract and compensation package of the Executive Director, there is no indication that the Board has direct knowledge of the executive staff salaries. The auditors reviewed the minutes from July 2008 through January 2011 and saw no review of salary increases reviewed by the Board. Employees were recognized for longevity, retirement, and perfect attendance during Board meetings, but there was no discussion of any salary increases or approval of salary schedules.

While the Board does have a detailed and equitable personnel and compensation policy, it also has a responsibility to perform an annual review of executive staff salaries to ensure the appropriate use of public funds.

Approval of Executive Staff Travel

Although SD1 has established a travel expense policy that defines allowable costs, executive staff travel was not reviewed or approved by the Board of Directors. Any business travel for employees beyond the SD1 service area must be pre-approved by an SD1 Deputy Executive Director, the Executive Director, or the employee’s Department Director or Senior Manager. Expenses incurred during approved travel obligations may be reimbursed after the trip is completed or can be pre-paid, depending on the nature of the travel requirements. Employees are expected to use the most cost effective method and means for completing their trips.

Travel and the related expenses of the executive staff, which includes the four Deputy Executive Directors, were presented to and approved by the Executive Director. The process involved the staff member sharing with the Executive Director the purpose for the travel, the anticipated expenses associated with the travel, and the expense amount of the travel included in the fiscal year budget. The Board of Directors, or a committee of the Board, was not involved in reviewing or approving travel expenses for the Deputy Executive Directors, other than approving the overall travel budget for the fiscal year.

Travel and expenses for the Executive Director did not require or receive prior approval, other than inclusion in the operating budget, which is approved by the Board. Policies did require the expense report of the Executive Director to be reviewed by the Deputy Executive Director, Administration, prior to submittal for payment.

Effective policies that provide proper transparency and accountability should require the Board of Directors to pre-approve any out-of-state travel plans and estimated costs of SD1 executive staff. Such approvals should be documented in the minutes of a Board meeting. Subsequent to attending approved travel activities, executive staff should report amounts expended to the Board for approval. When travel expenses of executive staff are not reviewed by the Board, travel costs may exceed budgeted amounts and allow excessive spending.

Audit Committee

No audit committee of the Board of Directors existed during the period of audit review, although the Certified Public Accounting (CPA) firm which conducted the financial audit of SD1 for the previous three years annually recommended that the Board consider forming an audit committee due to the increasing scrutiny of the use of public funds. An audit committee was formed by the Board of Directors in March of 2011.

Recommendations

We recommend the Board of Directors strengthen its policies to include several critical responsibilities necessary for proper and effective oversight of SD1. Specifically, our recommendations include the following:

We recommend SD1 strengthen its whistleblower reporting policies by creating and documenting an independent process whereby employees and/or customers have the option to directly make the Board aware of concerns involving matters that specifically need Board oversight. We recommend the Board establish methods that allow for concerns to be reported directly to its attention by all staff, including anonymous concerns, and any complaints against executive staff. The Board should further develop a process by which concerns are brought to the attention of the Board and ensure a process exists to analyze, investigate and resolve issues brought to its attention. An internal audit function could be used to ensure that concerns brought to the Board are independently investigated. The internal auditor should report findings directly to the Board.

We recommend the Board provide annual orientation training for new and returning Board members to ensure the members have at a minimum, a clear understanding of SD1's organizational structure and policies, their responsibilities as Board members, as well as their legal and fiduciary roles, and the purpose of the board on which they serve. In addition, the orientation should address ethical requirements of Board members and staff and any significant policy changes adopted by SD1 during the previous year. Material for the orientation should be written and formally presented in a manual to facilitate the orientation process and serve as a useful reference tool for Board members. The orientation manual should provide a description of SD1 structure, its revenue and investment information, as well as all ethics policies for Board members and staff of SD1. We also recommend that the orientation be facilitated by a knowledgeable independent party, such as a Board attorney who can participate in and oversee the orientation training.

We recommend SD1 Board of Directors adopt a policy to review and approve the salaries of the executive staff on an annual basis to ensure that the compensation paid is equitable to the responsibilities and duties of each position. The salaries should be reviewed specifically by the Board to ascertain appropriate use of funds given the mission of SD1, and such review should be documented in the minutes.

We recommend SD1's newly establish a Board audit committee appoint and approve the compensation of the CPA firm hired to conduct the financial audit of SD1. The audit committee should have the outside auditors report directly to it. If possible, the audit committee should be comprised of a least one member who has an understanding of accounting principles.

We recommend the Board, or a designated committee of the Board, pre-approve executive staff out-of-state travel, including estimated costs. The Board meeting minutes should document the review conducted by the Board. We also recommend the Board require a report of the actual travel expenses of executive staff, with Board approval, prior to expense reimbursement. The expense reports should sufficiently detail the expenses associated with meals, lodging, transportation, and entertainment of each trip, as well as the business purpose of each expense item.

Finding 2: Certain policies were not documented or sufficient to ensure accountability.

SD1 had no written policies or procedures regarding the use of credit cards, reimbursements to employees, electronic backup of financial information, and fixed asset inventory. Such policies are necessary to provide proper control and accountability required of a public agency.

SD1 has implemented a fairly comprehensive set of policies and procedures to provide internal control and proper oversight and accountability of its organization. These policies and procedures are documented in various policy documents and an Employee Handbook. Many of these guidelines require Board members and staff to sign acknowledgement forms attesting that they have read and understand the policy. SD1's written policies include information pertaining to various work conduct and structure, including salary administration, ethics, information technology, open records, procurement, gifts to employees, sponsorships, travel, surplus property, employment issues, and employee benefit programs. However, in order for SD1 to maintain proper control and accountability over the assets of the organization, it needs to strengthen its policies by adopting, in written form, policies regarding the use of credit cards and related reimbursements, electronic backup of financial information, and fixed asset inventory requirements.

Credit Card Use and Reimbursements

SD1 had no written policies on the use of credit cards, purchasing cards or reimbursement of use of personal credit cards. In addition to usage, no policy existed stating:

- Who was authorized to issue credit cards; and,
- Who was authorized to have or use a credit card.

The review of the minutes gave no indication that any review or oversight of credit card issuance or use was conducted by the Board or a committee of the board.

During the period of review, four employees had Financial Institute of America (FIA) credit cards on behalf of SD1, and five employees were issued American Express credit cards in March 2011. To ensure that any expenses made by an employee are monitored, written policies regarding credit card issuance, use, and reimbursement of use of personal credit cards is essential.

Electronic Backup of Financial Information

SD1 did not have a written policy regarding the electronic backup of financial information; however, SD1 backed up all financial information in certain databases on a daily basis. They also backed up all of the financial electronic file shares as part of their daily backup routine. Such procedures in the area of electronic backup of financial information should be in written form. Without written procedures for the electronic backup of financial information, transition or the absence of staff responsible for such procedures could allow for pertinent financial information to be lost.

Inventory Controls of Fixed Assets

SD1 had no written policies or procedures addressing fixed asset inventory requirements. SD1 did not conduct an annual or periodic inventory or physical accounting of SD1's fixed assets that is essential for proper accounting valuation and determining if equipment is missing. SD1 had a process for employees to follow when equipment was missing, damaged, or inappropriately used. However, the lack of maintaining inventory records and a periodic review of inventory allows for an asset to be misused, misplaced, damaged or possibly stolen without it coming to the attention of management. Good internal control over property requires an entity to account for furniture, equipment, or other items when purchased and to inventory it periodically.

Recommendations

We recommend SD1 adopt a credit card usage and oversight policy and document such policy in the employee handbook or through written documentation. The policy should detail required supporting documentation, timely review by the Board of Directors, and approval of executive staff credit card statements. If any expenses are classified as gifts or entertainment, they should be documented to include the name and title of the person making the purchase as well as the recipient and a description of why the expense was needed and how it relates to SD1.

Further, we recommend SD1 develop a policy related to reimbursement for use of personal credit cards with a stated timeframe allowed for making the reimbursement. Expense reimbursements requested by executive management should be reviewed by the Board ensuring that supporting documentation exists. Documentation should be retained to avoid any duplicate payments to employees.

We recommend SD1 adopt written policies that detail procedures for the backup of electronic financial information. Moreover, policies should include a process to report any lost or missing financial information or records.

We recommend SD1 adopt and implement property and inventory control policies and procedures to identify and account for all furniture, equipment, or other items valued over a certain specified dollar amount (specific dollar amount to be included in policy). Such policies and procedures should include recording of the following minimum information for each property item:

- Name of individual in receipt of furniture/equipment;
- Description of furniture/equipment;
- Vendor name;
- Model and serial numbers;
- Acquisition date; and,
- Acquisition cost.

We further recommend such inventory policies and procedures include an annual, or periodic, physical inventory of all fixed assets. Dispositions of property should also be reflected in inventory accounting. The property inventory and control policy should be made available to all employees who have responsibility for property assets and should include sufficient detail to ensure accurate and appropriate accounting for property inventory. SD1 may want to accomplish this recommendation by including its inventory and property control policies in its Employee Handbook.

Finding 3: Financial reviews and caucus meetings were not documented in meeting minutes.

The nature of financial reviews conducted by the Board of Directors was not documented in SD1 Board meeting minutes. Neither were meeting minutes recorded for Board caucus sessions held prior to monthly Board meetings. The only reference to the nature of any financial reviews by the Board was that a monthly financial report, and sometimes an annual financial report, was approved.

Financial Review

The meeting minutes did not document the extent of the financial review by the Board. No documentation indicated that the Board conducted a periodic review of expenditures, or expenditure categories, to evaluate whether those expenditures were reasonable and necessary, and to identify inappropriate, unusual, or excessive expenditures. Although comprehensive financial information may have been provided to the Board members and discussed, the detail of the review cannot be determined by reading the meeting minutes.

Caucus Sessions

Prior to the majority of SD1 Board meetings, the minutes document that the Board of Directors convened in caucus session for approximately one to two hours, but the minutes do not document any discussion or action taken during each caucus session. The caucus sessions were open meetings of the Board of Directors and SD1 staff, which the public was allowed to attend. However, minutes were not recorded. Some "consultants" and guests attended certain caucus meetings, and press notification of caucus meetings evidenced in the Board meeting packets confirm that the sessions were open meetings.

Pursuant to KRS 61.805, SD1, as a special district board is considered a public agency and subject to the Open Meetings requirements set forth in KRS 61.800-850. KRS 61.835 provides:

> **61.835 Minutes to be recorded – Open to public.**
> The minutes of action taken at every meeting of any such public agency, setting forth an accurate record of votes and actions at such meetings, shall be promptly recorded and such records shall be open to public inspection at reasonable times no later than immediately following the next meeting of the body.

Further, per a representative of the Office of the Attorney General, such caucus sessions are considered meetings and should have minutes recorded.

According to SD1, the caucus sessions were not recorded in the minutes because the meetings were originally meant to have more of an educational focus for the Board of Directors. As SD1 started to discuss a wider range of topics and issues, they assert that they started recording minutes of the meetings. However, the only "minutes" that SD1 provided to the auditors regarding these caucus sessions were agendas listing the participants and attached slides for the session, which were not prepared until January 2010. It appears that no actual minutes were recorded for any of the caucus sessions either as part of the Board meeting minutes or separately.

Recommendations

We recommend the Board of Directors ensure that Board meeting minutes document the exact nature of the financial reviews conducted by the Board. At least quarterly, the Board should receive a listing of expenditures with sufficient detail to identify inappropriate, unusual or excessive expenditures, and document its review of the listing. Any issues that result from these reviews and action taken to resolve the issues should also be documented.

We recommend that all discussion and actions taken during the caucus sessions held prior to the Board meetings, or at any other time, be recorded as open meeting minutes pursuant to KRS 61.835.

Finding 4: SD1 ethics policies for Board members and employees were not comprehensive.

Although some ethics policies existed for SD1 Board members and employees during the APA's period of review, no ethics policies existed pertaining to honoraria, investment/stock ownership, post employment, or acting as a representative of SD1 before a business owned by a family member. Furthermore, the policies in effect during the audit period addressing financial disclosure, acceptance of gifts, and conflicts of interest were inadequate, though SD1 made an attempt in its Ethics Policy adopted on March 22, 2011 to improve such policies. The lack of strong, enforceable ethics policies allowed the potential for, if not actual, conflicts of interest for certain SD1 Board members.

Financial Disclosure

The SD1 Ethics Policy adopted in 2009 had a limited disclosure policy for Board members and management, but had no requirement of an annual written statement of financial disclosure to be filed by Board members or executive management. The new Ethics Policy, dated March 22, 2011, requires Board Members, Executives, Directors, and Procurement personnel to complete and file an annual Conflict of Interest Disclosure Form. Those individuals must certify on the form that he or she has no conflict of interest to report or disclose the following:

- Actual transactions between SD1 and any entity or person with which the board member has a business, investment, or family relationship; and,
- Any for-profit or nonprofit boards on which the board member or spouse sits, or any for-profit businesses which the board member or immediate family member serves as an officer or director, or a majority shareholder.

This is an improvement to the policy, but in order for full disclosure, which should be required of public board members and executive staff, additional information should be required of all SD1 Board and executive staff members.

Acceptance of Gifts

Policies pertaining to the acceptance of gifts that were in effect during the audit period required employees to obtain authorization from the Executive Director for any gifts accepted in excess of $150 excluding the following:

a. Normal business entertainment items such as meals and beverages.
b. Items of minimal value, given in connection with sales campaigns and promotions or employee services, safety or retirement awards.
c. Contributions or donations to recognized charitable and nonprofit organizations.

Executive management was also required to track and record all gifts received. Under no circumstances was a gift or entertainment to be accepted that would influence the employee's judgment. Entertainment and services could be accepted by an employee when they were associated with a business meeting and the outside entity provided them to others as a normal part of its business. Examples included hospitality suites, golf outings, and business lunches and dinners. It was a violation of this policy for any employee to solicit or encourage an outside entity to give any item or service to the employee for personal gain regardless of its value. An employee was allowed to accept discounts on a personal purchase only if such discounts did not affect SD1's purchase price and were generally offered to all SD1 employees.

Gift Policy Revisions

The revised 2011 policies governing the acceptance of gifts include a new section, "Prohibition Against Bribes, Kickbacks, and Special Consideration," as well as a new section, "Gifts," that provides:

> Employees will avoid the intent and appearance of unethical or compromising practice in the receipt of gifts. Under no circumstances should a gift or entertainment be accepted that would influence the employee's judgment.
>
> For the purposes of this policy, "Gift" is defined as any gratuity, discount, entertainment, hospitality, loan, forbearance, or other tangible or intangible item having monetary value, including but not limited to, cash, food and drink, and honoraria for speaking engagements related to or attributable to employment or the official position of an employee, member, or officer.
>
> Gifts do not include the following:
>
> 1. Opportunities, benefits, and services that are available to the general public under the same conditions;
> 2. Anything for which the employee pays the market value;
> 3. A certificate, plaque or other ceremonial award that costs less than $100;
> 4. A gift given to you or a member of your family for a "major life event," e.g., the birth or adoption of a child, a wedding, a funeral or retirement; the limit for gifts given in honor of one of these listed "major life events" is $1,000;
> 5. Food and beverages not exceeding $100 per person on a single calendar day; or
> 6. Items of minimal value ($15 or less).

> All gifts with a fair market value of more than $15 must be reported on a "Gift Reporting Form" and submitted within seven (7) working days of receipt of the gift. Employees must seek authorization from the Executive Director for any gift with a fair market value of $150 or more.
>
> If an employee receives a gift that violates this policy and/or is later deemed inappropriate, the employee shall:
>
> 1. Return the gift if possible;
> 2. Pay the market value for the gift; or
> 3. Give the gift (or an amount of its equal value) to an appropriate charity (e.g., a 501I 3 organization).

Further, effective January 1, 2011, the SD1 Employee Handbook, Section 111, was updated and provides:

> Employees should not solicit or accept for personal benefit directly or indirectly any gift, loan, or any item of substantial monetary value from any person or company that is seeking to conduct or currently conducting business with SD1 without first receiving approval from their department Deputy Executive Director.

These improvements to SD1's Acceptance of Gifts policies, if enforced, serve to strengthen the ethical behavior of its employees. However, several of the gift exceptions such as allowing gifts to be accepted if approved by a Deputy Executive Director or the Executive Director, and allowing gifts up to a value of $1,000 for major life events, weaken the policy's effectiveness to the extent that conflicts may arise for employees that affect their impartiality in decision-making and recommendations. Allowing such exceptions seems unnecessary considering the policy already permits an employee to accept gifts up to $150 without any approval. Furthermore, the Employee Handbook policy on gifts, which prohibits gifts of any value unless approved, seems inconsistent with the gifts policy within the SD1 Ethics Policy.

Conflicts of Interest

Policies governing conflicts of interest during the period reviewed required Board members and management to disclose conflicts, and gave examples of situations where conflict of interest situations could occur, but the policy did not require Board members or employees to abstain from situations where a conflict of interest existed for them.

Conflict of interest policies adopted by SD1 in 2011 strongly discourage SD1 from conducting business with immediate family members of Board members or employees, but do not prohibit it. New policies also require Board members to annually sign an Ethics Policy Certification and Conflict of Interest Disclosure form. They also must disclose to the Board, and recuse themselves from discussions and votes, when they appear to have, or believe they have a conflict of interest that would prevent them from acting in the best interest of SD1.

Executives, Directors, the Purchasing Manager and other members of the Purchasing Department including Purchasing Liaisons within each department annually must sign an Ethics Policy Certification and Conflict of Interest Disclosure Form. Should any of these employees have a personal financial interest, or a financial interest in any agency, company, or entity that receives or stands to receive financial or other material benefits from performing services for SD1, that employee must disclose that interest to the Executive Director. All other employees must sign an Ethics Policy Certification at the time of hire and thereafter upon any significant content revision.

An employee who has, or appears to have, or believes they have a conflict of interest that would prevent him or her from acting in the best interest of SD1 must disclose that interest to the Director of Human Resources, the Executive Director, or the General Counsel. The conflict of interest will be reviewed by the Executive Management Team or by the President of the Board of Directors if the employee is part of the Executive Management Team and a determination will be made if a conflict exists and if it is appropriate to either remove the employee from the decision-making process or to prohibit the transaction with the outside entity with which the conflict of interest exists.

The Employee Handbook Section 107 policy on Conflicts of Interest states that the policy provides a framework of general guidelines so employees can seek further clarification on issues related to the subject of acceptable standard of operation. These new provisions, if enforced, will serve to strengthen the policies governing conflicts of interest for Board members and employees. Without a strong, detailed conflict of interest policy that is enforced by management, actions and decisions made by employees and Board members may be inequitable and based on favoritism rather than made impartially.

Board Member Conflicts

A comparison of vendor payments to Board member affiliated businesses exposed three apparent conflicts of interest of current and former SD1 Board members as noted in Table 10.

Table 10: Board Member Apparent Conflicts of Interest

Board Member Affiliated Business Vendor	Board Member Relationship to Vendor	SD1 Payments to Vendor	Fiscal Year
Reitman Auto Parts & Sales, Inc.	Secretary and Director	$500	2008-09
		$460	2009-10
		$250	2010-11 (3/16/11)
Reis Concrete	Director	$738	2008-09
Cardinal Engineering Corporation	President	$22,295	2008-09
		$21,501	2009-10
		$22,686	2010-11 (3/16/2011)
Turfway Concessionaire, LLC ^	Manager	$832	2008-09
		$498	2009-10

^ Paid Turfway Park LLC
Source: Information secured from Secretary of State and SD1

In the review of Board meeting minutes, there were 22 total instances where SD1 Board members abstained from voting. SD1 staff has asserted that 12 of these abstentions were due to potential conflicts of interest. One specific instance noted in the minutes involved a board member abstaining from the vote on a settlement agreement between SD1 and a construction company. This abstention was due to an ownership interest in a company that was a subcontractor of the construction company and also was doing business with SD1. Such an ownership interest presented an apparent conflict of interest for the Board member. Even if the Board member was not involved on behalf of SD1 in approving any agreements with or payments to the company in which he had an ownership interest, it gives the appearance of a, if not an actual, conflict of interest.

Enforcement

SD1's enforcement policy for its ethical requirements stated that "any infractions of this Ethics Policy will not be tolerated and SD1 will act promptly in addressing the violation. Any person found to have violated this policy may be subject to disciplinary action, up to and including termination of employment." The Employee Handbook Policy 709 Progressive Discipline, revised January 1, 2011, further expands and details disciplinary procedures regarding violations of the policies, rules or standards of conduct.

Recommendations

We recommend that SD1's Board of Directors strengthen its Ethics Policy by establishing a comprehensive code of ethics, applicable to both Board members and staff members. In developing a comprehensive code of ethics for the Board and staff, the following areas of conduct that are not in the current revised SD1 Ethics Policy should be considered for inclusion:

1) Honoraria;
2) Investment/Stock Ownership;
3) Post-Employment; and,
4) Representation of SD1 Before a Family-Owned/Related Business.

We also recommend SD1's current ethics policies be expanded to ensure the following:

- Board and executive staff members annually file by a specified date a financial interests disclosure statement. Required information should be disclosed on a form prescribed by the Board. In addition to what is required by SD1's Conflict of Interest Disclosure Form, the Board should consider including the following other disclosures on the prescribed form:

  - Any other occupation or positions of the filer or filer's spouse;
  - Businesses in which the filer or filer's spouse hold at least a specified percentage of interest (state percentage in policy);
  - Sources of income to the filer, the filer's spouse, or the filer's immediate family members exceeding a specified amount (state amount in policy);
  - Real property owned by the filer, the filer's spouse, or the filer's immediate family members, and its location;
  - Creditors of the filer, the filer's spouse, or the filer's immediate family who owe more than a specified amount (state amount in policy);
  - Sources of gifts over a specified amount (state amount in policy) to the filer, the filer's spouse, or the filer's immediate family, except those from family members; and,
  - Sanctions for noncompliance.

- Board members and employees responsible for selection and oversight of vendors, or recommendations related to such selection and oversight, have limitations, without arbitrary exceptions, on the value of gifts they may accept from persons or businesses seeking to or doing business with SD1 or seeking to influence the actions of SD1 in any way. Gift policies stated in SD1 Ethics Policy and Employee Handbook should be consistent.

- Board members and employees abstain from involvement in discussions or decisions pertaining to:

  - Persons or businesses from which they have accepted gifts, gratuities or compensation over a specified dollar amount;
  - Matters involving businesses in which they have a direct or indirect financial interest over a specified percentage;
  - Persons or businesses with which they have a partnership or financial ownership interest over a specified percentage;

  - Persons or businesses which compete with a business they own privately;
  - Matters involving family members, or businesses owned by or employing family members; and,
  - Any other matter that presents a conflict between the employee or Board member's personal interest and his or her duty to SD1 and the counties it serves.

  Documentation of such abstention should be in writing and placed in the employee's personnel file or recorded in the minutes of the Board meeting.

- Board members, employees, and any business owned by any Board member or employee be prohibited from having a contract or an agreement with SD1, or from representing a person or business privately before SD1.

- Board members and employees be prohibited from using their official positions to obtain a financial gain or benefit or advantage for themselves or family members.

- Board members and employees be prohibited from using confidential information acquired during their tenure to further personal economic interests.

- Board members and employees be prohibited from holding outside employment with, or accepting compensation from, any person or business with which they have involvement as part of their official duties for SD1.

In order to ensure compliance with SD1's Ethics Policy, we recommend SD1 adopt policies, procedures and responsibilities for investigating reported ethical misconduct and criteria for sanctions and disciplinary procedures.

Finding 5: Accounting controls need strengthening.

During the course of the examination there were several instances of accounting errors and of apparent lax accounting controls noted that suggest SD1 should review and strengthen accounting controls and oversight. The specific instances noted involved a formula error in a spreadsheet allocating labor costs to projects, significant accounting entries made without proper review or documentation, and errors in the rate setting "Pro Forma" model.

Errors Allocating Labor Costs

SD1 allocated in-house labor charges for various SD1 hourly and salary personnel to CIP capital projects for hours deemed worked by those persons on a particular project. SD1 utilized an Excel based spreadsheet to capture hours charged to a specific project and then by means of formulas in the spreadsheet extended the hours times applicable rates to arrive at an amount of SD1 labor cost to be charged to a particular project.

SD1 hourly employees were paid overtime at a rate equal to 1.5 times their base rate of pay. There was an erroneous formula imbedded in the spreadsheet to calculate the rate of pay for overtime hours chargeable to a project. The formula was "base rate of pay times the number of overtime hours times 1.5." The correct formula should have been "base rate of pay times 1.5." This error in the spreadsheet formula resulted in a total of 151 projects being charged excessive labor costs. Prior to 2009, 119 projects were overcharged a total of $736,172. Twelve projects that were still active, and included in CIP, were overcharged for labor costs in the amount of $180,122. The SD1 Director of Finance stated the overstated labor amounts for the active projects would be expensed as projects were closed and capitalized.

The accounting effect of this error was to understate SD1 "Operation, maintenance, and administration" expense (salaries) as salary expense was credited for more expense than was actually incurred. Likewise, some capital projects were over allocated labor charges thus erroneously inflating the amounts capitalized. Such an error resulted in reducing current year operating costs while amortizing the error over the useful life of the capital asset.

Even a cursory review by the auditors of the spreadsheet calculation raised immediate questions regarding the accuracy of the calculations. SD1's failure to recognize such a significant error in labor allocation calls into question the quality and frequency of accounting review and oversight.

No Supporting Documentation, Approval, or Prior Period Adjustments

As detailed in Finding 7, the SD1 Director of Finance and the current SD1 Controller were unable to produce a copy of fiscal year-end June 30, 2008 adjusting journal entries or provide the details that support the year-end adjusting entries. Those entries were recorded in the general ledger system as having "no documentation." The SD1 Director of Finance was unable to produce complete documentation of any supervisory review or approval of such adjustments. Furthermore, while some amount of the year-end adjusting entries involved expenses incurred prior to FY 2008, no prior period adjustments were made for fiscal years prior to 2008.

Allowing undocumented and unapproved entries to the general ledger creates the opportunity for erroneous and inappropriate entries to the general ledger. Such activity could raise serious questions as to the accuracy and integrity of the SD1 financial statements.

Permitting accounting entries to be made to the SD1 ledgers and not maintaining supporting documentation of those entries, nor maintaining any record of appropriate review and approval of those entries or any prior period adjustments indicates a serious lack of proper accounting system controls.

Rate Setting Model Error

As more fully described in Finding 12, an initial error in the 2008 rate setting "Pro Forma" model produced erroneous sewer rate projections of 25 percent for fiscal years ending 2009 and 2010. The incorrect 25 percent projected increases were communicated to SD1 executive staff in preparation for presentation to the Board for approval the following day. The error was detected by staff prior to presenting a recommendation to the Board for review and approval. The Board was presented with a recommendation for 15 percent rate increases, which were ultimately approved. Again, this error demonstrates the lack of proper accounting controls and the need for broader accounting and operational review and oversight of the model and rate setting process.

Engineering v. Accounting

Another example that questions the strength of SD1 accounting controls is the significant influence that project engineers have on the determination of whether projects costs should be capitalized and depreciated, or expensed in the current year. See Finding 6 for details of this matter.

The incidents noted above raise serious concerns regarding SD1's monitoring of accounting systems and controls. Strong accounting oversight and effective accounting controls over the various systems and models are critical to SD1 ensuring the lowest possible impact to its consumer base while continuing to maintain the integrity of the financial statements.

Recommendations

We recommend that SD1 make a concerted effort to address not only the issues noted above but to address and formalize the nature of accounting and financial oversight and review that would help prevent such errors in the future.

Specifically, we recommend that all projects that were overcharged in-house labor be considered for correction through prior period adjustments. Except for those labor charges allocated for the current fiscal year, the twelve projects that are still active and included in CIP that were overcharged in the amount of $180,122 also should be considered for correction through prior period adjustments.

In addition, we recommend SD1 assure the integrity and security of the SD1 ledgers by imposing strict controls on general ledger access, by evidencing review and approval of ledger entries, and by maintaining the approved documentation supporting all entries in the SD1 ledger. As provided in Finding 6, SD1 finance and accounting staff should ensure that applicable accounting standards are followed in determinations of all capital versus expense decisions.

We also recommend, as noted in Finding 12, that SD1 expand the participation and oversight of the rate setting model such that the responsibility for not only the data input but also the end product, i.e. the revised rates, is a multi-disciplinary responsibility. Expanded participation and oversight should also ensure continuity of expertise should a change in personnel occur.

Finding 6: SD1 Construction in Progress accounts included questionable charges.

The examination of specific charges recorded in the CIP account balances raised several questions as to whether the treatment of those costs was appropriate and accurate. Certain charges were included in CIP account balances and eventually capitalized as assets, rather than expensed in the year they were incurred. The auditors question the treatment of those charges.

The examination included a review of the SD1 capitalization policies, detailed in Chapter 1, and also included inquiries of the GASB and SD1's independent auditing firm, as well as other CPA firms with experience in municipal utility operations regarding capitalization policies and procedures. The APA reviewed the files on eight capital projects, listed in Table 8, ranging from expenditures of $213,776 to $115,812,941, and with a total accumulated cost to date in excess of $200,000,000. Total fiscal year-end CIP amounts are listed in Table 9. Included in the many aspects of those projects reviewed were the details of some individual charges to the projects.

While this review resulted in questions on several applications of SD1 capitalization policy, a concise and comprehensive definition of exactly what costs should be capitalized was not available from any of the governing or financial regulatory agencies. The available regulatory guidance is rather general and affords basic and general guidelines as to what expenses may qualify for capitalization. Thus, some expenses considered for capitalization may undoubtedly fall into a "gray" area that is subjective and subject to professional judgment.

With an explanation of the available regulatory guidance as a background, the APA noted that in some areas subjective decisions regarding capitalization were a necessity. Even so, we question the propriety of the following procedures and the ultimate determinations of SD1 to record the following charges to CIP instead of expensing these costs in the year incurred:

1. Including legal costs for non-easement related litigation and the prevailing wage determination in CIP account balances, which ultimately were capitalized and depreciated;
2. Allocating hourly and professional labor costs and capitalized interest after the project appears to have been completed;
3. Deferring the expensing of SD1's share of the cost of a project beyond a fiscal year end although SD1 acknowledged that the entire portion of SD1's share will ultimately be expensed;
4. Charging items questionable to the purpose of the project, i.e. catering charges, food purchases, TV and TV wall mount, desks, chairs, shelving, etc., small purchases from Lowes and Wal-Mart; and,
5. Including expenditures for flow and rain monitoring services in CIP, which ultimately were capitalized and depreciated.

Legal Expense for Litigation and Prevailing Wage Determination

An undated SD1 memo clarifying "Capitalization Policy…," quoted in Chapter 1, specifically states that "Legal costs associated with most capital projects and programs should be expensed and not capitalized." The memo also identifies "normal" legal expense that can be capitalized as being those "associated with attaining an easement." Legal expense not directly attributable to easement acquisition or site condemnation appears to be an item to expense rather than to capitalize according to the SD1 capitalization policy.

SD1 included in the CIP account balances for the Rivers Edge Project at least $217,041 of legal expense identified as litigation costs involving contractor issues and prevailing wage issues. SD1 sued the developer and the contractor responsible for the sewer project claiming SD1 was defrauded. SD1 also defended itself on charges that SD1 failed to pay the State of Kentucky required prevailing wage on the project. SD1 received a settlement from the developer in the first case and paid prevailing wages to the State of Kentucky in the second.

SD1 included in the CIP account balances for the Western Regional Wastewater Treatment Plant $62,279 of legal expense indentified as pertaining to "Stites Condemnation" and "SPEAR Reaffirmation." The litigation involved a lawsuit by the Alliance for Kentucky's Future, Inc. against the Kentucky Environmental and Public Protection Cabinet, SD1, and others, challenging, among other things, the site selection process whereby SD1 was permitted to acquire property for the construction of the wastewater treatment plant.

On the Western Regional Conveyance Tunnel project, SD1 was the plaintiff in litigation involving SD1 limiting or denying use of access easements on SD1 property to the defendants' landlocked private property. In this case, SD1 and the defendants reached an out of court settlement. Further, a bid protest was filed by one of the unsuccessful bidders on the project that submitted a bid $10,000,000 lower than the successful bidder, but according to SD1 did not meet the bid qualifications for the project. While details of the legal expense charged to this project did not identify the specific expenses related to each case, it appears that a significant amount of the legal expenses were charged to this project and inappropriately capitalized.

Labor Cost and Capitalized Interest Allocated to Completed Projects

The Rivers Edge Project involved the rerouting and upsizing of a combination sewer and storm water overflow line in conjunction with a private development along the Ohio River in Dayton, Kentucky. The Rivers Edge Project was placed in service on June 8, 2010. At that time, the contractor remained obligated to provide backfill overtop the newly installed sewer lines. As of April 30, 2011, the accumulated cost in CIP for this project was $14,194,437. Since June 30, 2010, SD1 has charged an additional $16,000 of SD1 hourly labor costs and $2,600 of contractor cost for “misc. jobs” to the project. While there may be justification for charging the project with some additional SD1 labor and contractor cost after a project is deemed complete and placed in service, continuing to allocate SD1 labor and contractor costs on a monthly basis seems inappropriate and raises questions whether such charges should be capitalized or deemed operating expense.

While SD1 indicates the project will be closed effective June 30, 2011, and capitalized effective January 1, 2011, SD1 plans to allocate capitalized interest to the project through the anticipated closing date of June 30, 2011. The project has already been charged with $649,608 of capitalized interest through June 30, 2010. SD1 may properly charge a project for interest incurred on borrowed funds used to finance a project (i.e. “capitalized interest”) until that project is deemed complete and is capitalized. The allocation of interest to a capital project has the accounting effect of reducing current year interest expense by the amount of interest “capitalized.” This accounting treatment allows SD1 to recognize that interest expense as part of the total cost of the project and to depreciate it, or recognize it, over the project’s useful life, which may be 20-50 years. The project, which was placed in service in June 2010, was held in CIP for an additional year before closing, allowing additional capitalized interest to be charged to the project.

Project Expenses Held in CIP beyond Year End

On the Prisoners Lake Project, SD1 partnered with the City of Covington to reduce CSOs by redirecting CSOs from Prisoners Lake in Covington to an irrigation pond to be constructed in Covington’s Devou Park. It was agreed that the City of Covington would contract for the work and SD1 would pay 75 percent of the cost of the project. Since the new irrigation pond and related pumps, etc. would be owned by Covington, SD1 acknowledged at the outset that SD1’s share of the cost would be expensed.

The project was deemed completed by Covington in late calendar year 2010, which is in FY 2011. Costs accumulated in fiscal year 2010 and fiscal year 2011 totaled $387,524 and $116,257, respectively. SD1 indicates that the total project expenditures will not be recorded as expenses until June 30, 2011, the end of fiscal year 2011. Thus, the $387,524 expenses for fiscal year 2010 were not and will not be reflected in the financial statements for fiscal year ended June 30, 2010, although the expenses should have been recorded in fiscal year 2010.

Deferring recognition of acknowledged expense amounts beyond the period in which they occur is a departure from the basic Generally Accepted Accounting Principle of matching revenues and expenses.

Questionable Project Expenditures

While reviewing the detail of charges to the various projects, numerous charges were noted for the purchase of food and catering, charges for Wal-Mart and Lowes, as well as specific charges for the purchase of a television and television wall mount, desks, chairs, shelving, etc. The dollar value and frequency of these observed types of purchases was insignificant to the total project expenditures, however, the nature of such charges raises questions as to their appropriateness to be capitalized to the project. Even if those charges were deemed to be properly chargeable to the project, the capitalization of such charges as being part of a project with a 30 to 50 year useful life would seem inappropriate given their significantly shorter useful life.

Flow and Rain Monitoring Services

The "Flow and Rain Monitoring Services" project was purposed to monitor meters on sewer and storm pipelines in order to provide statistical data on storm water and sewage flows and provide water quality sampling used in the calibration of an SD1 system-wide hydraulics waste water model. This model will enable SD1 to assess and evaluate collection system capacity and aid in the development of alternatives for Watershed Plans as required by the consent decree. The $4,896,836 cost of this project was capitalized on January 1, 2010 and will be depreciated on a straight line basis over a period of three years.

The decision to capitalize the cost of this project, as opposed to expensing the cost, is questionable given that monitoring does not lead to an identifiable "economic improvement" that can be attributed to this project. SD1's Capitalization Policy specifically states that project costs must lead to "Economic Improvement" in order to be capitalized. While such a model may ultimately aid in the identification of specific needs for capital projects, capitalization of such costs in the absence of currently identifiable economic improvement projects does not appear to comply with SD1's stated capitalization policy.

Project Engineers have Significant Influence

SD1 indicated that, beginning in 2010, SD1 held three meetings per year to review and assess the status of projects in CIP. Those attending the meetings included project engineers, executive management, and finance staff. In the meetings, for those projects that were deemed complete, a review of the accumulated cost was conducted to determine if there were any accumulated costs that should be expensed as opposed to being capitalized. It was noted by SD1 personnel that in those meetings the decision to capitalize certain expenditures and projects rather than accounting for them as expenses in the current year was primarily made by, or influenced by, the engineering staff who may not have been fully aware of proper accounting principles to guide such decisions.

As noted in other sections of this examination, the decision to capitalize an expenditure rather than recording an expense can be a very subjective decision. The decision of capital versus expense should be guided solely by available accounting authority and as such should ultimately be determined by knowledgeable finance or accounting staff. Allowing engineers to significantly influence capitalization decisions resulted in erroneous and non-compliant accounting entries affecting the integrity and accuracy of the financial statements.

Recommendations

We recommend SD1 review and update its Capitalization Policy for CIP to provide more detailed guidance regarding the expense or capitalization of expenditures for meals, catering, furniture, and fixtures, and to ensure the policy complies with any available governing authority. SD1 accounting and finance personnel are charged with, and held responsible for, the integrity of the SD1 financial statements. As such, they must be knowledgeable of and apply appropriate guidance to all aspects of SD1's financial records, including whether to expense or capitalize a cost.

Finding 7: Year-end adjustments to financial statements were made without approvals, support documentation, or necessary prior period adjusting entries.

As stated earlier, the review of financial statements focused primarily on the fiscal year-end 2008 statements. Fiscal year-end adjusting journal entries proposed by the CPAs totaling $2.7 million were made by SD1's former controller in January of 2009 to adjust the financial statements for the fiscal year ended June 30, 2008. These adjusting entries were made to correct expenditures originally charged to CIP that should have been recorded as expenses in the year incurred. SD1 was unable to provide the APA with a breakdown of expenditures or projects that comprised the total of these adjustments. Moreover, SD1 stated that these adjustments were made without any supervisory review or approval.

SD1 also indicated that prior period adjustments were not made even when costs accumulated in CIP for previous years were charged to expense in the current year. For example, SD1 accumulated charges from multiple years in CIP account balances for projects involving feasibility studies. If a specific capital project did not materialize as a result of a study, the CIP expenditures incurred to date were immediately expensed in the current period, regardless of when the costs were actually incurred.

In the normal course of closing the financial records for a fiscal year, management may make adjusting journal entries to the entity's records. Additionally, if an entity's financial auditor recommends that adjustments be made to the entity's records, it is up to management to decide whether to make those recommended adjustments. If the auditor proposed adjustments are not made, the auditor must weigh the amount of the recommended adjustment against a materiality threshold to determine what type of opinion to render on the financial statements.

Recommended Adjustments

During the fiscal year ended June 30, 2008 financial audit, SD1's CPA financial auditors initially stated that $21.7 million of SD1 expenditures in CIP account balances should have been classified originally as Operating & Maintenance (O & M) expenses. The financial auditors' initial recommendation was for SD1 to reclassify $12.7 million in CIP account balances to fiscal year 2008 O & M expenses and reclassify the remaining $9 million as a prior period adjustment. The recommended adjustments were for costs that should have been expensed as part of normal operations but rather were held in CIP.

SD1 management disagreed with the financial auditors recommended adjustments and requested that the financial auditors contact other sanitation districts for industry standards on the types of expenses that may be included in CIP. The financial auditors contacted one other district, the city of Milwaukee Metro Sewer District, as well as other CPAs, who thought that SD1's procedures for including certain expenditures in CIP were appropriate. As a result of those contacts, the financial auditors revised their recommendations and agreed to adjustments of nearly $2.7 million of the previously recommended $21.7 million adjustments, consisting primarily of cleaning costs and studies that should not have been capitalized as assets. SD1 decreased CIP account balances by $2.7 million while operating expenses were increased by $2.7 million for fiscal year ended June 30, 2008.

SD1 management was unable to provide the APA with complete supporting documentation or detail of the individual CIP projects that were adjusted as a result of the nearly $2.7 million audit adjustments. APA auditors did obtain from SD1 a list of several of the CIP projects alleged to be a part of this amount, but detail of the entire amount could not be determined or supported. Furthermore, the SD1 Director of Finance acknowledged there was no supervisory review or approval of the audit adjustments.

These adjusting entries, along with other adjusting journal entries totaling $12.4 million, were made after the fiscal year 2008 audit report date of January 9, 2009. A basic standard required as part of a governmental audit is that audited financial statements or other audited financial information must either agree or reconcile to the underlying accounting records. Because adjustments to the financial records for fiscal year ended June 30, 2008 continued to occur beyond the audit report date, it is difficult to say with certainty that the audited financial statements agreed to the underlying records of SD1.

Without supporting documentation or proper supervisory review and approval of year-end adjustments, errors may occur in the financial records creating inaccurate financial statements.

Prior Period Adjustments

Further, the APA auditors found that necessary prior period adjustments were not made, and as a result, prior year costs were expensed in the incorrect year.

SD1 made an adjustment for fiscal year 2008 to correct storm water grants to cities included in CIP account balances. SD1 reduced CIP account balances by $2.8 million and increased operating expenses by a corresponding amount. Included in the $2.8 million was approximately $162,000 in prior year costs, but no prior period adjustments were made. By not making the correct prior period adjustments, expenses were overstated for fiscal year ending June 30, 2008, thus potentially affecting bond ratings. Those prior year expenditures should have been recorded as adjustments to the year in which the expense was incurred.

As discussed in the 2005 Governmental Accounting, Auditing and Financial Reporting Book (Blue Book) issued by the Government Finance Officers Association, prior period adjustments made to the beginning net assets or fund balance, if applicable, are allowable because these are the net effect of changes resulting from corrections made to the records that affect prior periods.

A fundamental concept of accounting is that of matching. Matching is the process of recording appropriate revenues against the costs incurred to earn those revenues. If costs incurred during a prior period are written off as current year expense, the matching principle is not followed.

Recommendations

We recommend SD1 implement policies that require supervisory approval for any financial statement adjustments and that require documentation be retained to support any adjustments made. Such policies must be followed to ensure proper internal control over the financial records. We also recommend SD1 implement a policy disallowing adjusting journal entries after the audit is complete for the fiscal year under audit, except for prior period adjustments.

We recommend SD1 implement a policy for recording prior period adjustments, those expenditures incurred in previous years that are adjusted in a future period. Prior period adjustments should have supervisory approval before any entry is made.

Finding 8: The SD1 FY 2008 financial audit did not include a finding reporting a material financial adjustment and the lack of a capitalization policy.

The SD1 financial audit for fiscal year ended June 30, 2008 performed by a CPA firm did not include an audit finding in the audit report, although SD1 made a material audit adjustment and lacked a comprehensive capitalization policy.

As a result of recommendations by the CPA firm's auditors that performed SD1's financial statement audit for the fiscal year ending June 30, 2008, SD1's executive staff agreed to make audit adjustments to SD1 financial records for that year in the amount of nearly $2.7 million. The financial auditors reported to the SD1 Board in a separate letter dated January 30, 2009 that a material audit adjustment of approximately $2 million was made to SD1's financial records as a result of audit procedures.

When a financial auditor proposes material adjustments as a result of audit procedures, auditing standards require disclosing the adjustment in the audit findings of the report. SD1's financial auditors informed the APA that the adjustment amount was not considered material to the financial statements and should not have been reported to the Board in the January 30, 2009 letter as a material audit adjustment. Even though, given the capitalization issues surrounding CIP detailed in Finding 6, and the fact the financial auditors also recommended in a letter dated January 9, 2009 that SD1 implement a new comprehensive and definitive capitalization policy, a finding disclosing the adjustment and related capitalization matters should have been included in the audit report for fiscal year ending June 30, 2008.

While establishing materiality is a matter of auditor professional judgment, Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, defines *materiality* as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." In turn, materiality should involve both quantitative and qualitative considerations.

Quantitative factors require the auditor to apply a percentage, usually three to five percent, to a chosen benchmark, revenues or assets, in determining materiality for the financial statement or opinion unit for governmental entities.

Qualitative factors that the auditor may consider relevant to his or her consideration of whether misstatements are material include the following as outlined in auditing standards:

- The potential effect of the misstatement on trends, especially trends in profitability;
- A misstatement that changes a loss into income or vice versa;
- The potential effect of the misstatement on the entity's compliance with loan covenants, other contractual agreements, and regulatory provisions;
- The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions, and conflicts of interest; and
- The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.

By not disclosing in an audit finding what the APA believes is a material audit adjustment due to the percentage of the adjustment to the storm water fund, and the lack of SD1 implementing a comprehensive and definitive capitalization policy, the financial auditors were not in compliance with auditing standards that establish when to include an audit finding.

Recommendations

We recommend that any future financial audit reports issued include audit findings of any material audit adjustments or related matters.

Finding 9: SD1 did not comply with its procurement guidelines when obtaining goods and services.

SD1 contracted for professional engineering services, purchased materials and supplies directly from vendors, and procured services for the construction of a major project without following its own procurement requirements.

In SD1's Procurement Guidelines and Purchasing Procedures (Guidelines), adopted by the Board of Directors on September 25, 2007, SD1 states it "has adopted the Model Procurement Code and is required to follow the bidding requirements set forth in KRS 45A.345-45A.460." The Guidelines govern all SD1 procurement activities. The Guidelines address three categories of purchases:

1. Purchases of Construction of Improvements, Materials, Supplies, Equipment and Non-Professional Services Not Exceeding $20,000;
2. Purchases of Construction of Improvements, Materials, Supplies, Equipment and Non-Professional Services Exceeding the Aggregate Amount of $20,000; and,
3. Purchases of Professional Services.

Purchases or Services Not Exceeding $20,000

Pursuant to KRS 45A.385, "SD1 may use small purchase procedures for any procurement where the aggregate amount does not exceed $20,000." The expense and time involved to publicly advertise for bids and administer a formal bidding process are not justified for such purchases. Guidelines require the most favorable prices and terms to be obtained, consistent with quality and SD1 specifications, by means of competitive bids, estimates, or solicited quotations, where appropriate and practical. Consideration may be given to suppliers within a reasonable proximity as a matter of convenience, provided all other factors of quality, service and price are equal. Emergency purchases not exceeding $20,000 may be made under certain circumstances from vendors that have pre-approved agreements with SD1.

Purchases or Services Exceeding $20,000

Per SD1 Guidelines, the purchase of all construction of improvements, materials, supplies, equipment and non-professional services where the aggregate amount exceeds $20,000 must be publicly advertised for bids, except in certain situations where competition is not feasible and an exception pursuant to KRS 45A.380 exists (e.g. emergency, sole source, replacement parts). All bids received are to be reviewed by staff who will prepare a recommendation to the Board of Directors. The selection of a successful bidder requires approval by the Board of Directors. SD1 must retain all bids, tally sheets, worksheets and criteria used to evaluate the bids in accordance with retention schedules. A contract for goods or services must be issued in writing and signed by the Executive Director or his designee and by the contractor.

Procurement of Professional Services

SD1 Guidelines for the procurement of professional services does not require public advertisement for bids or the formal bidding process, although SD1 guidelines listed below state that SD1 will request formal proposals on larger projects. The Board of Directors is required every four years to request formal proposals for professional services in order to compile a list of qualified pre-approved engineering and geotechnical firms for use on smaller projects.

The selection and engagement of all professional services with expected fees in aggregate exceeding $20,000 requires approval by the Board of Directors. A professional services agreement for such services must be approved by the Board of Directors as well. SD1 may retain outside legal counsel for the sole purpose of preparing and finalizing appropriate professional services agreements. The Executive Director may select and engage professionals for services with expected fees of $20,000 or less.

In procuring engineering services or geotechnical services, SD1 utilizes the following guidelines:

a. For smaller projects involving engineering or geotechnical fees expected to be under $20,000, SD1 typically will utilize firms on a list that is pre-approved by the Board of Directors. Every four years or less, SD1 will compile a list of one or more firms following a formal request for statements of qualification. The firm or firms selected must demonstrate the professional, technical, financial and physical capability to perform the services desired.

b. For mid-size projects involving engineering or geotechnical fees expected to be between $20,000 and $100,000, SD1 will request proposals from firms that have demonstrated the professional, technical, financial and physical capability to perform the services desired. The Board of Directors will approve selected firms.

c. In requesting proposals for engineering or geotechnical services involving fees expected to be in excess of $100,000, SD1 will request formal proposals from interested firms. All proposals received will be reviewed by a selection committee that may include, but is not limited to, staff, consultants, and interested Board members. The selection committee will evaluate the professional, technical, financial and physical capability of the submitting firms to satisfactorily provide the services desired. In requesting formal proposals, it may be required that the proposals be submitted in two separate packets, one containing the technical proposal for providing the services desired and the second containing the price proposal. The requirement of separate packets for the technical proposal and the price proposal is discretionary and may involve competitive negotiation to ensure that SD1 receives the best services at the best price. The selection committee will prepare a recommendation to the Board of Directors for the firm to be selected for the desired professional services.

In its examination of CIP projects that had professional services, the auditors found one project without documentation of formal requests for proposals for engineering services or review by a selection committee, although the engineering services well exceeded the $100,000 threshold stated in the Guidelines above. Although the engineering firm was approved by the Board of Directors, the project listed in Table 11 below had no documentation that proposals were requested or reviewed by a selection committee.

Table 11: Professional Services Procurement Noncompliance

Project Number	Project Name	Professional Services Vendor	Original Contract Amount	Approved by Board of Directors
S580-7	Terraced Reforestation of Interstate Right-of-Way	Riegler Engineering, LLC	$193,900 & Expenses	Yes- June 16, 2009, not to exceed $193,900

Source: Information provided by SD1

Per an SD1 official, SD1 received federal stimulus funds for this project and had a limited timeframe in which to use the funds. Thus, in order to use the funds expediently, SD1 directly contracted with an engineer rather than requesting proposals for engineering services as required by its Guidelines.

Purchase of Pipe

SD1 has a multi-million dollar contract for the Western Regional Conveyance Tunnel construction project. A provision of the contract calls for the contractor to furnish "all labor, services, materials, equipment, plant, temporary facilities, machinery, apparatus, appliances, tools, supplies, incidentals, coordination, supervision, administration and all other things of every kind necessary to perform and complete in a timely and workmanlike manner, all work required for the completion of the Contract . . .." SD1 executed this contract after competitive bidding and in full compliance by SD1 with its procurement Guidelines.

However, an addendum to the bid documents allows SD1 to purchase directly and furnish to the contractor certain "owner-furnished materials" (the "owner" being SD1) to be used in the construction of the project. In accordance with this addendum, SD1 purchased drainage pipe couplings directly from a pipe vendor that the contractor would have used had the contractor purchased the items directly. Bid specifications did not require SD1 procurement guidelines to be followed. The cost of SD1 purchasing this pipe was $156,349, well above the $20,000 small purchase threshold, but it was not procured pursuant to SD1 Guidelines, which includes public advertising for bids. SD1 purchased this pipe directly from the contractor's vendor without going through the competitive bidding requirements for the purchase of materials exceeding $20,000. The pipe vendor was not a sole source, and SD1 did not purchase the items through a state Master Agreement or another political subdivision that were competitively bid at one point.

Additionally, SD1 purchased $228,890 of pipe from the same pipe vendor to substitute on the Western Regional Wastewater Treatment Plant project, another multi-million dollar project. The purchase was not competitively bid resulting in a noncompliance with SD1 procurement Guidelines. Neither of the pipe purchases detailed above was approved by the Board of Directors as required by SD1 Guidelines for purchases exceeding $20,000. The pipe purchased does not appear to be for an emergency, from a sole source vendor, or a replacement part.

Other Material and Supply Purchases

Other expenditures for the Western Regional Conveyance Tunnel construction project, detailed in Table 12 below, also were made without complying with competitive bidding requirements in SD1's procurement Guidelines. None of the purchases listed were approved by the Board of Directors, as required by SD1 Guidelines for purchases exceeding $20,000.

Table 12: Other Materials and Supplies Procurement Noncompliance

Project Number	Vendor	Date	Description	Expenditure Amount
C001	Hammer and Steel	8/1/2009	7,216 H Bearings	$377,974
C001	Hanson	11/1/2009	Pipe and Spigots	$1,215,621
C001	Stupp Bridge Company	11/1/2009	Structured Steel Items	$1,213,200
C001	Fontaine USA	3/9/2011	Penstocks and Hydraulic Items	$63,566

Source: Information provided by SD1

River's Edge Project

The River's Edge/Manhattan Harbour project is a private riverfront development planned for the Ohio River frontage in Dayton, Kentucky by DCI Properties. The development is to include a marina, restaurants, residential units, etc.

The property being developed had an existing 30 inch sewer/storm pipeline that required relocation to prevent issues with SD1 access to the pipeline and also to alleviate concerns with soil compacting over the line after the development was completed. While the need for a larger line was not in the scope of SD1 projects at that time, SD1 saw it as an opportunity to cost-effectively reduce combined sewer overflows. DCI had already contracted for engineering studies of the site and had engaged a local construction company to do the heavy grading, earth works, etc. on the development. After discussions between SD1 and DCI, SD1 decided to allow DCI and DCI's contractor to relocate the sewer/storm line. There was no documentation that the work was competitively bid or that the issue was presented to the Board for its discussion or approval. However, this project was included in annual capital budgets beginning in fiscal year 2008 that were approved by the Board.

SD1 funded its portion of the project, originally estimated at $10.5 million, which included the "upsizing of the line to 84," while DCI bore the ultimate cost equivalent of relocating the existing line estimated to be $4.5 million. Subsequently, SD1 amended the contract to account for a change in the scope of work. This change in scope increased SD1's estimated cost from $10.5 million to $13 million. The decision to increase the line size was not presented to the Board for its discussion or approval and the work was not competitively bid.

SD1 agreed to pay DCI a prorata share of the cost of construction based on completion to date by means of progress payments. DCI contracted with a construction company to perform construction development services such as pipeline installation, grading, earth moving, etc. SD1 procurement Guidelines were not followed for this project. None of the services procured were advertised or competitively bid, nor does any documentation exist that the agreements for this project were approved by the Board of Directors. Such noncompliance may result in SD1 not securing the best price and quality of product or service.

SD1 asserts that discussions of this project were held during SD1 Board "caucus" sessions, but no discussion of the topic was documented in SD1 minutes.

Improved Procurement Guidelines

SD1 officials stated that they are in the process of developing and implementing improved, internal procurement guidelines that better comply with the Model Procurement Code in KRS 45A than its current Guidelines. Implementation and enforcement of such guidelines will serve to ensure that the best and most cost effective selection of products and services are used by SD1.

Recommendations

We recommend that SD1 develop and implement, with Board approval, procurement guidelines that fully comply with the Model Procurement code in KRS 45A.345-45A.460, and KRS 45A.740, 45A,745, and 45A.750. Further, we recommend that SD1, through its Procurement Officer, implement procedures to ensure that SD1 complies with the provisions of its procurement guidelines. Employees responsible for procurement should be trained sufficiently on the guidelines.

We recommend SD1 procurement guidelines for securing professional engineering services are followed for all projects. All proposals received should be reviewed by a selection committee that may include, but is not limited to, staff, consultants, and interested Board members. The selection committee should evaluate the professional, technical, financial and physical capability of the firms and make a recommendation to the Board on its selection.

We recommend all purchases for nonprofessional goods or services where aggregate payments will exceed $20,000 be competitively bid, approved by the Board of Directors, and made through a written contract between SD1 and the vendor. Criteria established for vendor selection should be objective and include information such as the amount bid, qualifications of the vendor, and quality of the product.

We recommend that even if a project is a joint effort with another entity, any engineering and construction services procured through such a joint agreement should comply with SD1 procurement guidelines. All decisions related to the joint agreement should be approved by the Board of Directors and documented in the Board meeting minutes.

Finding 10: Capital project change orders were not always preapproved in writing by staff, nor reviewed by the Board.

Internal controls and procedures related to capital project change orders did not provide proper oversight for increases to project totals. Several change orders for capital projects were not consistently approved in writing by SD1 staff prior to incurring expenses related to the change order. Auditors found no evidence of Board members being informed of project increases through change orders to Board approved project totals, or of the necessity for such increases. Consequently, the expenditures made for professional engineering services on one project reviewed by auditors totaled more than the Board approved amount for engineering services plus change orders.

Change Order Necessity

SD1 bid proposals for engineering and construction services in excess of an aggregate amount of $20,000 are required to be approved by the Board of Directors. As part of the approval process, the dollar amount of the related contract is approved as well. During the annual budget process, SD1 management presents an annual capital construction budget to the Board of Directors for their review and approval. That budget includes a listing of proposed projects for the coming year and an estimate of the cost of those projects. The proposed capital budget is approved by the Board as part of the Board's overall approval of the SD1 annual operating budget.

Once capital projects are initiated, it is not uncommon to require a change in the scope or specification of the project. Deviating from the original plan and the approved cost estimate is commonly referred to as a change order. A change order may or may not include a request for additional funds but should require approval by the appropriate SD1 personnel.

As part of this examination, auditors reviewed eight SD1 capital projects and observed the following issues with change orders associated with three of the eight projects.

Prisoner's Lake CSO Reduction

On the Prisoner's Lake CSO Reduction project, which was to reduce the CSO from Prisoners Lake in Covington and reroute overflows to an irrigation pond, the Board approved payment to the city of Covington for 75 percent of the cost of the project or $347,735. The total amount paid the City of Covington was $420,222. A $95,000 change order was issued by the city of Covington and approved via email by SD1 staff, but no evidence of Board review of that change order was found. The 2011 SD1 capital budget, which was approved by the Board, included an amount in excess of the actual payments to Covington.

I-75 Terraced Reforestation

On the I-75 Terraced Reforestation project, which was to reduce peak storm water runoff and improve water quality in the receiving system, the total amount of the contract for professional engineering services plus the approved change orders was less than the amount SD1 ultimately paid for the engineering services. The approved contract amount plus change orders for the engineering firm's services on the project totaled $255,777. The engineering firm in charge engaged three subcontractors to provide other engineering and design services to the project. The total amount paid the primary engineering firm for all engineering and design services was $255,137. Additionally, $85,000 paid by SD1 for engineering services provided by other engineering firms was reallocated to this project. Thus, the amount paid for engineering services for this project in total was $84,360 more than the Board approved amount for engineering services plus the amount of staff approved engineering change orders for this project.

Western Regional Conveyance Tunnel

On the Western Regional Conveyance Tunnel project, which was to divert flows off SD1's existing system and reduce sanitary sewer overflows and to replace ten pump stations, auditors found all change orders increasing the dollar amount of the project were approved by SD1 personnel, but not until several months after the work necessitating the change order had been completed and invoiced. Contractors risk not getting paid if written approval of the change order is not obtained prior to the purchasing of products or services rendered.

Board Members Not Informed

Documentation did not indicate that the Board was informed of, or ensured the necessity for, project costs that exceeded those amounts originally approved by the Board. Although the Board does not necessarily need to pre-approve change orders, which may be done by SD1 staff, proper internal control does require the Board to be made aware of any change orders increasing the total of a contract and the necessity for the related change to the project. The Board should be fully informed of the reasons for, and the amounts of, all contract costs that exceed those contract amounts originally approved by the Board.

Recommendations

We recommend SD1 management, on a regular basis, provide the Board with information on all projects that are approaching the Board approved amounts including the related change orders and reasons for such increases. We also recommend SD1 review change order policy and procedures to ensure that all requested change orders are approved by SD1 staff prior to the work being done and cost incurred. Acknowledging that an unapproved change order can disrupt and delay project progress, any SD1 policy and procedures should accommodate the need for avoiding costly delays.

Finding 11: SD1 did not consistently comply with requirements to withhold amounts from vendor payments.

SD1 did not consistently withhold the proper percent when paying contractor and vendor invoices as required in the contracts and purchase orders. For its CIP projects, SD1 entered into contracts with primary contractors for the construction of capital projects. Additionally, SD1 purchased products and equipment directly from vendors for the projects. In testing a sample of eight CIP projects, two of the projects were found to include payments for invoices where SD1 did not retain the proper percentage of payment as required by the contract or purchase order.

Western Regional Conveyance Tunnel

The contract between SD1 and the primary contractor for the Western Regional Conveyance Tunnel project required that 10 percent be withheld from payments of invoices until the contractor achieved 50 percent completion of all work. After 50 percent of the work was completed, no percent was to be withheld from invoice payments. SD1 paid multiple invoices to a pipe products company on this project via a purchase order that also stated SD1 would retain 10% from payments. Upon review, SD1 paid the pipe products company monthly invoices from June 2009 through September 2009 totaling $3,865,296 with no amount retained by SD1.

Table 13: Retention Not Withheld

Month	Invoice Total	Payment Made	10% Retention Not Withheld	Actual Payment Due
June 2009	$ 399,162	$ 399,162	$ 39,916	$ 359,246
July 2009	958,551	958,551	95,855	862,696
August 2009	45,705	45,705	4,571	41,134
August 2009	1,119,190	1,119,190	111,919	1,007,271
September 2009	1,342,688	1,342,688	134,269	1,208,419
Total	**$3,865,296**	**$3,865,296**	**$386,530**	**$3,478,766**

Source: APA calculated from information provided by SD1

Western Regional Wastewater Treatment Plant

The contract between SD1 and the primary contractor for the Western Regional Wastewater Treatment Plant project provided that even after 50 percent of the work on the project was complete, SD1 would retain 5 percent of the amount the contractor invoiced SD1. On November 15, 2010, SD1 paid the primary contractor on the project $3,739,556, the total invoice amount, with no percentage retained. Although 67 percent of the work on the project was complete, SD1 was still required to retain 5 percent, or $186,978, of the invoice amount, which it failed to do.

Requirements to retain a percent of the invoiced amount are included in contracts to assure SD1 that the quality of services and products purchased are satisfactory before total payment is made. It allows SD1 to determine that any lingering issues with the product or service are resolved before total payment is made. By not retaining a portion of the invoiced amount, SD1 diminishes its ability to ensure that services and products are delivered and completed in compliance with contract requirements.

Recommendations

We recommend SD1 engineering management review all contract payments and ensure the appropriate percent of any contract payment is withheld as specified by the contract. We further recommend that all invoices be reviewed by the Finance department to determine that an engineer has approved the proper payment amount prior to paying an invoice.

Finding 12: SD1 failed to establish a process to ensure the accuracy of projected rate increases to its customers.

The lack of review and oversight of the model followed by SD1 to project customer rates provided the opportunity for errors to occur in the rate setting process. To project future rate increases, the Director of Finance maintained an Excel spreadsheet financial model, or "Pro Forma," used to capture detailed historical financial activity of SD1. This model also enabled SD1 to input detailed projections of financial data and to conduct "what if" scenarios with various components of the financial data. Those financial projections were the basis for determining SD1's future requirements for operating funds and capital borrowings needed to ensure revenues and capital are sufficient to support daily operations, to service outstanding debt issues, and to maintain the various mandated reserves.

Rate Setting Model

The Pro Forma spreadsheet model is a complex and detailed series of thirteen worksheets that together ultimately provide the rate increases necessary to ensure the ongoing viability of SD1 and the SD1 capital program. The Director of Finance controlled access to the model and was the only person who updated the model with financial data. No process existed for an internal review of the calculations. The Director was also the only person who inputed the pro forma data for projection of rates with no additional internal review performed. In addition, there were no written instructions as to how to update the financial information in the model or on how to operate the model.

In September 2007, SD1 engaged an outside consultant to review SD1's rate structure and to also evaluate rate adjustment impacts on its customers. As part of that review, the consultant reviewed updated financial data used in the model and used the model output to assist with analyzing alternative rate adjustments. The review did not include assessment of the functionality of the model.

Acknowledging the complexity of the rate setting process and the many financial components involved in that process, the spreadsheet model used by SD1 to produce and evaluate rate setting scenarios appears to be a reasonable and well planned model. However, the amount of manual input and the extensive base of knowledge required to effectively maintain and use that model dictates the need for broader financial oversight and review of the model and its outcomes. An error acknowledged by SD1 in the 2008 rate setting calculations discussed in Finding 5 supports the need for additional review.

Proposed Increase Error

In December 2008, the model, updated by the Director of Finance, initially projected rate increases of 25 percent for each of the fiscal years 2010 and 2011. Subsequent to notifying SD1 executive management of the proposed 25 percent rate increases, the Director was notified by the then Controller of significant errors in the model. The Controller was not normally a participant in the updating of the financial information in the model, nor was he involved in using the model to generate proposed rate increases. Those procedures were performed solely by the Director of Finance.

The errors noted by the Controller included the duplication of large amounts of debt and related interest charges. The Director revised the model to eliminate the errors and notified SD1 executive management that the rate increases for 2010 and 2011 would only be 15 percent for each year.

Were it not for the review and input provided by the then Controller, SD1 may have enacted sewer rates 10 percent above the amount necessary to operate SD1, fund its capital program, and meet debt service coverage requirements. Given the complexity of the process, SD1 should make every effort to ensure the integrity and accuracy of rate setting calculations.

Recommendations

We recommend SD1 establish an internal review and oversight process of the rate setting model to include additional financial related expertise as well as operational expertise. While the model is a financial tool, the sources for the financial inputs are derived from both accounting and operational personnel. The Director of Finance and the others involved in the review of the process should document that they have independently reviewed the information and agree to the rate recommended to the Board. Establishing a consistent oversight and review process of the model would also expose other staff to the functionality of the model and provide a degree of backup for those interacting with the model.

We also recommend that SD1 document the procedures followed to update the model as well as the procedures followed to produce the various scenarios or iterations that may be required during any rate setting period. Documenting those procedures of such a critical process is essential and could prove invaluable should someone less familiar with the model be required to operate it.

Finding 13: SD1 provides billing credits to school districts that participate in SD1 sponsored environmental programs.

Schools within the SD1 coverage area can qualify for a 25 percent discount on their storm water surcharge if the SD1 approved Environmental Curriculum is taught in that school. The curriculum developed by SD1 meets the Kentucky Educational Core Content standards for grades 4 and 5. This credit is part of SD1's Credit Policy for non-residential property owners that was approved by the SD1 Board of Directors on April 17, 2003. If a school chooses to discontinue the curriculum, the credit is revoked. The amount of credits given is detailed in Table 14 below. While this program appears to be a commendable service to the communities, and an appropriate method for instilling environmental awareness in the student population, the granting of discounts to participating school districts would seem to result in an inequitable allocation of rate abatement with the cost ultimately borne by the remaining customer base.

Table 14: School Credits

Fiscal Year	Amount of School Credits
2008	$38,759
2009	$39,871
2010	$51,811

Source: Information provided by SD1

Recommendations

Given the impact on the customer base of the ever increasing sewer rates, we recommend SD1 reconsider the practice of providing credits for school districts that participate in environment education awareness programs. We further recommend that SD1 ensure that the public, the County Judges/Executive, and the SD1 Board members are fully aware of any credits provided to customers, as well as the implications and financial impact of such a program. The Board of Directors should be fully aware of each and every credit program administered by SD1 and its value, and determine whether such programs are the best use of public monies.

Finding 14: SD1 expenditures for lobbying, sponsorships, public relations, and employee benefits are questionable uses of public funds.

While evaluating SD1 expenditures, certain expenses for lobbying efforts, public relations, sponsorships, and employee benefits were found that appear to be questionable uses of public funds.

Public Relations

On July 1, 2010, SD1 entered into an agreement with a Northern Kentucky based public relations, corporate communications, and government relations group to provide SD1 services in the area of public and media relations. As part of that one year agreement, the Northern Kentucky group was to develop and implement a plan that would result in at least eight positive news stories about SD1 in local, state, and/or national news media. The agreement required the group to be paid a total of $20,000 for the eight news stories and also provided for a $5,000 bonus to be paid to the group if more than eight positive news stories were placed with news media during the one year term of the agreement.

In addition to the payments provided for public relations, the agreement also called for SD1 to pay the group $150 per hour on an as-needed basis for “Crisis Management Assignments,” “Specific Government Relations Assignments,” and “Special Project Assignments.” This included payments for lobbying efforts.

The agreement was approved by the Board on July 27, 2010, but was not competitively bid. Table 15 details the $100,650 paid to this group in fiscal year 2011.

Table 15: Public Relations/Lobbying Expenditures

Type of Expenditure	Amount Paid
Positive News Media Articles	$20,000
Community/Public Relations	$22,918
Government Relations/Lobbying	$57,732
Total Payment	**$100,650**

Source: Information provided by SD1

The recent public criticism of SD1's rate increases and the questions regarding financial management may represent a challenge to SD1's public image and credibility. As previously stated, SD1 decided to enter into a $20,000, to potentially over $100,000, contract for "at least eight positive news stories about SD1 in local, state, and/or national news media" and public relation/lobbying purposes. According to SD1, during the 2010 session of the General Assembly, the contracted group helped SD1 pass House Bill 540, which requires the Division of Water to consider the ability of rate payers to afford sewer bill increases when it enforces the Clean Water Act. In a time of financial distress imposed on the SD1 customer base by rising sewer rates, it appears that certain contract expenses, including those for positive news stories, are an unnecessary use of public funds.

Sponsorships

SD1 sponsors several Northern Kentucky Chamber of Commerce events. Many of these events are attended by SD1 employees or are events with which SD1 employees may be associated as committee members. The events and the amount of the SD1 sponsorships are detailed in Table 16 below.

Table 16: Sponsorships

Event	Description	2009 Sponsorship Fee	2010 Sponsorship Fee
Legacy	Leadership development program	$500	$ 0
Northern Kentucky United	State legislators gather in Northern Kentucky to discuss regional issues and meet with local political and business leaders	$1,500	$1,500
Washington Fly-in	U.S. Chamber of Commerce event in D.C. to discuss issues and policies affecting the business community	$400	$400
Leadership Northern Kentucky	Provides training to local participants to develop leadership skills and knowledge of regional issues	$500	$ 0
Regional Youth Leadership	Exposes select local high school juniors to local and regional issues and leaders	$400	$ 0
Kentucky Legislative Reception	Special reception for the Northern Kentucky Legislative Caucus	$ 0	$800

Source: Information provided by SD1 and entity websites

The auditors question whether the use of funds for such sponsorships are a necessary use of SD1 public funds.

Employee benefits

As of March 2011, SD1 employed 248 full-time employees. In addition to the normal employee benefits such as vacation, sick pay, insurance, educational assistance, etc., SD1 also provided employees an annual employee family picnic and individual incentive allowances and rewards. Employees also were awarded extra vacation days based on perfect work attendance. The individual incentive awards were described by SD1 as taking an employee to lunch, having a departmental lunch catered, or possibly having a departmental cookout. SD1 indicates that the cost per employee of the annual family picnic was less than $30 per employee. Prior to the Christmas holiday, SD1 provided a $70 gift certificate to each employee.

A review of the SD1 employee benefits account noted charges identified as "Employee Picnic" totaling $4,632, $6,165, and $6,575 for fiscal years 2008, 2009, and 2010, respectively. Charges for "Christmas gift" totaled $14,235, $14,595, and $14,824, for the same years. In addition, "Incentive Pool" and "Incentive Program" charges in the amounts of $23,086, $21,518, and $8,367 were noted for fiscal years 2008, 2009, and 2010. "Employee Recognition Event" charges were $5,239, $2,300, and $2,198 for the same years.

The monetary and non-monetary rewards, such as the Christmas gifts and incentives, and the attendance incentives are admittedly a seemingly effective means for SD1 to recognize and reward employee contributions to SD1's mission and overall success.

Recommendations

Given the examples noted above, we recommend SD1 and the Board review SD1's public relations, lobbying, and sponsorship efforts to ensure that all expenditures are necessary, reasonable, and an appropriate use of public funds. We also recommend that SD1 and the Board review SD1's extended employee benefits to insure that the incentive programs, Christmas gifts, and attendance rewards are all necessary and fiscally responsible expenditures.

SANITATION DISTRICT 1 RESPONSE

August 1, 2011

The Honorable Crit Luallen
Auditor of Public Accounts
Commonwealth of Kentucky
209 St. Clair Street
Frankfort, KY 40601-1817

RE: Response to Examination Report

Dear Ms. Luallen:

On behalf of the Board of Directors (Board) for Sanitation District No. 1 (SD1), I would like to thank you for this opportunity to respond to the Auditor of Public Accounts' (APA) report of the "Examination of Certain Policies, Procedures, Controls, and Financial Activity of Sanitation District No. 1." We also appreciate the professionalism your staff exhibited through this process. After reviewing the report, the Board remains fully confident in its staff and supports their continued efforts to be the innovative leaders needed to meet SD1's current challenges.

The APA set forth in its report that the purpose of this examination was to ensure that processes, policies, and procedures were in place to provide strong oversight of financial activity, and the Board is pleased that the APA found that the overall policies, procedures, and practices of SD1 "generally provide an effective structure for the oversight and processes that govern the operations of the organization." As you and your staff likely learned through your review of SD1, operating a large sanitary and storm water utility in the present day can be a challenging endeavor. Strict environmental regulations imposed by U.S. EPA and the Kentucky Division of Water and the need to maintain aging infrastructure, as well as drastic reductions in federal funding, have required utilities across the country to increasingly rely on ratepayers for financial support.

Utility fee increases have become necessary to fund the required improvements for a utility to maintain compliance with applicable regulations. The Board and staff of SD1 recognize the realities that affect ratepayers' abilities to afford their utility bills. The APA report accurately reflects the incredibly difficult challenge SD1 faces in keeping rates affordable while having to fund debt service payments, operation and maintenance costs, and the capital costs of projects that are an obligation of the Consent Decree with U.S. EPA and the Kentucky Division of Water. SD1 has diligently pursued new and

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innovative business strategies and implemented numerous staff-driven cost saving opportunities in order to reduce the financial burden placed on our customers. As noted in the report, SD1's sewer rates are below the average of the compared metropolitan areas. The Board values the APA's acknowledgement that SD1 was in compliance with the rate setting requirements of KRS 220 regarding Board approvals and public notices and that SD1 has adopted rate setting guidelines that have expanded the opportunity for public discussion and comment.

The APA also found that SD1's records retention policies are "in compliance with [the Kentucky Department for Libraries and Archives] KDLA-approved Local Government Retention Schedule requirements." SD1 is proud of its management of records, and the Board is pleased to have this additional validation of the records management program.

With regard to the "32 Recommendations for Public and Nonprofit Boards," we understand that these were used as a tool for examining SD1; however, the Board feels it is important to note that the recommendations were not specifically created for SD1 and do not reflect its statutory obligations. We also question the applicability of certain recommendations to a sanitary and storm water utility such as SD1. While the Board fully respects the opinions expressed by the APA in this report, it is our duty to review all recommendations and implement those changes that serve the best interests of SD1 ratepayers. The Board respectfully disagrees with a number of the statements in the audit findings and wishes to provide additional information not reflected in the APA report. Detailed below are the Board's responses to certain findings and recommendations.

Finding 1

The APA recommends that the Board strengthen its policies to include several responsibilities necessary for proper and effective oversight of SD1. While the Board will definitely give the APA's recommendations due consideration and attention, the APA points to no examples where the Board has failed to meet its statutory obligations. The Board feels that it is fully and effectively carrying out its oversight duties and responsibilities. While we recognize there are areas that could be improved, it is not a matter of proper versus improper, and the APA seems to overstate its recommendations in that regard.

As part of the Board's oversight, an Audit Committee was appointed in March 2011. The committee will review the APA's recommendations and report back to the entire Board with its recommendations on areas of improvement.

The APA recommends that the Board create an independent process whereby employees and/or customers have the option to directly make the Board aware of concerns that require Board oversight and have a process to analyze, investigate and resolve issues brought to its attention. The Board currently relies on executive management to bring such issues to them. However, the Board wants to ensure that a clear process is in place so employees and customers will feel comfortable bringing issues directly to the Board. Thus, staff is already working on a new policy for the Board's review and approval in order to implement this recommendation.

The APA recommends that the Board provide annual orientation training for new and returning Board members to ensure the members have a clear understanding of the purpose of SD1, the organizational structure, the policies, and their legal and fiduciary roles and responsibilities. It further recommends that this all be included in a written manual. The Board currently has an orientation process that includes a manual. The President of the Board and key staff have begun attending orientation sessions for new members.

The Board recognizes the importance of making its new members aware of all areas identified by the APA when they begin their terms on the Board. Contrary to the APA's assertions, Board members are confident in their ability "to effectively perform" their duties and feel no reluctance to "ask pertinent questions" or "enter into discussions." The Board will reexamine the orientation process and manual in light of the APA recommendation and determine if there are changes to be made. Once the Board finalizes the specifics of its orientation program, the Board members will document their participation to evidence their commitment to continued education.

The APA makes recommendations regarding approval of salaries of executive staff and executive staff travel. The Board does approve the contract and salary of the Executive Director and has delegated approval of other executive staff salaries and travel to the Executive Director. The Board will consider the recommendations.

Finding 2

The APA found that certain SD1 policies were not documented or sufficient to ensure accountability. It is worth noting that the formal documentation of any policy does not necessarily ensure that the associated processes and procedures are followed. Effective implementation of any policy requires a combination of capable, ethical staff and management. The Board agrees that SD1 can improve by creating and strengthening written policies and procedures regarding the use of credit cards, reimbursements to employees, electronic backup of financial information, and fixed asset inventory; however, the report did not sufficiently address the fact that SD1 has procedures that provide oversight and control of these matters. The procedures currently in place are as follows:

- ***Credit Cards and Reimbursement to Employees*** – All credit card purchases or reimbursements require receipts and the approval of the Executive Director or the appropriate departmental directors. Credit card charges and reimbursements made on behalf of executive management are approved by the Executive Director. All employees are expected to get approval prior to making the purchase, except in very rare emergency situations.

- ***Electronic Backup of Financial Information*** – SD1 backs up all financial information in its databases and electronic file shares as part of its daily backup routine. To ensure that all information created in the course of SD1 business is secure and backed up, SD1's Information Technology Acceptable Use Policy requires employees to save all data and information to servers designated for storing files and prohibits data and information to be stored on local PCs, laptops, or locally attached storage locations. Employees that do not comply with this policy are subject to disciplinary action.

- ***Fixed Asset Inventory*** – The accounting department maintains a listing of SD1's inventory of fixed assets, which is updated periodically to account for new acquisitions or disposals. SD1 conducts periodic inventory or physical accounting of its vehicles and construction equipment, but this is an area that staff, prior to this examination, had already identified as an area that can be improved. Staff has been in the process of evaluating its options on how best to improve this process, as it will require a significant amount of additional labor and other resources to adequately address.

Finding 3

Throughout the report, the APA makes numerous references to items that are not included in the Board's minutes. It cites KRS 61.835 of the Kentucky Open Meetings Act and the Office of the Attorney General (OAG) Opinion No. 81-387 to support their recommendation to record in the minutes all discussions and actions taken during the caucus meetings.

Pursuant to KRS 61.835, the minutes recorded at every public meeting must set forth an accurate record of votes and actions taken. OAG 81-387 clarifies that "there is no statute prescribing the necessary contents of the minutes of a public body except the provision of KRS 61.835 that the minutes shall set forth an accurate record of votes and actions at such meetings." In conclusion, the Attorney General held "minutes of a meeting, open or closed, are not required to show any more than the formal action taken and the votes cast by the members. It is not required to summarize the discussion or record what any of the members said."

Although the Board takes no action during the caucus meetings, the meetings are open to the public in accordance with the Kentucky Open Meetings Act. SD1 keeps record of the following for each caucus meeting:

- Date
- Start and end times
- Participants
- Agenda
- Presenters
- Handouts/PowerPoints

Thus, SD1 is currently exceeding the legal requirements for keeping minutes.

The APA also recommends that SD1 record the nature of the financial review conducted by the Board in the minutes. The minutes currently reference the Board's approval of the financial report but do not outline the documents that are reviewed and approved. Each month, the Board is provided a packet of information the week prior to the Board meeting. The packet contains, among other things, a narrative financial summary, a balance sheet, a cash flow statement, a statement of net assets (income statement), a listing of revenues for the period and year-to-date (YTD), a listing of operating expenses for the period and YTD, a listing of capital projects, and a listing of fixed assets. The Board will begin identifying these documents as part of their financial report approval in the official minutes.

Finding 4

The APA states that SD1's Ethics Policy is not comprehensive, and it makes a number of recommendations on revisions to the policy. SD1's Board-approved Ethics Policy states that "an actual or potential conflict of interest exists when a Board member or SD1 employee is in a position to influence a decision that may result in personal financial gain for that Board member or employee or for an immediate family member as a result of SD1's business dealings."

Pursuant to SD1's current policy, Board members, Executives, Directors, the Purchasing Manager, and other members of the Purchasing Department, including Purchasing Liaisons within each department, must complete a Conflict of Interest Disclosure Form annually. Should a Board member or employee have a personal financial interest or a financial interest in any agency, company, or entity that receives or stands to receive financial or other material benefits from performing services for SD1, the Board member or employee must disclose that interest to the Executive Director. The policy contains the following safeguards to protect against actual or potential conflicts of interest:

- Board members shall recuse themselves from discussions and votes where they have, appear to have, or believe they have a conflict of interest that would prevent them from acting in the best interests of SD1.

- Should any employee have, appear to have, or believe they have a conflict of interest that would prevent them from acting in the best interest of SD1, that employee shall disclose that interest to the Director of Human Resources, the Executive Director or the General Counsel. The conflict of interest will be reviewed by the Executive Management Team or by the President of the Board of Directors if the employee is part of the Executive Management Team, and a determination will be made if a conflict exists and if it is appropriate to either remove the employee from the decision-making process or to prohibit the transaction with the outside entity with which the conflict of interest exists.

The Board is not aware of any situation where one of its members did not recuse themselves from discussions and votes where they had, appear to have had, or believed they had a conflict of interest. Thus, the Board fundamentally disagrees with the APA that the transactions cited in their report amounted to conflicts of interest.

The Board is well aware of and fully embraces the need to ensure that SD1 maintains the highest standards of conduct, integrity, ethics, and objectivity in its operations. The Board and executive management consistently set the tone from the top regarding ethical expectations. The Board believes strict adherence to and enforcement of the current policy provides the necessary framework to maintain and uphold a culture of openness, trust and integrity. However, the Board will consider the recommendations of the APA when making future revisions to the policy.

Finding 5

SD1 is required to have an annual independent financial audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the Government Auditing Standards, issued annually by the Comptroller General of the United States. Without exception, SD1 has received an "unqualified opinion" on all of its financial statements, which is the most favorable opinion an audit firm can render. These opinions have come from multiple independent CPA Firms. Furthermore, independent auditors annually review internal accounting and compliance controls. There were "no findings of any deficiencies" in internal controls the independent auditors considered to be material weaknesses during any of the three years reviewed by the APA.

The APA report referenced "several instances of accounting errors and of apparent lax accounting controls noted that suggest SD1 should review and strengthen accounting controls and oversight." These instances involve three errors that occurred prior to the conclusion of fiscal year 2009; no subsequent accounting errors were identified. More information on each is as follows:

- ***Errors Allocating Labor Costs*** - Identified by the APA was a formula error in a spreadsheet created and used by a former Controller of SD1. The error imbedded in the spreadsheet, used from December of 2005 through November of 2008, calculated the rate-of-pay of overtime work incorrectly, essentially overstating the amount of overtime dollars to be allocated to capital projects. Subsequent to a former Controller leaving SD1, the error was identified by a staff accountant and corrected in the spreadsheet at the end of 2009.

  To correct the overstatement, SD1 has been working with its independent auditors to make the necessary prior period adjustments and current year adjustments as we close the fiscal year.

  Furthermore, SD1 has added additional controls and oversight by changing its procedures in Fiscal Year 2009 for allocating internal labor for capital projects to include the uploading of the labor into our accounting software, in which the calculation now occurs. A revised version of the spreadsheet is also used, and the results from the spreadsheets and accounting system are compared. In addition, the process receives oversight by the Accounting Manager and a staff accountant as an additional control.

- ***No Supporting Documentation, Approval, or Prior Period Adjustments*** – SD1's staff was unable to provide the APA with a complete listing of documentation and details to support the adjusting entries, because a former Controller did not maintain the necessary documentation when he made these entries while working with SD1's independent auditing firm for the fiscal year-end June 30, 2008. A former Controller made these entries to the general ledger within the scope of his role and responsibilities in the closing of the fiscal year. Some of the data has been recovered and/or recreated through emails and other information retained by the independent auditors who conducted the review of fiscal year 2008.

  Although the APA noted this one instance, SD1's independent auditors have not offered any indication of a ". . . serious lack of proper accounting system controls," as was stated in the APA report.

- ***Rate Setting Model Error*** - The APA report states the rate-setting model used in preparation for a presentation to the Board for approval the following day contained an error. SD1 acknowledges there was an error in the model; however, it was identified and corrected prior to the results being used for the Board review and approval. An internal review identified a potential duplication error of a debt-service line item. The question led to the error confirmation and correction prior to its official use.

  The rate-setting model has subsequently been enhanced and improved with more redundancies to lessen the potential for a material error. SD1 acknowledges that further strengthening of the controls for this model will continue. More on this process may be found in the response to Finding 12.

- ***Engineering vs. Accounting*** – The APA report claims project engineers have significant influence in determining whether project costs should be capitalized or expensed. Due to the complexity of capital projects, engineers are an essential part of the process, but no inappropriate influence by the engineers exists on accounting decisions when closing projects.

  SD1 conducts tri-annual meetings that include accounting and engineering staff to discuss the status of ongoing capital projects. These meetings are led by the accountants and are designed to obtain the necessary information for the accounting staff to make the appropriate decisions on cost allocations associated with projects that have been completed. In addition to the cost of the projects, it is necessary for the accounting staff to fully understand whether the project is new or is replacing an existing asset. The accounting staff is better able to properly reallocate all costs associated with various capital projects based on the information discussed at these meetings.

Finding 6

The APA report states that specific charges in the account balances for capital improvement projects (CIP) raised several questions as to whether the treatment of those costs were appropriate and accurate. The APA submitted in its report that their work included a review of the SD1 capitalization policies and inquiries of the Governmental Accounting Standards Board (GASB) and SD1's independent auditing firm, as well as other CPA firms with experience in municipal utility operations regarding capitalization policies and procedures.

SD1 concurs with the APA's statement that "available regulatory guidance is rather general and affords basic and general guidelines as to what may qualify for capitalization." The APA further states ". . . some expenses considered for capitalization may undoubtedly fall into a 'gray' area that is subjective and subject to professional judgment" and "that in some areas, subjective decisions regarding capitalization were a necessity."

SD1 accounting staff has been reviewing and updating its capitalization policies over the past three years. This process began in 2008 when SD1 staff began reviewing updated guidelines from GASB regarding capitalization of expenses. Staff met with the incoming external independent audit firm to seek input and guidance on properly identifying capitalized expenses. In addition, staff sought input from GASB, the Government Finance Officers Association (GFOA), and its prior external independent audit firm.

Despite the admitted subjectivity, the APA questioned the propriety of charges in six areas:

- ***Legal Expense for Litigation and Prevailing Wage Determination*** – The APA identified legal expenses in the CIP balances for the Rivers Edge Project. The project is being closed effective June 30, 2011. Under its revised Capitalization Policy, SD1 acknowledges that legal costs which do not fully meet the requirements should not be capitalized as ancillary costs necessary for the construction of the asset. SD1 intends to expense the identified legal cost, and it will not become part of the amount that is capitalized for the project.

  The APA also identified legal expenses in the CIP balances for the Western Regional Conveyance Tunnel Project. This project is ongoing and will not be closed for at least another year. SD1 intends to review the legal costs in the current year to determine if they meet the requirements to be capitalized. Legal costs determined not to meet SD1's Capitalization Policy will not become part of the amount that is capitalized for the project.

- ***Labor Cost and Capitalized Interest Allocated to Complete Projects*** – The APA identified labor and contractor costs associated with the Rivers Edge Project, a project that was substantially complete as of June 8, 2010. By definition, a substantially complete project is one that is functioning but for which additional work is required to complete the project. As such, labor and contractor costs continued past the date the asset was placed into service, and interest will continue to be capitalized until the close of the project. SD1 will review and reallocate all associated costs in CIP for the project at the official close of the project.

- ***Project Expenses Held in CIP Beyond Year End*** – The APA identified costs associated with the Prisoner's Lake Project, a project that was developed in partnership with the City of Covington, that were held in CIP and that SD1 intended to expense at the conclusion of the project. This stimulus-funded project was very unique for SD1 and we agree with the APA's recommendation.

- ***Questionable Project Expenditures*** – In reviewing the detail of various projects, the APA commented that the dollar value and frequency of these observed types of purchases were insignificant to the total project expenditures. Further, the APA states that even if those charges were deemed to be properly chargeable to the project, the capitalization of such charges, as being a project with a 30 to 50-year useful life, would seem inappropriate given their "significantly shorter useful life." SD1 agrees with the APA's comments that, even if those charges were deemed to be properly chargeable to the project, the purchases may be better handled as single fixed asset purchases with a significantly shorter useful life, or as expensed items.

- ***Flow and Rain Monitoring Services*** – The APA report questioned the decision to capitalize the Flow and Rain Monitoring Services Project. Prior to the capitalization, SD1 accounting staff reviewed allocation options with an independent auditing firm and reviewed the handling of this type of project by other sewer utilities. SD1, through this process, determined that the cost associated was necessary for the development of a model to be used for capital projects. The depreciable life of this model is three years.

- ***Project Engineers have Significant Influence*** – See the response to Finding 5. The APA made note that the decision to capitalize an expenditure rather than record an expense can be a very subjective decision. Given that, SD1 questions the APA's comment that erroneous and non-compliant accounting entries affected the integrity and accuracy of the financial statements. No direct reference was made to the violation of Generally Accepted Accounting Principles (GAAP) or regulatory guidance.

As stated earlier, SD1 is required to have an annual independent financial audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the Government Auditing Standards, issued by the Comptroller General of the United States annually. Without exception SD1 has received an "unqualified opinion," the highest opinion given, on the financial statements of SD1. These opinions include a review of the costs of "construction in progress" and have come from multiple independent CPA firms over the years.

Finding 7

The APA reports that during the fiscal year ending June 30, 2008, SD1's CPA financial auditors initially stated that $21.7 million of SD1 expenditures in CIP account balances should have been classified originally as operating and maintenance expenses. As the APA previously acknowledged, capitalization may fall into a "gray" area that is subjective. In addition, the APA indicated that "available regulatory guidance is rather general and affords basic and general guidelines as to what may qualify for capitalization." Knowing an adjustment of $21.7 million would have required a significant and immediate increase in the rate charged for sanitary sewer service and other fees to meet its bond coverage requirements, SD1 felt it needed to perform the necessary due diligence before implementing such a significant adjustment. SD1 management asked the CPA financial auditors to provide a thorough rationale to ensure the proposed adjustment was justified and warranted." After taking further independent review, the CPA financial auditors determined that certain expenditures in CIP were appropriate and reduced their recommendation to $2.7 million to be removed from CIP and expensed.

This recommended adjustment of $2.7 million was made for the fiscal year ending June 30, 2008 by SD1's former Controller within the scope of his role and responsibilities in the closing of the fiscal year. SD1 requires that journal entries in the accounting system have the proper documentation and approvals kept on file.

Though SD1 agrees that no supervisory review or approval of the adjustments were made, SD1 management was aware of these entries through its discussions with the CPA financial auditors. Upon completion of the fiscal year ending June 30, 2008, SD1 received an "unqualified opinion" by the CPA financial auditors.

In addition, the APA found that prior period adjustments of approximately $162,000 were not made for the fiscal year ending June 30, 2008. During the close of the fiscal year, prior period adjustments were not requested or suggested by the independent CPA financial auditors. Though SD1 followed the guidance of its independent CPA financial auditors at the time, SD1 understands and appreciates the recommendations made by APA in the report.

Finding 8
A response to this finding is being provided by SD1's current independent CPA firm in a separate letter to the APA.

Finding 9
We agree that some revisions to SD1's procurement policy may be necessary to better reflect the flexibility in procurement that is sometimes necessary to maximize the ability to save ratepayer dollars. The three examples cited in Finding 9 were not undertaken with intent to circumvent procurement policies, but rather because each represented a unique opportunity for SD1 to realize cost savings through the design and construction of capital projects that are critical elements of its long-term plans for improved wastewater management. Specifically, SD1's ability to quickly develop engineering plans for the Terraced Reforestation project in 2009 allowed for the use of federal stimulus funds to support its design and construction (Kentucky's federal stimulus program was based on a 52.1% principal forgiveness loan structure). SD1's decision to directly purchase over $25 million in materials for the Western Regional Conveyance Tunnel project (as opposed to the traditional contractor purchase approach) provided cost savings by leveraging its tax exempt status. The River's Edge project provided an opportunity to cost-effectively construct improvements to the sewer system in Dayton through a joint effort with a mixed-use development project, which reduced annual combined sewer overflow volume by 56 million gallons.

The Board will take the APA's recommendations under advisement regarding revised procurement policies. In order to fulfill its responsibilities in the most efficient and cost-effective manner possible, SD1 will continue to identify and utilize innovative approaches that comply with procurement requirements when acquiring goods and services.

Finding 10
SD1 is currently implementing a large-scale capital improvement program that requires the design and construction of many sanitary and storm water improvement projects throughout Northern Kentucky. A majority of these projects provide sewer overflow reduction or water quality improvements to receiving streams, which are the primary requirements of SD1's Consent Decree. In order to make the best use of time at its monthly meetings, the Board has directed staff to manage the review and approval of contract change orders. The primary concern of the Board has been ensuring that projects are completed within the limits of their corresponding budgets, which are approved each year.

We will consider the APA's recommendation that more detailed information regarding change orders be presented to the Board on a routine basis. Any policy changes developed to address this recommendation will balance the value of direct Board involvement in change orders with the amount of time the Board would have to spend on a function that we believe is being properly performed by SD1 staff.

Finding 11

SD1 strives to develop and manage its contracts based on the application of procedures and policies that ensure a competitive bidding environment while also treating its vendors fairly. Based on our success in consistently obtaining competitive pricing and on our relatively low number of contract disputes with vendors, we believe we have been successful in achieving this goal. While we do not dispute the facts cited in Finding 11, it should be noted there were other factors related to the first example (pipe products company retainage) that we believe justified the staff's decision to modify the retainage requirements for that particular vendor. The second example (primary contract for Western Regional Wastewater Treatment Plant retainage) stemmed from the inconsistent use of contract language between the bidding documents and the final agreement. As such, both examples represent unique circumstances that are not generally representative of all SD1 contracts. We will take under advisement the APA's recommendation regarding the Finance Department's expanded role in the review and approval of invoices.

Finding 12

SD1 has used the Pro Forma model for over eight years in its rate-setting process. The model was originally developed by a very knowledgeable third party consultant and has been revised, improved upon, and updated every year since. The Pro Forma and its results are reviewed by SD1's financial advisors and rating agencies when the credit rating is established or reaffirmed prior to the selling or refunding of revenue bonds. During the time the model has been in place, no outside review has indicated that a material error existed.

SD1 concurs with the APA's recognition that "the spreadsheet model used by SD1 to produce and evaluate rate-setting scenarios appears to be a reasonable and well-planned model." SD1 appreciates the APA's understanding of the model complexity and agrees that effective maintenance and oversight is required by its accounting staff.

The APA report states that the Pro Forma spreadsheet model is a complex and detailed series of worksheets. The report also states there was a lack of review and oversight of the model that provided the opportunity for errors to occur in the rate-setting process. During the course of its review the APA found only one error, which it agrees was discovered and corrected prior to the model's results being used in the rate-setting process in December 2008. The error found was that the model initially projected rate increases of 25 percent for each of the fiscal years 2010 and 2011. This increase was presented to SD1 management in an initial presentation. Prior to final acceptance, the SD1 Director of Finance requested a former Controller to provide an independent review of the model data. During this review, the Controller identified a potential duplication error of a debt-service line item. In response to this finding, the Director of Finance updated the model and revised the rate increase projections to 15 percent for the two-year period. This updated projection was then presented to the Board prior to their discussion and decision regarding a rate increase.

SD1 agrees with the APA's conclusion, and that is why SD1 makes every effort to ensure the accuracy of the rate-setting calculations. These efforts include routine independent review by internal SD1 accounting staff and external review by the SD1 financial advisors and rating agencies.

Finding 13

When developing SD1's Environmental Unit, it took many hours of working with a teacher focus group to fine-tune a program that would be successful in the community. SD1 defines a successful education program as one that not only addresses the requirements our utility and schools must meet, but also one that attracts and retains participation. The APA report recommends that SD1 "reconsider the practice of providing credits for school districts that participate in environmental education awareness programs." With the heavy burden on teachers to meet Kentucky Core Content standards, as well as budget-cuts in schools, the credit program is essential to retaining participation. Based on conversations with teachers, SD1 knows that without the credit program, many schools would be forced to drop the Environmental Unit. Without school participation in this program, SD1 runs the risk of not being in compliance with public education and outreach permit requirements outlined in the Phase II Storm Water Management Plan.

Finding 14

The APA report states that SD1 entered into an agreement in fiscal year 2011 with a corporate communications group to provide SD1 services in the area of public and media relations. It is a standard practice for sanitary and storm water utilities to work with outside consultants in these areas. Moreover, SD1's Consent Decree and KPDES storm water permit specifically require public education and participation.

The report states that, "the group be paid $20,000 for eight news stories...during the one year term of agreement." While a portion of the contract was to be used for the purpose of sharing news about positive initiatives being spearheaded by SD1, this contract amount also covered the cost for the consultant to serve as SD1's main contact with the media and write and place all media releases. In addition, the contract provided for monitoring of legislative bodies and executive agencies in an effort to keep SD1 informed of any legislative bills that could potentially affect our operations. By working with this media consultant, SD1 was able to implement a well-rounded communication plan. This plan allowed SD1 to share news about positive initiatives, convey complicated topics to a broad audience, and respond to media requests. Being a partner with 33 local governments and having a customer base of over 100,000 accounts, it is imperative that SD1 be able to communicate effectively with these audiences. The consultant helped accomplish this challenging task.

SD1 also worked closely with this media consultant to conduct a communication assessment of our organization. The communication assessment was conducted after the Board instructed its Executive Director to improve the organization's communication efforts. The Board recognized that it was important for ratepayers to be well informed about many topics, including SD1's Consent Decree, its financial obligations, the value

of regional storm water management, and what SD1 was doing to save ratepayers money. The primary objective of the assessment was to examine SD1's past communications practices – what worked, what did not work, and what needed to be improved. Most importantly, the assessment defined how SD1 could better communicate with its audiences, such as ratepayers and elected officials.
In addition, this media consultant was uniquely qualified to assist with our government relations and lobbying efforts. As a result of their services, SD1 helped pass HB504 into law during the 2010 General Assembly. This innovative law – the first of its kind in the country – requires the Kentucky Division of Water to consider the ability of ratepayers to afford sewer rate increases when enforcing the Clean Water Act. This law is now being used as model legislation in other states around the country. Passage of this law required a coordinated effort with several cities, sewer districts, and legislators in Kentucky. SD1 could not have accomplished this task without the advice, expertise, and assistance of this media consultant. Therefore, SD1 believes the expense for this communication consultant during a two year period was a very beneficial use of ratepayer dollars.

The Board thanks you and your staff for your efforts in conducting this examination, and we appreciate the professionalism of your office in handling this matter. Please let us know if you have any additional questions or would like more supporting information.

Sincerely,

C.H. Heilman

Chuck Heilman
Board President

Cc: Brian Lykins, Executive Director, Office of Technology and Special Audits
SD1 Board Members
SD1 Executive Management

<u>AUDITOR'S REPLY TO EXAMINATION RESPONSE FROM SANITATION DISTRICT 1</u>

The auditors appreciate the cooperation and professionalism of the SD1 management and staff during the course of this examination. The following are Auditor's replies to certain issues raised in the SD1 response to the examination report:

Finding 1: Governance policies for the Board of Directors did not address several critical responsibilities necessary for proper and effective oversight.

The SD1 response to the auditor's Finding 1 included the statement, "[w]hile we recognize there are areas that could be improved, it is not a matter of proper versus improper, and the APA seems to overstate its recommendations in that regard."

Auditor's Reply: The recommendations for this finding offer specific opportunities to improve Board policies that will assist Board members in gaining a thorough understanding of their legal and fiduciary responsibilities, as well as insight into the organizational structure and operation of SD1. To that end, we do not believe the recommendations to be overstated.

Finding 4: SD1 ethics policies for Board members and employees were not comprehensive.

The SD1 response to Finding 4 included the following statements, "[t]he Board is not aware of any situation where one of its members did not recuse themselves from discussions and votes where they had, appear to have had, or believed they had a conflict of interest. Thus, the Board fundamentally disagrees with the APA that the transactions cited in their report amounted to conflicts of interest."

Auditor's Reply: Auditors reviewed Board meeting minutes to determine whether a Board member cited a potential conflict of interest involving a Board action. The Board meeting minutes did not document whether a Board member abstention from discussions or voting were due to conflicts of interest.

Finding 5: Accounting controls need strengthening.

The SD1 response to Finding 5 included the following: "Errors Allocating Labor Costs – Identified by the APA was a formula error in a spreadsheet created and used by a former Controller of SD1. The error imbedded in the spreadsheet, used from December of 2005 through November of 2008, calculated the rate-of-pay of overtime work incorrectly, essentially overstating the amount of overtime dollars to be allocated to capital projects. Subsequent to a former Controller leaving SD1, the error was identified by a staff accountant and corrected in the spreadsheet at the end of 2009."

Auditor's Reply: As stated in the SD1 response, the formula used from December 2005 through November 2008, "calculated the rate-of-pay of overtime work incorrectly, essentially overstating the amount of overtime dollars to be allocated to capital projects." Had there been sufficient oversight, review, and understanding of the labor allocation the error should have been identified and corrected long before the three-year period the error occurred.

The SD1 response to Finding 5 also stated: "No Supporting Documentation, Approval, or Prior Period Adjustments – SD1's staff was unable to provide the APA with a complete listing of documentation and details to support the adjusting entries, because a former Controller did not maintain the necessary documentation when he made these entries while working with SD1's independent auditing firm for the fiscal year-end June 30, 2008. A former Controller made these entries to the general ledger within the scope of his role and responsibilities in the closing of the fiscal year. Some of the data has been recovered and/or recreated through emails and other information retained by the independent auditors who conducted the review of fiscal year 2008."

Auditor's Reply: The SD1 response states that "[a] former Controller made these entries to the general ledger within the scope of his responsibilities in the closing of the fiscal year." It is weak internal control to allow unapproved and undocumented entries to be made to the general ledger, especially those involving multi-million dollar adjusting entries subsequent to the financial year-end close.

Finding 6: SD1 Construction in Progress accounts included questionable charges.

The SD1 response for Finding 6 includes the following: "Legal Expense for Litigation and Prevailing Wage Determination – The APA identified legal expenses in the CIP balances for the Rivers Edge Project. The project is being closed effective June 30, 2011. Under its revised Capitalization Policy, SD1 acknowledges that legal costs which do not fully meet the requirements should not be capitalized as ancillary costs necessary for the construction of the asset. SD1 intends to expense the identified legal cost, and it will not become part of the amount that is capitalized for the project.

The APA also identified legal expenses in the CIP balances for the Western Regional Conveyance Tunnel Project. This project is ongoing and will not be closed for at least another year. SD1 intends to review the legal costs in the current year to determine if they meet the requirements to be capitalized. Legal costs determined not to meet SD1's Capitalization Policy will not become part of the amount that is capitalized for the project."

Auditor's Reply: We question why legal costs are not readily recorded as legal expenses rather than included in CIP when they are reviewed and approved for payment. Including the amount in CIP and then subsequently determining the amount of legal cost to expense appears to increase the opportunity for legal costs to remain in CIP or to not be expensed in the appropriate period.

Further, the SD1 response to Finding 6 includes: "[a]s stated earlier, SD1 is required to have an annual independent financial audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the Government Auditing Standards, issued by the Comptroller General of the United States annually. Without exception SD1 has received an 'unqualified opinion,' the highest opinion given, on the financial statements of SD1. These opinions include a review of the costs of 'construction in progress' and have come from multiple independent CPA firms over the years."

Auditor's Reply: See Auditor's Reply to CPA firm's response to Finding 8.

Finding 8: The SD1 FY 2008 financial audit did not include a finding reporting a material financial adjustment and the lack of a capitalization policy.

The SD1 response states, "[a] response to this finding is being provided by SD1's current independent CPA firm in a separate letter to the APA."

Auditor's Reply: See Auditor's Reply to CPA firm's response to Finding 8.

Finding 12: SD1 failed to establish a process to ensure the accuracy of projected rate increases to its customers.

The SD1 response to Finding 12 includes: "[t]he APA report states that the Pro Forma spreadsheet model is a complex and detailed series of worksheets. The report also states there was a lack of review and oversight of the model that provided the opportunity for errors to occur in the rate-setting process. During the course of its review the APA found only one error, which it agrees was discovered and corrected prior to the model's results being used in the rate-setting process in December 2008. The error found was that the model initially projected rate increases of 25 percent for each of the fiscal years 2010 and 2011. This increase was presented to SD1 management in an initial presentation. Prior to final acceptance, the SD1 Director of Finance requested a former Controller to provide an independent review of the model data. During this review, the Controller identified a potential duplication error of a debt-service line item. In response to this finding, the Director of Finance updated the model and revised the rate increase projections to 15 percent for the two-year period. This updated projection was then presented to the Board prior to their discussion and decision regarding a rate increase."

Auditor's Reply: Auditors received differing information as to whether, as stated in the SD1 response, the SD1 Director of Finance requested a former controller to provide an independent review of the data model. Without documentation of this request it could not be specifically determined whether the former Controller was asked to review the data model or if he happened to do so at his own initiative.

RESPONSE FROM SANITATION DISTRICT 1
INDEPENDENT AUDITOR, VAN GORDER, WALKER & CO., INC.
TO EXAMINATION REPORT FINDING #8

The CPA firm in performing initial audit planning procedures for what was a new audit client in 2008, the SD1's trial balance, as presented to our firm, was consolidated into one single fund. Our original planning materiality considerations were based upon SAS-107's guidance that the auditor's opinion refers to materiality in the context of the financial statements taken as a whole. We calculated materiality for the SD1, a single opinion unit, based upon the value of the fixed assets of the SD1 per our audit guides. The $2.7 million dollar amount identified in the APA finding was below the SD1's materiality as a single opinion unit. At the request of the SD1's controller, when presenting the financial statements, we separated the Sanitation and the Storm Water accounts to provide a delineation of assets, liabilities, revenues, and expenditures of the different types of accounts. In discussions with the APA, it was these presentations that implied that the two should be treated as separate opinion units and have a separate materiality calculated for each fund type. We do not disagree that separate opinion units should have separate materiality calculations; however it was not the intent of this firm to produce a report with separate opinion units.

The use of the word "material" in the letter to the SD1's Board was an unfortunate choice of words. More accurately, the letter should have disclosed a "significant" adjustment.

As noted in the APA's report, the CPA firm did recommend to SD1's Board in its "management letter", that a revised capitalization policy be adopted. This recommended was approved and implemented by SD1 effective during the subsequent fiscal year.

AUDITOR’S REPLY TO RESPONSE FROM CPA FIRM

The APA appreciates the courtesy extended and professionalism shown to APA staff by the CPA firm during the course of the examination. The APA also appreciates the response provided by the CPA firm. While Statement on Auditing Standards (SAS) 107 is applicable to financial statement audits, as noted in the CPA firm response, it must be applied in the proper context. When issuing an opinion the auditor should determine a materiality level for the financial statements taken as a whole, which, in the context of a governmental audit, means establishing materiality levels by each opinion unit. Governmental financial statements presentation is based on requirements in Governmental Accounting Standards Board (GASB) standards to report separate financial statements or information for various reporting units (opinion units). Major funds, as presented in SD1 financial statements are considered a reporting unit. This change became effective with the implementation of GASB Statement 34 effective in three phases beginning with fiscal year ended June 30, 2002. SD1 issued financial statements that presented two major funds in accordance with GASB 34. The independent auditor's report issued by the CPA firm was intended to provide an opinion on each fund since a reference to each major fund was made in the audit report. Since the $2.7 million dollar amount was an adjustment to the storm water fund (the significantly smaller of the two funds) coupled with the finding to management that a comprehensive capitalization policy be adopted by SD1, it is the opinion of the APA that a finding should have been included in the SD1 audit report for the fiscal year ended June 30, 2008, concerning the audit adjustment and lack of capitalization policy.