

**Financial Statements and Reports of
Independent Certified Public Accountant
Rural Water District No. 7
Nowata County, Oklahoma
December 31, 2012**

**Turner & Associates, PLC
Certified Public Accountants
P.O. Box 378
Vinita, OK 74301
(918) 256-6788**

**Nowata County Rural Water District No. 7
Water District Officials
December 31, 2012**

Board of Directors

Clem Haddox
Brad Keeton
Brandon Kuehn
Glen Mangels
Jim Woody

Chairman
Vice-Chairman
Secretary/Treasurer
Director
Director

Nowata County Rural Water District No. 7
Table of Contents

Independent Auditor's Report	1-2
Report Required by <i>Government Auditing Standards</i> :	
Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with <i>Government Auditing Standards</i>	3-4
Basic Financial Statements:	
Statement of Net Position	5
Statement of Revenues, Expenses and Changes in Net Position	6
Statement of Cash Flows	7-8
Notes to the Financial Statements	9-13
Schedule of Findings and Responses	14-16



INDEPENDENT AUDITOR'S REPORT

Board of Directors
Rural Water District No. 7
Nowata County, Oklahoma

Report on the Financial Statements

We have audited the accompanying financial statements of the business-type activities of the Rural Water District No. 7, Nowata County, Oklahoma, as of and for the year ended December 31, 2012, and the related notes to the financial statements, which collectively comprise the District's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

As discussed in Note I, the financial statements present only the Rural Water District No. 7 and do not purport to, and do not present fairly the financial position of the County of Nowata, Oklahoma, as of December 31, 2012, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the enterprise fund activities of the Rural Water District No. 7, as of December 31, 2012, in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Management has omitted the management's discussion and analysis and budgetary comparison information that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.

TURNER & ASSOCIATES, PLLC

Vinita, Oklahoma
February 19, 2013



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

Board of Directors
Rural Water District No. 7
Nowata County, Oklahoma

We have audited in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the enterprise fund of the Rural Water District No. 7, County of Nowata, Oklahoma, as of and for the year ended December 31, 2012, and the related notes to the financial statements which collectively comprise the Rural Water District No. 7 financial statements, and have issued our report thereon dated February 19, 2013. The Rural Water District No. 7 did not present the Management's Discussion and Analysis and Budgetary Comparison Schedule that accounting principles generally accepted in the United States of America require to supplement, although not to be part of, the basic financial statements.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Rural Water District No. 7 internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Rural Water District No. 7 internal control. Accordingly, we do not express an opinion on the effectiveness of the Rural Water District No. 7 internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying schedule of findings and responses, we identified certain deficiencies in internal control over financial reporting, describe in the accompanying schedule of findings and questioned costs that we consider to be material weaknesses.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies, described in the accompanying schedule of findings and responses to be material weaknesses (2012-1 and 2012-2).

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Rural Water District No. 7 financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Rural Water District No. 7 Response to Findings

The Rural Water District No. 7 response to the findings identified in our audit are described in the accompanying schedule of findings and responses. The Rural Water District No. 7 response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

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

TURNER & Associates, PLLC

Vinita, Oklahoma
February 19, 2013

Nowata County Rural Water District No. 7
Statement of Net Position
December 31, 2012

		(Memo Only)
	<u>December 31, 2012</u>	<u>December 31, 2011</u>
ASSETS		
Current Assets		
Cash and Cash Equivalents	\$ 41,118.36	\$ 19,628.69
Investments	285,208.00	322,122.12
Accounts Receivable	28,770.80	17,856.50
Accrued Interest Receivable	0.00	166.18
Prepaid Insurance	6,682.04	6,658.69
Total Current Assets	<u>361,779.20</u>	<u>366,432.18</u>
Noncurrent Assets		
Capital Assets		
Property, Plant and Equipment, net of Accumulated Depreciation	871,714.67	929,134.21
Other Assets		
Utility Deposits	<u>575.00</u>	<u>575.00</u>
Total Noncurrent Assets	<u>872,289.67</u>	<u>929,709.21</u>
TOTAL ASSETS	1,234,068.87	1,296,141.39
LIABILITIES		
Current Liabilities		
Accounts Payable	<u>24,023.14</u>	<u>17,637.37</u>
NET POSITION		
Investment in Capital Assets	871,714.67	929,134.21
Unrestricted Net Position	<u>338,331.06</u>	<u>349,369.81</u>
TOTAL NET POSITION	<u>\$ 1,210,045.73</u>	<u>\$ 1,278,504.02</u>

The accompanying Notes to the Financial Statements are an integral part of this statement.

Nowata County Rural Water District No. 7
Statement of Revenues, Expenses and Changes in Net Position
For the Year Ended December 31, 2012

	<u>December 31, 2012</u>	(Memo Only) <u>December 31, 2011</u>
Operating Revenues		
Water Revenues	\$ 218,767.06	\$ 203,505.76
Tap Fees	15,000.00	3,750.00
Other Operating Revenues	3,879.09	2,502.08
Total Operating Revenues	<u>237,646.15</u>	<u>209,757.84</u>
Operating Expenses		
Water Purchases	132,349.73	111,048.09
Accounting and Legal	3,000.00	3,500.00
Contract Labor	23,685.00	20,640.00
Depreciation	57,419.54	58,297.16
Dues and Memberships	2,284.14	2,232.30
Insurance	7,775.44	7,608.05
Office Supplies	1,455.76	657.91
Postage	2,083.81	1,824.22
Repairs and Maintenance	7,615.15	9,450.63
Salaries and Wages	42,964.95	40,540.47
Telephone	1,732.39	1,901.76
Travel	14,045.96	12,629.21
Trustee Fees	1,484.94	1,271.55
Utilities	10,063.10	9,188.37
Total Operating Expenses	<u>307,959.91</u>	<u>280,789.72</u>
Operating Income (Loss)	(70,313.76)	(71,031.88)
Non-Operating Revenues (Expenses)		
Interest Income	<u>1,855.47</u>	<u>3,684.09</u>
Change in Net Position	(68,458.29)	(67,347.79)
Net Position, Beginning of Year	1,278,504.02	1,345,851.81
Net Position, End of Year	<u><u>\$ 1,210,045.73</u></u>	<u><u>\$ 1,278,504.02</u></u>

The accompanying Notes to the Financial Statements are an integral part of this statement.

Nowata County Rural Water District No. 7
Statement of Cash Flows
For the Year Ended December 31, 2012

	<u>December 31, 2012</u>	(Memo Only) <u>December 31, 2011</u>
Cash Flows from Operating Activities		
Cash Inflows:		
Payments Received from Customers	\$ 222,852.76	\$ 208,957.30
Other Cash Received	<u>3,879.09</u>	<u>-</u>
Total Cash Provided	<u>226,731.85</u>	<u>208,957.30</u>
Cash Outflows:		
Payments for Salaries and Benefits	66,649.95	61,216.88
Payments to Suppliers for Goods and Services	<u>177,528.00</u>	<u>162,554.63</u>
Total Cash Used	<u>244,177.95</u>	<u>223,771.51</u>
Net Cash Provided (Used) by Operating Activities	<u>(17,446.10)</u>	<u>(14,814.21)</u>
Cash Flows from Capital and Related Financing Activities		
Insurance Settlement	<u>-</u>	<u>2,502.08</u>
Cash Flows from Investing Activities		
Interest Received from Investments	2,021.65	3,992.21
Transfer Investment to Cash	<u>36,914.12</u>	<u>(3,847.38)</u>
Net Cash Provided (Used) for Capital and Related Financing Activities	<u>38,935.77</u>	<u>144.83</u>
Net Cash Inflow (Outflow) from All Activities	21,489.67	(12,167.30)
Cash and Cash Equivalents at Beginning of Year	<u>19,628.69</u>	<u>31,795.99</u>
Cash and Cash Equivalents at End of Year	<u><u>\$ 41,118.36</u></u>	<u><u>\$ 19,628.69</u></u>

The accompanying Notes to the Financial Statements are an integral part of this statement.

Nowata County Rural Water District No. 7
Statement of Cash Flows (Continued)
For the Year Ended December 31, 2012

	<u>December 31, 2012</u>	(Memo Only) <u>December 31, 2011</u>
Reconciliation of Operating Income (Loss) to Net Cash		
Provided by Operating Activities:		
Operating Income (Loss)	\$ (70,313.76)	\$ (71,031.88)
Depreciation	57,419.54	58,297.16
(Increase) Decrease in:		
Accounts Receivable	(10,914.30)	1,701.54
Other Receivables	166.18	-
Prepaid Insurance	(23.35)	(164.24)
Increase (Decrease) in:		
Other Payables	-	(2,502.08)
Accounts Payable	<u>6,385.77</u>	<u>(1,114.71)</u>
Net Cash Provided (Used) by Operating Activities	<u>\$ (17,279.92)</u>	<u>\$ (14,814.21)</u>

The accompanying Notes to the Financial Statements are an integral part of this statement.

Nowata County Rural Water District No. 7
Notes to the Financial Statements
For the Year Ended December 31, 2012

The following notes to the financial statements are an integral part of Rural Water District No. 7's financial statements.

I. Summary of Significant Accounting Policies

Rural Water District No. 7, Nowata County, Oklahoma (the "District") was created under the provisions of Title 82, O.S. 1981, Sections 1324.1-1324.26 inclusive, for the purpose of providing water to the members of the District it serves. Membership in the water district consists of water users who have paid the required membership and connection fees. The District is exempt from federal and state income taxes.

The membership consists of approximately 475 users, each entitled one vote. The Board of Directors consists of 5 members serving one to three-year terms. The vacant Board seats are elected at the annual meeting, and following, the Board of Directors meet and elect a chairman, vice-chairman and secretary/treasurer. All Board members serve without pay.

The accounting policies of the District conform to generally accepted accounting principles applicable to governmental units. The District complies with generally accepted accounting principles and applies all relevant Government Accounting Standards Board (GASB) pronouncements. In addition, the District applies Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements, in which case, GASB prevails. The District has elected not to follow FASB pronouncements issued since that date.

A. Financial Reporting Entity

Rural Water District No. 7 is an independent, self-contained reporting entity with no associated component units. The District's fund is an enterprise fund. Enterprise funds are proprietary funds used to account for business-like activities provided to the general public. These activities are financed primarily by user charges and the measurement of financial activity focuses on net income measurement similar to the private sector.

B. Measurement Focus, Basis of Accounting and Basis of Presentation – Fund Accounting

The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with Generally Accepted Accounting Principles (GAAP) promulgated in the United States of America. The accounting and financial reporting treatment is accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation are included on the statement of net assets. The operating statements present increases (e.g., revenues) and decreases (e.g., expenses) in net total assets. Depreciation expense is provided for capital assets based upon estimated useful lives.

Financial activity is accounted for on the flow of economic resources measurement focus using the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. The District complies with generally accepted accounting principles and applies all relevant Government Accounting Standards Board (GASB) pronouncements. In addition, the District applies Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements, in which case, GASB prevails. The District has elected not to follow FASB pronouncements issued since that date.

**Nowata County Rural Water District No. 7
Notes to the Financial Statements
For the Year Ended December 31, 2012**

I. Summary of Significant Accounting Policies (continued)

B. Measurement Focus, Basis of Accounting and Basis of Presentation – Fund Accounting

Memorandum Only – Total Column

The total column on the financial statements is captioned “Memo Only” to indicate that it is present only to facilitate financial analysis. Data in this column does not present assets and liabilities, revenues collected and expenditures paid in conformity with the statutory basis of accounting. Neither is such data comparable to a consolidation. Inter-fund eliminations have not been made in the aggregation of this data.

C. Assets, Liabilities, and Net Assets

1. Cash and Cash Equivalents

For purposes of the statement of cash flows, the District considers all cash on hand, demand deposits, and highly liquid investments, with an original maturity of three months or less when purchased, to be cash and cash equivalents.

2. Investments

Investments consist of certificates of deposit maturing in the following fiscal year with interest paid quarterly or biannually at varying rates.

3. Fair Value of Financial Instruments

The District’s financial statements include cash and investments. The District’s estimates of the fair value of all financial instruments do not differ materially from the aggregate carrying values of its financial instruments recorded in the accompanying balance sheet. The carrying amount of these financial instruments approximates fair value because of the short maturity of these instruments.

4. Inventory of Supplies and Materials

Inventory is stated at cost using the first-in, first-out method. Inventories, which consist of materials and supplies used for repairs to the system, are recorded under the purchases method where materials and supplies are recorded as an expense immediately when purchased. The District has determined that any materials and supplies on hand at year end are immaterial and have not been recorded as inventory.

5. Accounts Receivable

Accounts receivable consists primarily of charges for water sales. Management considers the amount fully collectible.

6. Prepaid Expenses

Prepaid expenses represent the unexpired premiums on general liability and workman’s compensation insurance policies.

**Nowata County Rural Water District No. 7
Notes to the Financial Statements
For the Year Ended December 31, 2012**

I. Summary of Significant Accounting Policies (continued)

C. Assets, Liabilities, and Net Assets (continued)

7. Capital Assets

The water storage and delivery system and furniture and equipment are recorded at cost. Donated capital assets are reported at estimated fair market value at the date of donation.

The cost of normal maintenance and repairs that do not add to the value of the asset or materially extend asset lives are not capitalized.

All reported capital assets are depreciated on the straight-line basis over the estimated useful lives ranging from five to forty years.

The capitalization amount is \$1,000.

8. Loan Costs

The District capitalizes costs associated with obtaining long-term debt and amortizes such costs over the term of the related debt. Currently the District has no outstanding debt.

9. Equity Classifications

Equity is classified as net assets and displayed in three components:

- a. Invested in capital assets --- Consists of capital assets including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any mortgages, notes, or other borrowings that are attributable to the acquisition, construction or improvement of those assets.
- b. Restricted net position --- Consists of net assets with constraints placed on the use either by (1) external groups such as creditors, grantors, contributors, or laws or regulations of other governments; or (2) law through constitutional provisions or enabling legislation.
- c. Unrestricted net position --- All other net assets that do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

10. Use of Estimates

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

Nowata County Rural Water District No. 7
Notes to the Financial Statements
For the Year Ended December 31, 2012

II. Detailed Notes Concerning the Funds

A. Cash and Investments

Authorized Investments: The district's policy for eligible investments is governed by State statutes which, in general, allow the District to invest in obligations of the United States and insured or collateralized Certificate of Deposits.

Custodial Credit Risk – Deposits: Custodial credit risk is the risk that in the event of a bank failure, the District's deposits may not be returned to it. The District's cash deposits, including interest-bearing certificates of deposit, are maintained in financial institutions. As of December 31, 2012, none of the District's investments were exposed to custodial credit risk because they were either insured or collateralized.

Interest rate risk: This is the risk that changes in market interest rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest rates. The District does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

B. Accounts Receivable

Following is an aged schedule of accounts receivable as of December 31, 2012:

<u>Current</u>	<u>30 Days</u>	<u>60 Days</u>	<u>90 Days</u>	<u>Total</u>
<u>\$ 18,988.31</u>	<u>\$ 6,272.72</u>	<u>\$ 2,123.23</u>	<u>\$ 1,386.54</u>	<u>\$ 28,770.80</u>

C. Changes in Capital Assets

Capital asset activity for the year was as follows:

	<u>Beginning of Year</u>	<u>Additions</u>	<u>Deletions</u>	<u>End of Year</u>
Capital Assets				
Tower and Pump Sites	\$ 4,370.00	\$ -	\$ -	\$ 4,370.00
Water Distribution System	2,282,825.27	-	-	2,282,825.27
Building	6,394.76	-	-	6,394.76
Furniture and Fixtures	14,637.49	-	-	14,637.49
Total	<u>2,308,227.52</u>	<u>-</u>	<u>-</u>	<u>2,308,227.52</u>
Accumulated Depreciation				
Tower and Pump Sites	(2,785.88)	(109.25)	-	(2,895.13)
Water Distribution System	(1,358,952.00)	(57,070.64)	-	(1,416,022.64)
Building	(2,797.72)	(159.87)	-	(2,957.59)
Furniture and Fixtures	(14,557.71)	(79.78)	-	(14,637.49)
	<u>(1,379,093.31)</u>	<u>(57,419.54)</u>	<u>-</u>	<u>(1,436,512.85)</u>
Net Capital Assets	<u>\$ 929,134.21</u>	<u>\$ (57,419.54)</u>	<u>\$ -</u>	<u>\$ 871,714.67</u>

Nowata County Rural Water District No. 7
Notes to the Financial Statements
For the Year Ended December 31, 2012

III. Other Information

A. Risk Management

The District is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees and natural disasters. The District purchases commercial insurance to cover these risks, including general and auto liability, property damage, and public officials liability. There were no significant reductions in insurance coverage from the prior year. Settled claims resulting from these risks have not exceeded commercial insurance coverage in any of the past three fiscal years.

B. Water Rates and Charges

The following water rate increase was effective on November 1, 2012.

No Water (minimum bill)	\$ 18.00
1st 5,000 Gallons	\$ 5.00 per thousand (or fraction thereof)
Over 5,000 Gallons	\$ 4.50 per thousand (or fraction thereof)
Initial Membership Fee	\$ 1,250.00

C. Water Loss Calculation

Month	Water Purchased (Gallons)	Water Sold (Gallons)	Percentage of Water Loss
2011-December	4,531,000	1,927,590	42.54%
2012-January	3,727,000	1,864,290	50.02%
February	3,395,000	1,906,280	56.15%
March	3,586,000	1,900,720	53.00%
April	3,068,000	2,049,330	66.80%
May	4,079,000	2,311,350	56.66%
June	5,982,000	3,065,060	51.24%
July	5,338,000	2,612,080	48.93%
August	5,402,000	2,980,310	55.17%
September	3,806,000	2,233,000	58.67%
October	4,318,000	2,980,310	69.02%
November	5,092,000	2,233,000	43.85%
	52,324,000	28,063,320	53.63%

D. Subsequent Events

Management has evaluated subsequent events through February 19, 2013, which is the date the financial statements were available to be issued and have determined that no additional information needs to be added to the financial statements.

**Rural Water District No. 7
Nowata County, Oklahoma
Schedule of Findings and Responses
For the Year Ended December 31, 2012**

FINDINGS - FINANCIAL STATEMENT AUDIT

2012-1 Material Weakness in Internal Control over Financial Reporting – Preparation of Financial Statements in Accordance with GAAP

Criteria:

The government's management is responsible for internal controls over financial reporting. This includes controls over the fair and complete presentation of the government's annual financial statements in accordance with generally accepted accounting principles (GAAP). The preparation of financial statements in accordance with GAAP requires internal controls over, (1) recording, processing, and summarizing accounting data (i.e. maintaining internal books and records, and (2) reporting government-wide and fund financial statements, including related footnotes (i.e. external financial reporting). Professional audit standards clearly indicate that the external financial statement auditor cannot perform any part of management's control activities or be a component of the internal controls over financial reporting.

Condition:

As is the case with many smaller and medium-sized entities, the government has historically relied extensively on its independent external auditors to provide the necessary expertise to assist in the preparation of the financial statements and footnotes as part of its controls over the external financial reporting process. Accordingly, the government's ability to prepare financial statements in accordance with GAAP is based, in part, on its external auditors, who cannot by definition be considered a part of the government's internal controls.

Cause:

The government lacks the necessary knowledge, expertise and education relative to preparing GAAP financial statements. As a result, management has elected to use outside assistance from the external auditors to assist in meeting its responsibilities relative to preparing its annual financial statements.

Effect or Potential Effect:

As a result of this condition, without reliance on its external auditors, the government lacks the necessary internal controls over the preparation of financial statements in accordance with GAAP. This condition also places the auditor in a questionable position regarding auditor independence as a result of potentially performing part of management's functions.

Recommendation:

The government should consider designing and implementing sufficient internal controls over financial reporting by obtaining the necessary knowledge, expertise, and continuing education to prepare financial statements in accordance with generally accepted account principles without reliance on the external financial statement auditor.

Client Response:

We concur with the recommendation for consulting with an accounting professional on significant transactions, but we feel it is cost prohibitive to have our year-end report disclosures prepared by an accounting professional and then engage an auditor to prepare the same report with his opinions.

**Rural Water District No. 7
Nowata County, Oklahoma
Schedule of Findings and Responses
For the Year Ended December 31, 2012**

FINDINGS - FINANCIAL STATEMENT AUDIT

2012-2 Material Adjusting Journal Entries

Criteria:

The government's management is responsible for internal controls over accounting and financial reporting. This responsibility includes the design and implantation of controls over the fair and complete presentation of the government's annual financial statements in accordance with generally accepted accounting principles (GAAP) from trial balances derived from the government's accounting records. For trial balances to be both complete and accurate, the government must have effective internal controls over recording, processing, summarizing, and adjusting accounting data. As evidence of effective internal controls over accounting and financial reporting, there should generally be few, if any, material adjustments to the trial balances required that are detected and corrected solely as a result of the financial statement audit. In other words, government management should not rely on the external auditor to detect and correct material misstatements in the books and records as part of its internal control, but rather should have its own procedures designed and in place that are independent of the external auditor to provide reasonable, although not absolute, assurance that material misstatements will be detected and corrected in its trial balances prior to audit.

Condition:

The government's trial balances for the year ended December 31, 2012, required a number of material adjusting journal entries in order for the financial statements to be prepared in accordance with GAAP. These necessary adjusting entries, identified solely as a result of the financial statement audit, included such adjustments as the following: adjusting accounts receivable and accounts payable; adjusting prepaid insurance, accrued interest, and recording depreciation.

Cause:

The government's accounting and financial reporting staff lacks the necessary knowledge, expertise and education, relative to the complex nature of applying GAAP applicable to state and local governments, sufficient to provide reasonable assurance that the trial balances used for preparing the GAAP financial statements are complete and accurate prior to audit. As a result, management has had to rely on the external auditors to identify and correct a number of material misstatements in the trial balances.

Effect:

As a result of this condition, without reliance on its external auditors, the government lacks the necessary internal controls over the completeness and accuracy of the trial balances that are used in the preparation of its financial statements in accordance with GAAP. This condition can result in undetected and uncorrected material misstatements in the financial statements that are not detected by management and may also not be detected by the financial statement audit. In addition, if management's intentions are to continue to rely on the external auditor to detect and correct material misstatements, this condition could place the auditor in a questionable position regarding auditor independence as a result of the auditor performing part of management's functions regarding to the trial balances.

**Rural Water District No. 7
Nowata County, Oklahoma
Schedule of Findings and Responses
For the Year Ended December 31, 2012**

FINDINGS - FINANCIAL STATEMENT AUDIT (continued)

2012-2 Material Adjusting Journal Entries (continued)

Recommendation:

The government should consider designing and implementing sufficient internal controls over the completeness and accuracy of trial balances by obtaining the necessary knowledge, expertise, and continuing education to apply GAAP in the development of working trial balances that will be used to prepare the government's annual financial statements. This could be achieved through employment of qualified accounting staff or the outsourcing of these control activities to a qualified accounting firm other than the external auditor.

Client Response:

Rural Water District No. 7 makes every effort to comply with the development of GAAP procedures.