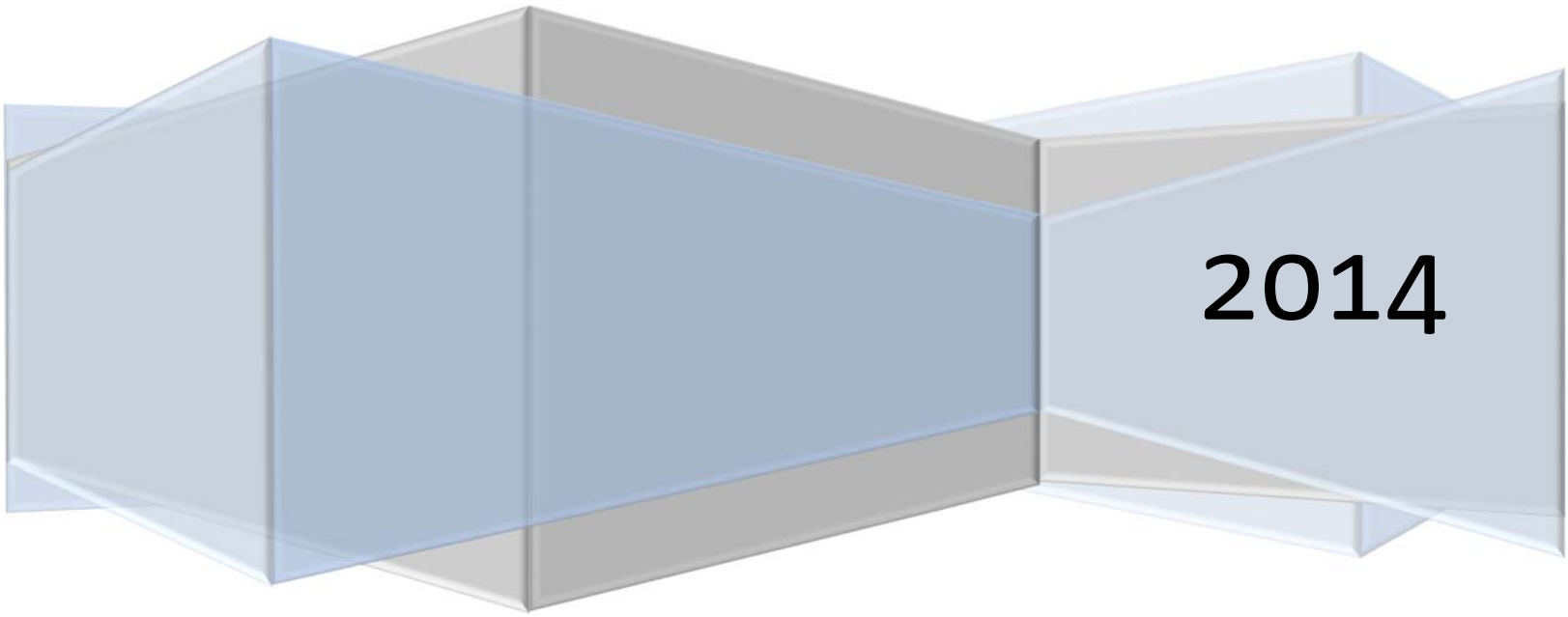
Rural Water and Sewer District No. 20

Financial Statements and Independent Auditor's Reports

As of and for the Year Ended December 31, 2014



RURAL WATER AND SEWER DISTRICT NO 20
PITTSBURG COUNTY, OKLAHOMA

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Board of Directors

Jeff Click	Chairman
Heath Corbin	Vice-Chairman
Vacant	Secretary
Vacant	Treasurer

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INDEPENDENT AUDITOR'S REPORT

To the Members of the Board
Rural Water and Sewer District No. 20
Pittsburg County, Oklahoma

I was engaged to audit the accompanying financial statements of the Rural Water and Sewer District No. 20, Pittsburg County, Oklahoma ("District"), as of December 31, 2014 and for the year then ended, 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. Management is also responsible for 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 error or fraud.

Auditor's Responsibility

My responsibility is to express an opinion on these financial statements based on my audit. I conducted my 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. Because of the significance of the matter described in the "Transactions with Related Parties" paragraph to the overall financial statement presentation, I was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Transactions with Related Parties

As discussed in footnote 3, the District was created to serve a startup planned community and was entirely financed by the developer who also served as the Chairman of the Board of Trustees until May, 2013 and continues to serve as operational manager for the District. Because of the startup nature of the entity, I was unable to determine that there was sufficient delineation between the District's transactions and those of the developer. As is often inherent with related party transactions, it may not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or what the terms and conditions would have been. This includes the purchase of the utility system from the developer in the current year at a price determined by the developer. As discussed in footnote 6, the District was in the early stages of development and did not have the working capital to support operations without the financial support from the developer.

Disclaimer of Opinion

Because of the significance of the matters described in the Transactions with Related Parties paragraph, I have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, I do not express an opinion on these financial statements.

Management's Discussion and Analysis Omitted

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

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, I have also issued my report dated March 18, 2016, on my consideration of the District's internal control over financial reporting and on my tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of my testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the District's internal control over financial reporting and compliance.

Anne Marie Elfrink, MS, CPA

Anne Marie Elfrink, MS, CPA

Tulsa, Oklahoma
March 18, 2016

Statement of Net Position – December 31, 2014

Assets		
Current assets:		
Cash and cash equivalents	$	28,131
Accounts receivable		4,861
Inventory - water meters		1,400
Total noncurrent assets		34,392
Noncurrent assets:		
Capital assets, net		957,147
Total assets		991,539
Liabilities		
Current liabilities:		
Accounts payable		31,965
Advances payable - related party		38,416
Accrued interest - related party		61,132
Total current liabilities		131,513
Noncurrent liabilities:		
Note payable - related party		966,139
Total liabilities		1,097,652
Net Position		
Net investment in capital assets (deficit)		(8,992)
Unrestricted (deficit)		(97,121)
Total net position (deficit)	$	(106,113)

See accompanying notes to the basic financial statements

Statement of Revenue, Expense and Change in Net Position – Year Ended December 31, 2014

Operating Revenues		
Charges for sales and services:		
Water	$	18,816
Sewer		17,799
Sanitation		12,020
Tap Fees		122,270
Total operating revenues		170,905
Operating Expenses		
Costs of sales and services:		
Water purchases		14,415
Sanitation contractor		9,504
Operations and maintenance		63,978
Management fees		13,200
Legal fees		14,191
Depreciation		19,419
Total operating expenses		134,707
Operating income		36,198
Nonoperating Expense		
Interest expense		46,905
Total nonoperating expense		46,905
Change in net position		(10,707)
Net position - beginning of year		(95,406)
Net position - end of year	$	(106,113)

See accompanying notes to the basic financial statements

Statement of Cash Flows – Year Ended December 31, 2014

Cash flows from operating activities:		
Receipts from members	$	168,892
Payments to suppliers		(91,007)
Cash provided by operating activities		77,885
Cash flows from noncapital financing activities:		
Payments to related party		(27,346)
Cash used in noncapital financing activities		(27,346)
Cash flows from capital financing activities:		
Purchases of capital assets		(25,709)
Cash used in capital financing activities		(25,709)
Net increase in cash and cash equivalents		24,830
Beginning cash and cash equivalents		3,301
Ending cash and cash equivalents	$	28,131

Reconciliation of change in net position to cash provided by operating activities:

Operating income	$	36,198
Increase in:		
Accounts receivable		(2,013)
Inventory		23,993
Accounts payable		288
Depreciation		19,419
	$	77,885

See accompanying notes to the basic financial statements

Notes to the Basic Financial Statements

1. **Summary of Significant Accounting Policies**

A. **Financial Reporting Entity**

The Rural Water and Sewer District No. 20, Pittsburg County, Oklahoma ("District") was incorporated on August 15, 2012 under Title 82, Section 1324.1 as amended, of the laws of the State of Oklahoma. The District is exempt from Federal and State income tax. The purpose of the District is to provide water and sewer services to the owners and occupants of property located within the District which primarily includes the Town of Carlton Landing, and others as authorized by law.

The District is governed by a board of four directors, elected by a majority vote of the homeowners present at the meeting in which the vote is taken. Elected positions include Chairman, Vice-Chairman, Secretary, and Treasurer.

B. **Basis of Presentation**

The accounting policies of Rural Water and Sewer District No. 20, Pittsburg County, Oklahoma conform to the basic principles of governmental accounting and financial reporting set forth by the Governmental Accounting Standards Board (GASB).

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.

C. **Measurement Focus and Basis of Accounting**

Measurement focus refers to how transactions are recorded within the various financial statements. Basis of accounting refers to when transactions are recorded regardless of the measurement focus applied.

The District's financial statements use the economic resources measurement. The District utilizes the basis of accounting generally accepted in the United States. Under this basis of accounting, revenues are recognized when earned and expenses are recorded when the liability is incurred or economic asset is used.

D. **Assets, Liabilities, and Net Position**

Cash and cash equivalents

For the purpose of the statement of cash flows, the District considers all cash on hand, demand deposit accounts, interest bearing checking accounts, and time deposit accounts including certificates of deposit with maturities of three months or less to be cash and cash equivalents.

Capital Assets and Depreciation

Depreciable assets are recorded at cost when purchased or constructed. Improvements are capitalized; the cost of normal maintenance and repairs that do not add to the value of the asset or materially extend the asset's life is not. Depreciation is calculated on a straight-line basis over the estimated useful lives of the depreciable assets.

Capital assets consist of utility infrastructure with an estimated useful life of 50 years. A capitalization threshold of $2,000 is used to report capital assets.

Due to related party

The District was formed to provide services to a planned community in Pittsburg County, Oklahoma known as the Town of Carlton Landing. Startup expenses financed by the developer and working capital advances that are expected to be repaid from the District's resources are reported as liabilities on the statement of net position.

Note payable – related party

All long-term debt is reported as incurred and consists of a note payable to the developer of the planned community the District serves in exchange for assumption of ownership and operation of the water and sewer systems constructed by the developer.

Net position

Net position is divided into three components:

a. *Net investment in capital assets* – Consists of capital assets including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributed to the acquisition, construction, or improvement of those assets.
b. *Restricted net position* – Consists of net assets with constraints placed on the use by 1) external groups such as creditors, grantors, contributors, or laws and 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 "net investment in capital assets".

It is the District's policy to first use restricted net position prior to the use of unrestricted net position when an expense is incurred for purposes for which restricted and unrestricted net position are available.

E. **Revenues and expenses**

Operating Revenues – Operating revenues include activities that have the characteristics of exchange transactions, such as service fees.

Nonoperating revenues – Nonoperating revenues include activities that have the characteristics of nonexchange transactions such as grants from other governments, gifts and contributions, and other revenue sources that are defined as nonoperating revenue.

Operating Expenses – Operating expenses are those that are essential for delivery of services to the District's customers.

Nonoperating Expenses - Nonoperating expenses are those that relate to the financing of the District's activity, such as interest expense, and non-recurring and/or unusual expenses such as startup costs.

2. **Detailed Notes on Transaction Classes/Accounts**

A. **Cash and investments**

Deposits and investments - State statutes govern the District's investment policy. Permissible investments include direct obligations of the United States Government and Agencies; certificates of deposit of savings and loan associations, and bank and trust companies. Collateral is required for demand deposits and certificates of deposit for all amounts not covered by federal deposit insurance. Investments are stated at cost plus accrued interest.

Custodial Credit Risk – 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 does not have a written policy for custodial credit risk. At December 31, 2014, all of the District's cash was held in a demand account bearing no interest and was fully covered by federal deposit insurance.

B. Capital assets and depreciation

For the year ended December 31, 2014, capital asset balances changed as follows:

	Balance at 12/31/2013	Additions	Deletions	Balance at 12/31/2014
Capital Assets:				
Sewer system	$ 673,530	$ 1,044	$ -	$ 674,574
Water system	292,609	24,665	-	317,274
Total capital assets	966,139	25,709	-	991,848
Less accumulated depreciation	(15,282)	(19,419)	-	(34,701)
Net capital assets	$ 950,857	$ 6,290	$ -	$ 957,147

C. **Long Term Debt**

For the year ended December 31, 2014, there were no changes in the District's long-term debt:

	Balance at 12/31/2013	Additions	Deductions	Balance at 12/31/2014
Note payable	$ 966,139	$ -	$ -	$ 966,139

At December 31, 2014, the District's long term debt consisted of the following note:

Note payable to Humphreys Partners 2009, LLC, dated September 10, 2013 in the original amount of $1,361,000 and amended on August 15, 2015 to the amount of $966,139 retroactively, with a fixed interest rate of 5.0%, and payable monthly in the amount equal to the excess of the District's monthly revenues less operating expenses, with payments beginning July 31, 2015. Payments may be waived at the option of the note holder; interest continues to accrue $966,139

3. **Related Party Transactions**

The District was financed by and had significant transactions with the developer of the planned community it serves, Humphrey Partners 2009, LLC. In addition, the water and sewer system infrastructure was constructed by the developer and sold to the District at an amount determined by the developer.

Effective January 1, 2014, the District entered into an agreement with Carlton Landing Enterprises, LLC, an entity owned by the developer, to provide management services, including personnel and support staff. During the year ended December 31, 2014, management fees paid under this contract were $13,200.

A member of the Board of Directors is a partner in a construction company that is a principal builder in the Town of Carlton Landing and is a common owner with the developer and the entity providing management services to the District.

4. **Risk Management**

The District is exposed to various risks of loss related to torts, errors, and omissions. At this time, the District carries no surety bonds or other types of insurance.

5. **Commitments and Contingencies**

The District is not involved in any legal proceedings, which normally occur in the course of operations, at this time. While legal proceedings cannot be foreseen, the District believes that any settlement or judgment would not have a material effect on the financial condition of the District.

6. **Going Concern**

The District was in the early stages of operations commencement as of December 31, 2014, and did not have the working capital to support operations. Management believes that, as new homes are built, the membership base and planned fee structure should be adequate to support ordinary operations, including amortization of debt.

7. **Subsequent Events**

Management has evaluated events and transactions that occurred after the balance sheet date for potential recognition and disclosure through March 18, 2016, the date on which the financial statements were available to be issued.

Anne Marie Elfrink, MS, CPA

Member AICPA, OSCPA, and GFOA

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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*

To the Members of the Board
Rural Water and Sewer District No. 20
Pittsburg County, Oklahoma

I was engaged to audit the financial statements of the Rural Water and Sewer District No. 20, Pittsburg County, Oklahoma ("District"), as of December 31, 2014 and for the year then ended, and the related notes to the financial statements, which collectively comprise the District's basic financial statements and have issued my report thereon dated March 18, 2016. I did not opine on the District's financial statements due to extensive related party transactions, an inability to certify the value of the fixed assets, and the lack of observable substance related to the sale of the infrastructure to the District by a related party, including an inability by the District to generate sufficient revenue to amortize the associated debt under the stated terms. Except as discussed in the preceding sentence, I conducted my audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the District is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing my audit, I considered the District's internal control over financial reporting as a basis for designing my auditing procedures for the purpose of expressing my opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the District's internal control over financial reporting. Accordingly, I do not express an opinion on the effectiveness of the District's internal control over financial reporting.

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

My consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material

weaknesses, or significant deficiencies. I consider the following deficiencies described in the accompanying *Schedule of Findings and Management Responses* to be material weaknesses: [2014-01, 2014-02, 2014-03, 2014-04, 2014-05, 2014-06, 2014-07] Given the above described limitations, other material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the District's financial statements are free of material misstatement, I 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 my audit, and accordingly, I do not express such an opinion. The results of my tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*

Purpose of This Report

The purpose of this report is solely to describe the scope of my 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.

Anne Marie Elfrink, MS, CPA

Anne Marie Elfrink, MS, CPA

Tulsa, Oklahoma
March 18, 2016

SCHEDULE OF FINDINGS AND MANAGEMENT RESPONSES

This schedule is presented as an addendum to accompany the "*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".* Consideration of items listed should be made in conjunction with that report.

2014-01 – Water Meter Inventory and Control

CONDITION: The District was not able to provide an inventory of all water meters purchased, including both the ones in inventory as well as those that had been placed in service. This is continued from 2013.

CRITERIA: Water meters are the primary mechanism for measurement of both water and sewer services to be billed to customers. For this reason, there should be a comprehensive system of control over their installation, including a responsible party for each active meter.

CAUSE OF CONDITION: The District is newly formed and formal operating procedures had not been established as of December 31, 2014.

POTENTIAL EFFECT OF CONDITION: Users of water and sewer services may not be properly identified and billed, causing a loss of revenues to the District.

RECOMMENDATION: A comprehensive inventory of all water meters purchased to date be established, including the location of the meter, whether or not it is active, and the responsible party for any active meters.

RESPONSE: The District has developed a water meter control system that was implemented in September 2015.

2014-02 – Related Party Transactions

CONDITION: The District is managed by the principal developer of a planned community who has also financed operating shortages. Expenditures are not approved by an independent Board prior to commitment or occurrence; no purchase orders are issued. The Board Chairman has a business affiliation with the developer. At December, 2014 there were only two Board members. An additional Board member was appointed by the existing Board members in 2015; however, there was no indication as to the publication of the openings in an attempt to get additional owner input into the filling of the vacant slots. This is compounded by the lack of liability insurance protecting the Board, and is continued from 2013.

CRITERIA: A related party relationship may result in transactions that would not ordinarily take place between unrelated parties or would be subject to different terms and conditions.

CAUSE OF CONDITION: Since the District is a startup entity, it lacked sufficient working capital to cover necessary expenses without significant involvement from the developer.

POTENTIAL EFFECT OF CONDITION: Transactions may not be accurately reflected or may not reflect the true economic substance of the event. Errors or fraud may take place and be undetected.

RECOMMENDATION: The District should increase efforts to assure that business is transacted in an independent and "arm's length" manner. For example, increased efforts to recruit and encourage

participation of membership landowners who are independent of the developer, the Board should have benefit of review of the support of a transaction prior to its payment, and the District should consider development of a policy to require expenditures above a certain amount be submitted to the Board for approval in advance of commitment.

RESPONSE: The District will consider implementation of the recommendation.

2014-03 – Risk Management

CONDITION: As of the date of this report, the District did not have insurance in place that protected the district and the Board of Directors from risk of loss. This is continued from 2013.

CRITERIA: The District should have insurance policies in place that include fidelity bonds for anyone with access to cash, errors and omissions insurance for Board officers and members, general liability insurance, and property insurance for any property owned by the District.

CAUSE OF CONDITION: Since the District is a startup entity with few assets, it did not have the capital necessary to fund the purchase of insurance.

POTENTIAL EFFECT OF CONDITION: The District or District Board members could be named as a party in a law suit that could be costly to defend and impair the District's ability to continue to provide essential services to its members.

RECOMMENDATION: The District should consult with its attorney regarding recommended protection and consider the need for insurance as described above.

RESPONSE: The District management is actively working on obtaining the recommended coverages.

2014-04 – Segregation of Duties

CONDITION: Duties are concentrated in the hands of a few individuals who are responsible for all phases of accounting functions. For instance, payments are being made electronically by the administrative assistant without review or knowledge of the Board Chairman who is the only authorized signer on the bank account. The District management is able to initiate payments to itself without benefit of review. In the year under audit, a $30,000 payment was made to the developer (for reimbursement of advances made in prior years), without documentation as to the authorization of the Board. Because of the lack of division of responsibility, internal control is determined to be weak, and in some instances, non-existent. This is compounded by the fact that the administrative manager of the District has common ownership with the developer.

CRITERIA: A good system of internal control requires a proper segregation of duties to prevent one person from being in a position to authorize, execute, and record the same transaction.

CAUSE OF CONDITION: The District is small with limited staff that prevents segregation of duties that might be possible in a larger district.

POTENTIAL EFFECT OF CONDITION: Errors or fraud could take place and be undetected.

RECOMMENDATION: District management should review internal control policies to look for ways in which segregation of duties could be strengthened, including a review of its documentation of proper authorization and review prior to initiating payments.

RESPONSE: The District management will consider ways to improve segregation of duties and strengthen documentation of proper authorization prior to initiating payments.

2014-05 – Record Retention

CONDITION: Nine of the 29 disbursements selected on a random basis did not have any support of any kind, including payments to the developer and a total of $18,125 paid to a single contractor.

CRITERIA: Title 51 Chapter 1 Section 24A.4 of the Oklahoma Statutes states that every public body and public official has a specific duty to keep and maintain complete records of the receipt and expenditures of any public funds reflecting all financial and business transactions relating thereto.

CAUSE OF CONDITION: The District does not have policies and procedures in place to require documentation of its transactions. District administrative personnel do not appear to be aware of the requirements related to the administration of public funds.

POTENTIAL EFFECT OF CONDITION: Errors or fraud could take place and be undetected.

RECOMMENDATION: The District should review it policies and procedures regarding the sufficiency and retention of records to demonstrate good stewardship of public funds and open access to records.

RESPONSE: District management will consider review of its policies and procedures regarding the sufficiency and retention of records.

2014-06 – Member (Customer) Files

CONDITION: An attempt to review of a random selection of ten member (customer) files indicated only one had an application/agreement for service on file and none had a benefit unit certificate.

CRITERIA: Title 82 Chapter 18 Section 1324.12 of the Oklahoma Statutes requires each landowner within the district to subscribe to a number of such units in proportion to the extend he desires to participate in the benefits of the improvements. Good business practice dictates that an agreement for services be executed that outlines the terms of those services prior to the services being provided.

CAUSE OF CONDITION: The District does not have policies and procedures in place to require that a member file, application and agreement for service, or benefit unit certificate be maintained.

POTENTIAL EFFECT OF CONDITION: The terms and entitlement for service could be ambiguous and/or not consistently applied.

RECOMMENDATION: The District should review its procedures regarding the maintenance of customer files to include the retention of an application and agreement that outlines the terms of service. Consideration should be given to the development of a procedure for issuing benefit unit certificates. The District's attorney should be involved in the development of these procedures. The policy should be implemented retroactively for all existing members.

RESPONSE: District management will consider review of its procedures regarding customer files, application and agreement for services, and initiating a benefit unit certificate, to include retroactive application.

2014-07 – Cutoff Procedures

CONDITION: A review of the outstanding receivables at December 31, 2014 indicated that two members continued to receive service during the year despite being up to seven months in arrears.

CRITERIA: The District should develop and uniformly enforce procedures to notify and follow through with discontinuance of service following non-payment of outstanding amounts.

CAUSE OF CONDITION: The District did not have cutoff procedures in place during the year.

POTENTIAL EFFECT OF CONDITION: The District will not receive the revenue due which would cause other members to absorb the cost of service.

RECOMMENDATION: The District should develop policies and procedures for cutoff of service due to non-payment and ensure even application of the policy.

RESPONSE: The Board of Trustees has approved a policy to require cutoff of services if a member is 90 days or more in arrears which will take effect immediately.