

# **MADISON WATER UTILITY**

Madison, Wisconsin

**COMMUNICATION TO THOSE CHARGED  
WITH GOVERNANCE AND MANAGEMENT**

As of and for the Year Ended December 31, 2016

# MADISON WATER UTILITY

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**REQUIRED COMMUNICATION OF INTERNAL CONTROL RELATED MATTERS  
IDENTIFIED IN THE AUDIT TO THOSE CHARGED WITH GOVERNANCE**

To the Water Utility Board  
Madison Water Utility  
Madison, Wisconsin

In planning and performing our audit of the financial statements of the Madison Water Utility as of and for the year ended December 31, 2016, in accordance with auditing standards generally accepted in the United States of America, we considered its internal control over financial reporting (internal control) as a basis for designing our auditing procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of its internal control. Accordingly, we do not express an opinion on the effectiveness of its internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control 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 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 following deficiency in Madison Water Utility's internal control to be material weaknesses, as further discussed on the following page:

> Internal Control Over Financial Reporting

As certain processes are combined with the municipality those systems were reviewed and control deficiencies, if any, reported as part of the municipality's overall audit. These include payroll, special assessments, information technology, and risk assessment.

This communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be, and should not be, used by anyone other than these specified parties.

*Baker Tilly Veitchau Krause, LLP*

Madison, Wisconsin  
June 28, 2017

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## **INTERNAL CONTROL OVER FINANCIAL REPORTING**

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Auditing standards require that we perform procedures to obtain an understanding of your government and its internal control environment as part of the annual audit. This includes an analysis of the utility's year-end financial reporting process and preparation of your financial statements.

A properly designed system of internal control allows for the presentation of year-end financial data and financial statements without material errors. At this time, the utility does not have internal controls in place that allow for the presentation of materially correct year-end financial statements. As a result, we consider this absence of controls to be a material weakness in internal control over the utility's financial reporting.

Our audit includes a review and evaluation of the utility's internal controls relating to financial reporting. Common attributes of a properly designed system of internal control for financial reporting are as follows:

- > There is adequate staffing to prepare financial reports throughout and at the end of the year.
- > Staff is properly trained and knowledgeable to perform all financial reporting functions.
- > Complete and accurate financial statements including footnotes are prepared.
- > Financial reports are reviewed by an individual who is not the preparer for completeness and accuracy.

Our evaluation of the internal controls over financial reporting has identified control deficiencies that are considered material weakness surrounding the preparation of financial statements and footnotes, adjusting journal entries identified by the auditors, and an independent review of financial reports.

To provide some perspective, establishment of such internal controls can be a difficult task for governments. Many governments do rely on their auditors to prepare certain year-end adjusting entries and prepare the year-end financial statements. Because the auditors are not involved with the utility's day-to-day activities, it is important that management have the skills, knowledge, and experience to review the audit adjustments and financial statements prepared by the auditors to ensure completeness, accuracy, and consistency with management's knowledge of transactions impacting the utility during the year.

**OTHER COMMUNICATIONS TO THOSE CHARGED WITH GOVERNANCE**

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## **TWO WAY COMMUNICATION REGARDING YOUR AUDIT**

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As part of our audit of your financial statements, we are providing communications to you throughout the audit process. Auditing requirements provide for two-way communication and are important in assisting the auditor and you with more information relevant to the audit.

As this past audit is concluded, we use what we have learned to begin the planning process for next year's audit. It is important that you understand the following points about the scope and timing of our next audit:

- a. We address the significant risks of material misstatement, whether due to fraud or error, through our detailed audit procedures.
- b. We will obtain an understanding of the five components of internal control sufficient to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. We will obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. We will use such knowledge to:
  - > Identify types of potential misstatements.
  - > Consider factors that affect the risks of material misstatement.
  - > Design tests of controls, when applicable, and substantive procedures.

We will not express an opinion on the effectiveness of internal control over financial reporting or compliance with laws, regulations, and provisions of contracts or grant programs.

- c. The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles while other matters are not important. In performing the audit, we are concerned with matters that, either individually or in the aggregate, could be material to the financial statements. Our responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by errors or fraud, are detected.

We are very interested in your views regarding certain matters. Those matters are listed here:

- a. We typically will communicate with your top level of management unless you tell us otherwise.
- b. We understand that the utility and the board have the responsibility to oversee the strategic direction of your organization, as well as the overall accountability of the entity. Management has the responsibility for achieving the objectives of the entity.
- c. We need to know your views about your organization's objectives and strategies, and the related business risks that may result in material misstatements.
- d. Which matters do you consider warrant particular attention during the audit, and are there any areas where you request additional procedures to be undertaken?
- e. Have you had any significant communications with regulators or grantor agencies?
- f. Are there other matters that you believe are relevant to the audit of the financial statements?

Also, is there anything that we need to know about the attitudes, awareness, and actions of the utility concerning:

- a. The utility's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control?
- b. The detection or the possibility of fraud?

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**TWO WAY COMMUNICATION REGARDING YOUR AUDIT (cont.)**

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We also need to know if you have taken actions in response to developments in financial reporting, laws, accounting standards, governance practices, or other related matters, or in response to previous communications with us.

With regard to the timing of our audit, here is some general information. Our final financial fieldwork is scheduled during the spring to best coincide with your readiness and report deadlines. After fieldwork, we wrap up our financial audit procedures at our office and may issue drafts of our report for your review. Final copies of our report and other communications are issued after approval by your staff. This is typically 6-10 weeks after final fieldwork, but may vary depending on a number of factors.

Keep in mind that while this communication may assist us with planning the scope and timing of the audit, it does not change the auditor's sole responsibility to determine the overall audit strategy and the audit plan, including the nature, timing, and extent of procedures necessary to obtain sufficient appropriate audit evidence.

We realize that you may have questions on what this all means, or wish to provide other feedback. We welcome the opportunity to hear from you.

**COMMUNICATION OF OTHER CONTROL DEFICIENCIES, RECOMMENDATIONS  
AND INFORMATIONAL POINTS TO MANAGEMENT THAT ARE NOT  
MATERIAL WEAKNESSES OR SIGNIFICANT DEFICIENCIES**

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## **FINANCIAL RESULTS**

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The management discussion and analysis section of the utility's financial statements highlights financial and operating information useful to management. It contains an excellent discussion of the major financial and operational events for the year.

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## **STATUS OF PRIOR YEAR COMMENTS AND RECOMMENDATIONS**

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### ***DEBT COVERAGE REQUIREMENTS (12/31/15 LETTER)***

The general debt covenant provisions of the utility's revenue bonds require the utility to maintain a debt coverage ratio of 1.25. During the year, the utility issued an additional \$41.6 million in revenue bonds which raised the funding requirement by approximately \$4 million beginning in 2016. As a result, the utility did not meet the debt coverage requirement for 2015. New water rates were placed into effect beginning in October 2015 which should reduce the shortfall. We recommend that the utility monitor their debt coverage requirement and account for this new issuance in order to stay in compliance with their bond agreement.

#### ***Status Update – 12/31/2016***

The water utility met the debt coverage requirement by a slight margin in 2016. We continue to recommend the utility closely monitor this metric to ensure proper compliance with bond covenants.

### ***COMMUNICATION WITH OTHER DEPARTMENTS (12/31/15 LETTER)***

The City of Madison completed a multi-year ERP implementation during the year which significantly changed various processes and transaction cycles. Several of the process changes impacted the water utilities operations. During the audit, we noted several instances where transactions and balances on the cities books did not equal that of the water utility. Staff and Baker Tilly time was spent reconciling and balancing the books of each entity with no formal process being used. We recommend the utility develop and communicate a systematic process for reconciling and balancing activity with other departments to ensure accurate financial reporting.

#### ***Status Update – 12/31/2016***

During the audit we noted a significant reduction in balancing and reconciliation assistance from the prior year and commend management for proactively addressing this comment during 2016. BT recorded minor adjustments to balance the water utility's books with city records to ensure proper balancing at the city-wide level. We continue to recommend the city departments balance their funds regularly. This point is considered cleared for 2016.

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**STATUS OF PRIOR YEAR COMMENTS AND RECOMMENDATIONS (cont.)**

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***APPROACH TO FISCAL YEAR 2015 (12/31/14 LETTER)***

At the financial manager's request, we delayed our scheduled audit fieldwork to allow for the utility to have records ready for audit. The City of Madison has a very detailed timeline the audit is required to follow, including liquidated damages if Baker Tilly does not meet the deadlines. The audit is scheduled for the third week in April to allow enough time after year end to prepare while still providing adequate time for our completion and review of the audit before the audit team for the City needs the utility's information for inclusion in their citywide report. We have the following recommendations for the utility to consider allowing for a smoother process in 2015:

- > We recommended certain revenue analytics and reconciliations are prepared as discussed above.
- > Open work orders in Construction Work in Progress need to be reviewed for any items that may need to be expensed in the year the cost was incurred. This was the basis for one of the financial statement restatements during this year's audit.
- > The utility uses the account completed construction not classified to hold costs for projects that have been completed but the utility has not had the time to close them out to the proper primary plant accounts. Last year, we verbally recommended this account be properly closed out before the rate study was filed with the PSC since this holding account is only meant for use in temporary and rare situations to begin depreciating projects that have not been closed out. Instead of closing out this account in 2014, the balance grew to \$31,242,000 from \$13,667,000. We recommend this account be properly closed out to primary plant accounts in 2015.
- > Conversions to new accounting software are often very time consuming and often do not go as planned. An already stressful situation can be made worse by a lack of communication and planning. We learned from finance management that the utility believes it does not have an adequate chart of accounts established for the new accounting software. We also learned that reconciliations for 2015 were substantially behind, perhaps due to the conversion. It is critical that the chart of accounts concerns be addressed and any remaining conversion issues are cleared with the City as soon as possible. 2015 month end closing and reconciliations should be caught up to date as soon as possible as well.

We are available to assist the utility with any of these points as well as talking through other details to ensure 2015 financial records are complete, accurate and timely.

***Status Update – 12/31/2016***

Utility staff made significant improvements in 2016. They prepared and provided a complete revenue consumer analysis for 2016 activity, initiated the close-out process for all completed work orders, closed the remaining balance from completed construction not classified, and provided year-end reconciliation to us. Management placed an increased emphasis on addressing this comment and effectively established sound procedures during the year. This point is considered cleared in 2016.

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**STATUS OF PRIOR YEAR COMMENTS AND RECOMMENDATIONS (cont.)**

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***REVIEW OF CUSTOMER ADVANCES (12/31/14 LETTER)***

The utility collects customer advances for construction and meter projects. Once a project is complete, the utility will determine whether the customer advances related to the project should be recognized as revenue or a refund is given to the customer if the actual project costs were less than the advance received. It was noted that there are several customer advances received that date back to 2006, which could mean there are customer advances retained that are related to completed projects. We are recommending that the utility review customer advances to see if related projects are complete and whether the utility should recognize the advances related to completed projects as revenue or provide a refund to the customer.

***Status Update – 12/31/2016***

We noted during our testing that customer advances dating back to 2008 were removed from the account with refunds provided to the customer or revenue recognized for the completed projects. It appears the utility is effectively monitoring customer advances to ensure any advances related to completed projects are addressed in a timely manner. We consider this matter cleared.

***REVIEW OF WORK ORDER CLOSING PROCESS (12/31/14 LETTER)***

The utility completes a significant amount of construction each year and as such the proper accounting for capital assets is a key area for the finance department. Costs including labor, materials, contractor charges and overheads are accumulated in a separate work order for each project. When the project is complete, finance obtains reports from engineering on the types of assets and quantities installed and removed. This is used to close the work order and record the assets in the detailed property accounts as required by the Public Service Commission of Wisconsin (PSCW). We recommend that the utility review the process of closing work orders and work with engineering to help in determining whether projects with open work orders have been placed in service and should be closed to capital assets.

In addition, work orders have also been closed to a temporary account called completed construction not classified. This account is depreciated on an annual basis but is meant as a temporary account. This account should be reviewed and properly classified before the utility intends to file the next water rate increase.

***Status Update – 12/31/2016***

The utility closed out the remaining balance of the completed construction not classified and a significant portion of the construction work in progress accounts to primary plant accounts in 2016. Staff also made considerable efforts to ensure that work orders and account reconciliations were completed in a timely manner for 2016. We consider this point cleared for 2016.

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## PROFESSIONAL STANDARDS UPDATE / INFORMATIONAL POINTS

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### *OBSERVATIONS FROM PUBLIC SERVICE COMMISSION (PSC) WATER RATE CASES*

PSC reviews of rate applications are very thorough and require diligence in application preparation. Even if you are not considering a rate increase in the near term, below are some items to be aware of to assist down the road.

- > Contributions in Aid of Construction (CIAC) – The PSC requests a reconciliation of CIAC revenue to CIAC plant additions. The utility should prepare reconciliation since the last full rate case. Timing differences, if any, should be documented and reviewed annually so that proper allocations between utility financed and contributed plant are made before a rate application is submitted.
- > Construction Authorizations (CA) – The PSC is:
  - Reviewing all projects that require a CA to make sure there was an authorization obtained. This includes the PSC taking a look back of all utility projects since the last rate case. If a CA was not obtained the PSC will suggest one is filed now. Without a CA, these costs may not be allowed in rate base.
  - Comparing original authorized costs to actual costs and requiring an amended construction authorization to be filed for additional costs over a certain percentage.
  - Reviewing account coding and retirement values for all projects and may reclassify additions or revised retirements retroactively.
- > Retirements – The PSC reviews retirement values and asking for support from the utility. Support for retirements should be from your Continuing Property Records (CPRs).
- > Expenses – The PSC reviews expenses looking for particular items such as:
  - Unallowable costs i.e. credit card fees and lobbying costs
  - Unusually large miscellaneous accounts for reclassification
  - Support for shared costs with the municipality
- > Well Maintenance and Replacement Costs – During the average life of many assets, there is a certain amount of maintenance that will be required. Water tower painting is a prime example of an expense that is necessary to keep an asset in service for its expected life. The PSC has been reviewing repair and replacement costs generally capitalized to the wells plant account and suggesting these be moved to expense for rate making purposes. We suggest the utility review its capitalization policy related to this account and consider following the PSC policy to avoid differences in annual reporting.

It is important that your utility start planning now and begin preparing these items in advance of your next rate increase. These items could significantly impact the next approved rate case and prolong the rate case process. We are available to discuss any of these items with you and in addition help you get started with documenting these items.

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**PROFESSIONAL STANDARDS UPDATE / INFORMATIONAL POINTS (cont.)**

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***CYBER SECURITY***

It's no surprise that cybersecurity continues to be a top concern for management and those charged with governance across governments of all sizes and types. Protecting citizen's data is critical for any government. In addition, there have been several incidents of critical malware or ransomware threats to communities of various sizes.

We recommend performing a cyber-risk assessment to identify the types and location of data on your system as well as considering the sensitivity or potential regulations associated with your data. This will allow you to make informed decisions about spending on cyber risk mitigation.

Our professionals are also available to assist with your cybersecurity questions, assessments, and programs.

**REQUIRED COMMUNICATIONS BY THE AUDITOR TO THOSE CHARGED WITH GOVERNANCE**

To the Water Utility Board  
Madison Water Utility  
Madison, Wisconsin

Thank you for using Baker Tilly Virchow Krause, LLP as your auditor. We have completed our audit of the financial statements dated June 28, 2017. This letter presents communications required by our professional standards.

***OUR RESPONSIBILITY UNDER AUDITING STANDARDS GENERALLY ACCEPTED  
IN THE UNITED STATES OF AMERICA***

The objective of a financial statement audit is the expression of an opinion on the financial statements. We conducted the audit in accordance with auditing standards generally accepted in the United States of America. These standards require that we plan and perform our audit to obtain reasonable, rather than absolute, assurance about whether the financial statements prepared by management with your oversight are free of material misstatement, whether caused by error or fraud. Our audit included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit does not relieve management or those charged with governance of their responsibilities.

As part of the audit we obtained an understanding of the entity and its environment, including internal control, sufficient to assess the risks of material misstatement of the financial statements and to design the nature, timing and extent of further audit procedures. The audit was not designed to provide assurance on internal control or to identify deficiencies in internal control.

***OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS***

Our responsibility does not extend beyond the audited financial statements identified in this report. We do not have any obligation to and have not performed any procedures to corroborate other information contained in client prepared documents, such as official statements related to debt issues.

***PLANNED SCOPE AND TIMING OF THE AUDIT***

We performed the audit according to the planned scope and general timing previously communicated in our letter about planning matters.

To the Water Utility Board  
Madison Water Utility

## ***QUALITATIVE ASPECTS OF THE ENTITY'S SIGNIFICANT ACCOUNTING PRACTICES***

### ***Accounting Policies***

Management is responsible for the selection and use of appropriate accounting policies. In accordance with the terms of our engagement letter, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the Madison Water Utility are described in Note 1 to the financial statements. As described in Note 1 to the financial statements, the utility changed accounting policies related to footnote disclosure for investments by adopting Statement of Governmental Accounting Standards (GASB) Statement No. 72, *Fair Value Measurement and Application* in 2016. We noted no other transactions entered into by the Madison Water Utility during the year that were both significant and unusual, and of which, under professional standards, we are required to inform you, or transactions for which there is a lack of authoritative guidance or consensus.

### ***Accounting Estimates***

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

Management's estimates of accrued sick leave and other postemployment benefit liabilities are based on a combination of historical data and possible future outcomes. We have reviewed the methodology for the accrued sick leave and the actuarial report for the other postemployment benefits and related assumptions in determining that it is reasonable in relation to the financial statements taken as a whole.

Management's estimate of the net pension asset/liability and related deferrals are based on information provided by the Wisconsin Retirement System as audited by the Legislative Audit Bureau. We evaluated the key factors and assumptions used to develop the pension asset and related deferrals in determining that it is reasonable in relation to the financial statements taken as a whole.

### ***Financial Statement Disclosures***

The disclosures in the notes to the financial statements are neutral, consistent, and clear.

### ***DIFFICULTIES ENCOUNTERED IN PERFORMING THE AUDIT***

We encountered no significant difficulties in dealing with management in performing our audit.

### ***CORRECTED MISSTATEMENTS***

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. Management has corrected all such misstatements. Please see the attached listing of all adjusting journal entries identified during the audit for further information.

To the Water Utility Board  
Madison Water Utility

#### ***DISAGREEMENTS WITH MANAGEMENT***

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the financial statements or the auditors' report. No such disagreements arose during the course of our audit.

#### ***CONSULTATIONS WITH OTHER INDEPENDENT ACCOUNTANTS***

In some cases, management may decide to consult with other accountants about auditing and accounting matters. If a consultation involves application of an accounting principle to the governmental unit's financial statements or a determination of the type of auditors' opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

#### ***MANAGEMENT REPRESENTATIONS***

We have requested certain representations from management that are included in the management representation letter. This letter follows this required communication.

#### ***INDEPENDENCE***

We are not aware of any relationships between Baker Tilly Virchow Krause, LLP and the Madison Water Utility that, in our professional judgment, may reasonably be thought to bear on our independence.

Relating to our audit of the financial statements of the Madison Water Utility for the year ended December 31, 2016, Baker Tilly Virchow Krause, LLP hereby confirms that we are, in our professional judgment, independent with respect to the Madison Water Utility in accordance with the Code of Professional Conduct issued by the American Institute of Certified Public Accountants. We provided no services to the Madison Water Utility other than audit services provided in connection with the audit of the current year's financial statements and nonaudit services which in our judgment do not impair our independence, including:

- > Financial statement preparation
- > Adjusting journal entries

None of these nonaudit services constitute an audit under generally accepted auditing standards, including *Government Auditing Standards*.

#### ***OTHER AUDIT FINDINGS OR ISSUES***

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as Madison Water Utility's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

To the Water Utility Board  
Madison Water Utility

***OTHER MATTERS***

We applied certain limited procedures to the required supplementary information (RSI) that supplements the basic financial statements. Our procedures consisted of inquiries of management regarding the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

With respect to the supplementary information accompanying the financial statements, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

***RESTRICTION OF USE***

This information is intended solely for the use of those charged with governance and management and is not intended to be, and should not be, used by anyone other than these specified parties.

We welcome the opportunity to discuss the information included in this letter and any other matters. Thank you for allowing us to serve you.

*Baker Tilly Veitchau Krause, LLP*

Madison, Wisconsin  
June 28, 2017

## **MANAGEMENT REPRESENTATIONS**

**AUDIT ADJUSTMENTS**