

Washington State Auditor's Office
Accountability Audit Report

Lewis County Water Sewer District No. 5

Report Date
February 27, 2014

Report No. 1011571

Issue Date
April 3, 2014



WASHINGTON
TROY KELLEY
STATE AUDITOR



Washington State Auditor Troy Kelley

April 3, 2014

Board of Commissioners
Lewis County Water Sewer District No. 5
Onalaska, Washington

Report on Accountability

We appreciate the opportunity to work in cooperation with your District to promote accountability, integrity and openness in government. The State Auditor's Office takes seriously our role to advocate for government accountability and transparency and to promote positive change.

Please find attached our report on Lewis County Water Sewer District No. 5's accountability and compliance with state laws and regulations and its own policies and procedures. Thank you for working with us to ensure the efficient and effective use of public resources.

Sincerely,

TROY KELLEY
STATE AUDITOR

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Audit Summary

Lewis County Water Sewer District No. 5 February 27, 2014

ABOUT THE AUDIT

This report contains the results of our independent accountability audit of Lewis County Water Sewer District No. 5 from January 1, 2012 through December 31, 2013.

We evaluated internal controls and performed audit procedures on the activities of the District. We also determined whether the District complied with state laws and regulations and its own policies and procedures.

In keeping with general auditing practices, we do not examine every transaction, activity or area. Instead, the areas examined were those representing the highest risk of noncompliance, misappropriation or misuse. The following areas were examined during this audit period:

- Conflict of interest
- Financial condition
- Open Public Meetings Act
- Utility billing controls

RESULTS

In most areas, the District complied with state laws and regulations and its own policies and procedures.

However, we identified conditions significant enough to report as findings:

- Lewis County Water Sewer District No. 5 Commissioners have a beneficial interest in District contracts.
- The District's financial condition puts it at risk of not being able to meet financial obligations and maintain current service levels.

Description of the District

Lewis County Water Sewer District No. 5 February 27, 2014

ABOUT THE DISTRICT

Lewis County Water Sewer District No. 5 was created in 1995 to provide water service to the Birchfield Master Planned Community near Onalaska. The District serves 14 water connections. It is governed by a three-member Board of Commissioners who set rates and policies for its customers. The District's annual revenue for fiscal years 2012 and 2013 was \$23,384 and \$39,825, respectively.

ELECTED OFFICIALS

These officials served during the audit period:

Board of Commissioners:

Virgil Fox (resigned February 4, 2012 and
elected November 28, 2013)
Gary Fox (appointed February 8, 2012
through November 28, 2013)
Rick Ditri (appointed January 11, 2012
through November 28, 2013)
Brad Olsen (appointed March 14, 2012
through November 28, 2013)
Carol Fox (elected November 28, 2013)
Kristine Carter (elected November 28,
2013)

DISTRICT CONTACT INFORMATION

Address: Lewis County Water Sewer District No. 5
921 B Middle Fork Road
Onalaska, WA 98570

Phone: (360) 864-5224

Website: www.lcwsd5.com

AUDIT HISTORY

This is the second audit of the District since it was established. The prior audit reported three findings in the following areas: beneficial interest, Open Public Meetings Act and financial condition. The current audit repeats the beneficial interest and financial condition findings.

Schedule of Audit Findings and Responses

Lewis County Water Sewer District No. 5 February 27, 2014

1. Lewis County Water Sewer District No. 5 Commissioners have a beneficial interest in District contracts.

Description of Condition

The District has a three Commissioner Board and two commissioners constitute a quorum for taking board action. District Commissioners No. 1 and No. 2 are a married couple and one of them works for the District as the water system operator. Commissioner No. 3 is also the District Bookkeeper.

Beneficial Interest

Washington law prohibits municipal officers from having a beneficial (financial) interest in a contract when the official participates in awarding the contract or is responsible for supervision of the contract.

We noted two instances where commissioners have a beneficial interest in District contracts:

- Commissioner No. 1 is the District water system operator and Commissioner No. 3 is the District bookkeeper. The two Commissioners set their own pay rates and approve their own hours and payments.
- In September 2003, acting in their capacity as private business owners - the married Commissioners, sold the water system to the District for \$314,000. During 2012, when these two Commissioners were not on the Board, the contract for the purchase of the water system was restated and approved by the District. However, as of November 28, 2013, the two Commissioners with a beneficial interest in the contract were back on the District Board and responsible for the management of the contract.

In the restated contract, the debt owed to the married Commissioners will be reduced in part by not billing them for the monthly \$46/per lot sewer standby fee. The District is not following the restated contract provisions and is paying off another debt the District owes to the married Commissioners rather than reducing the debt for the purchase of the water system.

As Commissioners of the District they set their own water rates, employee pay rates, approve payments to themselves, and elect to pay debt owed to themselves in the manner they choose which may or may not be in the best interests of the District's customers.

Cause of Condition

District Board members did not familiarize themselves with state law on beneficial interest in contracts.

Effect of Condition

District Commissioners were out of compliance with the Code of Ethics for Municipal Officers laws.

Recommendation

We recommend the District comply with state law regarding beneficial interest in a contract.

District's Response

GENERAL RESPONSE TO 2013 AUDIT

We wish to thank the Auditors for their work, we feel that they have been diligent, polite and in fact helpful and we do not wish to be critical of any individual. We also feel that they have been careful to take into consideration the unique and unusual environment that we are operating in, which must be considered and discussed in the analysis.

As a general review of our condition we are unfortunately in the same economic downturn started in 2007 and have no way of totally curing the beneficial interest claim. However, we are making significant improvements. We have eliminated the open meeting findings and will this year most certainly eliminate the financial condition finding.

It must be recognized that in our extremely small community there are only two other potential Commissioners (4 counting husbands and wives) eligible to serve as Commissioner. All other residents are highly transient renters none of which are interested or qualified to be Commissioners. This leaves us in a "Catch 22" situation and we again ask the Auditor's legal department to help us ascertain how we can comply with the letter of the law and at the same time best serve the customers. These other individuals did run for Commissioners and the voters chose us.

We doubt that this exact situation has existed anywhere else and if so we would like to learn how it was handled.

SPECIFIC RESPONSE TO BENEFICIAL INTEREST FINDING

We're having trouble understanding the beneficial interest finding. While there were financial issues discussed at the January 11 and February 8, 2012 meetings no action was taken that would constitute beneficial interest. In addition, from February 8, 2012 thru the end of 2013 there were commissioners with no potential beneficial interest. While we recognize that with the 2013 election in which the residents chose Virgil Fox to be commissioner that again presents the possibilities of beneficial interest for 2014 but does not change the circumstance for 2012 and 2013.

1) Commissioner #3 (Kristine Carter) is working for the District for the low wage of \$15.00 per hour for very few hours per week, for a total of approximately \$350.00 per month so it is clear that the customers have suffered no damage, and in fact been served extremely well and there is no beneficial interest involved at all.

2) Commissioner #1 was hired by Commissioners that have no beneficial interest. He is uniquely qualified to do the job and is doing so at a lesser wage (\$700.00/mo) than any other qualified party who could be found at that time and in addition has contributed \$2,881.24 to the District in the past 2 years. In addition to performing in excess of \$2,000.00 worth of repairs at no charge to the district and donating over \$1,500.00 of office and computer equipment and forgiving over \$90,000.00 worth of interest, all of which constitutes a very substantial gain to the district. There has been no beneficial gain intended or received for commissioner #1.

3) The claim "The District is not following the restated contract provisions and is paying off another debt the district owes the married Commissioners rather than reducing the debt for the purchase of the water system" is, we believe inaccurate. The \$314,000.00 contract states that it will not be paid off until additional connections occur and funds become available. Paying off another debt owed to the Commissioners in the meantime and within the budget, is we believe appropriate and is not in conflict or opposition to the contract.

Regarding the Commissioner setting their own pay rate, this is again could be true and a technical violation; however, there was no change made in 2012 or 2013 and therefore no beneficial interest affect. In addition the wages paid are well within the RCW 42.23.030 (6)(a) provision of \$1,500.00 per month exemption.

Cause of Condition

We believe this statement is incorrect the cause of the condition is not because of the Board's unfamiliarity with the rules but rather the fact that no other viable option exists, because of the unique circumstances mentioned above.

While the potential for beneficial gain exists during 2012-2013 none was intended or realized.

Effects of Condition

We do not disagree, we simply again ask advice and guidance on how else we could act in the best interest of the customers

Recommendation

On November 26, 2013, Commissioner Gary Fox and Commissioner elect Virgil Fox met with the Auditor staff for the specific purpose of obtaining their advice and guidance regarding potential beneficial interest and open meeting violation claims relating to the new election. The Auditors agreed to converse with their legal counsel and report back to us. On Dec 5, 2013 in a phone conversation and follow-up e-mail staff reported a "potential" problem and advised that we talk to our attorney. We promptly complied and the attorney's response was that we should put the proposed new management contract

out for public sealed bids. Again we complied. Results of that bid were discussed with the Auditor staff on Feb 26, 2014 and they agreed with our conclusion.

In summary we submit that while the Auditor's statements are true it is also true that the intent of the law has been fully observed at all times and that no financial gain to Commissioners has been intended or realized and that new Commissioners without beneficial interests were installed on Feb. 28, 2012; however, because of residency rules they could not continue to serve beyond the end of 2013.

All recommendations of the Auditor have been implemented to the extent possible. We believe that this finding while technically correct does not truly reflect a difficult situation/environment in which we are operating. We believe that the intent of the law is being realized at all times.

Auditor's Remarks

We appreciate the District's response and recognize that the District has met with us several times and by doing so, has shown it is committed to ongoing quality improvement and working to improve its procedures; however, we continue to emphasize that the District work with its attorney to ensure compliance with state law regarding beneficial interests.

Our Office cannot provide legal advice or make management decisions for the District.

We will follow up on these issues during the next audit.

Applicable Laws and Regulation

RCW 42.23.030, Interest in contracts prohibited, states in part:

No municipal officer shall be beneficially interested, directly or indirectly, in any contract which may be made by, through or under the supervision of such officer, in whole or in part, or which may be made for the benefit of his or her office, or accept, directly or indirectly, any compensation, gratuity or reward in connection with such contract from any other person beneficially interested therein

Schedule of Audit Findings and Responses

Lewis County Water Sewer District No. 5 February 27, 2014

2. The District's financial condition puts it at risk of not being able to meet financial obligations and maintain current service levels.

Background

We reported concerns relating to the District's financial condition in the prior audit. The District's overall financial condition has continued to decline.

Description of Condition

The District's revenues, expenses and ending cash balance with the County Treasurer for 2009 to 2013 was:

	2009	2010	2011	2012	2013
Revenues	\$10,127	\$11,144	\$16,965	\$23,384	\$39,825
Expenses	\$24,027	\$30,677	\$43,780	\$26,268	\$39,151
Excess/(Deficit)	(\$13,900)	(\$19,533)	(\$26,815)	(\$2,884)	\$674
Cash balance	(\$11,941)	(\$16,244)	(\$21,890)	(\$24,774)	(\$24,100)

The District's outstanding loans at the end of 2013 were:

Loan description	Balance on December 31, 2013
Owed to County Treasurer	\$ 24,100
Open note to Commissioners (for personal loans for District legal fees)	\$ 9,914
Loan for purchase of water system owed to Commissioners	\$ 314,000
Owed to Lewis County Water District No. 2	\$ 5,470
Total outstanding loans	\$ 353,484

It does not appear the District has sufficient cash to pay these obligations.

Cause of Condition

The District did not charge water rates sufficient to cover operating expenses and loan payments.

In addition, the District has still not established a formal, comprehensive financial management plan.

Effect of Condition

The District does not have enough revenue to cover operating expenses, so it continues to go further into debt. It is in danger of not being able to repay its loans or provide service at current levels.

Recommendation

We recommend the District Board Members take immediate action to:

- Assess its financial operations and make necessary adjustments to expenditures, rates and/or services.
- Establish a written comprehensive plan to address its financial condition and to ensure its expenditures do not exceed revenues.
- Monitor and evaluate the District's financial condition to ensure the plan is followed and the desired results are achieved. The plan should be revised as needed to resolve financial issues.

District's Response

We do not agree that the District's financial condition puts it at risk of not being able to meet its financial obligations.

The district has instituted its annual budget to conform to guidelines required by states' auditors. With the severe downturn in the economy since 2007, the water district has made great efforts to create an excess in its annual operations budget. Our negative cash balance increased to a high of \$24,774.00 in 2012 and that was reversed slightly in 2013 and the trend is still positive. We expect to reduce the amount outstanding to Lewis County Water District #2 by 50% in 2014. We are also making slight headway on reducing our outstanding liability with Lewis County. Once Water District #2 is paid off we can increase the payments to Lewis County.

We also disagree that the districts overall condition has continued to decline as we have not gone backward nor have we stayed the same. We have actually made a very slight gain and positive cash flow in 2013 and expect a slightly better result in 2014.

We do believe that we are generating sufficient cash to pay our obligations as the outstanding loan of \$314,000.00 does not by its terms, need to be paid until sufficient cash revenue is generated from new hookups.

In addition we monitor and make adjustments if necessary at each meeting to expense paid and accrued and liabilities owed. We budgeted for a surplus by increasing our rates to be at or near the highest for area water companies including Centralia, Chehalis and Onalaska. We are in the process of formalizing in writing the financial management process plan.

Each year beginning in September we begin assessing our rates and getting information from other water companies to calculate changes that may be forthcoming. We look for changes in the economic and political climate to see if we are meeting our responsibilities as service providers, both to the people we serve and also to those we report to. This is how we first prepared for our audit. Some issues we cannot change and we try to deal with those issues in a manner that does not harm the public.

After we gather the information we prepare a budget for upcoming expenses that we anticipate or project. We then check our revenue projections to see if we need to increase our rate structure and if so, what manner achieves the greatest good at the least cost to the consumer. In this process we review anticipated costs for state auditors, legal assistance, payroll for maintenance and office support. In this process we anticipate a reserve for contingencies. We feel we are in a strong position now to move forward and meet our obligations.

In view of the above facts it seems to beg the question, is the financial finding really appropriate.

I hope this helps to explain our financial condition and the positive trend we are making albeit slow.

Auditor's Remarks

We appreciate the District's response and recognize that the District is committed to improving its financial condition; however we continue to emphasize that the District establish a written comprehensive plan to address its financial condition and ensure its expenditures, including debt payments, do not exceed revenues.

The District had a negative fund balance at the end of the audit period and had to borrow funds from the County Treasurer to pay expenses. These kinds of significant risks are typically reported by us at a higher level.

We look forward to working with the District on this issue and will follow up on it during the next audit.

Applicable Laws and Regulations

RCW 57.08.081, Rates and charges — Delinquencies, states in part:

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(1) Subject to RCW 57.08.005(6), the commissioners of any district shall provide for revenues by fixing rates and charges for furnishing sewer and drainage service and facilities to those to whom service is available or for providing water, such rates and charges to be fixed as deemed necessary by the commissioners, so that uniform charges will be made for the same class of customer or service and facility. Rates and charges may be combined for the furnishing of more than one type of sewer or drainage service and facilities.

(2) In classifying customers of such water, sewer, or drainage system, the board of commissioners may in its discretion consider any or all of the following factors: The difference in cost to various customers; the location

of the various customers within and without the district; the difference in cost of maintenance, operation, repair, and replacement of the various parts of the system; the different character of the service furnished various customers; the quantity and quality of the service and facility furnished; the time of its use; the achievement of water conservation goals and the discouragement of wasteful practices; capital contributions made to the system including but not limited to assessments; and any other matters which present a reasonable difference as a ground for distinction. Rates shall be established as deemed proper by the commissioners and as fixed by resolution and shall produce revenues sufficient to take care of the costs of maintenance and operation, revenue bond and warrant interest and principal amortization requirements, and all other charges necessary for efficient and proper operation of the system. Prior to furnishing services, a district may require a deposit to guarantee payment for services. However, failure to require a deposit does not affect the validity of any lien authorized by this section.

(3) The commissioners shall enforce collection of connection charges, and rates and charges for water supplied against property owners connecting with the system or receiving such water, and for sewer and drainage services charged against property to which and its owners to whom the service is available, such charges being deemed charges against the property served, by addition of penalties of not more than ten percent thereof in case of failure to pay the charges at times fixed by resolution. The commissioners may provide by resolution that where either connection charges or rates and charges for services supplied are delinquent for any specified period of time, the district shall certify the delinquencies to the auditor of the county in which the real property is located, and the charges and any penalties added thereto and interest thereon at the rate of not more than the prime lending rate of the district's bank plus four percentage points per year shall be a lien against the property upon which the service was received, subject only to the lien for general taxes.

Status of Prior Audit Findings

Lewis County Water Sewer District No. 5 February 27, 2014

The status of findings contained in the prior years' audit reports of the Lewis County Water Sewer District No. 5 is provided below:

1. Lewis County Water Sewer District No. 5 Commissioners have a beneficial interest in District contracts.

Report No. 1006702, dated September 5, 2012

Background

Washington law prohibits public officials from having a beneficial interest in a contract. The law defines beneficial interest as a financial interest in a contract to which the government is a party, if the official participates in awarding the contract or is responsible for the contract by virtue of the office he or she holds.

The law states that when a public official has an interest in that type of contract, he or she may not vote on it and must disclose this interest in the minutes of the meeting in which the contract was approved.

In October 1995, a private business owner in Lewis County requested that Lewis County Commissioners approve formation of a municipal water district. State law allows citizens to file a request with the county to form a district at the written request of 60 percent of the residents who would be in the district. The County Commissioners approved the request and appointed two individuals as District Board Commissioners. Two Commissioners were:

- Owners of a corporation that owned the private utility company that later sold the water system to the District.
- The only residents of the District at the time, so County Commissioners did not appoint a third District Commissioner.
- Developers of the master-planned community the District was formed to serve.

In September 2003, these Commissioners, acting in their capacity as private business owners, sold the water utility to the District for \$314,000. The appraised value was \$326,000. The District did not have cash, so the Commissioners agreed to loan it the money for the purchase.

Because the District committed to accepting a loan to purchase the system and voted to purchase the system from the Commissioners' private company while they were on the Board, the Commissioners had a beneficial interest in the transaction.

We also identified additional beneficial interests. One Commissioner developed and maintained the water system and the other Commissioner was the District bookkeeper. The two Commissioners set their own pay rates and approved their own hours. They also charged the District for office space, phone and Internet service without an adopted plan or cost study to support that the District pays only its fair share of these expenses.

Status

This finding has been partially resolved and is repeated in the accompanying Schedule of Audit Findings and Responses as Finding 1.

2. Lewis County Water Sewer District No. 5's Board did not comply with the Open Public Meetings Act.

Report No. 1006702, dated September 5, 2012

Background

Municipal water districts are subject to the state's Open Public Meetings Act, which requires them to notify the public of the time, location and subject matter of meetings to discuss and take action on District business.

A separate law requires districts to take meeting minutes and make them available to the public on request. Under the Act, a meeting is any action regarding District business when a quorum of Board members is present. Because the ordinance creating the Board has three members, two members constitute a quorum. An action includes any discussion, deliberation or decision made when a quorum of Board members is present.

From its formation on January 27, 1995 to September 2003, two of the District Commissioners developed and owned a private water utility.

The District violated the Act on September 5, 2003, when the two Board Members, who were the only members of the Board at that time, signed a commitment for the District to borrow \$314,000 from their company to purchase the water system that the company built and owned. The District did not notify the public of this meeting and minutes were not taken.

Although the District began taking action on official business at some point after its formation in 1995, it did not publicly advertise any meetings until December 4, 2006. We also found that from the date the District was formed until December 4, 2006, the Board did not take minutes at meetings to document its discussions and decisions.

Status

This finding has been resolved.

3. The Board did not effectively set rates or reduce operating costs for the District, resulting in a decline in its financial condition. In addition, it is at risk of exceeding its statutory debt limit.

Report No. 1006702, dated September 5, 2012

Background

The District's overall financial condition has declined since 2007. The District's revenues, expenses and ending cash balance with the County Treasurer for 2007 to 2011 was:

	2007	2008	2009	2010	2011
Revenues	\$ 8,189	\$ 29,074	\$ 10,127	\$ 11,144	\$ 16,965
Expenses	\$ 9,646	\$ 34,440	\$ 24,027	\$ 30,677	\$ 43,780
Excess/(Deficit)	\$ (1,455)	\$ (5,366)	\$ (13,900)	\$ (19,533)	\$ (26,815)
Cash balance	\$4,165	\$ (5,256)	\$ (11,941)	\$ (16,244)	\$ (21,890)

Our audit determined the District Board did not charge water rates sufficient to cover operating expenses and debt payments, as required by state law (RCW 57.08.081(2)). In addition, the District did not charge connection fees and standby fees to Commissioners, which would have increased revenue (See the accompanying Schedule of Audit Findings and Responses, Finding 1.)

State law authorizes water districts to go into debt, if needed, to provide safe drinking water to residents of a district. The law limits the amount of debt to one-half of 1 percent of the value of the taxable property in the district.

The District's outstanding debt at the end of 2011 was:

Loan description	Balance on December 31, 2011
Owed to County Treasurer	\$ 21,900
Open note to Commissioners for personal loans for legal fees)	\$ 46,098
Loan for purchase of water system owed to Commissioners	\$ 314,000
Accrued interest on water system loan	\$ 100,776
Total outstanding debt	\$ 482,774

From 2007 to 2010, the District paid its bills through a line of credit with the County Treasurer's Office. After the District reached its borrowing limit with the treasurer in 2010, it relied on personal loans from the District Commissioners to cover operating expenses.

We found no contract or loan agreement for the personal loans from the District Commissioners. The Commissioners approved the loan during a meeting. The loan was an "open note" to cover attorney fees and has an annual interest rate of 5 percent.

As noted in the accompanying Schedule of Audit Findings and Responses, Finding 1, the Commissioners, acting in their capacity as private business owners, sold the water system to the District for \$314,000. This sale and loan took place in 2003, is in writing and carries an interest rate of 4.13 percent. Two notes memorialize the sale and indicate the debt would be satisfied out of water and sewer hook-up fees and credits against those fees; however, the notes do not indicate the fees were intended to be the sole source of payment and that the debt is not a general obligation of the District. To date,

the District has not had enough money to make payments on principal or interest. The Commissioners have verbally agreed to delay payment on the loan until December 10, 2016. Although this agreement is put in writing, no one signed it.

The annual interest on the water system loan is \$17,064. Since its inception the open note has been accruing interest at an annual rate of 5 percent, or \$2,305 per year. Interest expense on these loans nearly exceeds the District's entire 2012 budget. At its current financial status, operations of the District are not sustainable.

Status

This finding has not been resolved and is repeated in the accompanying Schedule of Audit Findings and Responses as Finding 2.



ABOUT THE STATE AUDITOR'S OFFICE

The State Auditor's Office is established in the state's Constitution and is part of the executive branch of state government. The State Auditor is elected by the citizens of Washington and serves four-year terms.

We work with our audit clients and citizens as an advocate for government accountability. As an elected agency, the State Auditor's Office has the independence necessary to objectively perform audits and investigations. Our audits are designed to comply with professional standards as well as to satisfy the requirements of federal, state, and local laws.

The State Auditor's Office employees are located around the state to deliver services effectively and efficiently.

Our audits look at financial information and compliance with state, federal and local laws on the part of all local governments, including schools, and all state agencies, including institutions of higher education. In addition, we conduct performance audits of state agencies and local governments and fraud, whistleblower and citizen hotline investigations.

The results of our work are widely distributed through a variety of reports, which are available on our Web site and through our free, electronic subscription service.

We take our role as partners in accountability seriously. We provide training and technical assistance to governments and have an extensive quality assurance program.

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