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August 31, 2011

To the Water Utility Board  
Madison Water Utility  
119 East Olin Avenue  
Madison, WI 53713

Dear Board Members:

The following are comments on matters that came to our attention during the course of the audit of the financial statements of the Madison Water Utility (utility) for the years ended December 31, 2010 and 2009, which we reported on August 31, 2011.

This letter is written to highlight certain items or bring other matters of attention to the Board Members. The comments and recommendations in this letter are not intended to reflect in any way on the integrity or ability of the personnel of the utility. They are made solely in the interest of establishing sound internal control practices and improving utility operations.

This letter is intended solely for the information and use of the board members and management, and is not intended to be, and should not be, used by anyone other than these specified parties.

#### ***2010 FINANCIAL HIGHLIGHTS***

During 2010 the utility increased its total net assets, or equity, by \$2,976,000 compared to an increase of \$562,000 in 2009. The bond refunding in 2009 combined with the ongoing proactive rate adjustments allowed the utility to exceed its minimum debt coverage requirement for the last two years. Although the utility does not have the desired level of unrestricted cash reserves the accounts required by the revenue bond resolutions are all fully funded and the utility has begun to pay down the short-term loan from the City of Madison which, once paid off, will allow the utility to begin to build an unrestricted reserve account.

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.

#### **CURRENT YEAR MATTERS**

##### ***USE OF COMPLETED CONSTRUCTION NOT CLASSIFIED***

For a number of years the utility has had a significant balance in the construction work in progress account. Management was aware that many of these projects were substantially complete and in service, however the final engineering information is not yet available in order to formally close the project costs into the detailed property accounts, such as distribution mains, services and hydrants. In an effort to mitigate the financial impact of this timing matter management instituted the use of completed construction not classified in 2010. This new category is used to track projects that are in service but cannot be fully closed out. This account is depreciated at a composite rate. The intent is not to leave projects in this account for an extended period of time, rather to use this as a first step in the close out process and to identify the projects are in service and should be included in the rate base for purposes of rate recovery.

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## **PRIOR YEAR MATTERS**

### ***BENCHMARKING AS A TOOL FOR IDENTIFICATION OF IMPROVEMENTS***

The utility has a history of efficient and effective operations. As the utility looks to continue this practice it is important for management to be able to focus efforts on the right areas. One way to identify potential areas for improvements is through benchmarking. Financial benchmarks, such as the current ratio, debt coverage ratio or reserve levels are one way to measure the success of a utility, however benchmarking of another kind can be useful in tracking areas of operations that are performing well and identifying areas for enhancements. Such benchmarks could include distribution maintenance cost per mile of system or per customer, customer service costs per customer, number of full time equivalent employees per customer, power or chemical cost per unit sold, etc. This information can be tracked internally in order to compare current operations to prior years. Often state or national organizations have similar information for other utilities as "industry benchmarks". Another option is to identify two or three local utilities that are similar in size or operation and benchmark against them. As each utility has its own unique environment this information cannot be looked at in a vacuum but can be a helpful tool to determine the allocation of limited resources for improvements.

### ***Status 12/31/2010***

The Board and management are currently in the process of developing benchmarking tools to be used in the ongoing analysis of operations.

## **INTERNAL CONTROL**

In planning and performing our audit of the financial statements of the Madison Water Utility for the years ended December 31, 2010 and 2009, in accordance with auditing standards generally accepted in the United States of America, we considered its internal control as a basis for designing our auditing procedures 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 would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and, therefore, there can be no assurance that all such deficiencies have been 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 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 a material weakness:

- > Financial reporting

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## **INTERNAL CONTROL (cont.)**

A significant deficiency is a deficiency, or 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. We consider the following deficiency in the utility's internal control to be a significant deficiency:

- > Segregation of duties

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, risk assessment, human resources and information technology.

### ***Financial Reporting***

In theory, a properly designed system of internal controls consists of enough people, with sufficient training, to process and record monthly transactions, as well as prepare a complete set of annual financial statements. While most utility's staff do a good job of processing and recording monthly transactions, the reality is that very few have the background, training or time needed to prepare annual financial statements.

The definition of a material weakness in internal control includes consideration of the year end financial reporting process including the preparation of financial statements. In order for your municipality to avoid this type of material weakness, the system of internal controls would need to be able to accomplish the following:

1. Maintain the utility's books and records in such a condition that the auditor is not able to identify any material journal entries as a result of our audit procedures.
2. Be capable of preparing a complete set of year end financial statements in such a condition that the auditor is not able to identify any material changes as a result of the audit. A complete set of financial statements include the statement of net assets, changes in net assets and cash flows as well as the footnote disclosures.

This high level of internal control over financial reporting can be a difficult task for governments. As opposed to large private companies, most governments operate with only enough staff to process monthly transactions and reports, and often rely on their auditors to prepare the year end entries and financial reporting. As this is the case with your municipality, we are now required to inform you that these are material weaknesses in your internal controls.

### ***Segregation of Duties***

During 2010, the utility experienced some turnover within the finance department. As a result, there were times when there were as few as two people performing the duties of four individuals. This naturally limited the ability of staff to follow normal protocols related to independent reviews and approvals of transactions, reconciliations and reports. We understand that this is normal under the circumstances, however, we are required to report this as a significant deficiency in internal control. We do note that since the positions have been filled, the normal processes have been re-established.

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## **COMMUNICATION TO AUDIT COMMITTEE OR ITS EQUIVALENT**

### ***OUR RESPONSIBILITY UNDER U.S. GENERALLY ACCEPTED AUDITING STANDARDS***

We have audited the financial statements of Madison Water Utility for the years ended December 31, 2010 and 2009, and have issued our report thereon dated August 31, 2011. Professional standards require that we provide you with the following information related to our audit.

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 the board 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 timing previously communicated to the City of Madison Common Council in our planning letter.

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

#### ***Accounting Policies***

Management has the responsibility for 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. No new accounting policies were adopted and the application of existing policies was not changed during 2010. We noted no 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.

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## **COMMUNICATION TO AUDIT COMMITTEE OR ITS EQUIVALENT (cont.)**

### ***QUALITATIVE ASPECTS OF THE ENTITY'S SIGNIFICANT ACCOUNTING PRACTICES (cont.)***

#### ***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 estimate of the accrued revenue is based on actual and historical billing data. We evaluated the key factors and assumptions used to develop the accrued revenue in determining that it is reasonable in relation to the financial statements taken as a whole.

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.

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

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

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

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

### ***AUDIT ADJUSTMENTS***

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.

For purposes of this letter, professional standards define an audit adjustment as a proposed correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. An audit adjustment may or may not indicate matters that could have a significant effect on the Madison Water Utility's financial reporting process. Matters underlying adjustments proposed by the auditor could potentially cause future financial statements to be materially misstated. There were no adjustments as a result of this year's audit.

### ***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 auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

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**COMMUNICATION TO AUDIT COMMITTEE OR ITS EQUIVALENT (cont.)**

***CONSULTATIONS WITH OTHER 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 is attached.

***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 Madison Water Utility for the year ended December 31, 2010, Baker Tilly Virchow Krause, LLP hereby confirms in accordance with the Code of Professional Conduct issued by the American Institute of Certified Public Accountants, that we are, in our professional judgment, independent with respect to the Madison Water Utility and provided no services to the Madison Water Utility other than the audit of the current year's financial statements and non-audit services which, in our judgment, do not impair our independence, including:

- > Financial statement preparation

***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 the 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.

**CLOSING COMMENTS**

We appreciate the assistance provided to us by utility personnel during the audit. As always, it is a pleasure working with the City of Madison Water Utility. If you have any questions or comments, please contact us.

Sincerely,

BAKER TILLY VIRCHOW KRAUSE, LLP

*Baker Tilly Virchow Krause, LLP*

Quality and Reliability since 1882

**Madison  
Water  
Utility**



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June 8, 2011

Baker Tilly Virchow Krause, LLP  
Ten Terrace Court  
P.O. Box 7398  
Madison, WI 53707

Dear Auditors:

We are providing this letter in connection with your audit of the financial statements of the Madison Water Utility as of December 31, 2010 and 2009 and for the years then ended for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the respective financial position, results of operations, and cash flows of Madison Water Utility in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the financial statements of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. We have engaged you to advise us in fulfilling that responsibility. We are also responsible for adopting sound accounting policies, establishing and maintaining internal control and preventing and detecting fraud.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, the following representations made to you during your audit.

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America and include all properly classified funds and other financial information of the primary government and all component units required by generally accepted accounting principles to be included in the financial reporting entity
2. We have made available to you all –
  - a. Financial records and related data.
  - b. Minutes of the meetings of our governing body and summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

5. All known audit and bookkeeping adjustments have been included in our financial statements.
6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
7. We have no knowledge of any fraud or suspected fraud affecting the entity involving:
  - a. Management,
  - b. Employees who have significant roles in internal control, or
  - c. Others where the fraud could have a material effect on the financial statements.
8. We have no plans or intentions that may materially affect the carrying value or classification of assets, liabilities or fund equity.
9. The following, if any, have been properly recorded or disclosed in the financial statements:
  - a. Joint ventures
  - b. Related party transactions, including revenues, expenses, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
  - c. Collateralization agreements with financial institutions.
  - d. Guarantees, whether written or oral, under which the utility is contingently liable.
  - e. All accounting estimates that could be material to the financial statements, including the key factors and significant assumptions underlying those estimates, and we believe the estimates are reasonable in the circumstances.
10. We are responsible for compliance with the laws, regulations, and provisions of contracts and grant agreements applicable to us, including debt contracts and debt covenants; and we have identified and disclosed to you all laws, regulations and provisions of contracts and grant agreements that we believe have a direct and material effect on the determination of financial statement amounts, including legal and contractual provisions for reporting specific activities in separate funds.
11. There are no –
  - a. Violations or possible violations of budget ordinances, provisions of contracts and grant agreements, laws or regulations and any related debt covenants whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
  - b. Rates being charged to customers other than the rates as authorized by the applicable authoritative body.
  - c. Violations of restrictions placed on revenues as a result of a bond resolution covenants – such as revenue distribution, or debt service funding.



June 8, 2011

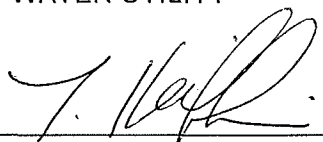
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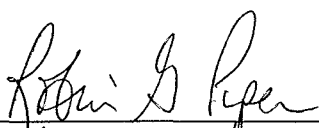
11. (cont.)

- d. Unasserted claims, assessments or pending lawsuits that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.
  - e. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5.
12. Provision, when material, has been made to reduce excess or obsolete inventories to their estimated net realizable value.
  13. We have satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral other than liens created by our revenue debt.
  14. We have complied with all aspects of contractual agreements that would have a material effect on the financial statement in the event of noncompliance.
  15. Net asset components (invested in capital assets, net of related debt; restricted; and unrestricted) are properly classified.
  16. Provisions for uncollectible receivables have been properly identified and recorded.
  17. Interfund activity and balances have been appropriately classified and reported.
  18. Special and extraordinary items are appropriately classified and reported.
  19. Deposits and investment securities are properly classified in category of custodial credit risk.
  20. Capital assets are properly capitalized and depreciated.
  21. Required supplementary information (RSI) is measured and presented within prescribed guidelines.
  22. Expenses have been appropriately classified in or allocated to functions and programs in the statement of activities, and allocations have been made on a reasonable basis.
  23. Revenues are appropriately classified in the statement of activities within program revenues, general revenues, contributions to term or permanent endowments, or contributions to permanent fund principal.

To the best of our knowledge and belief, no events, including instances of noncompliance, have occurred subsequent to December 31, 2010 and through the date of this letter that would require adjustment to, or disclosure in, the aforementioned financial statements.

MADISON WATER UTILITY

Signed   
Title/Date General Manager 6/8/2011

Signed   
Title/Date Finance/Acctg Mgr 6/8/2011