

July 24, 2012

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, 2011 and 2010, which we reported on July 24, 2012.

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.

2011 FINANCIAL HIGHLIGHTS

During 2011, the utility increased its total net assets, or equity, by \$2,750,000 compared to an increase of \$2,976,000 in 2010. Cash and investments increased by \$11,986,000 due to an increase in construction funds from the 2011 bond issue combined with a deferred tax equivalent payment to the City of Madison. Sales of water increased \$1,403,000 in 2011 due to an eight percent increase in water rates in May 2011.

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. The accounts required by the revenue bond resolutions are all fully funded and the utility continues to pay down its loan from the City of Madison which, once paid off, will allow the utility to begin to build an unrestricted reserve account. In order for these positive trends to continue it is imperative management continue to proactively seek rate adjustments given the capital plans for the next several years.

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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CURRENT YEAR MATTERS

REVIEW OF CAPITALIZED INTEREST

The utility often issues debt to fund capital projects that incurs interest during the construction process. Accounting standards require the utility calculate this cost of capital and include it in the project cost as capitalized interest. This component of the project cost is calculated using an average cost of borrowing. Given recent large borrowings, management should review the rate applied to calculate capitalized interest to ensure that the rate is consistent with the current average rate on the utility's outstanding debt.

INDEPENDENT REVIEW OF WORK ORDER CLOSINGS

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). Independent review of work order closings should be reviewed by someone other than the preparer. We noted that due to time constraints, not all work orders were independently reviewed this year. The utility should strive for timely reporting that allows for such controls to operate as designed.

ACCOUNTING FOR METERS

The PSCW chart of accounts states that meters should be charged to account 346 "Plant in Service" and depreciated at the time of purchase rather than tracked through inventory. Historically, the utility has flowed its meters through inventory, however, the balance of meters on hand at year end has not been significant. In 2011, in preparation for the H2O project, the amount of meters in inventory increased substantially. We recommend management consider moving the accounting for meters out of inventory and into account 346 to follow PSCW recommended accounting at this time.

EVALUATION OF YEAR-END PROCEDURES

During the audit, we noted that there were a lot of entries, allocations and reconciliations that are only done once a year. For example, work orders are closed once per year. If engineering were able to provide data on completed projects quarterly, finance could complete closings throughout the year. Similarly, the clearing accounts and interfunds are only reconciled at year end. Completion on a periodic basis would result in less time investigating activity from several months ago and more accurate financial data during the year. We recommend that management review the listing of all year-end procedures to determine which could be performed monthly or quarterly to alleviate compression at year end.

PRIOR YEAR MATTERS

USE OF COMPLETED CONSTRUCTION NOT CLASSIFIED

For a number of years the utility had a significant balance in the construction work in progress account. Management was aware that many of these projects were in service; however, the final engineering information is not yet available in order to formally close the project. 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 have not yet been 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 (cont.)

USE OF COMPLETED CONSTRUCTION NOT CLASSIFIED (cont.)

Status 12/31/2011

The utility has progressed in formally closing work orders at year end. However, the utility maintains a significant balance in the completed construction not classified account. We encourage management to continue these efforts with a goal of moving the projects out of completed construction not classified in 2012.

INTERNAL CONTROL

In planning and performing our audit of the financial statements of the Madison Water Utility for the year ended December 31, 2011, 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 and others we consider to be significant deficiencies.

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

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 deficiencies in the utility's internal control to be significant deficiencies:

- > Segregation of duties
- > Information technology controls

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, and risk assessment.

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INTERNAL CONTROL (cont.)

FINANCIAL REPORTING

In theory, a properly designed system of internal control staffed with enough people with sufficient training would provide your organization with the ability to not only process and record monthly transactions, but also prepare the annual financial statements.

The definition of a material weakness in internal control includes consideration of the year-end financial reporting process. To avoid the auditor reporting a material weakness in internal control, your system controls would need to be able to accomplish the following:

1. Present the books and records to the auditor in such a condition that the auditor is not able to identify any material journal entries as a result of 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. This includes drafting the statement of net assets, statement of changes in net assets and statement of cash flows as well as preparing 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 utility, we are required to inform you that these are material weaknesses in your internal controls.

SEGREGATION OF DUTIES

Similar to 2010, during 2011 the utility experienced turnover within the finance department. As a result, there have been some duties that were transitioned and many of the year end procedures were being performed by someone for the first time. Due to time constraints, we noted that certain items, including some work order closings and certain reconciliations were not independently reviewed. This is understandable under the circumstances, however, we are required to report this as a significant deficiency in internal control.

INFORMATION TECHNOLOGY CONTROLS

As part of the 2011 audit, we were required to identify the processes in place that provide a controlled information technology (IT) environment for the applications, supporting systems and infrastructure determined to be critical to the financial statement audit. We documented the processes in place for three main areas of focus: manage changes, logical access and IT operations. We then assessed the design effectiveness of each of these processes and noted the following opportunities to strengthen the city's IT controls.

The city does not have a formally documented change management process. We recommend that the city develop formal change management procedures for all program changes, upgrades, system changes, and maintenance. Additionally a standard form (paper or electronic) should be used to request, record and facilitate all changes.

Network passwords are complex and are forced to change every 60 days. Many of the applications used do not have these same requirements. Consider applying the same criteria to all significant financial applications.

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INTERNAL CONTROL (cont.)

INFORMATION TECHNOLOGY CONTROLS (cont.)

Access rights should be reviewed at least once a year by management to ensure users don't have access beyond their job responsibilities and segregation of duties is maintained. Documentation of this review should be maintained and available for the audit.

Server room access is restricted by card access rights. The card access system is maintained by Dane County. City personnel should review, at least annually, the list of individuals with access to the server room. Server room access reports should also be reviewed regularly to monitor who is accessing the server room and when. Documentation of these reviews should be maintained.

A formal IT job schedule should be created to identify all IT operations including batch jobs to ensure jobs are successful and scheduled and run them in the correct order.

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, 2011, and have issued our report thereon dated July 24, 2012. 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.

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.

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COMMUNICATION TO AUDIT COMMITTEE OR ITS EQUIVALENT (cont.)

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 2011. 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.

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 significant difficulties in dealing with management in performing our audit.

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COMMUNICATION TO AUDIT COMMITTEE OR ITS EQUIVALENT (cont.)

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. Adjustments as a result of this year's audit included:

Recording 2010 grant revenue	\$ 54,835
Recognition of EPA grant as revenue	146,360
Recording PILOT expense	4,519,770
Reclassification of monthly sewer/storm billings	1,138,214
Reclassification of year end shared meter charges to sewer	528,196
Record new special assessments	465,149
Segregate IRS interest subsidy as revenue rather than net with interest expenses	197,600
Record activity in accrued compensated absences	185,300
Record retainages payable at year end	407,180
Adjust capitalized taxes for projects in CCNC	297,337
Adjust return on meters billed to sewer to rate of return authorized in May 2011	28,763
Record refund due to wholesale customer	90,000

The details of all audit adjustments are available from management.

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.

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.

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COMMUNICATION TO AUDIT COMMITTEE OR ITS EQUIVALENT (cont.)

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, 2011, 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
- > Preparation of adjusting journal entries

None of these non audit 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 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 1887



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June 22, 2012

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, 2011 and 2010, 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 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 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 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. We have engaged you to advise us in fulfilling that responsibility.
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 and we are in agreement with those adjustments.

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 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, 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, 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, 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 covenant – such as revenue distribution or debt service funding.
 - 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.

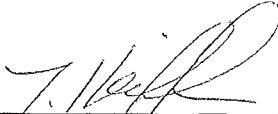
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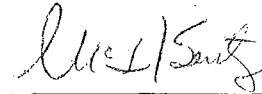
12. Provision, when material, has been made to reduce excess or obsolete inventories to their estimated net realizable value.
13. We have satisfactory title to all owned assets and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral other than liens created by our revenue debt.
14. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements 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. Deposits and investment securities are properly classified as a category of custodial credit risk.
19. Capital assets are properly capitalized and depreciated.
20. We acknowledge our responsibility for the required supplementary information (RSI). The RSI is measured and presented within prescribed guidelines and the methods of measurement and presentation have not changed from those used in the prior period. We have disclosed to you any significant assumptions and interpretations underlying the measurement and presentation of the RSI.
22. In regard to the non-attest services performed by you listed below, we have 1) made all management decisions and performed all management functions; 2) designated an individual with suitable skill, knowledge, or experience to oversee the services; 3) evaluated the adequacy and results of the services performed, and 4) accepted responsibility for the results of the services.
 - a. Financial statement preparation
 - b. Adjusting journal entries

To the best of our knowledge and belief, no events, including instances of noncompliance, have occurred subsequent to December 31, 2011 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 7/24/12

Signed 

Title/Date FINANCIAL MANAGER 6/25/2012