

INVESTIGATIVE AUDIT REPORT

WATAUGA RIVER REGIONAL WATER AUTHORITY
JULY 1, 2006, THROUGH MARCH 31, 2007



State of Tennessee



**Comptroller of the Treasury
Department of Audit
Division of Municipal Audit**



STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Justin P. Wilson

Comptroller

STATE CAPITOL

NASHVILLE, TENNESSEE 37243-0260

PHONE (615) 741-2501

January 27, 2009

Members of the Board of Directors
Watauga River Regional Water Authority
386 Highway 91, Suite 1
Elizabethton, TN 37643-6060

Gentlemen:

Presented herewith is the report on our investigative audit of selected records of the Watauga River Regional Water Authority. This investigative audit focused on the period July 1, 2006, through March 31, 2007. However, when warranted, this scope was expanded.

Section 9-2-102, *Tennessee Code Annotated*, requires that the Comptroller of the Treasury prescribe a uniform system of bookkeeping designating the character of books, reports, receipts and records, and the method of keeping same, in all state, county and municipal offices, including utility districts, which handle public funds. The purpose of our audit was to determine the extent of the entity's compliance with certain laws and regulations.

The findings and recommendations in this report relate to those conditions that we believe warrant your attention. All responses to each of the findings and recommendations are included in the report.

Copies of this report are being forwarded to Governor Phil Bredesen, the State Attorney General, the District Attorney General, certain state legislators, and various other interested parties. A copy is available for public inspection in our office.

Very truly yours,

Justin P. Wilson
Comptroller of the Treasury



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
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Justin P. Wilson
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Dennis F. Dycus, CPA, CFE, Director
Division of Municipal Audit

January 27, 2009

Mr. Justin P. Wilson
Comptroller of the Treasury
State Capitol
Nashville, TN 37243-0260

Dear Mr. Wilson:

As part of our ongoing process of examining the records of utility districts, we have completed our investigative audit of selected records of the Watauga River Regional Water Authority. This investigative audit focused on the period July 1, 2006, through March 31, 2007. However, when the audit warranted, this scope was expanded.

Section 9-2-102, *Tennessee Code Annotated*, requires that the Comptroller of the Treasury prescribe a uniform system of bookkeeping designating the character of books, reports, receipts and records, and the method of keeping same, in all state, county and municipal offices, including utility districts, which handle public funds. The purpose of our audit was to determine the extent of the entity's compliance with certain laws and regulations.

Our investigative audit resulted in findings and recommendations related to the following:

1. Payroll payments to executive director salary exceeds authorized rate by at least \$11,375
2. Inadequate, inaccurate payroll records and lack of approved payroll procedures
3. Failure to develop and enforce comprehensive, equitable written agreements with utility members
4. Problematic informal relationship between the Authority and North Elizabethton Water Co-op
5. Inadequate collection procedures for the North Elizabethton Water Co-op
6. Inadequate disbursement procedures

Mr. Justin P. Wilson
Comptroller of the Treasury
January 27, 2009

In addition to our findings and recommendations, we are also providing management's response. If after your review, you have any questions, I will be happy to supply any additional information which you may request.

Sincerely,

A handwritten signature in black ink, appearing to read "Dennis F. Dycus". The signature is fluid and cursive, with a large initial "D" and "F".

Dennis F. Dycus, CPA, CFE, Director
Division of Municipal Audit

**INVESTIGATIVE AUDIT OF SELECTED RECORDS OF THE
WATAUGA RIVER REGIONAL WATER AUTHORITY
FOR THE PERIOD JULY 1, 2006, THROUGH MARCH 31, 2007**

BACKGROUND

Creation, Governance and Initial Membership

The Watauga River Regional Water Authority [authority] was created in 2001 by the Tennessee General Assembly (Tennessee *Private Acts* Chapter 29) to develop water and wastewater resources for its Carter County area members.

The authority is governed by a board of directors made up of the county executive of Carter County and representatives of its members. It was originally made up of one utility cooperative and five member utility districts: the North Elizabethton Water Cooperative, First Utility District, Siam Utility District, Hampton Utility District, Roan Mountain Utility District, and South Elizabethton Utility District.

Funding

The authority is funded by customer surcharges billed to customers of participating utility districts. According to the State of Tennessee Attorney General Opinion No. 03-051, the authority is authorized to impose fees on member utility districts and the county, or individual water customers of those entities, in order to pay operating expenses. The approval of the boards of directors of the respective utility districts or of the county commission is not required. The board of the authority initially approved a 50¢ per connection surcharge to begin May 1, 2003. In May 2005, the authority's board of directors approved an increase in the monthly surcharge from 50¢ per connection to \$2 per connection to begin July 15, 2005. In May 2007, the authority's board of directors approved an increase in the monthly surcharge fee from \$2 per connection to \$10 per connection to begin in July 2007. However, on August 6, 2007, the authority's board of directors voted to decrease the monthly surcharge fee from \$10 per connection to the current surcharge rate of \$7 per connection.

Change in Membership

In March 2005, the Roan Mountain Utility District asked to withdraw from the authority after initial feasibility studies indicated water service would not be provided to that particular area until 2028. The authority granted that request, acknowledging that the cost to provide service to the Roan Mountain Utility District could become too expensive.

The original legislation that created the authority did not name the City of Elizabethton as a member of the authority but gave the city the option to join by a two-thirds vote of its board of commissioners. The City of Elizabethton's Board of Commissioners voted to exercise that option

in June 2001. The City of Elizabethton participated as a surcharge-paying member until its board of commissioners voted to withdraw from the authority in August 2006.

In December 2006, the authority's board of directors agreed to take over the assets and liabilities of the North Elizabethton Water Cooperative following a vote by the co-op membership in favor of the acquisition. According to the plan presented at the time, the North Elizabethton Water Cooperative and a second utility service area under development referred to as Fish Springs were to remain separate and self-supporting entities operated by the authority.

Hampton Utility District began withholding its surcharge payments to the authority in September 2007. The authority took legal action that resulted in Hampton Utility District settling with them with payments of approximately \$100,000. The Hampton Utility District along with First Utility District opted out of the authority by legislation that was approved by the Carter County Commission in May 2008.

In October 2008, the City of Elizabethton signed a separate water purchase agreement with the authority, which stated, in part:

It is recognized by the parties that the Water Authority is in the earliest stages of development, that construction of its water plant has not commenced, and that the performance of this Agreement cannot occur until the Water Authority has constructed a water treatment plant and transmission lines, the completion of which, at the earliest, will occur in late 2011.

Also, according to the agreement, the authority agreed to provide to the City of Elizabethton a minimum of 300,000 gallons and up to 1 million gallons of water per day at a negotiated price. The City of Elizabethton agreed to start making payments on a \$5 million capital contribution no later than 30 days after the authority executes a contract to build the water plant and construction lines.

Current Association Membership

There are three¹ remaining water service providers who retain membership in the association and levy a surcharge to their customers on behalf of the authority. They are the North Elizabethton Water Cooperative (operated by the authority), Siam Utility District, and South Elizabethton Utility District. The authority has used surcharge funds already collected to pay engineering and attorneys' fees for the creation of plans for a water plant using Wilbur Lake as its water source. The land for the project has been purchased; however, construction has not yet begun.

¹ This does not include the City of Elizabethton, which has made a commitment to participate at a later date.

FINDINGS AND RECOMMENDATIONS

1. **FINDING:** Payroll payments to executive director salary exceeds authorized rate by at least \$11,375

The executive director received salary in excess of that approved by the Watauga River Regional Water Authority [authority] board of directors. The board authorized the starting salary for the executive director at “\$52,000 per year subject to such annual increases in compensation determined as appropriate,” according to an employment agreement dated July 7, 2003. There was no documentation in authority files of any subsequent approved salary increase. The executive director informed state auditors that the board had increased his annual salary to \$54,600 in July 2006. However, auditors noted that the executive director actually received a gross salary, including bonus, of \$58,075 in calendar year 2006. In calendar year 2007, the executive director received a gross compensation of \$65,975, which exceeded by \$11,375 the authorized compensation cited by the executive director.

RECOMMENDATION:

To ensure that employees do not receive compensation in excess of approved amounts, members of the board of directors should periodically review employee compensation, including monthly and quarterly amounts, to ensure compliance with approved rates. In addition, members of the board of directors should take immediate action to recover the unauthorized excess payroll payments made to the executive director.

MANAGEMENT’S RESPONSE:

Members of the Board of Directors:

Management and the board of directors concur that payroll for the executive director was exceeded in 2007. We concur that poor documentation of raises and budget occurred. The salary of the executive director is currently \$61,800. His salary has been increased in several budgets, but were not broken out. The figures have been included in the salaries and wages portion of the Watauga River Regional Water Authority [authority] budget. The board of directors reaffirmed this budget and salary for the director at the regular meeting on January 5, 2009. Future budgets will have breakouts of salary by position and will be separated from the regular budget items.

The executive director will immediately return the overage of the \$61,800, which amounts to \$4,175. Our CPA, Mr. James Barker, investigated this action, noting the poor documentation of salary items. He normally monitors payroll figures; however, there were two incidences of computer failure with the import/export functions of the program that did not allow for proper review. The executive director had no knowledge of the overpayment and regrets the error. It will be amended immediately, and W-2 forms will be amended.

The board of directors passed a new payroll policy at the January 5, 2009, meeting. This new policy calls for Mr. Barker to execute all payroll from his office, and all checks will be signed by the director and an authorized board member. Authority staff will not generate payroll checks, and the new pay schedule will be in place as of February 15, 2009. Checks will be issued on the 1st and 15th of each month. New W-4 forms will be completed, indicating the proper salary for each employee. This will also aid in segregation of duties.

The authority regrets the error, and the secretary/treasurer will monitor payroll on a quarterly basis. The minutes of the January 5, 2009, meeting are enclosed, along with a copy of the new payroll and petty cash policies.

2. **FINDING: Inadequate, inaccurate payroll records and lack of approved payroll procedures**

Auditors noted that the total budgeted amount for salaries and wages for the authority for the fiscal year ending June 30, 2007, was \$61,800. However, the executive director's actual compensation of \$65,975 exceeded the budgeted line item. Our audit also revealed that the intervals between payroll checks to the executive director in 2007 varied from as little as 2 days to as much as 43 days. We also noted that the executive director continued to receive payroll checks at irregular intervals in 2008. Due to this erratic pay cycle, the executive director's excessive pay noted in the previous finding was not detected. In addition, auditors noted that payroll records prepared and maintained by the bookkeeper were not accurate. The executive director's actual compensation exceeded what was reported to the Internal Revenue Service on Form W-2 by \$8,350. Auditors also noted inconsistencies between the amounts shown in payroll records and actual amounts of payroll checks issued to the executive director.

We were unable to find an authority policy outlining payroll procedures, including frequency of payroll checks. The lack of a policy for payroll procedures was noted in a letter dated June 5, 2007, from the board attorney to the executive director. A draft policy included with the letter suggested that all employees of the authority be paid by check on Friday morning on a bi-weekly basis. However, auditors could find no evidence that this policy was ever brought before the board for consideration.

RECOMMENDATION:

To fulfill their fiduciary duty and protect the assets of the organization, members of the board of directors of the authority should adopt and enforce a comprehensive written payroll policy. Salary advances and early payroll checks should be forbidden. A detailed pay-rate listing by employee classification should be included as supplementary schedules to support salary appropriations in the budget. In addition, members should periodically compare actual payroll with budgeted amounts. Members of the board should also ensure that management is keeping complete and accurate payroll records.

MANAGEMENT'S RESPONSE:

Members of the Board of Directors:

Management and the board of directors concur with the findings of the audit. A new payroll policy has been established as shown in the response to Finding 1. Lack of staff experience with financial matters led to this situation, and all parties involved will receive proper training and guidance as directed by the state's Comptroller's Office.

Executive Director:

Response is the same as that of the members of the board of directors.

3. **FINDING: Failure to develop and enforce comprehensive, equitable written agreements with utility members**

The authority failed to adopt uniform written rules to which all utility members would conform, and further failed to require that all utility members execute written agreements acknowledging the rights and obligations of all parties. As a result, state auditors found that not only were utility members required to rely on their own interpretation regarding certain aspects of the arrangement, the authority executive director applied different standards to the various utility members.

In a March 10, 2003 meeting, board members of the authority assessed a surcharge payment on active connections for all authority members to begin May 1, 2003. However, First Utility District of Carter County did not make its first payment to the authority until May 2004. There was no documentation on file explaining this apparent 11-month exemption of approximately \$16,500 in surcharge payments.

In November 2005, First Utility District fell behind on surcharge payments. According to our review of financial records, First Utility District billed customers at least \$57,000 in surcharges that were not remitted to the Watauga River Regional Water Authority from November 2005 through May 2008. In official communication to the authority in June 2008, a representative for First Utility stated that all fees for the surcharge were forwarded to the authority. We were unable to find any documentation that the authority regularly recognized the discrepancy between the actual payments made by First Utility and the representations of its officials. In addition, we were unable to find documentation that the authority reviewed surcharge payments for their accuracy and timeliness.

According to the minutes of the meetings of the board of the authority, the decision to enter into a written agreement with the authority was left to the utility members of the authority. Only one utility signed a written agreement with the authority specifying the terms of the surcharge payments. Due to the lack of written agreements for most members of the authority, there were no clear rules for how utility members were to

collect and remit the surcharges. Auditors observed that member utilities were not required to include supporting documentation with their surcharge payments. As a result, authority management was unable to determine the accuracy of the surcharge collections remitted to them. Auditors contacted the member utilities and found that some utilities paid the surcharge based on the number of active accounts billed, while others paid based on the number of utility customers who paid in full.

Auditors also observed that some utilities charged sales tax on the surcharge and others did not. According to the Tennessee Department of Revenue, the surcharge would be considered part of the sales price of water sold to a residential customer as defined by Section 67-6-106(71), *Tennessee Code Annotated*. Therefore, sales tax on the surcharge should be collected at the time of the sale by the entity making the sale, and forwarded to the Tennessee Department of Revenue.

RECOMMENDATION:

To ensure that the surcharge is applied fairly and equitably to all applicable customers, the board should adopt uniform policies and procedures that specify the calculation of and collection of the surcharge payment from customers of member utilities. These policies should be set forth in written agreements with all member utilities.

MANAGEMENT'S RESPONSE:

Members of the Board of Directors:

Management and the board of directors concur with the finding. When the surcharge was levied, each utility was told that the surcharge was based on the number of active connections, and that the surcharge was required to be remitted on the 15th of each month. Utility members were not required to sign an agreement at the time of the private act; we understood that the private act constituted an agreement that all member utilities must follow. Authority staff were not persistent in demanding immediate collection, and will do so in the future.

We concur that we did not develop written agreements for these members. As of January 9, we have a contract with the City of Elizabethton, and pending contracts for Siam Utility District and South Elizabethton Utility District that will be signed shortly.

The sales tax issue was determined by the Department of Revenue, and the utilities were notified of the finding.

The surcharge and other payments will be addressed in the future contracts. The board will consult with its attorney in order to determine actions needed for the surcharge discrepancies. We will report our findings and decided course of action to you as soon as possible. If you deem a different course of action is needed, please notify us as soon as possible.

Executive Director:

Response is the same as that of the members of the board of directors.

4. **FINDING: Problematic informal relationship between the Authority and North Elizabethton Water Co-op**

The investigative audit revealed no clear and documented distinction between the operations of the authority and the North Elizabethton Water Co-op [co-op]. The resulting confusion created difficulty in determining adequate rates and fees for both the co-op customers and the authority members. The minutes of the October 10, 2006, authority board meeting indicated that board members voted to accept the assets and liabilities of the co-op. The decision followed a vote by the co-op membership in favor of the acquisition. At the time of the acquisition, the co-op had failed to forward to the authority more than \$6,800 in surcharge payments collected from its customers. Without explanation, this trend continued even after the acquisition. Our audit revealed that the co-op consistently failed to forward to the authority the full amount of surcharges collected from customers. As of September 2008, the co-op owed \$31,490 in surcharges collected from its customers on behalf of the authority. As a result, the fee required by the authority was being used to subsidize the operations of the co-op.

The co-op repaid some of the surcharges owed to the authority by paying some of the authority's bills. For example, in March 2007, the co-op purchased furniture for the authority's board room at a cost of \$4,280. However, three days later, the authority purchased a truck for the co-op costing \$4,350. We noted that in 2008, the executive director received several payroll checks from the bank account of the co-op. The payroll checks were apparently in lieu of a repayment of surcharges owed by the co-op to the authority.

The Watauga River Regional Water Authority was created and operates under 2001 Tennessee *Private Acts* Chapter 29 and accordingly, per Section 6, the board is required to charge rates, fees and charges to ensure that "any system shall be and always remain self-supporting."

RECOMMENDATION:

To ensure accountability, the authority and the co-op should properly account for their own debts and obligations. The authority must demonstrate compliance with its enabling legislation and remain a self-supporting entity. In addition, comingling funds increases the risk that errors or fraud will occur and not be detected.

MANAGEMENT’S RESPONSE:

Members of the Board of Directors:

Management and board of directors concur with the findings of the audit. The board and management were attempting to improve the co-op’s system, which is surely distressed. Much progress has been made in correcting the co-op’s deficiencies, and the \$40 minimum bill was a serious issue for both management and board. Recently, the City of Elizabethton raised the rates for the co-op, and at the January 5 meeting of the board, co-op customer rates were raised by \$16.17 in order to meet the city’s water rates and to pay the authority the arrears of the surcharge. The minimum bill for co-op customers is now \$56 for 2,000 gallons.

Policies and procedures will be adopted for a more stringent co-op management. All arrears will be paid, and all authority divisions will stand alone financially. The co-op will be required to stand alone financially and pay all surcharges.

Executive Director:

Response is the same as that of the members of the board of directors.

5. **FINDING: Inadequate collection procedures for the North Elizabethton Water Co-op**

Collection procedures for the co-op were inadequate. State auditors noted the following deficiencies:

- Collections were not deposited intact. The executive director and office staff routinely cashed personal checks through the cash drawer.
- The executive director removed cash from the cash drawer presumably for petty cash purchases. However, there was not sufficient documentation to determine if purchases made with the cash were made for a valid purpose of the co-op.
- Authority personnel maintained no documentation that collections were reconciled to bank deposits, adjustments, penalties, and accounts receivable on a monthly basis.
- The same individual who made collections also posted collections, prepared the summary of collections report, prepared deposits, and made deposits.
- Some adjustments to co-op accounts were not recorded on the monthly adjustment record.

RECOMMENDATION:

To fulfill their fiduciary duty and protect the assets of the organization, members of the board of directors of the authority should ensure that all collections are deposited promptly and intact into an authorized bank account and a monthly reconciliation is performed of the detail listing of accounts receivable in the billing register to the general ledger control account. Also, to decrease the risk of undetected errors and irregularities, members of the board should review employees' responsibilities to ensure that no employee has control over a complete transaction and that each adjustment is properly documented and approved and that documentation is maintained in the organization's records.

MANAGEMENT'S RESPONSE:

Members of the Board of Directors:

Management and the board of directors concur with the findings of improper collection procedures. The board passed a new policy on petty cash on January 5th, which basically eliminates the system. The board of directors is confident that no money was taken from the co-op improperly. The drawer is no longer used for petty cash or check cashing for customers or employees. Reconciliation of collections has not be done by our office. We have relied on our CPA for this; however, our computer software allows for this, and staff will begin to reconcile all deposits and adjustments on a monthly basis. Separation of duties is a difficult issue for small utilities, as we do not have the manpower to cover all aspects of the financial transactions. We will do everything it takes to improve.

Executive Director:

Response is the same as that of the members of the board of directors.

6. **FINDING: Inadequate disbursement procedures**

Authority management failed to maintain adequate supporting documentation for some disbursements. In addition, cashiers checks were obtained for some purchases.

From the time of the merger of the authority and the co-op until April 2007, monthly maintenance for the co-op was performed by a contractor without a written agreement. For some payments to the contractor, the executive director failed to obtain and file adequate documentation of the work performed and/or supplies purchased from the contractor. In addition, there was no documentation that the executive director monitored projects to ensure that the co-op received the services for which the entity was billed.

Also, it appears that some other additional disbursements were not properly reviewed by the executive director prior to payment. For example, we noted that one bill to an

engineering firm was paid twice and another not paid at all. Fortunately, the engineering firm noticed the discrepancy and properly credited the account of the authority.

Finally, we noted that the authority paid legal fees in the amount of \$2,762.43 in May 2007 on behalf of an apparent start-up utility district, Fish Springs/Little Milligan.

The Watauga River Regional Water Authority was created and operates under 2001 Tennessee *Private Acts*, Chapter 29 and accordingly, per Section 4 (20) the board was granted the authority to adopt by majority vote of the board the purchasing procedures for utility districts as defined in *Tennessee Code Annotated*, Title 7, Chapter 82, Part 8.

RECOMMENDATION:

To fulfill their fiduciary duty and protect the assets of the organization, members of the board of directors of the authority should ensure that all disbursements are made by using prenumbered checks with two signatures required on all checks. In addition, members of the board should adopt the purchasing policy as set forth in state statutes. Finally, the board should ensure that payment is issued only after adequate supporting documentation has been reviewed to determine the expenditure fulfills a valid purpose of the organization.

MANAGEMENT'S RESPONSE:

Members of the Board of Directors:

The management and board of directors concur that there were issues with a contractor that resulted in inadequate reimbursement procedures. The executive director and the administrative manager repeatedly requested invoices for materials, supplies and labor, and that a direct account be provided to the authority. Two months after acquisition of the co-op, the authority discharged the contractor, with the failure to provide invoices and inventory as the primary causes.

The authority now does work in-house and has been successful in lowering water loss and has improved service to the customers. All contractors are closely monitored by the executive director and will continue to be in the future. We will adopt the purchasing procedures set forth in state statutes.

The Fish Springs Project was an "orphan" that no one would pick up. The authority ended up with the project as a last resort to provide water to the residents in the Far Mountain region. All money that the board authorized came with the caveat that such money would be repaid when the utility came online. We would request further guidance from the Comptroller's Office on this matter.

Executive Director:

Response is the same as that of the members of the board of directors.