

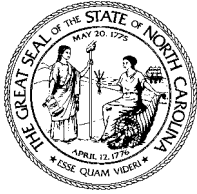
**TOWN OF BUTNER WATER
AND SEWER SYSTEM**
Butner, North Carolina

Financial Statement Audit Report

Year Ended June 30, 2003

Performed Under Contract With the
North Carolina Office of the State Auditor

Ralph Campbell, Jr.
State Auditor



Ralph Campbell, Jr.
State Auditor

STATE OF NORTH CAROLINA

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The Honorable Michael F. Easley, Governor
The General Assembly of North Carolina
Secretary Carmen Hooker Odom, Department of Health and Human Services

This report represents the results of the financial statement audit of the Town of Butner Water and Sewer System ("System") for the year ended June 30, 2003. Thomas and Gibbs CPAs, PLLC performed this audit under contract with the Office of the State Auditor and their report is submitted herewith.

The audit of the System was conducted in accordance with the Trust Agreement between the State of North Carolina and the First-Citizens Bank & Trust Company, Trustee. This Agreement authorizes and secures the State of North Carolina Butner Water and Sewer System Revenue Bonds. The Agreement provides that the State shall cause the North Carolina Department of Health and Human Services to prepare and deliver to the Department Secretary within 180 days after the close of each fiscal year financial statements of the System. The Agreement also provides that the State shall cause the State Auditor to prepare and file annually with the Trustee, each Credit Provider and the Local Government Commission a statement by the State Auditor containing the calculation to determine compliance with the rate covenants described in Section 704 of the Agreement.

General Statute 147-64.2 provides that the State Auditor shall perform or coordinate all audit functions for the State government. General Statute 147-64.7 allows the State Auditor to obtain the services of independent public accountants to carry out its duties and functions.

North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of all audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.

Respectfully Submitted,

A handwritten signature in black ink that reads "Ralph Campbell, Jr." in a cursive script.

Ralph Campbell, Jr.
State Auditor

TOWN OF BUTNER WATER AND SEWER SYSTEM
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Year Ended June 30, 2003

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and Consultants

INDEPENDENT AUDITORS' REPORT

Secretary Carmen Hooker Odom,
Department of Health and Human Services
Town of Butner Water and Sewer System
Butner, North Carolina

We have audited the accompanying Statement of Net Assets of the Town of Butner Water and Sewer System (the "System") as of June 30, 2003 and the related Statement of Revenues, Expenses, and Changes in Fund Net Assets and the Statement of Cash Flows for the year ended June 30, 2003. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements of the Town of Butner Water and Sewer System are intended to present the financial position and results of operations and cash flows of only that portion of the State of North Carolina financial reporting entity that is attributable to the transactions of the System. They do not purport to, and do not, present fairly the financial position of the State of North Carolina as of June 30, 2003, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Town of Butner Water and Sewer System as of June 30, 2003, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 30, 2003, on our consideration of the System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Our audit was performed for the purpose of forming an opinion on the basic financial statements of the Town of Butner Water and Sewer System taken as a whole. The supplementary information in Schedule 1 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

Thomas & Gibbs CPAs, PLLC

Thomas & Gibbs CPAs, PLLC

Durham, North Carolina
November 30, 2003

TOWN OF BUTNER WATER AND SEWER SYSTEM
STATEMENT OF NET ASSETS
June 30, 2003

Exhibit A

ASSETS

Current Assets:

Cash and Cash Equivalents (Note 2)	\$ 4,071,571
Restricted Investments - Held Outside the State Treasurer (Note 2)	850,906
Restricted State Treasurer's Securities Lending Collateral	3,358,032
Accounts Receivable (net of allowance for uncollectibles of \$24,130)	277,907
Interest Receivable	13,171
Inventories	160,550
Total Current Assets	8,732,137

Non-current Assets:

Cash and Cash Equivalents - Designated for Capital Improvements (Note 2)	2,342,004
Restricted Cash and Cash Equivalents - Customer Deposits (Note 2)	76,206
Restricted Cash and Cash Equivalents - Capital Improvements (Note 2)	1,177,552
Restricted Investments - Held Outside the State Treasurer (Note 2)	1,870,187
Deferred Charges - Bond Issuance Cost	123,221
Capital Assets, net (Note 3)	23,976,917
Total Non-current Assets	29,566,087

Total Assets

38,298,224

LIABILITIES

Current Liabilities:

Accounts Payable	941,711
Obligations Under State Treasurer's Securities Lending Agreements	3,358,032
Intragovernmental Payable	135
Accrued Interest Payable	27,436
Deferred Revenues	2,804
Accrued Vacation Leave (Note 4)	11,607
Bonds Payable (Note 4)	245,000
Total Current Liabilities	4,586,725

Non-current Liabilities:

Customer Deposits Payable	76,206
Accrued Vacation Leave (Note 4)	107,557
Bonds Payable (Note 4)	9,325,000
Total Non-current Liabilities	9,508,763

Total Liabilities

14,095,488

NET ASSETS

Invested in Capital Assets, net of related debt	17,128,010
Restricted for Capital Improvements	1,177,552
Unrestricted	5,897,174
Total Net Assets	\$ 24,202,736

The accompanying notes to the financial statements are an integral part of this statement.

TOWN OF BUTNER WATER AND SEWER SYSTEM
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN FUND NET ASSETS
Year Ended June 30, 2003

Exhibit B

Operating Revenues:	
Sales and Services (net of allowances of \$3,889)	\$ 3,658,584
Fees, Licenses and Fines	13,475
Miscellaneous Revenues	22,511
Total Operating Revenues – (pledged as security for revenue bonds)	3,694,570
 Operating Expenses:	
Personal Services and Employee Benefits	1,315,275
Supplies and Materials	175,074
Contracted Personal Services	201,685
Travel	2,006
Communications	7,088
Utilities	438,572
Other Services	138,182
Depreciation and Amortization	635,469
Insurance	4,009
Other	148,504
Total Operating Expenses	3,065,864
 Operating Income	 628,706
 Non-operating Revenues (Expenses):	
Investment Earnings	232,319
Debt Service Fees	(50,542)
Loss on Disposal of Capital Assets	(1,295)
Interest Expense	(59,381)
Net Non-operating Revenues	121,101
 Net Income Before Contributions and Transfers	 749,807
Capital Contributions	1,177,552
Transfers Out	(185,190)
 Change in Net Assets	 1,742,169
Net Assets -- July 1, 2002	22,460,567
 Net Assets -- June 30, 2003	 \$ 24,202,736

The accompanying notes to the financial statements are an integral part of this statement.

TOWN OF BUTNER WATER AND SEWER SYSTEM
STATEMENT OF CASH FLOWS
Year Ended June 30, 2003

Exhibit C

Cash Flows from Operating Activities:	
Receipts from Customers	\$ 3,147,123
Receipts from Other State Funds for Services Provided	554,384
Payments to Employees and Fringe Benefits	(1,297,840)
Payments to Vendors and Suppliers	(618,903)
Payments to Other State Funds for Services Used	(266,282)
Other Payments	<u>(95,638)</u>
Net Cash Provided by Operating Activities	<u>1,422,844</u>
Cash Flows from Noncapital Financing Activities:	
Transfers to Other Funds	<u>(274,099)</u>
Net Cash Used by Noncapital Financing Activities	<u>(274,099)</u>
Cash Flows from Capital and Related Financing Activities:	
Capital Contributions	1,177,552
Acquisition and Construction of Capital Assets	(3,198,934)
Proceeds from Sales of Capital Assets	20,631
Principal Paid on Capital Debt	(235,000)
Interest and Fees Paid on Capital Debt	(430,977)
Payments to Bond Escrow Agent	<u>(47,085)</u>
Net Cash Used by Capital and Related Financing Activities	<u>(2,713,813)</u>
Cash Flows from Investing Activities:	
Proceeds from Sales and Maturities of Investments	3,053,465
Interest on Investments	<u>175,314</u>
Net Cash Provided by Investing Activities	<u>3,228,779</u>
Net Increase in Cash and Cash Equivalents	1,663,711
Cash and Cash Equivalents - July 1, 2002	<u>6,003,622</u>
Cash and Cash Equivalents - June 30, 2003	<u>\$ 7,667,333</u>

TOWN OF BUTNER WATER AND SEWER SYSTEM
STATEMENT OF CASH FLOWS (continued)
Year Ended June 30, 2003

Exhibit C

Reconciliation of Net Operating Revenues (Expenses) to Net Cash

Provided (Used) by Operating Activities:

Operating Income	\$	997,649
Adjustments to Reconcile Operating Income to Net Cash		
Provided (Used) by Operating Activities:		
Depreciation and Amortization		635,469
Changes in Assets and Liabilities:		
Receivables, net		(248,037)
Inventories		5,270
Accounts Payable		16,278
Accrued Vacation Leave		17,542
Due to Other Funds		(153)
Deposits Payable		(1,593)
Deferred Revenues		419
		419

Net Cash Provided by Operating Activities	\$	1,422,844
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Noncash Investing, Capital and Financing Activities:

Assets Acquired through the Assumption of a Liability	\$	3,358,032
Noncash Distributions from North Carolina Capital Management Trust		76,221

Composition of Cash and Cash Equivalents:

Current Assets:		
Cash and Cash Equivalents		4,071,571
Non-current Assets:		
Cash and Cash Equivalents - Designated for Capital Improvements		2,342,004
Restricted Cash and Cash Equivalents - Customer Deposits		76,206
Restricted Cash and Cash Equivalents - Capital Improvements		1,177,552
		1,177,552

Total Cash and Cash Equivalents - June 30, 2003	\$	7,667,333
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The accompanying notes to the financial statements are an integral part of this statement.

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2003

NOTE 1 -SIGNIFICANT ACCOUNTING POLICIES

- A. Financial Reporting Entity** - The Town of Butner Water and Sewer System (System) is a part of the State of North Carolina and is not a separate legal or reporting entity. The System's accounts and transactions are included in the State of North Carolina's *Comprehensive Annual Financial Report* (CAFR) as an enterprise fund. The accompanying financial statements present only those accounts and transactions associated with the operations of the System.
- B. Basis of Presentation** - The accompanying financial statements are presented in accordance with accounting principles generally accepted in the United States of America as prescribed by Governmental Accounting Standards Board (GASB), which consist of GASB statements and interpretations, as well as American Institute of Certified Public Accountants (AICPA) and Financial Accounting Standards Board (FASB) pronouncements specifically made applicable to state and local government entities by GASB statements and interpretations. In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Fund Accounting*, the System does not apply FASB pronouncements issued after November 30, 1989 for proprietary activities, unless the GASB amends its pronouncements to specifically adopt FASB pronouncements issued after that date.
- C. Basis of Accounting** - The accompanying financial statements were prepared using the economic resource measurement focus and the accrual basis of accounting. Under the accrual basis, revenues are recognized when earned and expenses are recorded when an obligation has been incurred.
- D. Cash and Cash Equivalents** – This classification consists of cash on hand and the System's equity position in the short-term investment fund managed by the North Carolina State Treasurer. The funds on deposit with the State Treasurer are available on demand. This classification appears on the accompanying Statement of Net Assets and Statement of Cash Flows.
- E. Investments** – This classification represents deposits in the North Carolina Capital Management Trust cash portfolio, a SEC-registered 2(a)(7) money market mutual fund. The investment value is determined by the portfolio's share price and number of shares owned.

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2003

NOTE 1 -SIGNIFICANT ACCOUNTING POLICIES (continued)

- F. State Treasurer’s Securities Lending Collateral** -While the System does not directly engage in securities lending transactions, it deposits certain funds with the State Treasurer’s Short-Term Investment Fund which participates in securities lending activities. Based on the State Treasurer’s allocation of these transactions, the System recognizes its allocable share of the assets and liabilities related to these transactions on the accompanying financial statements as “Restricted State Treasurer’s Securities Lending Collateral” and “Obligations Under State Treasurer’s Securities Lending Agreements.” The allocable share of the costs arising from these transactions is immaterial to the System and has been netted against investment income rather than reported as an expense.

Based on the authority provided in G.S. §147-69.3(e), the State Treasurer lends securities from its investment pools to broker-dealers and other entities (borrowers) for collateral that will be returned for the same securities in the future. The Treasurer’s securities custodian manages the securities lending program. During the year, the custodian lent U.S. government securities, corporate bonds, notes, and common stock for collateral. The custodian is permitted to receive cash, U.S. government securities, or irrevocable letters of credit as collateral for the securities lent. The collateral is initially pledged at 102 percent of the market value of the securities lent, and additional collateral is required if its value falls to less than 100 percent of the market value of the securities lent. There are no restrictions on the amount of loans that can be made. Substantially all security loans can be terminated on demand by either the State Treasurer or the borrower.

Additional details on the State Treasurer’s securities lending program are included in the State of North Carolina’s *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller’s Internet home page <http://www.osc.state.nc.us/> and clicking on “Financial Reports,” or by calling the State Controller’s Financial Reporting Section at (919) 981-5454.

- G. Accounts Receivable** – This classification consists of charges to customers for water and sewer services. Accounts receivable are recorded net of estimated uncollectible amounts and are expected to be collected within one year.
- H. Inventories** – Inventories, consisting of supplies for internal use, are stated at cost using the first-in, first-out method.

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2003

NOTE 1 -SIGNIFICANT ACCOUNTING POLICIES (continued)

- I. Capital Assets** – Capital Assets are stated at cost at date of acquisition or construction net of accumulated depreciation. The System capitalizes all assets that have a value or cost greater than or equal to \$5,000 at the date of acquisition and an expected useful life of more than one year. Net interest expense incurred during the construction of capital assets has been capitalized. Depreciation is computed using the straight-line method over the following useful lives: buildings range from 20-50 years, other structures and improvements from 10-40 years, and equipment from 3-15 years.
- J. Restricted Assets** – Restricted assets represent assets whose use is restricted by external parties or by law through constitutional provisions or enabling legislation.
- K. Compensated Absences** – The System’s policy is to record the cost of vacation leave when earned. The policy provides for a maximum accumulation of unused vacation leave of 30 days which can be carried forward each January 1st or for which an employee can be paid upon termination of employment. Also, any accumulated vacation leave in excess of 30 days at year-end is converted to sick leave. Under this policy, the accumulated vacation leave for each employee at June 30th equals the leave carried forward at the previous December 31st plus the leave earned, less the leave taken between January 1st and June 30th. When classifying compensated absences into current and noncurrent, leave is considered taken using a last-in, first-out method.

The System has the policy of recording the cost of sick leave when taken and paid rather than when the leave is earned. The policy provides for unlimited accumulation of sick leave, but the employee cannot be compensated for any unused sick leave upon termination of employment. Consequently, no liability has been reported for unused sick leave.

- L. Bonds Payable** – The amount of outstanding bonds payable maturing within one year of the balance sheet date is reported as a current liability. All of the bonds are subject to purchase on demand of the holder; however, the System has arranged for a letter of credit that will provide alternative financing for a period exceeding one year. Consequently, the balance of bonds payable which mature more than one year from the balance sheet date is reported as a noncurrent liability.

The System enters into interest rate swap agreements to modify interest rates on outstanding debt. Other than the net interest expenses resulting from these agreements, no amounts are recorded in the financial statements.

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2003

NOTE 1 -SIGNIFICANT ACCOUNTING POLICIES (continued)

M. Net Assets – The System’s net assets are classified as follows:

Invested in Capital Assets Net of Related Debt – This represents the System’s total investment in capital assets, net of outstanding debt obligations related to those capital assets. To the extent debt has been incurred but not yet expended for capital assets, such amounts are not included as a component of invested in capital assets net of related debt.

Restricted Net Assets – Restricted net assets are those in which the System is legally or contractually obligated to spend in accordance with restrictions imposed by external parties.

Unrestricted Net Assets – Unrestricted net assets are all those not invested in capital assets or restricted by external parties.

Restricted and unrestricted resources are tracked separately in the accounting system. When both restricted and unrestricted funds are available for expenditure, management decides on a case-by-case basis which funds to use.

N. Revenue and Expense Recognition – The System presents its revenues and expenses as operating or nonoperating based on recognition definitions from GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*. Operating activities are those activities that are necessary and essential to the mission of the System. Operating revenues include all charges to water and sewer customers. Investment income is considered nonoperating since it is either investing, capital or noncapital financing activities. Operating expenses are all expense transactions incurred other than those related to investing, capital or noncapital financing activities. Revenues received for capital financing activities, as well as related expenses, are considered neither operating nor nonoperating activities and are presented after nonoperating activities on the accompanying Statement of Revenues, Expenses, and Changes in Fund Net Assets.

O. Capital Contributions – This classification represents capital grants or contributions received from other sources.

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2003

NOTE 2 -DEPOSITS AND INVESTMENTS

- A. Deposits in State Treasurer's Short-Term Investment Fund** – Unless specifically exempt, state agencies are required by General Statute §147-77 to deposit moneys received with the State Treasurer or with a depository institution in the name of the State Treasurer. These moneys are invested in accordance with G.S. §147-69.1(c) and 147-69.2, and as required by law are “readily convertible into cash.” All investments of the fund are held either by the Department of State Treasurer or its agent in the State’s name. The fund’s uninvested cash is either covered by federal depository insurance or, pursuant to 20 NCAC 7, is collateralized under either the dedicated or pooling method. Under the dedicated method, deposits are individually collateralized. Under the pooling method, each depository establishes an escrow account in the name of the State Treasurer to secure all of its public deposits. The financial statements and disclosures for the State Treasurer’s Cash and Investment Pool (which includes the State Treasurer’s Short-Term Investment Fund) are included in the State of North Carolina’s *Comprehensive Annual Financial Report*.

At June 30, 2003, the System’s deposit in the State Treasurer’s Short-Term Investment Fund had a book balance of \$7,667,333 and a bank balance of \$7,765,484.

- B. Investments** – House Bill 1629 authorized the System to issue revenue bonds to finance improvements to the water and sewer system. The Revenue Bond Trust Agreement allows unexpended bond proceeds to be invested in obligations that will mature on or before the date funds are expected to be required for expenditure or withdrawal. The System has invested all of the unexpended bond proceeds in the North Carolina Capital Management Trust (NCCMT). The NCCMT is a liquid money market mutual fund maintaining a \$1 per share value. The fund is invested in AAA commercial paper, U.S. Treasury notes and corporate securities. At June 30, 2003, the investment had a cost and fair value of \$2,721,093. Since the System only owns shares in the fund rather than specific underlying securities, the investment has not been categorized according to custodial risk.

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
 JUNE 30, 2003

Note 3 – CAPITAL ASSETS

A summary of changes in capital assets is presented as follows:

	<u>Balance June 30, 2002</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance June 30, 2003</u>
Capital Assets, Non-Depreciable				
Construction in Progress	\$ 13,622,526	\$ 4,226,131	\$ -	\$ 17,848,657
Total Capital Assets, Non-Depreciable	13,622,526	4,226,131	-	17,848,657
Capital Assets, Depreciable				
Buildings	3,277,583	-	-	3,277,583
Machinery and Equipment	538,829	197,982	146,032	590,779
Other Structures and Improvements	10,477,064	-	-	10,477,064
Total	14,293,476	197,982	146,032	14,345,426
Less Accumulated Depreciation:				
Buildings	1,600,846	127,172	-	1,728,018
Machinery and Equipment	485,381	24,561	124,105	385,837
Other Structures and Improvements	5,624,992	478,319	-	6,103,311
Total	7,711,219	630,052	124,105	8,217,166
Total Capital Assets, Depreciable, net	6,582,257	(432,070)	21,927	6,128,260
Total Capital Assets, net	<u>\$ 20,204,783</u>	<u>\$ 3,794,061</u>	<u>\$ 21,927</u>	<u>\$ 23,976,917</u>

NOTE 4 –LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities - A summary of changes in long-term liabilities for the year is presented as follows:

	<u>Balance July 1, 2002</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance June 30, 2003</u>	<u>Current Portion</u>
Bonds Payable	\$ 9,805,000	\$ -	\$ 235,000	\$ 9,570,000	\$ 245,000
Accrued Vacation Leave	101,623	75,371	57,830	119,164	11,607
Total Long-Term Liabilities	<u>\$ 9,906,623</u>	<u>\$ 75,371</u>	<u>\$ 292,830</u>	<u>\$ 9,689,164</u>	<u>\$ 256,607</u>

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
 JUNE 30, 2003

NOTE 4 –LONG-TERM LIABILITIES (continued)

B. Bonds Payable – At June 30, 2003, the System had bonds outstanding as follows:

Purpose	Series	Effective Interest Rate	Final Maturity Date	Original Amount of Issue	Principal Paid Through June 30, 2003	Principal Outstanding June 30, 2003
Water Treatment Plant Upgrade and Expansion	2001	4.21	9/1/2025	\$ 9,905,000	\$ 335,000	\$ 9,570,000

The bonds were issued pursuant to House Bill 1629 ratified by the North Carolina General Assembly in June 2000. Bond proceeds are to be used to pay the costs of the project to renovate and expand the wastewater treatment plant and water treatment plant; the construction, extension, and replacement of water and sanitary sewer mains and lines and other improvements to the water and sewer system; and certain costs in connection with issuance of the bonds.

Revenue generated by System operations has been pledged for payment of bond principal and interest. The bonds, which are tax exempt, bear variable interest rates; however, the System has entered into an interest rate swap agreement that effectively results in the System paying interest at a fixed rate. Based on the swap agreement, the System owes the counterparty interest calculated at a rate of 4.21%. In return, the counterparty pays the System interest based on a variable rate that matches the rate required by the bonds. Under the agreement the System pays interest to bondholders at the variable rate and then the difference between the variable and fixed rate interest amount is exchanged with the counterparty. The bond principal amount is not exchanged; it is only the basis on which the interest payments are calculated.

Using rates of June 30, 2003, debts service requirements of the variable-rate debt, net swap payments and total debt service requirements at the effective interest rate, assuming current interest rates remain the same for their term, were as follows. As rates vary, variable-rate bond interest payments and net swap payments will vary.

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
 JUNE 30, 2003

NOTE 4 –LONG-TERM LIABILITIES (continued)

Fiscal Year Ending June 30	Variable-Rate Bonds		Interest Rate Swaps, Net	Effective Interest	Total
	Principal	Interest			
2004	\$ 245,000	\$ 93,863	\$ 301,299	\$ 395,162	\$ 640,162
2005	255,000	91,338	293,193	384,531	639,531
2006	270,000	88,675	284,647	373,322	643,322
2007	280,000	85,900	275,739	361,639	641,639
2008	295,000	82,988	266,390	349,378	644,378
2009-2013	1,675,000	366,688	1,177,066	1,543,754	3,218,754
2014-2018	2,085,000	272,013	873,160	1,145,173	3,230,173
2019-2023	2,600,000	154,050	494,500	648,550	3,248,550
2024-2028	1,865,000	23,863	76,599	100,462	1,965,462
Total	\$9,570,000	\$ 1,259,378	\$ 4,042,593	\$ 5,301,971	\$ 14,871,971

The bonds are subject to purchase on demand of the holder at a price equal to principal plus accrued interest upon seven days' notice and delivery to the System's tender agent, First-Citizens Bank and Trust Company. Under an irrevocable letter of credit and reimbursement agreement issued by Bank of America, N.A., the tender agent is entitled to draw amounts sufficient to pay the purchase price of the bonds delivered. The letter of credit is valid through April 15, 2004 and automatically extends for an additional period of 364 days, unless otherwise terminated in accordance with the provisions of the agreement.

Upon notice from the tender agent, the remarketing agent, Banc of America Securities LLC, has agreed to exercise its best efforts to remarket the bonds, also at a price equal to principal plus accrued interest. The sales proceeds are used to reimburse Bank of America, N.A. for amounts drawn on the letter of credit. If the remarketing agent is unable to resell the bonds within 367 days, the System must pay off the letter of credit outstanding balance.

The System is required to pay an annual fee for the letter of credit of .28% of the amount of bonds outstanding plus 35 days of accrued interest assuming a maximum interest rate of 12% per annum. In addition, the remarketing agent receives an annual fee of .10% (10 basis points) of the weighted average daily outstanding principal amount of the bonds.

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2003

NOTE 4 –LONG-TERM LIABILITIES (continued)

C. Interest Rate Swap

Objective of the interest rate swap: In order to protect against the potential of rising interest rates, the System entered into an interest rate swap in connection with its \$9,905,000 Butner Water and Sewer System Revenue Bond Series 2001. The intention of the swap agreement was to effectively change the System's interest rate on the bonds to a fixed rate of 4.21% (plus remarketing and liquidity fees and any difference between the variable rate received by the System (65% of LIBOR) and the rate paid by the System on the variable rate bonds).

Terms: The swap agreement is with Bank of America, N.A. based on a notional amount of \$9,905,000 to mature on September 1, 2025. The swap's notional amount of \$9,905,000 matches the \$9,905,000 variable-rate bonds. Under the swap, the System pays a fixed payment of 4.21% to Bank of America, N.A. and receives a variable payment of 65% of LIBOR which was 1.12% at June 30, 2003. On the other hand, the bond's variable rate coupons (1.00% at June 30, 2003) are closely associated with the variable BMA, which was .98% as of June 30, 2003.

Fair Value: Because interest rates have declined since execution of the swap, the swap has a negative fair value (the System would have to pay the counterparty if the System terminated the swap) of \$1,401,046 (Bank of America) as of June 30, 2003. The swap's negative fair value if terminated may be countered by a reduction in total interest payments required under a new swap creating a lower synthetic fixed rate. Because the coupons on the System variable-rate bonds adjust to changing interest rates, the bonds do not have a corresponding fair value increase. The mark-to-market valuations were established by market quotations from the counterparty representing mid-market or average estimates/quotes of the amounts that would be paid for replacement transactions (having the effect of preserving the economic benefit to the counterparty).

Credit risk: As of June 30, 2003 the System was not exposed to credit risk because the swap had a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the System would be exposed to credit risk in the amount of the derivative's fair value.

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2003

NOTE 4 –LONG-TERM LIABILITIES (continued)

Basis risk and termination risk: The swap exposes the System to basis risk (including effects of any reduction in marginal tax rates) should the relationship between LIBOR and BMA converge, changing the synthetic rate to the System on the bonds. The effect of this difference in basis is indicated by the difference between the intended synthetic rate of 4.21% and the actual synthetic rate as of June 30, 2003 of (3.48% + 1.00%) 4.48% reflecting a Bond Rate/LIBOR relationship of 89.29% compared to 65% of LIBOR the System is receiving as of June 30, 2003. The swap may be terminated by either party if the other party fails to perform under the terms of the contract. If the swap is terminated, the associated variable-rate bonds would no longer carry synthetic interest rates. Also, if at the time of termination the swap has a negative fair value, the System would be liable to the counterparty for that amount.

NOTE 5 – RISK MANAGEMENT

The System is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. These exposures to loss are handled via a combination of methods, including participation in state-administered insurance programs. There have been no significant reductions in insurance coverage from the previous year and settled claims have not exceeded coverage in any of the past three fiscal years.

Tort claims of up to \$500,000 are self insured under the authority of the State Tort Claims Act. In addition, the System provides an additional \$11,000,000 public officers' and employees' liability insurance via contract with a private insurance company. The premium, based on a composite rate, is paid by the System directly to the insurer.

The State Property Fire Insurance Fund (Fund), an internal service fund of the System, insures all System owned buildings and contents for fire and various other property losses up to \$2,500,000 per occurrence. The Fund purchases excess insurance from private insurers to cover losses over the amounts insured by the Fund. Losses covered by the Fund are subject to a \$500 per occurrence deductible except for theft losses which carry a \$1,000 per occurrence deductible.

All System owned vehicles are covered by liability insurance administered by the North Carolina Department of Insurance. The System is self-insured for the first \$500,000 of any loss through a retrospective rating plan. Excess insurance coverage is purchased through a private insurer to cover losses greater than \$500,000. The liability limits for losses occurring in state are \$500,000 per claimant and \$5,000,000 per occurrence. The System is charged premiums to cover the cost of excess insurance and to pay for those losses falling under the self-insured retention.

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2003

NOTE 5 – RISK MANAGEMENT (continued)

Blanket public employee dishonesty and computer fraud insurance is provided for agencies of the System with a limit of \$5 million per occurrence, subject to a \$50,000 deductible and a 10% participation in each loss above the deductible. The coverage is placed with a private insurance company and is administered by the North Carolina Department of Insurance.

Employees and retirees are provided health care coverage by the Comprehensive Major Medical Plan. This employee benefit plan is funded by employer and employee contributions.

The North Carolina Workers' Compensation Program provides benefits to workers injured on the job. All employees of the System are included in the program. When an employee is injured, the System's primary responsibility is to arrange for and provide the necessary treatment for work related injury. The System is self-insured for workers' compensation. A third party administrator processes workers' compensation claims. System agencies, including the System, contribute to a fund administered by the Office of the State Controller to cover their workers' compensation claims. The third party administrator receives a per case administration fee and draws down State funds to make medical and indemnity payments on behalf of the State in accordance with the North Carolina Workers' Compensation Act.

Term life insurance of \$25,000 to \$50,000 is provided to eligible employees. This self-insured death benefit program is administered by the Department of the State Treasurer and funded via employer contributions.

Additional details on state-administered risk management programs are disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

NOTE 6 – PENSION AND DEFERRED COMPENSATION PLANS

- A. Retirement Plan** – All full-time employees participate in the Teachers' and State Employees' Retirement System (the Retirement System) of North Carolina. The Retirement System is a multiple-employer, cost sharing defined benefit pension plan administered by the North Carolina State Treasurer.

After five years of creditable service, members of the Retirement System qualify for a vested deferred benefit. Employees who retire on or after age 65 and complete 5 years of membership service, reach age 60 with 25 years of membership service, or complete 30 years of creditable service receive a retirement allowance of 1.81% of an average final compensation (based on the four consecutive years that produce the highest average) multiplied by the number of years of creditable service. Employees may retire with reduced benefits if they reach age 50 with 20 years of creditable service or reach age 60 with 5 years of creditable service.

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2003

NOTE 6 – PENSION AND DEFERRED COMPENSATION PLANS (continued)

Benefit and contribution provisions for the Retirement System are established by North Carolina General Statute §135-5 and 135-8 and may be amended only by the North Carolina General Assembly. Employer and member contribution rates are set each year by the North Carolina General Assembly based on annual actuarial valuations. For the year ended June 30, 2003, these rates were set at 0% of covered payroll for employers and 6% of covered payroll for members.

For the year ended June 30, 2003, the Town of Butner Water and Sewer System had a total payroll of \$1,116,057, all of which was covered under the Retirement System. Total employee and employer contributions for pension benefits for the year were \$66,963 and \$0, respectively. The Town of Butner Water and Sewer System made one hundred percent of its annual required contributions for the years ended June 30, 2003, 2002, and 2001, which were \$0, \$21,760, and \$55,580, respectively.

- B. Supplemental Retirement Income Plan** - IRC Section 401(k) Plan - All full-time employees are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k). All costs of administering the plan are the responsibility of plan participants. No costs are incurred by the System.
- C. Deferred Compensation Plan** - IRC Section 457 Plan – The State of North Carolina offers its permanent employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 through the North Carolina Public Employee Deferred Compensation Plan (the Plan). The Plan permits each participating employee to defer a portion of his or her salary until future years. The deferred compensation is available to employees upon separation from service, death, disability, retirement or financial hardships if approved by the Board of Trustees of the Plan. The Board, a part of the North Carolina Department of Administration, maintains a separate fund for the exclusive benefit of the participating employees and their beneficiaries, the *North Carolina Public Employee Deferred Compensation Trust Fund*. The Board also contracts with an external third party to perform certain administrative requirements and to manage the trust fund's assets. All cost of administering and funding the Plan are the responsibility of the Plan participants. No costs are incurred by the System.

TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2003

NOTE 7 – OTHER POSTEMPLOYMENT BENEFITS

- A. Health Care for Long-Term Disability Beneficiaries and Retirees** -The System participates in state administered programs which provide post employment health insurance to eligible former employees. Eligible former employees include long-term disability beneficiaries of the Disability Income Plan of North Carolina and retirees of the Teachers' and State Employees' Retirement System. These benefits were established by Chapter 135, Article 3, Part 3, of the General Statutes and may be amended only by the North Carolina General Assembly. Funding for the health care benefit for long-term disability beneficiaries and retirees is financed on a pay-as-you-go basis. The System contributed 2.35% of the covered payroll under the Teachers' and State Employees' Retirement System for these health care benefits. For the fiscal year ended June 30, 2003, the System's total contribution to the Plan was \$26,227. The System assumes no liability for retiree health care benefits provided by the programs other than its required contribution. Additional detailed information about these programs is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.
- B. Long-Term Disability** - The System participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, the DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. For the fiscal year ended June 30, 2003, the System contributed .52% of covered payroll, or \$5,804 to the DIPNC. The System assumes no liability for long-term disability benefits under the plan other than its contribution. Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

NOTE 8 – COMMITMENTS AND CONTINGENCIES

Construction Commitments – The System had outstanding commitments of \$4,399,952 at June 30, 2003 for capital improvement projects.

NOTE 9 – TRANSFERS

Transfers are routinely used to move revenues that the System is legally required to collect to a fund that is legally authorized to expend them. Accordingly, the System transferred \$184,809 during the year to the System's special revenue funds to support other Town of Butner operations. Also in accordance with legal provisions, the System routinely transfers employer tax savings generated from employee withholding under the North Carolina Flex Benefit Program to a special revenue fund of the System to support program administration. During the year, \$381 was transferred to the general fund for this purpose.

**TOWN OF BUTNER WATER AND SEWER SYSTEM
TRUST AGREEMENT RATE COVENANT CALCULATION
JUNE 30, 2003**

Schedule 1

Section 704(a) Calculation:

Calculation of Income Available for Debt Service:

Revenue from Services:

Operating Revenue (Exhibit B)	\$ 3,694,570
Add investment earnings on revenue deposits	<u>172,938</u>

Revenue from Services	3,867,508
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Adjusted Current Expenses:

Operating Expenses (Exhibit B)	3,065,864
Less Depreciation/Amortization (Exhibit B)	<u>(635,469)</u>

Less Adjusted Current Expenses	<u>2,430,395</u>
--------------------------------	------------------

Income Available for Debt Service	1,437,113
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Determination of Largest Rate Covenant Requirement:

120% of long-term debt service requirement on parity indebtedness (120% of \$668,655 – adjusted for capitalized interest)	802,386
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100% of long-term debt service requirement on parity indebtedness and subordinated indebtedness	668,655
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Less Largest Rate Covenant Requirement	<u>802,386</u>
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Excess Income Available for Debt Service – in accordance with Section 704(a)	<u>\$ 634,727</u>
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Section 704(b) Calculation:

Calculation of Receipts:

Operating Revenue (Exhibit B)	\$ 3,694,570
Add investment earnings on revenue deposits	<u>172,938</u>

Receipts	3,867,508
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Requirements Against Receipts:

Adjusted Current Expenses:

Operating Expenses (Exhibit B)	3,065,864
Less Depreciation/Amortization (Exhibit B)	<u>(635,469)</u>

Adjusted Current Expenses	2,430,395
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TOWN OF BUTNER WATER AND SEWER SYSTEM
TRUST AGREEMENT RATE COVENANT CALCULATION (continued)
JUNE 30, 2003

Schedule 1

Section 704(b) Calculation (continued):

Deposits Required by Sections 504(a), (b) and (c):		
Section 504(a) as to payment of interest adjusted for capitalized interest	433,655	
Section 504(b) as to payment of principal	235,000	
Section 504(c) as to deposits to the Parity Reserve Account and the Special Reserve Account	<u>0</u>	
Section 504 Deposits		668,655
Deposits Required by Subordinated Indebtedness Resolutions		<u>0</u>
Less Requirements Against Receipts		<u>3,009,050</u>
Excess Income Available for Debt Service – In accordance with Section 704(b)		<u>\$ 768,458</u>

Note: The above calculations have been prepared using terms defined in the Revenue Bond Trust Agreement. These terms are defined differently under generally accepted accounting principles. All amounts have been measured in accordance with generally accepted accounting principles.



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**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL
CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL
STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

Secretary Carmen Hooker Odom,
Department of Health and Human Services
Town of Butner Water and Sewer System
Butner, North Carolina

We have audited the financial statements of the Town of Butner Water and Sewer System (the "System") as of and for the year ended June 30, 2003, and have issued our report thereon dated November 30, 2003. As discussed in Note 1, the financial statements of the Town of Butner Water and Sewer System are intended to present the financial position and results of operations and cash flows of only that portion of the State of North Carolina financial reporting entity that is attributable to the transactions of the System.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the System's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the System's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

The following reportable condition noted as a result of our audit are described in the Audit Findings and Recommendations section of this report:

Finding

1. Inadequate Internal Control Over Billings and Collections

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the management of the System, the Governor, the Office of State Budget and Management, the Office of the State Controller, and the General Assembly and is not intended to be, and should not be, used by anyone other than these specified parties.

Thomas & Gibbs CPAs, PLLC

A handwritten signature in black ink that reads "Thomas & Gibbs CPAs, PLLC". The signature is written in a cursive, slightly slanted style.

Durham, North Carolina
November 30, 2003

TOWN OF BUTNER WATER AND SEWER SYSTEM
AUDIT FINDINGS AND RECOMMENDATIONS
JUNE 30, 2003

Matters Related to Internal Control Over Financial Reporting

1. INADEQUATE INTERNAL CONTROL OVER BILLINGS AND COLLECTIONS

During our audit, we noted certain weaknesses over the System's utility billings, collections, and accounts receivable system. Generally, management has taken action to correct the weaknesses; however, the problems continued to exist during a significant portion of the current audit period. The specific weaknesses and corrective actions taken by management were as follows:

- The billing system should provide information in a format needed for effective management, monitoring, and record keeping. For example, the water and sewer revenues are summarized on the daily transaction report but they are not summarized monthly or on year end reports. The system should also provide a comparison of usage of current month to previous year's same month for example, comparing February 2003 to February 2002, in order to determine unusual variations in water use. Management utilizes the Preliminary Billing report for determining the top users. However, management should also document evidence of such by initialing and dating such review.

Recommendation: While action has been taken to address many of the issues raised during the June 30, 2003 and 2002 audits of the System, we believe that further enhancements are needed. We recommend the following:

- Management should continue to improve the usefulness of information for effective management, monitoring, and recording keeping. Management should show evidence of the review by initialing and dating such review.

Agency's Response: The System provides the following response:

- We have contacted the software vendor, ICS Systems, Inc., for assistance in developing monthly and yearly summarization of the Daily Transaction Report if the system can generate such information.

Staff will attempt to develop a usage comparison of each current month to the previous year's same month usage if possible; however, we feel this will necessitate a manual review procedure and do not know how labor intensive this might be.

Management will document evidence of review of the Preliminary Billing Report in identifying the top users by initialing and dating reports.

DISTRIBUTION OF AUDIT REPORT

In accordance with General Statutes 147-64.5 and 147-64.6(c)(14), copies of this report have been distributed to the public officials listed below. Additional copies are provided to other legislators, state officials, the press, and the general public upon request.

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The Honorable Richard H. Moore	State Treasurer
The Honorable Roy A. Cooper, III	Attorney General
Mr. David T. McCoy	State Budget Officer
Mr. Robert L. Powell	State Controller
Ms. Carmen Hooker Odom	Secretary, Department of Health and Human Services
Ms. Laketha Miller	Acting Controller, Department of Health and Human Services

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