

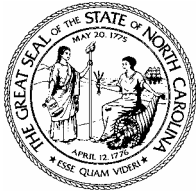
**TOWN OF BUTNER WATER
AND SEWER SYSTEM**
Butner, North Carolina

Financial Statement Audit Report

Year Ended June 30, 2005

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

Leslie W. Merritt, Jr. CPA, CFP
State Auditor



STATE OF NORTH CAROLINA
Office of the State Auditor

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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, 2005. Huntley, Sigmon, Walton & Wilson, a certified public accounting firm, 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.

Leslie W. Merritt, Jr.

Respectfully Submitted,
Leslie W. Merritt, Jr., CPA, CFP
State Auditor

**TOWN OF BUTNER WATER AND SEWER SYSTEM
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HUNTLEY
SIGMON
WALTON &
WILSON

HSW&W

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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, 2005, 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, 2005. 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, 2005, 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.

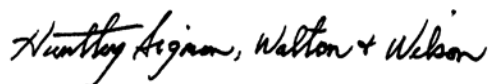
INDEPENDENT AUDITORS' REPORT (CONCLUDED)

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, 2005, 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 September 29, 2005, 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 in 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.

Huntley, Sigmon, Walton & Wilson



Lenoir, North Carolina
September 29, 2005

Town of Butner Water and Sewer System
Statement of Net Assets
June 30, 2005

Exhibit A

ASSETS

Current Assets:

Cash and Cash Equivalents (Note 2)	\$ 4,902,558
Restricted State Treasurer's Securities Lending Collateral	3,905,000
Accounts Receivable (Net of Allowance for Uncollectibles of \$23,580)	121,150
Interest Receivable	11,901
Inventories	160,866
	<hr/>
Total Current Assets	9,101,475

Noncurrent Assets:

Cash and Cash Equivalents - Designated for Capital Improvements (Note 2)	296,968
Restricted Cash and Cash Equivalents - Customer Deposits (Note 2)	76,885
Restricted Cash and Cash Equivalents - Capital Improvements (Note 2)	2,060,751
Deferred Charges - Bonx Issuance Cost (Note4)	112,388
Capital Assets, Net (Note 3)	25,396,789
Intangible Assets, Net (Note 10)	1,569,003
	<hr/>
Total Noncurrent Assets	29,512,784
	<hr/>
Total Assets	38,614,259

LIABILITIES

Current Liabilities:

Accounts Payable	48,099
Obligations Under State Treasurer's Securities Lending Agreements	3,905,000
Intergovernmental Payable	877
Accrued Interest Payable	34,479
Deferred Revenues	1,972
Accrued Vacation Leave (Note 4)	16,883
Bonds Payable (Note 4)	270,000
Notes Payable (Note 10)	112,072
	<hr/>
Total Current Liabilities	4,389,382

Noncurrent Liabilities:

Customer Deposits Payable	76,885
Accrued Vacation Leave (Note 4)	118,507
Bonds Payable (Note 4)	8,800,000
Notes Payable (Note 10)	1,456,932
	<hr/>
Total Noncurrent Liabilities	10,452,324
	<hr/>
Total Liabilities	14,841,706

NET ASSETS

Invested in Capital Assets, Net of Related Debt	16,326,789
Restricted for Capital Improvements	2,060,751
Unrestricted	5,385,013
	<hr/>
Total Net Assets	\$ 23,772,553

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, 2005***

Exhibit B

REVENUES

Operating Revenues:	
Sales and Services (Net of Allowances of \$450)	\$ 3,530,743
Fees, Licenses and Fines	13,542
Miscellaneous Revenues	21,786
	<hr/>
total Operating Revenues - (Pledged as Security for Revenue Bonds)	3,566,071
	<hr/>

EXPENSES

Operating Expeenses:	
Personal Services and Employee Benefits	1,360,308
Supplies and Materials	150,801
Contracted Personal Services	110,530
Travel	1,192
Communications	13,702
Utilities	451,889
Other Services	91,324
Depreciation	1,663,753
Authorization	5,416
Insurance	6,095
Other	283,855
	<hr/>
Total Operating Expenses	4,138,865
	<hr/>
Operating Loss	(572,794)
	<hr/>

NONOPERATING REVENUES (EXPENSES)

Investment Earnings	135,004
Debt Service Fees	(40,929)
Gain on Disposal of Capital Assets	79,335
Interest Expense	(414,490)
	<hr/>
Net Nonoperating Revenues	(241,080)
	<hr/>
Net Loss Before Contributions and Transfers	(813,874)
	<hr/>
Capital Contributions	400,000
Transfers Out	(258,069)
	<hr/>
Change in Net Assets	(671,943)
	<hr/>
Net Assets - July 1, 2004	24,444,496
Net Assets - June 30, 2005	\$ 23,772,553
	<hr/> <hr/>

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, 2005***

Exhibit C

CASH FLOWS FROM OPERATING ACTIVITIES

Receipts from Customers	\$ 3,069,962
Receipts from Other State Funds for Services Provided	542,371
Payments to Employees and Fringe Benefits	(1,371,007)
Payments to Vendors and Suppliers	(595,959)
Payments to Other State Funds for Services Used	(255,748)
Other Payments	(248,275)
	<hr/>
Net Cash Provided by Operating Activities	1,141,344
	<hr/>

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

Transfers to Other Funds	(258,069)
	<hr/>

CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES

Capital Contributions	400,000
Acquisition and Construction of Capital Assets	(284,888)
Proceeds from Sales of Capital Assets	79,335
Principal Paid on Capital Debt	(255,000)
Interest and Fees Paid on Capital Debt	(414,532)
Payments to Bond Escrow Agent	(41,638)
	<hr/>
Net Cash Used by Capital and Related Financing Activities	(516,723)
	<hr/>

CASH FLOWS FROM INVESTING ACTIVITIES

Proceeds from Sales and Maturities of Investments	95,604
Interest on Investments	133,717
	<hr/>
Net Cash Provided by Investing Activities	229,321

Net Increase in Cash and Cash Equivalents	595,873
Cash and Cash Equivalents - July 1, 2004	6,741,289
	<hr/>
Cash and Cash Equivalents - June 30, 2005	\$ 7,337,162
	<hr/> <hr/>

**RECONCILIATION OF NET OPERATING REVENUES (EXPENSES)
TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES**

Operating Loss	\$ (572,794)
Adjustments to Reconcile Operating Income to Net Cash Provided (Used) by Operating Activities:	
Depreciation and Amortization	1,669,169
Changes in Assets and Liabilities:	
Receivables, Net	62,752
Inventories	(2,556)
Accounts Payable	(6,161)
Accrued Vacation Leave	(10,699)
Due to Other Funds	(337)
Deposits Payable	1,823
Deferred Revenues	147
	<hr/>

Net Cash Provided by Operating Activities	\$ 1,141,344
	<hr/> <hr/>

Town of Butner Water and Sewer System
Statement of Cash Flows
Year Ended June 30, 2005

Exhibit C
Page 2

COMPOSITION OF CASH AND CASH EQUIVALENTS

Current Assets:	
Cash and Cash Equivalents	\$ 4,902,558
Noncurrent Assets:	
Cash and Cash Equivalents - Designated for Capital Improvements	296,968
Restricted Cash and Cash Equivalents - Customer Deposits	76,885
Restricted Cash and Cash Equivalents - Capital Improvements	<u>2,060,751</u>
Total Cash and Cash Equivalents - June 30, 2005	<u>\$ 7,337,162</u>

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Assets Acquired through the Assumption of a Liability	\$ 3,905,000
Change in Construction in Progress as a Result of Accruals	2,300
Assets Acquired through Purchase Agreement	1,681,705

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, 2005

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 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. 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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, GNMA’s, 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.ncosc.net/> and clicking on “Financial Reports,” or by calling the State Controller’s Financial Reporting Section at (919) 981-5454.

- F. 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.
- G. Inventories** – Inventories, consisting of supplies for internal use, are stated at cost using the first-in, first-out method.
- H. 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. 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

- I. Restricted Assets** – Restricted assets represent assets whose use is restricted by external parties or by law through constitutional provisions or enabling legislation.
- J. Compensated Absences** – The System’s policy is to record the cost of vacation leave when earned. The policy provides for a maximum carryforward of unused vacation leave of 30 days which can be carried forward each January 1 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 30 equals the leave carried forward at the previous December 31 plus the leave earned, less the leave taken between January 1 and June 30. When classifying compensated absences into current and noncurrent, leave is considered taken using a last-in, first-out method.

In addition to the vacation leave described above, compensated absences includes the accumulated unused portion of the special annual leave bonuses awarded by the North Carolina General Assembly to all full-time permanent employees as of September 30, 2002, and as of July 1, 2003. The unused portion of this leave remains available until used, notwithstanding the limitation on annual leave carried forward described above.

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.

- K. 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.

- L. 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 investment 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.

M. 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.

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

NOTE 2 - DEPOSITS AND INVESTMENTS

Deposits in State Treasurer's Short-Term Investment Fund – Unless specifically exempt, the System is required by *North Carolina General Statute 147-77* to deposit moneys received with the State Treasurer or with a depository institution in the name of the State Treasurer.

At June 30, 2005, the System's deposit in the State Treasurer's Short-Term Investment Fund had a book balance of \$7,337,162 and a bank balance of \$7,420,573. Deposit and investment risks associated with the State Treasurer's

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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. An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page <http://www.ncosc.net/> and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

NOTE 3 - CAPITAL ASSETS

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

	Balance July 1, 2004	Increases	Decreases	Balance June 30, 2005
Capital Assets, Nondepreciable:				
Land	\$ 0	\$ 33,450	\$ 0	\$ 33,450
Construction in Progress	559,127	305,769		864,896
Total Capital Assets, Nondepreciable	<u>559,127</u>	<u>339,219</u>		<u>898,346</u>
Capital Assets, Depreciable:				
Buildings	3,277,583			3,277,583
Machinery and Equipment	676,148			676,148
Other Structures and Improvements	32,272,375		56,964	32,215,411
Total Capital Assets, Depreciable	<u>36,226,106</u>		<u>56,964</u>	<u>36,169,142</u>
Less Accumulated Depreciation/Amortization for:				
Buildings	1,855,190	127,172		1,982,362
Machinery and Equipment	422,181	39,821		462,002
Other Structures and Improvements	7,729,575	1,496,760		9,226,335
Total Accumulated Depreciation	<u>10,006,946</u>	<u>1,663,753</u>		<u>11,670,699</u>
Total Capital Assets, Depreciable, Net	<u>26,219,160</u>	<u>(1,663,753)</u>	<u>56,964</u>	<u>24,498,443</u>
Capital Assets, Net	<u>\$ 26,778,287</u>	<u>\$ (1,324,534)</u>	<u>\$ 56,964</u>	<u>\$ 25,396,789</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:

	Balance July 1, 2004	Additions	Reductions	Balance June 30, 2005	Current Portion
Bonds Payable	\$ 9,325,000	\$ 0	\$ 255,000	\$ 9,070,000	\$ 270,000
Accrued Vacation Leave	146,089	51,461	62,160	135,390	16,883
Total Long-Term Liabilities	<u>\$ 9,471,089</u>	<u>\$ 51,461</u>	<u>\$ 317,160</u>	<u>\$ 9,205,390</u>	<u>\$ 286,883</u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

B. Bonds Payable – At June 30, 2005, the System had bonds outstanding as follows:

Purpose	Series	Effective Interest Rate	Final Maturity Date	Original Amount of Issue	Principal Paid Through 06/30/2005	Principal Outstanding 06/30/2005
Water Treatment Plant Upgrade and Expansion	2100	4.21%	9/1/25	\$ 9,905,000	\$ 835,000	\$ 9,070,000

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, 2005, 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 terms were as follows. As rates vary, variable-rate bond interest payments and net swap payments will vary.

Bond Issuance Costs associated with the Bonds have been amortized over 25 years (i.e. original costs \$135,407/25 years = \$5,416).

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Fiscal Year Ending June 30	Variable Bonds Payable		Interest Rate Swaps, Net	Effective Interest	Total
	Principal	Interest			
2006	\$ 270,000	\$ 239,423	\$ 133,899	\$ 373,322	\$ 643,322
2007	280,000	231,930	129,709	361,639	641,639
2008	295,000	224,066	125,311	349,377	644,377
2009	305,000	215,899	120,743	336,642	641,642
2010	320,000	207,360	115,968	323,328	643,328
2011-2015	1,830,000	894,442	500,225	1,394,667	3,224,667
2016-2020	2,275,000	615,431	344,186	959,617	3,234,617
2021-2025	2,845,000	267,334	149,509	416,843	3,261,843
2026-2030	650,000	4,388	2,454	6,842	656,842
Total Requirements	<u>\$ 9,070,000</u>	<u>\$ 2,900,273</u>	<u>\$ 1,622,004</u>	<u>\$ 4,522,277</u>	<u>\$ 13,592,277</u>

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, 2006, 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.

- 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 3.34% at June 30, 2005. On the other hand, the bond's variable rate coupons (2.70% at June 30, 2005) are closely associated with the variable BMA, which was 2.28% as of June 30, 2005.

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 counter-party if the System terminated the swap) of \$1,100,439 (Bank of America) as of June 30, 2005. 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's 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 counter-party 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 counter-party).

Credit risk: As of June 30, 2005, 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.

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, 2005, of (2.039% + 2.700%) 4.739% reflecting a Bond Rate/LIBOR relationship of 48.43% compared to 65% of LIBOR the System is receiving as of June 30, 2005. 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 State provides an additional \$5,000,000 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 State, insures all State-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 State-owned vehicles are covered by liability insurance administered by the North Carolina Department of Insurance. The State 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.

Blanket public employee dishonesty and computer fraud insurance is provided for agencies of the State 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 State is self-insured for workers' compensation. A third party administrator processes workers' compensation claims. State 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 established by the State to provide pension benefits for employees of the State, its component units, and local boards of education. The plan is 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 at any age, receive a retirement allowance of 1.82% 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.

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

ended June 30, 2005, these rates were set at 2.17% of covered payroll for employers and 6% of covered payroll for members.

For the year ended June 30, 2005, the Town of Butner Water and Sewer System had a total payroll of \$1,098,376, of which \$1,077,900 was covered under the Retirement System. Total employee and employer contributions for pension benefits for the year were \$23,390 and \$64,674, respectively. The Town of Butner Water and Sewer System made 100 percent of its annual required contributions for the years ended June 30, 2005, 2004, and 2003, which were \$23,390, \$2,770, and \$0, respectively.

The Retirement System's financial information is 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.ncosc.net/> and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

- 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.

NOTE 7 – OTHER POSTEMPLOYMENT BENEFITS

- A. Health Care for Long-Term Disability Beneficiaries and Retirees -** The System participates in State administered programs which provide

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 3.2% of the covered payroll under the Teachers' and State Employees' Retirement System for these health care benefits. For the fiscal year ended June 30, 2005, the System's total contribution to the Plan was \$34,493. 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, 2005, the System contributed .445% of covered payroll, or \$4,797 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 – COMMENTS AND CONTINGENCIES

Construction Commitments – The System had outstanding commitments of \$416,043 at June 30, 2005, for capital improvement projects. In addition, there were commitments from Powell Bill and Park Funds, not a part of the System, for \$342,103.

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 \$257,610 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

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

Benefit Program to a special revenue fund of the System to support program administration. During the year, \$459 was transferred to the general fund for this purpose.

NOTE 10 - INTANGIBLE ASSET AND NOTES PAYABLE

On August 27, 2004, the Town of Butner Water and Sewer System purchased from Bay River Metropolitan Sewerage District certain of its allocation of Nitrogen Credits. Total cost is \$1,681,075 to be paid in 15 annual installments of \$112,072 each on September 1, the last payment to be made in the year 2019. The Nitrogen Credits expire annually in equal amounts over the life of the agreement (i.e. \$112,072 per year). Under certain conditions, the System may discontinue future payments with the rights to the credits reverting back to Bay River.

NOTE 11 - ARBITRAGE REBATE

The System is currently contracting to have the Arbitrage Yield Rebate calculated following IRS Code Section 148 which is due no later than 60 days after the end of every 5th bond year throughout the term of the 2001 Bond Issue. The System currently has estimated any "Arbitrage Rebate and Penalty in lieu of Arbitrage Rebate" will be immaterial. The result of falling investment rates since the inception of the 2001 Bonds should result in a yield that will not be "materially higher than the yield of the bond issue."

NOTE 12 - MEMORANDUM OF UNDERSTANDING WITH GRANVILLE COUNTY

The North Carolina Department of Health and Human Services (NCDHHS) entered into an agreement of understanding with the Granville County Board of Commissioners on November 9, 2004. The agreement would establish a regional water and wastewater authority to be known as South Granville Water and Sewer Authority (SGWASA) with the intention of placing some of the operational and planning responsibilities for the Butner utilities within the Authority. NCDHHS expects to transfer the electing System's employees and operational responsibility to the Authority on January 1, 2006. The transfer of ownership of the System's assets and termination of Bond Payable (Note 4-B) has not been determined. SGWASA's board consists of seven members appointed by: Granville County (2), the Towns of Creedmoor (2), Stem (1), and the Butner Planning Authority (2).

***Town of Butner Water and Sewer System
Trust Agreement Rate Covenant Calculation
June 30, 2005***

Schedule 1

SECTION 704(a) CALCULATION:

CALCULATION OF INCOME AVAILABLE FOR DEBT SERVICE

Revenue from Services:			
Operating Revenue (Exhibit B)	\$	3,566,071	
Add Investment Earnings on Revenue Deposits		<u>134,665</u>	
Revenue from Services			\$ 3,700,736
Adjusted Current Expenses:			
Operating Expenses (Exhibit B)		4,138,865	
Less Depreciation/Amortization (Exhibit B)		<u>1,669,169</u>	
Less Adjusted Current Expenses			<u>2,469,696</u>
Income Available for Debt Service			\$ 1,231,040

DETERMINATION OF LARGEST RATE COVENANT REQUIREMENT

120% OF Long-Term Debt Service Requirement on Parity Indebtedness (120% of \$669,150 - Adjusted for Capitalized Interest)		802,980	
100% of Long-Term Debt Service Requirement on Parity Indebtedness and Subordinated Indebtedness		669,150	
Less Largest Rate Covenant Requirement			<u>802,980</u>
Excess Income Available for Debt Service - In Accordance with Section 704(a)			<u><u>\$ 428,060</u></u>

SECTION 704(B) CALCULATION:

Calculation of Receipts:			
Operating Revenue (Exhibit B)		3,566,071	
Add Investment Earnings on Revenue Deposits		<u>134,665</u>	
Receipts			\$ 3,700,736

REQUIREMENTS AGAINST RECEIPTS:

Adjusted Current Expenses:			
Operating Expenses (Exhibit B)		4,138,865	
Less Depreciation/Amortization (Exhibit B)		<u>1,669,169</u>	
Adjusted Current Expenses			2,469,696
Deposits Required by Sections 504(a), (b), and (c)			
Section 504(a) as to Payment of Interest (Adjusted for Capitalized Interest)		414,150	
Section 504(b) as to Payment of principal		<u>255,000</u>	
Section 504 Deposits			<u>669,150</u>
Less Requirements Against Receipts			<u>3,138,846</u>
Excess Income Available for Debt Service - In Accordance with Section 704(b)			<u><u>\$ 561,890</u></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.

**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND
ON COMPLIANCE AND OTHER MATTERS 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, 2005, and have issued our report thereon dated September 29, 2005. 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.

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.

**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND
ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT
OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE
WITH GOVERNMENT AUDITING STANDARDS (CONCLUDED)**

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

Finding

1. Failure to Close and Depreciate Completed Construction Projects
2. Failure to Timely Prepare Bank Reconciliations
3. Failure to Reconcile Customer Deposits

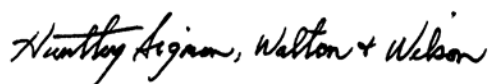
A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected 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. However, we consider Item #1 to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the System's financial statements are free of material misstatements, 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 or other matters that are required to be reported under Government Auditing Standards.

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 Auditor, 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.

Huntley, Sigmon, Walton & Wilson



Lenoir, North Carolina
September 29, 2005

**TOWN OF BUTNER WATER AND SEWER SYSTEM
AUDIT FINDINGS AND RECOMMENDATIONS
JUNE 30, 2005**

Matters Related to Internal Control Over Financial Reporting

The following finding and recommendation was identified during the current audit and describes a condition that represents a significant deficiency in internal control and noncompliance with laws, regulations, contracts, grant agreements or other matters.

1. FAILURE TO CLOSE AND DEPRECIATE COMPLETED CONSTRUCTION PROJECTS

During our June 30, 2004, audit, we noted that construction projects for the System had not been closed for several years. The System investigated the Construction In Progress asset and determined that for several years a number of projects were not closed due to a failure to communicate to the North Carolina Department of Health and Human Services (NCDHHS) Controller's Office that the projects were closed. The resulting closing and depreciation calculation required a restatement of net assets, accumulated depreciation, and depreciation expense for several years. The net effect being a \$407,455 prior period adjustment and additional depreciation of \$740,488 for the year ended June 30, 2004.

Recommendation: The System should review their current procedures for closing construction projects and establish a year-end CAFR procedure to ensure that projects are reviewed and closed at June 30 of each year.

Agency's Response: NCDHHS has reviewed their procedures and determined that the NC State Property and Construction Division, upon completion of the final engineering studies, will copy to both the NCDHHS – Property and Construction Division and the NCDHHS – Controller's office. In addition, a procedure will be added by the State Controller's office to the CAFR checklist to review construction in progress for any omissions at June 30 of each year.

June 30, 2005 Review: Our review of the June 30, 2005, CAFR indicated that the prior year's correction of Construction in Progress had been completed and that as of June 30, 2005, the projects listed as uncompleted were in fact not completed. In addition, NCDHHS has commenced the expensing of previously capitalized interest during the June 30, 2005, year, for all completed projects. Finding will be eliminated if there are no recurrences of either condition during the June 30, 2006, year.

2. FAILURE TO TIMELY PREPARE BANK RECONCILIATIONS

During our audit for June 30, 2005, we noted that the System had not completed the bank reconciliations in a timely manner for several months. The problem was a direct result of staff turnover during the year. It was also reported to us that the System had reported that the reconciliations were complete on NCDHHS's monthly reconciliation report by error. We were present when the August 2005 reconciliation was completed.

AUDIT FINDINGS AND RECOMMENDATIONS (CONCLUDED)

Recommendations: The System should train additional staff in the reconciliation process to ensure that turnover or staff vacations do not cause a delay in the reconciliation process.

Agency's Response: NCDHHS realizes the importance of timely bank reconciliations. We have taken action to ensure all reconciliations are timely prepared and to train additional staff in the process to compensate when unexpected staff absences or turnover occur.

3. FAILURE TO RECONCILE CUSTOMER DEPOSITS

During our audit for June 30, 2005, we noted that the Butner utility deposit reports at June 30, did not reconcile to amounts reported in the financial statements. The financial statements reported approximately \$24,000 more in utility customer deposits than what is reported on Butner's subsidiary ledger.

Recommendations: The System should reconcile the financial statements to the subsidiary ledger at least annually, determine the proper balance, and adjust their reports.

Agency's Response: NCDHHS has reviewed the utility customer deposit and has determined these reports have been in disagreement for several years. The System will confirm with the current utility customers their deposit balance at a specific date and make the necessary adjustments during the June 30, 2006, year.

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	Controller, Department of Health and Human Services

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