

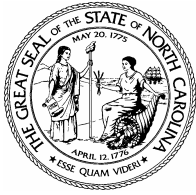
**TOWN OF BUTNER WATER
AND SEWER SYSTEM**
Butner, North Carolina

Financial Statement Audit Report

Year Ended June 30, 2006

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, 2006. HUNTLEY, SIGMON & MANIFOLD, 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 cursive script that reads "Leslie W. Merritt, Jr.".

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

**TOWN OF BUTNER WATER AND SEWER SYSTEM
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HUNTLEY
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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, 2006 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, 2006. 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, 2006, 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, except for the recognition of the loss on the transfer of the assets and bonds, 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, 2006, 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 April 7, 2007, 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.

Except for the recognition of the loss on the transfer of the System assets and bonds, the accompanying financial statements have been prepared assuming that the System will not continue as a going concern. As discussed in Note 12 to the financial statements, the System's intention is to transfer all assets and bonds to a utility district on or about January 1, 2007.

The Management's Discussion and Analysis, as listed in the table of contents, is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

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 & MANIFOLD, CPAs, PLLC



Lenoir, North Carolina
April 7, 2007

MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

The following discussion and analysis provides an overview to assist the reader in interpreting and understanding the accompanying basic financial statements. This overview includes comparative financial analysis with discussion of significant changes from the prior year, as well as, a discussion of currently known facts, decisions, and conditions. This information is provided by the Town of Butner Water and Sewer System's management in conjunction with the issuance of the accompanying financial statements.

Overview of the Basic Financial Statements

The *Statement of Net Assets* provides information relative to the Town of Butner Water and Sewer System's assets, liabilities, and net assets as of the last day of the fiscal year. Assets and liabilities on these Statements are categorized as either current or noncurrent. Current assets are those that are available to pay for expenses in the next fiscal year. Current liabilities are those payable in the next fiscal year. Net assets on this statement are categorized as either invested in capital assets (net of related debt), restricted or unrestricted. Restricted net assets are categorized as either nonexpendable or expendable. Overall, the *Statement of Net Assets* provides information relative to the financial strength of the Town of Butner Water and Sewer System and its ability to meet current and long-term obligations.

The *Statement of Revenues, Expenses, and Changes in Net Assets* provides information relative to the results of the Town of Butner Water and Sewer System's operations, nonoperating activities, and other activities affecting net assets that occurred during the fiscal year. Nonoperating activities include primarily investment earnings, interest expense, debt service fees and gain or loss on asset disposal. Overall, the *Statement of Revenues, Expenses, and Changes in Net Assets* provides information relative to the Town of Butner Water and Sewer System's management of its operations and its ability to maintain its financial strength. The above statements are articulated by agreeing the ending net asset balance reported on both statements.

The *Statement of Cash Flows* provides information relative to the Town of Butner Water and Sewer System's sources and uses of cash funds for operating activities, noncapital financing activities, capital financing activities, and investing activities. This statement provides a reconciliation of beginning cash balances to ending cash balances and is representative of activity reported on the *Statement of Revenues, Expenses, and Changes in Net Assets* as adjusted for changes in beginning and ending balances of noncash accounts on the *Statement of Net Assets*.

The three statements described above are the basic financial statements required by the Governmental Accounting Standards Board (GASB) accounting principles. In accordance with GASB, the financial statements are presented on the Town of Butner Water and Sewer System as a whole and use reporting concepts in a manner similar to that required of a business enterprise. The financial statement balances reported are presented in a classified format to aid the reader in understanding the nature of the financial statement balance.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

In using the financial statements, the *Notes to the Financial Statements* accompanying the financial statements should be read in conjunction with the financial statements. The *Notes to the Financial Statements* provide information relative to the significant accounting principles applied in the financial statements, authority for and associated risk of deposits and investments, detailed information on accounts and pledges receivable, revenues and expenses, required information on pension plans and other post employment benefits, insurance against losses, commitments and contingencies, accounting changes, and if necessary a discussion of adjustments to prior periods and events subsequent to the Town of Butner Water and Sewer System's financial statement period. Overall, the *Notes to the Financial Statements* provide information to better understand details, risk, and uncertainty associated with amounts reported in the Financial Statements.

Brief Agency Highlights

The Town of Butner Water and Sewer System provides water and sewer service to both public and private users within Granville County.

Analysis of Financial Position and Results of Operations

The Town of Butner Water and Sewer System's net assets as of June 30, 2006, were \$21,758,431. The decrease primarily resulted from lower revenues for the year when the water and sewer operations were transferred to South Granville Water and Sewer Authority (SGWASA) in January 2006 (See Note 12).

Condensed Financial Information

The following table summarizes the Town of Butner Water and Sewer System's assets, liabilities and net assets as of June 30, 2006, and 2005.

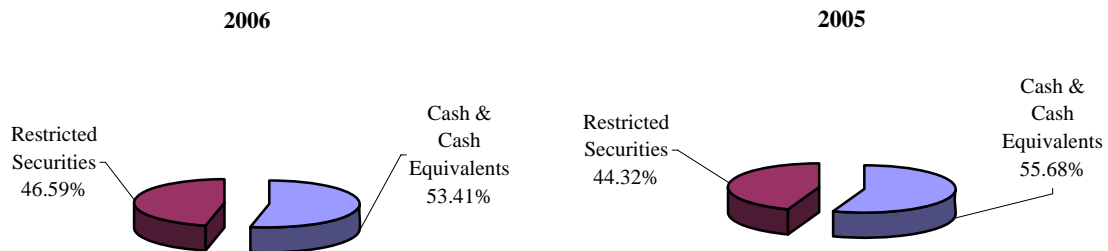
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Condensed Statement of Net Assets
June 30, 2006 and 2005
(in thousands)

	2006 Amount	2005 Amount	Percent Change
Assets			
Current Assets	\$ 8,877,425	\$ 9,101,475	(2.46) %
Capital Assets, Net	24,199,185	25,396,789	(4.72) %
Other Noncurrent Assets	3,189,353	4,115,995	(22.51) %
Total Assets	36,265,963	38,614,259	(6.08) %
Liabilities			
Current Liabilities	14,454,792	4,389,382	229.31 %
Noncurrent Liabilities	52,740	10,452,324	(99.50) %
Total Liabilities	14,507,532	14,841,706	(2.25) %
Net Assets			
Invested in Capital Assets, Net of Related Debt Restricted	15,399,185	16,326,789	(5.68) %
Capital Improvement Unrestricted	1,625,449	2,060,751	(21.12) %
Unrestricted	4,733,797	5,385,013	(12.09) %
Total Net Assets	\$ 21,758,431	\$ 23,772,553	(8.47) %

The following graphically illustrates the assets, liabilities and net assets of the Town of Butner Water and Sewer System.

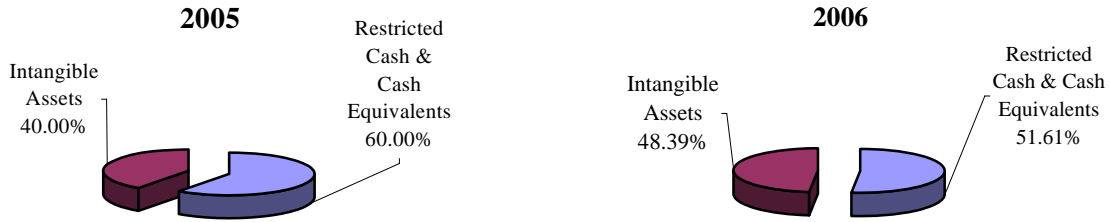
Current Assets



MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

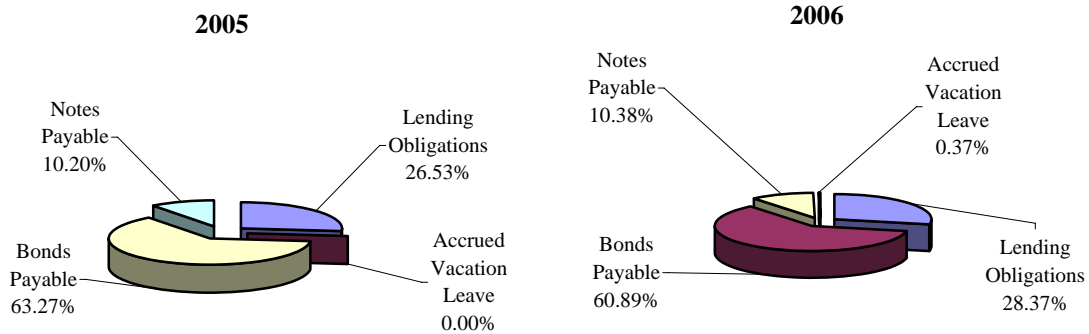
Current assets as of June 30, 2006, consisted primarily of cash and equivalents, \$4.7 million, and restricted securities, \$4.1 million. Current assets as of June 30, 2005, consisted primarily of cash and equivalents, \$4.9 million, and restricted securities, \$3.9 million.

Other Current Assets



Noncurrent assets as of June 30, 2006, consisted primarily of restricted cash and cash equivalents, \$1.6 million and intangible assets, \$1.5 million. Noncurrent assets as of June 30, 2005, consisted primarily of restricted cash and cash equivalents, \$2.4 million, and intangible assets, \$1.6 million.

Liabilities

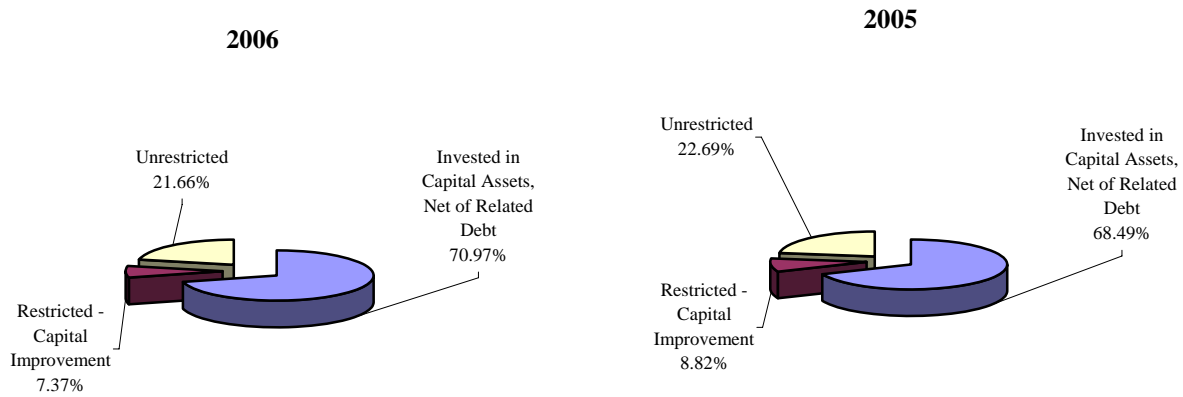


Current liabilities as of June 30, 2006, consisted primarily of obligations under lending agreements, \$4.1 million, bonds payable, \$8.8 million, and notes payable, \$1.5 million. Current liabilities as of June 30, 2005, consisted primarily of obligations under lending agreements, \$3.9 million, and bonds, notes payable and accounts payable, \$0.5 million.

Noncurrent liabilities as of June 30, 2006, consisted entirely of accrued vacation leave and customer deposits of \$52,740. Noncurrent liabilities as of June 30, 2005, consisted primarily of bonds payable, \$8.8 million and notes payable, \$1.5 million.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Net Assets



Net assets invested in capital assets, net of related debt, were \$15.4 million and \$16.3 million as of June 30, 2006, and 2005 respectively. Restricted for capital improvement net assets were \$1.6 million and \$2.1 million as of June 30, 2006, and 2005 respectively. Unrestricted net assets were \$4.7 million and \$5.4 million as of June 30, 2006, and 2005 respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The Statements of Revenues, Expenses, and Changes in Net Assets present the results of the Town of Butner Water and Sewer System's operations for the report period. The following table summarizes the Town of Butner Water and Sewer System's revenues, expenses, and changes in net assets for the years ended June 30, 2006, and 2005.

**Condensed Statement of Revenues, Expenses,
and Changes in Net Assets
For the Fiscal Years Ended June 30, 2006 and 2005
(in thousands)**

	2006 Amount	2005 Amount	Percentage Change
Operating Revenues	\$ 2,399,461	\$ 3,566,071	(32.71) %
Operating Expenses	<u>3,927,951</u>	<u>4,138,865</u>	<u>(5.10) %</u>
Operating Loss	<u>(1,528,490)</u>	<u>(572,794)</u>	<u>(166.84) %</u>
Nonoperating Revenues	179,468	214,339	(16.27) %
Nonoperating Expenses	<u>(427,087)</u>	<u>(455,419)</u>	<u>(6.22) %</u>
Loss Before Other Revenues and Expenses	(1,776,109)	(813,874)	(118.29) %
Other Revenues - Transfers & Contributions	<u>(230,013)</u>	<u>141,931</u>	<u>(262.06) %</u>
Decrease in Net Assets	(2,014,122)	(671,943)	(199.75) %
Net Assets Beginning of Year (Restated)	<u>23,772,553</u>	<u>24,444,496</u>	<u>(2.75) %</u>
Net Assets End of Year	<u><u>\$ 21,758,431</u></u>	<u><u>\$ 23,772,553</u></u>	<u><u>(8.47) %</u></u>

While the Town of Butner Water and Sewer System shows operating losses, this is an expected outcome for an entity given the intent to transfer operations as described in Note 12.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

Operating and Nonoperating Revenues



The Town of Butner Water and Sewer System had operating revenues of \$2.4 million and \$3.6 million, for the years ended June 20, 2006, and June 30, 2005, respectively. For the fiscal year, ended June 30, 2006, nonoperating revenues totaled \$.2 million, primarily investment earnings. For the fiscal year, ended June 30, 2005, nonoperating revenues totaled \$.2 million, which consisted of investment earnings and asset sales.

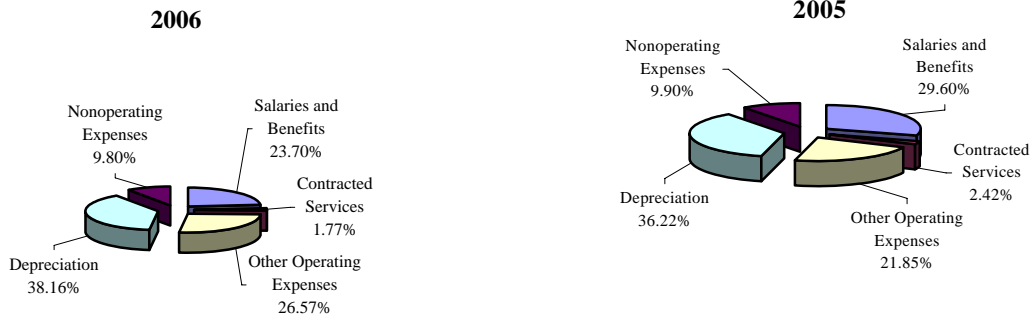
The following table summarizes the Town of Butner Water and Sewer System's expenses (operating and nonoperating) for the reporting periods.

**Operating and Nonoperating Expenses
For the Fiscal Years Ended June 30, 2006 and 2005
(in thousands)**

	2006 Amount	2005 Amount	Percentage Change
Operating Expenses:			
Salaries and Benefits	\$ 1,031,563	\$ 1,360,308	(24.17) %
Contracted Services	77,468	110,530	(29.92) %
Other Operating Expenses	1,157,138	1,004,274	15.22 %
Depreciation	1,661,782	1,663,753	(0.12) %
Total Operating Expenses	3,927,951	4,138,865	(5.10) %
Nonoperating Expenses:			
Interest/Debt Service Fees	\$ 427,087	\$ 455,419	(6.22) %

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

The following is a graphic illustration of expenses (operating and nonoperating) for the reporting periods.



The Statements of Cash Flows provide additional information about the Town of Butner Water and Sewer System's financial results by reporting the major sources and uses of cash. The following table summarizes the Town of Butner Water and Sewer System's cash receipts and payments for the years ended June 30, 2006, and 2005.

**Condensed Statement of Cash Flows
For the Fiscal Years Ended June 30, 2006 and 2005
(in thousands)**

	2006 Amount	2005 Amount	Percentage Change
Cash Provided (Used) by:			
Operating Activities	\$ 277,575	\$ 1,141,344	(75.68) %
Noncapital Financing Activities	(238,013)	(258,069)	(7.77) %
Capital and Related Financing Activities	(1,132,545)	(516,723)	(119.78) %
Investing Activities	159,015	229,321	(30.65) %
Net Increase (Decrease) in Cash	(933,968)	595,873	(256.74) %
Cash - Beginning of the Year	7,337,162	6,741,289	8.84
Cash - End of the Year	\$ 6,403,194	\$ 7,337,162	(12.73) %

The net cash from operating activities shows net inflows of funds of \$.3 million and \$1.1 million for the years ended June 30, 2006, and 2005 respectively. The major inflows were receipts from customers. The major outflows were payments to employees for services and vendors for goods and services.

The net cash from noncapital financing activities shows net outflows of \$.2 million and \$.2 million for the years ended June 30, 2006, and 2005 respectively. As previously referenced, State appropriations account for the entire outflow.

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONCLUDED)

The net cash from capital and related financing activities indicate net outflows of \$1.1 million and \$.5 million for the years ended June 30, 2006, and 2005 respectively. The primary outflows for both years of \$.7 million were for debt related payments consisting of principal, interest and bond costs. Outflows for acquisition and construction of capital assets were \$.5 million and \$.3 million for the years ended June 30, 2006, and 2005 respectively.

For the year ending June 30, 2006, and 2005 respectively, the Town of Butner Water and Sewer System had a net cash inflow of \$.2 million each year from investing activities. This inflow resulted entirely from investment income.

Economic Factors That Will Affect the Future

The main factors affecting the economic outlook for the Town of Butner Water and Sewer System were the intention of transferring all System property and assets to SGWASA and the retirement of all System bond debt by January 2007. The operations component of the System was transferred to SGWASA in January 2006. Subsequently, the North Carolina General Assembly authorized the transfer of System property and assets to and retirement of all bond debt by SGWASA per Session Law 2006-591, ratified on July 13, 2006. The transfer of all operations, property, and assets of the Butner Water and Sewer System to SGWASA and the payment of the bond debt were completed as of January 2007; thus oversight of the system is no longer the responsibility of the North Carolina Department of Health and Human Services.

Town of Butner Water and Sewer System
Statement of Net Assets
June 30, 2006

Exhibit A

ASSETS

Current Assets:

Cash and Cash Equivalents (Note 2)	\$ 4,777,745
Restricted State Treasurer's Securities Lending Collateral	4,095,000
Accounts Receivable (Net of Allowance for Uncollectible)	3,889
Inventories	791
	<hr/>
Total Current Assets	8,877,425

Noncurrent Assets:

Restricted Cash and Cash Equivalents - Capital Improvements (Note 2)	1,625,449
Deferred Charges - Bonx Issuance Cost (Note4)	106,972
Capital Assets, Net (Note 3)	24,199,185
Intangible Assets, Net (Note 10)	1,456,932
	<hr/>
Total Noncurrent Assets	27,388,538

Total Assets	<hr/> <hr/> 36,265,963
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LIABILITIES

Current Liabilities:

Accounts Payable	66,323
Obligations Under State Treasurer's Securities Lending Agreements	4,095,000
Intergovernmental Payable	364
Accrued Interest Payable	33,113
Accrued Vacation Leave (Note 4)	3,060
Bonds Payable (Notes 4 & 12)	8,800,000
Notes Payable (Note 10)	1,456,932
	<hr/>
Total Current Liabilities	14,454,792

Noncurrent Liabilities:

Customer Deposits Payable	27,933
Accrued Vacation Leave (Note 4)	24,807
	<hr/>
Total Noncurrent Liabilities	52,740

Total Liabilities	<hr/> <hr/> 14,507,532
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NET ASSETS

Invested in Capital Assets, Net of Related Debt	15,399,185
Restricted for Capital Improvements	1,625,449
Unrestricted	4,733,797
	<hr/>
Total Net Assets	<hr/> <hr/> \$ 21,758,431

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, 2006***

Exhibit B

REVENUES

Operating Revenues:	
Sales and Services (Net of Allowances of \$450)	\$ 2,376,903
Fees, Licenses and Fines	8,240
Miscellaneous Revenues	14,318
	<hr/>
Total Operating Revenues - (Pledged as Security for Revenue Bonds)	<hr/> 2,399,461 <hr/>

EXPENSES

Operating Expeenses:	
Personal Services and Employee Benefits	1,031,563
Supplies and Materials	247,864
Contracted Personal Services	77,468
Travel	302
Communications	8,417
Utilities	267,100
Other Services	46,684
Depreciation	1,661,782
Amortization	5,416
Insurance	2,132
Other	579,223
	<hr/>
Total Operating Expenses	<hr/> 3,927,951 <hr/>
Operating Loss	<hr/> (1,528,490) <hr/>

NONOPERATING REVENUES (EXPENSES)

Insurance Recovery	27,908
Investment Earnings	147,238
Debt Service Fees	(33,042)
Gain on Disposal of Capital Assets	4,322
Interest Expense	(394,045)
	<hr/>
Net Nonoperating Expenses	<hr/> (247,619) <hr/>
Net Loss Before Contributions and Transfers	(1,776,109)
Transfers In	801,440
Transfers Out	(1,039,453)
	<hr/>
Change in Net Assets	<hr/> (2,014,122) <hr/>
Net Assets - July 1, 2005	23,772,553
Net Assets - June 30, 2006	<hr/> \$ 21,758,431 <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, 2006***

Exhibit C

CASH FLOWS FROM OPERATING ACTIVITIES

Receipts from Customers	\$ 2,077,651
Receipts from Other State Funds for Services Provided	378,362
Payments to Employees and Fringe Benefits	(1,139,016)
Payments to Vendors and Suppliers	(526,357)
Payments to Other State Funds for Services Used	(226,094)
Other Payments	(286,971)
	<u>277,575</u>
Net Cash Provided by Operating Activities	<u>277,575</u>

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

Transfers from Other Funds	801,440
Transfers to Other Funds	(1,039,453)
	<u>(238,013)</u>
Net Cash Used by Noncapital Financing Activities	<u>(238,013)</u>

CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES

Insurance Recoveries	27,908
Acquisition and Construction of Capital Assets	(483,372)
Proceeds from Sales of Capital Assets	4,323
Principal Paid on Capital Debt	(270,000)
Interest and Fees Paid on Capital Debt	(365,263)
Payments to Bond Escrow Agent	(40,725)
Bond Issuance Costs	(5,416)
	<u>(1,132,545)</u>
Net Cash Used by Capital and Related Financing Activities	<u>(1,132,545)</u>

CASH FLOWS FROM INVESTING ACTIVITIES

Interest on Investments	159,015
	<u>159,015</u>
Net Cash Provided by Investing Activities	<u>159,015</u>
Net Increase in Cash and Cash Equivalents	(933,968)
Cash and Cash Equivalents - July 1, 2005	7,337,162
	<u>7,337,162</u>
Cash and Cash Equivalents - June 30, 2006	<u>\$ 6,403,194</u>

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

Operating Loss	\$ (1,528,490)
Adjustments to Reconcile Operating Income to Net Cash Provided (Used) by Operating Activities:	
Depreciation and Amortization	1,667,198
Changes in Assets and Liabilities:	
Receivables, Net	117,261
Inventories	160,075
Accounts Payable	20,491
Accrued Vacation Leave	(107,523)
Due to Other Funds	(513)
Deposits Payable	(48,952)
Deferred Revenues	(1,972)
	<u>277,575</u>
Net Cash Provided by Operating Activities	<u>\$ 277,575</u>

***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	\$ 4,777,745
Noncurrent Assets:	
Restricted Cash and Cash Equivalents - Capital Improvements	<u>1,625,449</u>
Total Cash and Cash Equivalents - June 30, 2006	<u><u>\$ 6,403,194</u></u>

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Assets Acquired through the Assumption of a Liability	\$ 4,095,000
Change in Construction in Progress as a Result of Accruals	2,268

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

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TOWN OF BUTNER WATER AND SEWER SYSTEM
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2006

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. 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 1st or for which an employee can be paid upon termination of employment. In addition, 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.

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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 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, 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 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.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

At June 30, 2006, the System's deposit in the State Treasurer's Short-Term Investment Fund had a book balance of \$6,403,194 and a bank balance of \$6,404,024. Deposit and investment risks associated with 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*. 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 for the year is presented as follows:

	Balance June 30, 2005	Increases	Decreases	Balance June 30, 2006
Capital Assets, Nondepreciable:				
Land	\$ 33,450	\$ 0	\$ 0	\$ 33,450
Construction in Progress	864,896	483,372		1,348,268
Total Capital Assets, Nondepreciable	898,346	483,372		1,381,718
Capital Assets, Depreciable:				
Buildings	3,277,583			3,277,583
Machinery and Equipment	676,148		19,194	656,954
General Structures and Improvements	32,215,411			32,215,411
Total Capital Assets, Depreciable	36,169,142		19,194	36,149,948
Less Accumulated Depreciation:				
Buildings	1,982,362	127,172		2,109,534
Machinery and Equipment	462,002	37,794		499,796
General Structures and Improvements	9,226,335	1,496,816		10,723,151
Total Accumulated Depreciation	11,670,699	1,661,782		13,332,481
Total Capital Assets, Depreciable, Net	24,498,443	(1,661,782)	19,194	22,817,467
Capital Assets, Net	\$ 25,396,789	\$ (1,178,410)	\$ 19,194	\$ 24,199,185

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, 2005	Additions	Reductions	Balance June 30, 2006	Current Portion
Bonds Payable	\$ 9,070,000	\$ 0	\$ 270,000	\$ 8,800,000	\$ 8,800,000
Accrued Vacation Leave	135,390	16,407	123,930	27,867	3,060
Compensated Absences	\$ 9,205,390	\$ 16,407	\$ 393,930	\$ 8,827,867	\$ 8,803,060

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

B. Bonds Payable – At June 30, 2006, the System had bonds outstanding as follows:

	Series	Effective Interest Rate	Final Maturity Date	Original Amount of Issue	Principal Paid Through June 30, 2006	Principal Outstanding June 30, 2006
Water Treatment Plant Upgrade and Expansion	2001	4.21	9/1/2025	<u>\$ 9,095,000.00</u>	<u>\$ 1,105,000.00</u>	<u>\$ 8,800,000.00</u>

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, 2006, 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.

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-Rate Bonds		Interest-Rate Swaps, Net	Effective Interest	Total
	Principal	Interest			
2007	\$ 280,000	\$ 290,209	\$ 71,430	\$ 361,639	\$ 641,639
2008	295,000	280,369	69,008	349,377	644,377
2009	305,000	270,149	66,493	336,642	641,642
2010	320,000	269,465	63,863	323,328	643,328
2011	335,000	248,274	61,108	309,382	644,382
2012-2016	1,910,000	1,055,343	259,755	1,315,098	3,225,098
2017-2021	2,380,000	690,555	169,969	860,524	3,240,524
2022-2026	2,975,000	235,098	57,867	292,965	3,267,965
Total	\$ 8,800,000	\$ 3,339,462	\$ 819,493	\$ 4,148,955	\$ 12,948,955

Auditor's Note: See Note 12 for reclassification of all Bonds outstanding as current.

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, 2007, 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. Bonds Payable

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 5.33% at June 30, 2006. On the other hand, the bond's variable rate coupons (2.70% at June 30, 2006) are closely associated with the variable BMA, which was 3.97% as of June 30, 2006.

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 \$ 384,983 (Bank of America) as of June 30, 2006. 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, 2006, 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, 2006, of (0.743% + 2.700%) 3.443% reflecting a Bond Rate/LIBOR relationship of 17.64% compared to 65% of LIBOR the System is receiving as of June 30, 2006. The swap may be terminated by either party if the other party fails to perform under the terms of the contract. If the swap were terminated, the associated variable-rate bonds would no longer carry synthetic interest rates. In addition, if at the time of termination the swap has a negative fair value, the System would be liable to the counterparty for that amount.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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.

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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 ended June 30, 2006, these rates were set at 2.34% of covered payroll for employers and 6% of covered payroll for members.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

For the year ended June 30, 2006, the Town of Butner Water and Sewer System had a total payroll of \$847,451, of which \$712,850 was covered under the Retirement System. Total employee and employer contributions for pension benefits for the year were \$42,771 and \$16,681, respectively. The Town of Butner Water and Sewer System made one hundred percent of its annual required contributions for the years ended June 30, 2006, 2005, and 2004, which were \$16,681, \$23,390, and \$2,770, 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 post employment health insurance to eligible former employees. Eligible former employees include long-term disability beneficiaries of the

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

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 3.8% of the covered payroll under the Teachers' and State Employees' Retirement System for these health care benefits. For the fiscal year ended June 30, 2006, the System's total contribution to the Plan was \$27,088. 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, 2006, the System contributed .52% of covered payroll, or \$3,707 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 \$400,459 at June 30, 2006, for capital improvement projects. In addition, there were commitments from Powell Bill and Park Funds, not a part of the System, for \$110,897.

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 \$1,039,177 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

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

support program administration. During the year, \$276 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 1st, 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 to Bay River. On July 5, 2006, the System sold to SGWASA (Note 12) all of the intangible assets in exchange for the related debt. Because of the sale, all notes payable have been classified as current.

NOTE 11 - ARBITRAGE REBATE

The System contracted with an arbitrage specialist to have the Arbitrage Yield Rebate calculated following Internal Revenue Service (IRS) Code Section 148. The specialist issued a report indicating that no rebate amount is required for the subject revenue bonds, and accordingly, no return or payment to the IRS is required. The issue of the Series 2001 bonds is now closed.

NOTE 12 - MEMORANDUM OF UNDERSTANDING WITH GRANVILLE COUNTY AND TRANSFERS OF OPERATIONS AND ASSETS TO SGWASA

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 established a regional water and wastewater authority 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 transferred the electing System's employees and operational responsibility to the Authority on January 1, 2006. SGWASA's Board consists of seven members appointed by: Granville County (2), the Towns of Creedmoor (2) and Stem (1), and the Butner Planning Authority (2).

Senate Bill 491 ratified on July 13, 2006, provided for the transfer of the assets of the System "on or before January 1, 2007, or as soon thereafter as all conditions set forth herein are met.....SGWASA prior to said transfer, shall make the arrangements necessary to retire, assume, or otherwise satisfy any debt issued by the State that is secured by the System or by the revenues of the

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

System and which is outstanding as of the date of transfer” (Note 4B-Bonds Payable). The Bill also provided for SGWASA to fund operations of the Butner Reservation under Section 2(c), and for the Department to transfer a sum for the purpose of “a reserve for operations and maintenance expenses and extraordinary repairs and replacements” of \$2,069,433. The transfer of these funds occurred on December 5, 2006. The bonds were retired and the transfer of assets occurred on December 15, 2006. The effect of such transfers is the discontinuance of the water and sewer operations and elimination of violations of the Bond Convent under Section 704A and B. As a result of these subsequent events, all bond debt has been classified in these financial statements as current and due on demand.

Town of Butner Water and Sewer System
Trust Agreement Rate Covenant Calculation
June 30, 2006

Schedule 1

SECTION 704(a) CALCULATION:

CALCULATION OF INCOME AVAILABLE FOR DEBT SERVICE

Revenue from Services:		
Operating Revenue (Exhibit B)	\$	2,399,461
Add Investment Earnings on Revenue Deposits		<u>147,238</u>
Revenue from Services	\$	2,546,699
Adjusted Current Expenses:		
Operating Expenses (Exhibit B)		3,927,951
Less Depreciation/Amortization (Exhibit B)		<u>1,667,198</u>
Less Adjusted Current Expenses		<u>2,260,753</u>
Income Available for Debt Service	\$	285,946

DETERMINATION OF LARGEST RATE COVENANT REQUIREMENT

120% of Long-Term Debt Service Requirement on Parity Indebtedness (120% of \$635,263 - Adjusted for Capitalized Interest)	762,316
100% of Long-Term Debt Service Requirement on Parity Indebtedness and Subordinated Indebtedness	635,263
Less Largest Rate Covenant Requirement	<u>762,316</u>
Excess Deficit Available for Debt Service - In Accordance with Section 704(a)	<u><u>\$ (476,370)</u></u>

SECTION 704(b) CALCULATION:

Calculation of Receipts:		
Operating Revenue (Exhibit B)		2,399,461
Add Investment Earnings on Revenue Deposits		<u>147,238</u>
Receipts	\$	2,546,699

REQUIREMENTS AGAINST RECEIPTS:

Adjusted Current Expenses:		
Operating Expenses (Exhibit B)		3,927,951
Less Depreciation/Amortization (Exhibit B)		<u>1,667,198</u>
Adjusted Current Expenses		2,260,753
Deposits Required by Sections 504(a), (b), and (c)		
Section 504(a) as to Payment of Interest (Adjusted for Capitalized Interest)		365,263
Section 504(b) as to Payment of principal		<u>270,000</u>
Section 504 Deposits		<u>635,263</u>
Less Requirements Against Receipts		<u>2,896,016</u>
Excess Income Available for Debt Service - In Accordance with Section 704(b)	\$	<u><u>(349,317)</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.

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**INDEPENDENT AUDITOR'S 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, 2006, and have issued our report thereon dated April 7, 2007. 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.

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. Except for the recognition of the loss on the transfer of the System assets and bonds, the accompanying financial statements have been prepared assuming that the System will not continue as a going concern. As discussed in Note 12 to the financial statements, the System's intention is to transfer all assets and bonds to a utility district on or about January 1, 2007.

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

**INDEPENDENT AUDITOR’S REPORT
ON INTERNAL CONTROL OVER FINANCIAL REPORTING
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GOVERNMENT AUDITING STANDARDS (CONTINUED)**

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

Finding

1. Failure to Post Prior Year Capitalized Interest
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 Finding No. 1 to be a material a 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 it’s 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 instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and are described in the Audit Findings and Recommendations section of this report:

Finding

4. Violation of Bond Covenants Sections 704 A and B

**INDEPENDENT AUDITOR'S 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)**

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 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 & MANIFOLD, CPAs, PLLC

Huntley, Sigmon & Manifold, CPAs, PLLC

Lenoir, North Carolina
April 7, 2007

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AUDIT FINDINGS AND RECOMMENDATIONS

Matters Related to Internal Control Over Financial Reporting

1. FAILURE TO POST PRIOR YEAR CAPITALIZED INTEREST

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, and \$6,617 for the year ended June 30, 2005.

Recommendation: The System should post to their financial statements a prior year adjustment of \$414,170 as a reduction in construction in progress and debit the net assets as of July 1, 2007.

Agency's Response: NCDHHS posted the required entry as a prior year adjustment on November 30, 2006.

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 2006 reconciliation was completed.

June 30, 2006 Review: The System had completed on a timely basis all monthly bank reconciliations from August 2006 through July 2007.

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 financial statements. The financial statements reported approximately \$24,000 more in utility customer deposits than is reported on Butner's subsidiary ledger.

June 30, 2006 Review: NCDHHS has reviewed the utility customer deposit and determined these reports have been in disagreement for several years. The System confirmed this with an internal audit completed September 13, 2006. As a result, the financial statements contain a liability of \$27,933 in customer deposits that will be recognized as revenue during the June 30, 2007, year.

AUDIT FINDINGS AND RECOMMENDATIONS (CONCLUDED)

4. VIOLATION OF BOND COVENANTS

NCDHHS has violated the Bond Covenants regarding the calculation of Section 704(a) and 704(b) as calculated in Schedule 1.

Agency's Response: NCDHHS had transferred all services to SGWASA in January 2006 with all assets to be transferred by January 2007, assuming the debt associated with the assets has been extinguished by SGWASA. See Note 12 for more details.

ORDERING INFORMATION

Audit reports issued by the Office of the State Auditor can be obtained from the web site at www.ncauditor.net. Also, parties may register on the web site to receive automatic email notification whenever reports of interest are issued. Otherwise, copies of this report may be obtained by contacting the:

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