Washington State Auditor's Office

Financial Statements Audit Report

Northshore Utility District
King County

Audit Period
January 1, 2012 through December 31, 2012

Report No. 1009913

Issue Date
June 10, 2013

Washington
Troy Kelley
State Auditor

Washington State Auditor
Troy Kelley

June 10, 2013

Board of Commissioners
Northshore Utility District
Kenmore, Washington

Report on Financial Statements

Please find attached our report on the Northshore Utility District's financial statements.

We are issuing this report in order to provide information on the District's financial condition.

Sincerely,

Troy X. Kelley

TROY KELLEY
STATE AUDITOR

Table of Contents

Northshore Utility District
King County
January 1, 2012 through December 31, 2012

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*

Northshore Utility District
King County
January 1, 2012 through December 31, 2012

Board of Commissioners
Northshore Utility District
Kenmore, Washington

We have audited, 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, the financial statements of the Northshore Utility District, King County, Washington, as of and for the years ended December 31, 2012 and 2011, and the related notes to the financial statements, which collectively comprise the District's basic financial statements, and have issued our report thereon dated May 22, 2013. During the year ended December 31, 2012, the District implemented Governmental Accounting Standards Board Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources and Net Position*.

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audits of the financial statements, we considered the District's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the District's internal control. Accordingly, we do not express an opinion on the effectiveness of the District's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the District's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

COMPLIANCE AND OTHER MATTERS

As part of obtaining reasonable assurance about whether the District's financial statements are free from material misstatement, we performed tests of the District's compliance with certain provisions of laws, regulations, contracts and grant agreements, 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*.

PURPOSE OF THIS REPORT

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the District's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the District's internal control and compliance. Accordingly, this communication is not suitable for any other purpose. However, this report is a matter of public record and its distribution is not limited. It also serves to disseminate information to the public as a reporting tool to help citizens assess government operations.

Troy X. Kelley

TROY KELLEY
STATE AUDITOR

May 22, 2013

Independent Auditor's Report on Financial Statements

Northshore Utility District
King County
January 1, 2012 through December 31, 2012

Board of Commissioners
Northshore Utility District
Kenmore, Washington

REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying financial statements of the Northshore Utility District, King County, Washington, as of and for the years ended December 31, 2012 and 2011, and the related notes to the financial statements, which collectively comprise the District's basic financial statements as listed on page 5.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits 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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the District's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the District's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Northshore Utility District, as of December 31, 2012 and 2011, and the changes in financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Matters of Emphasis

As discussed in Note 1 to the financial statements, in 2012, the District adopted new accounting guidance, Governmental Accounting Standards Board Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources and Net Position*. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 6 through 10 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

OTHER REPORTING REQUIRED BY GOVERNMENT AUDITING STANDARDS

In accordance with *Government Auditing Standards*, we have also issued our report dated May 22, 2013 on our consideration of the District's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the District's internal control over financial reporting and compliance.

Troy X. Kelley

TROY KELLEY
STATE AUDITOR

May 22, 2013

Financial Section

Northshore Utility District
King County
January 1, 2012 through December 31, 2012

REQUIRED SUPPLEMENTARY INFORMATION

BASIC FINANCIAL STATEMENTS

MANAGEMENT DISCUSSION AND ANALYSIS

For the Year Ended December 31, 2012

As management of the Northshore Utility District (the District), we offer readers of the District's financial statements this narrative overview and analysis of the financial activities of the District for the fiscal year ended December 31, 2012. We encourage readers to consider the information presented here in conjunction with the District's financial statements, which begin on page 10.

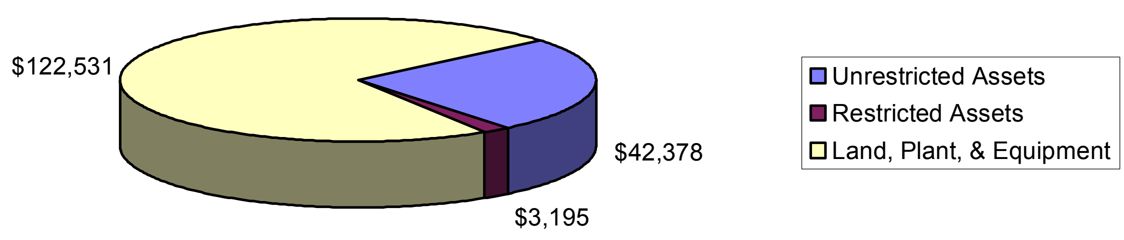
The financial position of the District has improved slightly over prior years, which were mildly affected by an economic downturn and slow economic growth.

- The assets of the District exceeded its liabilities, creating a net position at the close of 2012 of $158,633,021, which is an increase of $1.13 million over 2011.
- As of the close of 2012, the District cash balance was $39,317,143 representing an increase of $850,256 from December 31, 2011.

The District had total operating revenues of $33,251,180 and operating expenses of $35,592,953 for the fiscal year ended December 31, 2012.

A majority of the District's assets are held in land, plant, and equipment. Other assets are categorized as restricted or unrestricted, as illustrated below:

2012 Asset Categories ($000)



Overview of the Financial Statements

The management discussion and analysis is intended to serve as an introduction to the District's basic financial statements. The District's basic financial statements are comprised of District-wide financial statements and notes to the financial statements. The District began implementing the Governmental Accounting Standards Board (GASB) Statement No. 34 model of financial reporting in 2003. In 2012, the District implemented GASB Statement No. 63. These statements establish standards for external financial reporting for all state and local government entities.

DISTRICT FINANCIAL STATEMENTS

The District's financial statements are designed to provide readers with a broad overview of the District's finances, in a manner similar to a private sector business.

The *Statement of Net Position* presents information on all of the District's assets and liabilities, with the difference between the two reported as net position. Over time, increases or decreases in net position may serve as a useful indicator of whether the financial position of the District is improving or deteriorating. Assets are designated as either "Unrestricted" or "Restricted" based upon their purpose. Restricted assets are those subject to constraints that are externally imposed, such as those imposed by creditors through debt covenants. Funds without a designated purpose are referred to as "Unrestricted." The District had assets restricted for construction and debt service of $3,194,520 and $4,282,015 as of December 31, 2012, and 2011, respectively.

The *Statement of Revenues, Expenses, and Changes in Net Position* presents information showing how the District's position changed during the most recent fiscal year. All changes are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g., depreciation as well as earned but unused vacation leave).

The *Statement of Cash Flows* accounts for the net change in cash and cash equivalents by summarizing cash receipts and cash disbursements resulting from operating activities, capital and related financing activities and investment activities. This statement assists the user in determining the source of cash coming into the District, the items for which cash was expended, and the beginning and ending cash balance.

The notes provide additional information that is essential to a full understanding of the data provided in the District's financial statements. The notes to the financial statements can be found on pages 15 through 38 of this report.

The overall financial condition of the District improved slightly over prior years, which were affected by an economic downturn, and remains strong as indicated by continued increases in net position over 2011 and 2010. The most significant financial impact of the recession and slow recovery has been in the area of new housing development. Development in the District is once again on the rise. This trend is reflected in the increase of facilities benefit charges of $1,455,629 collected in 2012 compared to $927,800 in 2011. This is an increase of almost 57%. Between 2010 and 2011, these charges decreased by 14%. During 2012 the District was almost back to the pre-recession level of $1,600,372 in 2008. Investment rates of return began falling in 2007 and the figure for 2012 of .57% had not changed significantly from 2011.

Condensed Statement of Net Position	2012	2011	2010	2012-2011 Change	Change %
Current, Restricted and Other Assets	$45,572,149	$45,251,627	$44,913,119	$320,522	0.7%
Capital Assets (net of depreciation)	122,530,659	120,511,877	118,222,606	2,018,782	1.7%
Total Assets	$168,102,807	$165,763,504	$163,135,725	$2,339,304	1.4%
Non-Current Liabilities	$7,067,215	$5,760,017	$5,146,920	$1,307,198	22.7%
Current Liabilities	2,402,571	2,503,135	2,329,391	($100,564)	-4.0%
Total Liabilities	$9,469,786	$8,263,152	$7,476,311	$1,206,634	14.6%
Net Position					
Invested in capital assets, net of related debt	$116,112,422	$115,552,943	$113,075,687	$559,479	0.5%
Restricted Assets	3,194,519	4,282,015	4,571,841	(1,087,496)	-25.4%
Unrestricted Assets	39,326,080	37,665,394	38,011,886	1,660,686	4.4%
Total Net Position	$158,633,021	$157,500,352	$155,659,414	$1,132,670	0.7%

The net position of the District increased $1.13 million from $157,500,352 in 2011 to $158,633,021 in 2012. In 2010, the District's net position was $155,659,414.

In 2012, the majority of the District's gross income (89.8%) was derived from water and wastewater service charges received from its ratepayers. The District also derives cash flows from street light service, connection charges (facility benefit charges) and investment earnings.

Additional assets are received from developers in the form of infrastructure donated to the District upon completion of their projects (developer donated plant).

Condensed Statement of Revenues, Expenses and Changes in Net Position

	2012	2011	2010	2012-2011 Change	Change (%)
Operating Revenues:					
Sewer	$19,141,024	$18,393,221	$17,003,151	$747,803	4.1%
Water	13,867,860	13,229,750	12,400,875	638,110	4.8%
Other	1,604,936	1,521,562	1,400,309	83,374	5.5%
Less discounts	(1,362,640)	(1,299,465)	(1,180,318)	(63,175)	4.9%
Non-Operating Revenues:				-	
Facility benefit charges	1,455,629	927,800	1,078,460	527,829	56.9%
Other	543,822	306,067	440,851	237,755	77.7%
Total Revenues	35,250,631	33,078,935	31,143,328	$2,171,696	6.6%
Operating Expenses	35,592,952	32,305,125	28,322,977	3,287,827	10.2%
Non-Operating Expenses	133,300	133,881	176,743	(581)	-0.4%
Total Expenses	35,726,252	32,439,006	28,499,720	3,287,246	10.1%
(Deficit) Before Plant Donation	(475,621)	639,929	2,643,608	(1,115,550)	-174.3%
Developer donated plant	1,608,290	1,201,009	1,886,328	407,281	33.9%
Change in Net Position	1,132,669	1,840,938	4,529,936	(708,269)	-38.5%
Beginning Net Position	157,500,352	155,659,414	151,129,478	1,840,938	1.2%
Ending Net Position	$158,633,021	$157,500,352	$155,659,414	$1,132,669	0.7%

CAPITAL ASSETS AND DEBT ADMINISTRATION

By far the largest portion of the District's total assets (72.9%) is investment in capital assets (e.g. buildings, land, utility plant, and equipment). The District uses these capital assets to provide water and sewer services to residential and commercial ratepayers in the District. The unrestricted net position of the District represents assets that are available for future use to provide utility services.

As of December 31, 2012, the District's investment in capital assets for its activities, shown on the Statement of Net Position as Capital Assets was $122,530,659 net of accumulated depreciation. This is an increase of $2,018,782 from December 31, 2011. Capital assets include land, improvements to land and land rights, buildings, building improvements, vehicles, machinery, equipment, utility plant, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period. Please refer to Note 3 on page 20.

LONG-TERM DEBT

The District took advantage of favorable interest rates in 2003 by advance refunding of its outstanding 1995 Revenue Bonds, while at the same time, acquiring $4.2 million in new financing. In preparation for this event, the District made a presentation to Standard & Poors, the credit rating agency, in May 2003 and obtained an improved credit rating of “AA”. An advance refunding transaction occurs when the District retires its outstanding bonds ahead of their scheduled due date with a new series of bonds. In most cases, the advance refunding results in lower debt service costs. Revenue bonds offer a number of distinct advantages. Much like a home mortgage, revenue bonds allow the District to spread out payments over 20 years. Instead of burdening today’s ratepayers with the total cost of improvements, all users of the system over the next 20 years will shoulder that cost. Please refer to Note 6 of the financial statements on page 23. In 2008, Standard & Poor’s updated the District’s bond rating from “AA” to “AAA.”

The District has historically sought Public Works Trust Fund loans issued by the Washington Public Works Board to finance its water and sewer capital projects. These loans are offered to competing public entities to fund capital projects. In 2010, the District applied for and in 2011 was awarded $3.105 million in State funding to construct a gravity sewer main bypass of the District’s lift station 10. This lift station sits on the shores of Lake Washington. It is difficult to access, particularly during inclement weather, and its elimination will greatly reduce the District’s environmental exposure should the lift station fail. The current annual interest rate on these loans ranges from 0.5% to 1.0%.

2010 was the last year that the District had revenue bond debt service payments in excess of $1 million. Bond principal payments dropped from $1,360,000 in 2010 to under $300,000 each year beginning in 2011. During 2012 the District decided to call all remaining 2003 revenue bonds on May 1, 2013. See additional information in Note 6 beginning on page 23. In the absence of new debt and early redemption, the total long-term debt principal outstanding after 2012 will be $2,500,000 for revenue bonds and $4,567,216 for Public Works Trust Fund (PWTF) loans.

Comparative Statement of Net Position
As of December 31, 2012 and 2011

	2012	2011
ASSETS		
Current assets		
Cash and cash equivalents	$36,122,623	$34,184,872
Accounts receivable	3,505,706	3,430,438
Estimated unbilled service revenue	1,581,765	1,648,096
Restricted Assets:		
Construction Fund:		
Cash and cash equivalents	2,094,546	2,961,812
Revenue Bond Fund:		
Cash and cash equivalents	1,099,974	1,320,203
Inventory	381,787	775,316
Other current assets - prepaid items	136,769	129,807
TOTAL CURRENT ASSETS	44,923,170	44,450,544
Non-current & Other Assets		
Assessments receivable	303,946	354,116
Installment contracts receivable	300,132	397,710
Unamortized bond discount & issuance costs	44,901	49,257
Other restricted assets	-	-
Capital Assets		
Non-depreciable - land & land rights	2,633,576	2,633,577
Depreciable assets:		
Buildings	9,478,660	9,478,659
Data processing and office equipment	1,767,149	1,711,263
Engineering equipment and vehicles	4,619,844	4,526,732
Sewer utility plant	86,590,897	85,076,803
Water utility plant	82,060,892	80,543,940
Less: Accumulated depreciation	(75,501,324)	(71,474,367)
Construction in progress	10,880,965	8,015,270
Total Capital Assets	122,530,659	120,511,877
TOTAL NON-CURRENT & OTHER ASSETS	123,179,638	121,312,960
TOTAL ASSETS	$168,102,807	$165,763,504

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

Comparative Statement of Net Position
As of December 31, 2012 and 2011

	2012	2011
LIABILITIES		
Current liabilities		
Accounts payable	$1,459,716	$1,137,234
Accrued employee benefits	222,702	257,712
Other liabilities	636	22,879
Current portion of State Public		
Trust Fund Loans	412,854	366,850
Payables from Restricted Assets		
Accounts payable	78,069	501,793
Accrued interest payable	23,595	16,667
Current portion of Revenue Bonds	205,000	200,000
TOTAL CURRENT LIABILITIES	2,402,572	2,503,135
Non-current Liabilities:		
State Public Trust Fund Loans	4,567,215	3,055,017
Payables from Restricted Assets:		
Revenue Bonds	2,500,000	2,705,000
TOTAL PAYABLES - RESTRICTED ASSETS	7,067,215	5,760,017
TOTAL LIABILITIES	9,469,787	8,263,152
NET POSITION		
Invested in capital assets, net of related debt	116,112,422	115,552,943
Restricted assets - facilities construction		
and debt service	3,194,519	4,282,015
Unrestricted assets	39,326,080	37,665,394
TOTAL NET POSITION	158,633,021	157,500,352
TOTAL LIABILITIES AND NET POSITION	$168,102,807	$165,763,504

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

Comparative Statement of Revenues, Expenses, and Changes in Net Position
For the Years Ended December 31, 2012 and 2011

	2012	2011
OPERATING REVENUES		
Utility Sales - Sewer service	$19,141,024	$18,393,221
Utility Sales - Water service	13,867,860	13,229,750
Utility Sales - Street light service	417,757	417,755
Less discounts and adjustments	(1,362,640)	(1,299,465)
Net Utility Sales	32,064,001	30,741,261
Other Operating Revenue	1,187,179	1,103,807
Total Operating Income	33,251,180	31,845,068
OPERATING EXPENSES		
Sewage treatment charge	12,373,386	12,363,771
Water purchased for resale	4,933,403	4,743,305
Cost of street lighting	315,439	311,767
Maintenance	6,790,387	4,462,101
Administration - General	6,141,867	5,525,341
Depreciation	4,107,835	4,054,495
Property, Excise, and B&O Tax	930,636	844,345
Total Operating Expenses	35,592,953	32,305,125
OPERATING INCOME (LOSS)	(2,341,773)	(460,057)
NON-OPERATING REVENUES (EXPENSES)		
Connection fees	1,455,629	927,800
Assessment interest income	51,876	64,678
Investment interest income	500,377	233,839
Gain from disposition of assets	(8,430)	7,550
Reimbursement agreement costs	-	-
Bond and loan interest expense	(128,642)	(129,221)
Bond discount, issuance, and registration costs	(4,658)	(4,660)
Total Non-operating Revenues	1,866,152	1,099,986
Income Before Extraordinary Items and Capital Contributions	(475,621)	639,929
Capital Contributions - Developer donated plant	1,608,290	1,201,009
CHANGE IN NET POSITION	1,132,669	1,840,938
TOTAL NET POSITION, January 1	157,500,352	155,659,414
TOTAL NET POSITION, December 31	$158,633,021	$157,500,352

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

Comparative Statement of Cash Flows
For the Years Ended December 31, 2012 and 2011

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts for utility services	$33,323,660	$31,836,906
Payments to wholesale service providers	(17,344,443)	(17,665,997)
Payments for state and local taxes	(930,636)	(844,345)
Payments for payroll & related costs	(5,080,124)	(3,945,517)
Payments for administration & operations	(6,066,728)	(6,048,802)
Net cash provided by operating activities	3,901,730	3,332,245
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Purchase of capital assets - equipment	(169,971)	(1,396,454)
Purchase of system expansion	(6,112,142)	(3,675,223)
Receipts from connection fees	1,452,820	927,800
Principal paid on capital debt	1,363,202	546,787
Interest paid on capital debt	(150,886)	(179,367)
Net receipts on disposal of capital assets	13,250	7,550
Net cash used in capital and related financing activities	(3,603,727)	(3,768,907)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Interest on investments	500,377	233,839
Interest on contracts	31,558	25,223
Interest on assessments	20,318	39,455
Net cash provided by investing activities	552,253	298,517
Net increase in cash and cash equivalents	850,256	(138,145)
Cash balance - beginning of year	38,466,887	38,605,032
Cash balance - end of year	$39,317,143	$38,466,887
NON-CASH INVESTING, CAPITAL AND FINANCING ACTIVITIES:		
Contribution of capital assets from developers *	$1,608,290	$1,201,009

* Utility plant donated by developers is recorded at the contract price paid by the developer for the facilities accepted by the district.

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

Comparative Statement of Cash Flows
For the Years Ended December 31, 2012 and 2011

	2012	2011
RECONCILIATION OF OPERATING INCOME TO NET CASH FROM OPERATING ACTIVITIES		
Operating income	($2,341,772)	($460,057)
Adjustments to reconcile operating income to net cash Provided by operating activities:		
Depreciation expense	4,107,835	4,054,495
Writeoff of assets in current year not impacting cash	1,827,374	-
Changes in assets and liabilities		
(Increase) decrease in accounts receivable	72,481	(8,162)
(Increase) decrease in inventory	372,099	(541,730)
(Increase) in other current assets	(6,962)	(2,501)
Increase (decrease) in accounts payable	(101,242)	297,286
(Decrease) in accrued payroll benefits	(35,010)	(4,680)
Increase (decrease) in other current liabilities	6,928	(2,406)
Net cash provided by operating activities	$3,901,730	$3,332,245

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

NOTES TO FINANCIAL STATEMENTS

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of Northshore Utility District conform to generally accepted accounting principals (GAAP) as applicable to proprietary funds of governments. The following is a summary of the most significant policies (including identification of those policies which result in material departures from generally accepted accounting principles):

a. Reporting Entity

Northshore Utility District is a municipal corporation governed by an elected five-member board. As required by generally accepted accounting principles, management has considered all potential component units in defining the reporting entity. The District has no component units.

b. Basis of Accounting and Presentation

The accounting records of the District are maintained in accordance with methods prescribed by the State Auditor under the authority of Chapter 43.09 of the Revised Code of Washington (RCW).

The District uses the full-accrual basis of accounting where revenues are recognized when earned and expenses are recognized when incurred. An exception to full accrual is that interest on assessments is recorded when received. Capital asset purchases are capitalized and long-term liabilities are accounted for in the appropriate funds.

The District distinguishes between operating revenues and expenses from non-operating ones. Operating revenues and expenses result from providing services and producing and delivering goods in connection with the District's principal ongoing operations. The principle operating revenues of the District are charges to ratepayers for water and sewer services. Unbilled utility service receivables are recorded at year-end. Operating income includes gains and losses from the disposal of capital assets. Operating expenses of the District include the cost of sales and services, administration expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

The District implemented the Governmental Accounting Standards Board (GASB) Statement No. 34 in 2003 and Statement No. 63 in the current year. These statements establish standards for external financial reporting for all state and local government entities.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

c. Cash and Cash Equivalents

For purposes of the Statement of Cash Flows, the District considers all highly liquid investments (including restricted assets) with a maturity of three months or less when purchased to be cash equivalents. The District maintains a deposit relationship with a local commercial bank, which was selected through the contracting of treasury services provided by King County.

d. Capital Assets

See Note 3

e. Restricted Funds

In accordance with bond resolutions (and certain related agreements) separate restricted depository accounts are required to be established. These depository accounts are with King County, the *ex-officio* Treasurer for the District. King County refers to these depository accounts as "funds." The assets held in these "funds" are restricted for specific uses, including construction, debt service, and other special reserve requirements. Restricted "funds" currently include the following:

Water Construction Fund	$1,135,263
Sewer Construction Fund	$959,283
Bond Reserve Fund	$982,339
Debt Service Fund	$117,635

f. Receivables

The District records receivables when billing takes place. The District takes advantage of its authority to lien properties with delinquent utility charge balances. Such liens are recorded with the appropriate County Recorder and are maintained until the balances are paid in full. Interest is assessed on these liens until paid. For this reason, there is not an allowance for bad debts.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

g. Inventory

Inventory is valued at the average acquisition cost, which approximates the market value. The District performs an annual physical inventory count.

h. Investments

District funds not required for immediate expenditure are invested via King County, the District's *ex-officio* treasurer, in the King County Investment Pool (Pool). Investments are stated at cost. For various risks related to the investments, see Deposits and Investments Note No. 2 on page 19.

i. Compensated Absences

Compensated absences are absences for which employees will be paid, such as vacation and sick leave. The District records unpaid leave for compensated absences as an expense and liability when incurred.

Vacation pay, which may be accumulated up to 240 hours, is payable upon resignation, retirement or death. Sick leave may accumulate indefinitely and is payable upon the following conditions:

- The District will pay 100% of accrued and unused sick leave upon the death of an active employee.
- The District allows all employees to cash-out accrued sick leave hours credited during the preceding calendar year less any sick leave used during the same calendar year up to a maximum of 56 hours if the employee has a balance of 224 accrued hours in sick leave before cash-out.
- The District does not pay for unused sick leave upon termination of employment.

j. Unamortized Debt Expenses

Costs relating to the sale of bonds are deferred and amortized over the lives of the respective bond issues.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (concluded)

k. Construction Financing

The District has issued revenue bonds for long-term financing of capital improvements. See Note No. 6 on page 23.

In 1985, the District started a series of public works projects to replace aging components of the District's sewer and water systems. The District also funds these select capital improvements of the District's sewer and water systems from accumulated reserves. Where applicable, property owners connecting to these facilities in the future will reimburse the District for the cost of these projects plus interest. In some instances, the District has started these projects in response to customers' needs, such as failed septic systems. In other instances, the District has tried to install facilities prior to major street resurfacing projects by King County and other municipalities for cost savings.

Developers also build regular system extensions. Upon the completion of the project, the developer donates those installed facilities to the District. Developer donations are recorded at the developer's cost of the improvements.

NOTE 2 – DEPOSITS AND INVESTMENTS

a. Deposits

The District's deposits are entirely covered by federal depository insurance (FDIC) or by collateral held in a multiple financial institution collateral pool administered by the Washington Public Deposit Protection Commission (PDPC).

b. Investments

In accordance with State law, the District's governing body has entered into a formal interlocal agreement with the District's *ex officio* treasurer, King County, to have all its funds not required for immediate expenditure invested in the King County Investment Pool (Pool). As of December 31, 2012, the District had the following investments:

Year	Investment Type	Fair Value	Average Duration
2012	King County Investment Pool	$39,442,958	1.36 Years
2011	King County Investment Pool	$38,563,054	0.71 Years

Impaired Investments: As of December 31, 2012, all impaired commercial paper investments have completed enforcement events. The King County impaired investment pool (Impaired Pool) held one commercial paper asset where the Impaired Pool accepted an exchange offer and is receiving the cash flows from the investment's underlying securities. The Impaired Pool also held the residual investments in four commercial paper assets that were part of completed enforcement events, where the Impaired Pool accepted the cash-out option. The District's share of the impaired investment pool is $224,150 and the districts fair value of these investments is $110,065.

Interest Rate Risk: As of December 31, 2012, the Pool's average duration to maturity was 1.36 years. As a means of limiting its exposure to rising interest rates, securities purchased in the Pool must have a final maturity, or weighted average life, of no longer than five years. While the Pool's market value is calculated on a monthly basis, unrealized gains and losses are not distributed to participants. The Pool distributes earnings monthly using an amortized cost methodology.

Credit risk: As of December 31, 2012, the District's investment in the Pool was not rated by a nationally recognized statistical rating organization (NRSRO). In compliance with state statutes, Pool policies authorize investments in U.S. Treasury securities, U.S. agency securities, and mortgage-backed securities,

NOTE 2 – DEPOSITS AND INVESTMENTS (concluded)

municipal securities (rated at least "A" by two NRSROs), commercial paper (rated at least the equivalent of "A-1" by two NRSROs), commercial paper (rated at least the equivalent of "A-1" by two NRSROs), certificates of deposits issued by qualified public depositories, repurchase agreements, and the Local Government Investment Pool managed by the Washington State Treasurer's Office.

NOTE 3 – CAPITAL ASSETS

Capital assets are defined by the District as assets with initial individual cost of more than $5,000 and an estimated useful life in excess of one year.

Major expenses for capital assets such as major repairs which increase useful lives are capitalized. Maintenance, repairs, and minor renewals are accounted for as expenses when incurred.

Utility plants in service and other capital assets are recorded at cost. Donations by developers are recorded at the developer's cost.

Capital asset activity for the years ended December 31, 2012 was as follows:

2012

	Beginning Balance	Increase	Decrease	Ending Balance
Capital assets not being depreciated:				
Land & land rights	$2,633,577	-	-	$2,633,577
Construction in progress	8,015,270	7,207,839	(4,342,144)	10,880,965
Total capital assets not being depreciated	10,648,847	7,207,839	(4,342,144)	13,514,542
Capital assets being depreciated:				
Buildings	9,478,659	-	-	9,478,659
Data processing and office equipment	1,711,263	55,886	-	1,767,149
Engineering equipment and vehicles	4,526,732	178,107	(84,995)	4,619,844
Sewer utility plants	85,076,803	2,462,594	(948,500)	86,590,897
Water utility plants	80,543,940	4,061,291	(2,544,339)	82,060,892
Total capital assets being depreciated	181,337,397	6,757,878	(3,577,834)	184,517,441
Less accumulated depreciation for:				
Buildings	(3,583,261)	(324,915)	-	(3,908,176)
Equipment and vehicles	(4,910,085)	(513,699)	80,877	(5,342,907)
Sewer utility plants	(26,915,776)	(1,713,247)	-	(28,629,023)
Water utility plants	(36,065,245)	(1,555,973)	-	(37,621,218)
Total accumulated depreciation	(71,474,367)	(4,107,834)	80,877	(75,501,324)
Total Capital Assets, net	$120,511,877	$9,857,883	($7,839,101)	$122,530,659

NOTE 3 – CAPITAL ASSETS (continued)

Capital asset activity for the years ended December 31, 2011 was as follows:

2011

	Beginning Balance	Increase	Decrease	Ending Balance
Capital assets not being depreciated:				
Land & land rights	$2,633,577	-	-	$2,633,577
Construction in progress	7,962,718	5,527,964	(5,475,412)	8,015,270
Total capital assets not being depreciated	10,596,295	5,527,964	(5,475,412)	10,648,847
Capital assets being depreciated:				
Buildings	8,478,242	1,000,417	-	9,478,659
Data processing and office equipment	1,713,653	-	(2,390)	1,711,263
Engineering equipment and vehicles	4,208,927	396,036	(78,231)	4,526,732
Sewer utility plants	82,931,628	2,145,175	-	85,076,803
Water utility plants	77,794,354	2,749,586	-	80,543,940
Total capital assets being depreciated	175,126,804	6,291,214	(80,621)	181,337,397
Less accumulated depreciation for:				
Buildings	(3,278,792)	(304,469)	-	(3,583,261)
Equipment and vehicles	(4,509,592)	(481,114)	80,621	(4,910,085)
Sewer utility plants	(25,282,413)	(1,633,363)	-	(26,915,776)
Water utility plants	(34,429,696)	(1,635,549)	-	(36,065,245)
Total accumulated depreciation	(67,500,493)	(4,054,495)	80,621	(71,474,367)
Total Capital Assets, net	$118,222,606	$7,764,683	($5,475,412)	$120,511,877

The original cost of operating property retired or otherwise disposed of and the cost of installation, less salvage, is charged to accumulated depreciation. However, in the case of the sale of a significant operating unit or system, the original cost is removed from the utility plant accounts, accumulated depreciation related to the property sold is charged, and the net gain or loss on disposition is credited or charged to income.

Capital assets are depreciated using straight-line method of depreciation over the following estimated useful lives:

Buildings	20 to 30 years
Vehicles	3 to 10 years
Office and Engineering Equipment	3 to 10 years
Utility Plants	10 to 50 years

NOTE 3 – CAPITAL ASSETS (concluded)

Preliminary costs incurred for proposed projects are deferred pending construction of the facility. Costs relating to projects ultimately constructed are transferred to utility plant; charges that relate to abandoned projects are expensed.

During a prior year approximately $1.5 million of water meter purchases were recorded to a capital asset account. These items were subsequently scrapped. However, the cost of these meters remained on the books. The District wrote off the cost of these meters in the current year. This amount is not considered material to the financial statements.

NOTE 4 – CONSTRUCTION IN PROGRESS

Construction in progress represents expenses to date on capital projects, which were $10,880,965 in 2012 and $8,015,270 in 2011. Project details as of December 31, 2012, and 2011, were as follows:

PROJECT	2012	2011
Lift Station 10 Rehabilitation	$3,835,502	$1,723,847
Decant Facility	2,458,483	672,004
Other Miscellaneous Projects	1,293,338	1,117,888
Northshore Ridge	960,097	960,097
133/72 Water Main Extension	570,126	5,134
Inglemoor Pump House Improvement	524,336	462,521
Regional Water Authority (RWA)	181,611	771,962
Sewer System Improvements	362,820	-
CIP-Fleet Vehicles	357,410	52,495
City of Kenmore Culvert Replacement	129,222	8,949
124/116 Sewer and Water Main Replacement	63,688	43,532
PRV Rehabilitation	51,124	51,124
2010 Water Main Replacement Phase 1 &2	44,513	44,513
Inglemoor Transmission Main	25,453	23,511
SR 522 West Phase Water Main	23,242	23,194
SR 522 Phase I Water Main	-	119,852
SR 522 Phase II Water Main	-	1,573,719
Lift Station 19 Improvements	-	65,431
116/80 Water Main Extension	-	295,497
Total Construction in Progress	$10,880,965	$8,015,270

NOTE 5 – LEASE COMMITMENTS

The District had no lease commitments for the periods ended December 31, 2012, and 2011.

NOTE 6 – LONG-TERM DEBT

a. Revenue Bonds

The scheduled maturity of the 2003 Revenue Bonds outstanding as of December 31, 2012 and the related interest rates are as follows:

Payment Date	2003 Revenue Bonds	Interest Rate
May 1, 2013 *	$205,000	3.40%
May 1, 2014	210,000	3.40%
May 1, 2015	215,000	3.55%
May 1, 2016	225,000	3.55%
May 1, 2017	235,000	3.80%
May 1, 2018	245,000	3.80%
May 1, 2019	250,000	4.00%
May 1, 2020	265,000	4.00%
May 1, 2021	275,000	4.00%
May 1, 2022	285,000	4.10%
May 1, 2023	295,000	4.15%
	$2,705,000	

* 2013 maturing bond was reclassified as current portion of long-term debt in 2012 reporting.

NOTE 6 – LONG-TERM DEBT (continued)

The 2003 issue was a combination refunding and new financing revenue bond and was rated as “AA” by Standard & Poor’s. Of the bond proceeds, $4,665,000 was used to finance capital projects and $5,335,000 was used to redeem the 1995 bonds at par on May 15, 2003. This issue consists of term bonds maturing from 2004 to 2023. The bonds maturing in years 2004 through 2013 are not subject to optional redemption prior to maturity. Bonds maturing on or after May 1, 2014, are subject to redemption at the option of the District, in whole or in part (and, if in part, with maturities to be selected by the District) on any date, on or after May 1, 2013, at the price of par plus accrued interest, if any, to the date of redemption.

The District has set aside $1,099,974 in restricted assets exclusively for debt service purposes. These represent sinking funds and reserve requirements as contained in the bond indenture.

There are other limitations and restrictions contained in the bond indenture. The District is in compliance with all significant limitations and restrictions.

The District has one outstanding bond issue:

Revenue Bond	Date of Issue	Maturity Date	Amount of Original Issue	Outstanding as of 12/31/12
2003 Revenue Bonds	5/15/2003	5/1/2023	$10,000,000	$2,705,000

NOTE 6 – LONG-TERM DEBT (continued)

b. Junior Lien Loans

The District had junior lien loans of $4,980,069 as of December 31, 2012 and $3,421,867 as of December 31, 2011 from the Washington Public Works Trust Fund, including current portions of $412,854 for 2012 and $366,850 for 2011.

The District has seven loans currently outstanding from the Washington State Public Works Trust Fund.

Year	Term in Years	Interest Rate	Received Proceeds	Loan Balance as of 12/31/12
1995	20	1.0%	$661,138	$104,390
1996	20	1.0%	1,896,300	403,918
2002	20	0.5%	408,000	216,750
2004	20	0.5%	862,570	548,964
2005	20	0.5%	878,454	601,047
2011	20	0.5%	3,105,000	3,105,000
			$7,811,462	$4,980,069
			Less current maturity	(412,854)
			Long-term portion	$4,567,215

The proceeds from these low interest 20-year loans are used for water main replacement and sewer main extension programs. The principal is repaid in up to twenty-five equal annual installments. In 2011, the District was awarded another low interest loan. As of December 31, 2012, all of the $3,105,000 in proceeds of the 2011 loan had been drawn. Repayments will start in 2013. At year-end 2012, $412,854 of the $4,980,069 loans outstanding was reclassified as a current liability.

The District has not obtained short-term debt in the past. It does not anticipate obtaining short-term debt in the future.

NOTE 6 – LONG-TERM DEBT (continued)

c. Combined Long-Term Debt Service Schedule

	2003 Revenue Bond Issuance		Public Works Trust Fund Loans		Total
Year	Principal	Interest	Principal	Interest	Cash Flow
2013	$205,000	$100,013	$412,854	$27,365	$745,232
2014	210,000	92,958	412,854	24,699	740,511
2015	215,000	85,571	412,854	21,956	735,381
2016-2020	1,220,000	298,001	1,486,367	78,169	3,082,537
2021-2031	855,000	53,634	2,255,141	60,009	3,223,784
2021-2031					
Total	$2,705,000	$630,177	$4,980,070	$212,198	$8,527,445

d. Changes in Long-Term Liabilities

During the years ended December 31, 2012 and 2011 the following changes occurred in long-term liabilities:

	Beginning Balance 1/1/2012	Additions	Reductions	Ending Balance 12/31/2012	Due Within One Year
Bonds Payable	$2,905,000	-	($200,000)	$2,705,000	$205,000
Public Works Trust Fund Loans	$3,421,868	$1,925,051	($366,850)	$4,980,069	$412,854

	Beginning Balance 1/1/2011	Additions	Reductions	Ending Balance 12/31/2011	Due Within One Year
Bonds Payable	$3,095,000	-	($190,000)	$2,905,000	$200,000
Public Works Trust Fund Loans	$2,685,080	$1,179,948	($443,160)	$3,421,868	$366,850

NOTE 6 – LONG-TERM DEBT (continued)

Debt service coverage requirements as determined by the 2003 bond covenants are as follows:

	2012-District Total	2011-District Total
Net Service Revenue	$33,251,180	$31,845,068
Cost of service	(17,622,227)	(17,418,843)
Net operating & administrative expense	(17,970,724)	(14,886,282)
Net operating income (loss)	(2,341,771)	(460,057)
Interest / Investment income:		
From assessments	51,876	64,678
From investments	500,377	233,839
Gain from asset sale	(8,430)	7,550
Total Interest / Investment income	543,823	306,067
Add: Items not included in bond coverage calculation per covenants:		
Depreciation expense	4,107,835	4,054,495
Income available for debt service	2,309,887	3,900,505
Other source of funds:		
Matured assessments	50,172	103,149
Facility benefit charges	1,455,629	927,800
Total Other sources	1,505,801	1,030,949
Total available for debt service	3,815,688	4,931,454
Debt service coverage required	(617,854)	(566,850)
Excess (deficit) coverage requirement	$3,197,834	$4,364,604
Times Coverage	5.2	7.7

NOTE 6 – LONG-TERM DEBT (concluded)

The reserve balances required by the covenants of the 2003 revenue bond issue for the years ending December 31, 2012 and 2011 are:

Debt service reserve:	2012	2011
Average annual debt service	$277,931	$303,489
Applicable coverage factor per bond covenants	1.25	1.25
Lesser of:		
(A) Average annual debt service times coverage factor	347,414	379,361
(B) Maximum annual debt service	305,013	306,698
(C) 10% of bonds outstanding	270,500	290,500
Debt service reserve required by bond covenants:	270,500	290,500
Actual reserve balance:		
Cash	982,339	970,791
Balance in excess of requirement	$711,839	$680,291

Subsequent to December 31, 2012 the District decided to invoke the optional redemption clause of the Sewer and Water Revenue and Refunding Bonds, 2003.

The following is an excerpt from The Bond Purchase Agreement (Tab 6), Appendix A, paragraph (g):

> *The Bonds maturing on and after May 1, 2014, are subject to redemption at the option of the District, in whole or in part on any date, on or after May 1, 2013, at the price of par, plus accrued interest, if any, to the date of redemption.*

On May 1, 2013, the District exercised the above provision for early redemption. It paid $2,705,000 in principal plus accrued interest of $51,749 to the holders for all 2003 Revenue Bonds maturing on or after May 1, 2014 as well as those maturing on May 1, 2013. As of May 1, 2013, the District no longer had any outstanding bonded debt.

NOTE 7 – PENSION PLAN

Substantially all of the District's full-time and qualifying part-time employees participate in one of the following statewide retirement systems administered by the Washington State Department of Retirement Systems, under cost-sharing multiple-employer public employee defined benefit retirement plans. The Department of Retirement Systems (DRS), a department within the primary government of the State of Washington, issues a publicly available comprehensive annual financial report (CAFR) that includes financial statements and required supplementary information for each plan. The DRS CAFR may be obtained by writing to: Department of Retirement Systems, Communications Unit, P.O. Box 48380, Olympia, WA 98504-8380; or it may be downloaded from the DRS website at www.drs.wa.gov. The following disclosures are made pursuant to the GASB Statement 27, Accounting for Pensions by State and Local Government Employers and the GASB Statement 50, Pension Disclosures, an Amendment of GASB Statements No. 25 and No. 27.

Public Employees' Retirement System (PERS) Plans 1, 2, and 3

Plan Description

The Legislature established PERS in 1947. Membership in the system includes: elected officials; state employees; employees of the Supreme, Appeals, and Superior courts; employees of legislative committees; community and technical colleges, college and university employees not participating in higher education retirement programs; employees of district and municipal courts; and employees of local governments. Approximately 50 percent of PERS salaries are accounted for by state employment. PERS retirement benefit provisions are established in RCW Chapters 41.34 and 41.40 and may be amended only by the State Legislature.

PERS is a cost-sharing multiple-employer retirement system comprised of three separate plans for membership purposes: Plans 1 and 2 are defined benefit plans and Plan 3 is a defined benefit plan with a defined contribution component.

PERS members who joined the system by September 30, 1977 are Plan 1 members. Those who joined on or after October 1, 1977 and by either February 28, 2002 for state and higher education employees, or by August 31, 2002 for local government employees, are Plan 2 members unless they exercised an option to transfer their membership to Plan 3. PERS members joining the system on or after March 1, 2002 for state and higher education employees, or by September 1, 2002 for local government employees have the irrevocable option of choosing membership in either PERS Plan 2 or Plan 3. The option must be exercised within 90 days of employment. Employees who fail to choose within 90 days default to Plan 3.

NOTE 7 – PENSION PLAN (continued)

Notwithstanding, PERS Plan 2 and Plan 3 members may opt out of plan membership if terminally ill, with less than five years to live.

PERS is comprised of and reported as three separate plans for accounting purposes: Plan 1, Plan 2/3, and Plan 3. Plan 1 accounts for the defined benefits of Plan 1 members. Plan 2/3 accounts for the defined benefits of Plan 2 members and the defined benefit portion of benefits for Plan 3 members. Plan 3 accounts for the defined contribution portion of benefits for Plan 3 members. Although members can only be a member of either Plan 2 or Plan 3, the defined benefit portions of Plan 2 and Plan 3 are accounted for in the same pension trust fund. All assets of this Plan 2/3 defined benefit plan may legally be used to pay the defined benefits of any of the Plan 2 or Plan 3 members or beneficiaries, as defined by the terms of the plan. Therefore, Plan 2/3 is considered to be a single plan for accounting purposes.

PERS Plan 1 and Plan 2 retirement benefits are financed from a combination of investment earnings and employer and employee contributions. Employee contributions to the PERS Plan 1 and Plan 2 defined benefit plans accrue interest at a rate specified by the Director of DRS. During DRS' Fiscal Year 2012, the rate was five and one-half percent compounded quarterly. Members in PERS Plan 1 and Plan 2 can elect to withdraw total employee contributions and interest thereon upon separation from PERS-covered employment.

PERS Plan 1 members are vested after the completion of five years of eligible service.

PERS Plan 1 members are eligible for retirement after 30 years of service, or at the age of 60 with five years of service, or at the age of 55 with 25 years of service. The monthly benefit is 2 percent of the average final compensation (AFC) per year of service, but the benefit may not exceed 60 percent of the AFC. The AFC is the monthly average of the 24 consecutive highest-paid service credit months.

The monthly benefit is subject to a minimum for retirees who have 25 years of service and have been retired 20 years, or who have 20 years of service and have been retired 25 years. If a survivor option is chosen, the benefit is reduced. Plan 1 members retiring from inactive status prior to the age of 65 may also receive actuarially reduced benefits. Plan 1 members may elect to receive an optional COLA that provides an automatic annual adjustment based on the Consumer Price Index. The adjustment is capped at 3 percent annually. To offset the cost of this annual adjustment, the benefit is reduced.

NOTE 7 – PENSION PLAN (continued)

PERS Plan 1 provides duty and non-duty disability benefits. Duty disability retirement benefits for disablement prior to the age of 60 consist of a temporary life annuity. The benefit amount is $350 a month, or two-thirds of the monthly AFC, whichever is less. The benefit is reduced by any workers' compensation benefit and is payable as long as the member remains disabled or until the member attains the age of 60, at which time the benefit is converted to the member's service retirement amount. A member with five years of covered employment is eligible for non-duty disability retirement. Prior to the age of 55, the benefit amount is 2 percent of the AFC for each year of service reduced by 2 percent for each year that the member's age is less than 55. The total benefit is limited to 60 percent of the AFC and is actuarially reduced to reflect the choice of a survivor option. Plan 1 members may elect to receive an optional COLA amount (based on the Consumer Price Index), capped at 3 percent annually. To offset the cost of this annual adjustment, the benefit is reduced.

PERS Plan 1 members can receive credit for military service while actively serving in the military if such credit makes them eligible to retire. Members can also purchase up to 24 months of service credit lost because of an on-the-job injury.

The survivor of a PERS Plan 1 member who dies after having earned ten years of service credit has the option, upon the member's death, of either a monthly survivor benefit or the lump sum of contributions plus interest.

PERS Plan 2 members are vested after the completion of five years of eligible service. Plan 2 members are eligible for normal retirement at the age of 65 with five years of service. The monthly benefit is 2 percent of the AFC per year of service. The AFC is the monthly average of the 60 consecutive highest-paid service months. There is no cap on years of service credit; and a cost-of-living allowance is granted (based on the Consumer Price Index), capped at 3 percent annually.

PERS Plan 2 members who have at least 20 years of service credit and are 55 years of age or older are eligible for early retirement with a reduced benefit. The benefit is reduced by an early retirement factor (ERF) that varies according to age, for each year before age 65.

PERS Plan 2 members who have 30 or more years of service credit and are at least 55 years old can retire under one of two provisions:

- With a benefit that is reduced by 3 percent for each year before age 65; or
- With a benefit that has a smaller (or no) reduction (depending on age) that imposes stricter return-to-work rules.

NOTE 7 – PENSION PLAN (continued)

PERS Plan 2 retirement benefits are also actuarially reduced to reflect the choice, if made, of a survivor option. The surviving spouse or eligible child(ren) of a PERS Plan 2 member who dies after having earned ten years of service credit have the option of either a monthly benefit or a lump sum payment of the member's contributions plus interest.

PERS Plan 3 has a dual benefit structure. Employer contributions finance a defined benefit component and member contributions finance a defined contribution component. As established by RCW Chapter 41.34, employee contribution rates to the defined contribution component range from 5 percent to 15 percent of salaries, based on member choice. There are currently no requirements for employer contributions to the defined contribution component of PERS Plan 3.

PERS Plan 3 defined contribution retirement benefits are dependent upon the results of investment activities. Members may elect to self-direct the investment of their contributions. Any expenses incurred in conjunction with self-directed investments are paid by members. Absent a member's self-direction, PERS Plan 3 investments are made in the same portfolio as that of the PERS 2/3 defined benefit plan.

For DRS' fiscal year 2012, PERS Plan 3 employee contributions were $95.2 million, and plan refunds paid out were $66.2 million.

The defined benefit portion of PERS Plan 3 provides members a monthly benefit that is 1 percent of the AFC per year of service. The AFC is the monthly average of the 60 consecutive highest-paid service months. There is no cap on years of service credit, and Plan 3 provides the same cost-of-living allowance as Plan 2.

Effective June 7, 2006, PERS Plan 3 members are vested in the defined benefit portion of their plan after ten years of service; or after five years of service, if twelve months of that service are earned after age 44; or after five service credit years earned in PERS Plan 2 by June 1, 2003. Plan 3 members are immediately vested in the defined contribution portion of their plan.

Vested Plan 3 members are eligible for normal retirement at age 65, or they may retire early with the following conditions and benefits:

- If they have at least ten service credit years and are 55 years old, the benefit is reduced by an ERF that varies with age, for each year before age 65.
- If they have 30 service credit years and are at least 55 years old, they have the choice of a benefit that is reduced by 3 percent for each year before age 65; or a

NOTE 7 – PENSION PLAN (continued)

benefit with a smaller (or no) reduction factor (depending on age) that imposes stricter return-to-work rules.

PERS Plan 3 retirement benefits are also actuarially reduced to reflect the choice, if made, of a survivor option.

PERS Plan 2 and Plan 3 provide disability benefits. There is no minimum amount of service credit required for eligibility. The Plan 2 monthly benefit amount is 2 percent of the AFC per year of service. For Plan 3, the monthly benefit amount is 1 percent of the AFC per year of service. These disability benefit amounts are actuarially reduced for each year that the member's age is less than 65, and to reflect the choice of a survivor option. There is no cap on years of service credit, and a cost-of-living allowance is granted (based on the Consumer Price Index) capped at 3 percent annually.

PERS Plan 2 and Plan 3 members may have up to ten years of interruptive military service credit; five years at no cost and five years that may be purchased by paying the required contributions.

PERS Plan 2 and Plan 3 members who become totally incapacitated for continued employment while serving the uniformed services, or a surviving spouse or eligible child(ren), may request interruptive military service credit.

PERS Plan 2 and Plan 3 members can purchase up to 24 months of service credit lost because of an on-the-job injury.

PERS members may also purchase up to five years of additional service credit once eligible for retirement. This credit can only be purchased at the time of retirement and can be used only to provide the member with a monthly annuity that is paid in addition to the member's retirement benefit.

Beneficiaries of a PERS Plan 2 or Plan 3 member with ten years of service who is killed in the course of employment receive retirement benefits without actuarial reduction. This provision applies to any member killed in the course of employment, on or after June 10, 2004, if found eligible by the Director of the Department of Labor and Industries.

A one-time duty-related death benefit is provided to the estate (or duly designated nominee) of a PERS member who dies in the line of service as a result of injuries sustained in the course of employment, or if the death resulted from an occupational disease or infection that arose naturally and proximately out of the

NOTE 7 – PENSION PLAN (continued)

member's covered employment, if found eligible by the Department of Labor and Industries.

There are 1,184 participating employers in PERS. Membership in PERS consisted of the following as of the latest actuarial valuation date for the plans, dated June 30, 2011:

Retirees and Beneficiaries Receiving Benefits		79,363
Terminated Plan Members Entitled to But Not Yet Receiving Benefits		29,925
Active Plan Members Vested		105,578
Active Plan Members Non-vested		46,839
	Total	**261,705**

Funding Policy

Each biennium, the state Pension Funding Council adopts PERS Plan 1 employer contribution rates, PERS Plan 2 employer and employee contribution rates, and PERS Plan 3 employer contribution rates. Employee contribution rates for Plan 1 are established by statute at 6 percent for state agencies and local government unit employees, and at 7.5 percent for state government elected officials. The employer and employee contribution rates for Plan 2 and the employer contribution rate for Plan 3 are developed by the Office of the State Actuary to fully fund Plan 2 and the defined benefit portion of Plan 3. Under PERS Plan 3, employer contributions finance the defined benefit portion of the plan and member contributions finance the defined contribution portion. The Plan 3 employee contribution rates range from 5 percent to 15 percent, based on member choice. Two of the options are graduated rates dependent on the employee's age.

As a result of the implementation of the Judicial Benefit Multiplier Program in January 2007, a second tier of employer and employee rates was developed to fund, along with investment earnings, the increased retirement benefits of those justices and judges that participate in the program.

The methods used to determine the contribution requirements are established under state statute in accordance with RCW Chapters 41.40 and 41.45.

NOTE 7 – PENSION PLAN (concluded)

The required contribution rates expressed as a percentage of current-year covered payrolls, as of December 31, 2012, and 2011, were as follows:

2012	PERS Plan I	PERS Plan II	PERS Plan III
Employer (a)	7.21% (b)	7.21% (b)	7.21% (c)
Employee	6.00% (d)	4.64% (d)	(e)

2011	PERS Plan I	PERS Plan II	PERS Plan III
Employer (a)	7.25% (b)	7.25% (b)	7.25% (c)
Employee	6.00% (d)	4.64% (d)	(e)

(a) The employer rates include the employer administrative expense fee currently set at 0.16%.

(b) The employer rate for state elected officials is 10.74% for Plan 1 and 7.21% for Plan 2 and Plan 3.

(c) Plan 3 defined benefit portion only.

(d) The employee rate for state elected officials is 7.50% for Plan 1 and 4.64% for Plan 2.

(e) Variable from 5.0% minimum to 15.0% maximum based on rate selected by the PERS 3 member.

Both the District and the employees made the required contributions. The District's required contributions for the years ending December 31, 2012 were as follows:

	PERS Plan 1	PERS Plan 2	PERS Plan 3
2012	$ 4,557	$ 238,169	$ 11,906
2011	$ 5,150	$ 194,274	$ 9,914
2010	$ 7,746	$ 163,191	$ 7,967

NOTE 8 – PRIOR PERIOD ADJUSTMENTS

The District had no prior period adjustments for 2012 or 2011.

NOTE 9 – JOINT VENTURES

Snohomish River Regional Water Authority (SRRWA)

From the early 1950s to 1992, the Weyerhaeuser Company (Weyco) owned and operated a pulp mill in Everett, Washington, using a water right that allowed up to 36 million gallons per day (mgd) to be drawn from the adjacent Snohomish River for industrial use. Although Weyco closed the mill, it kept the 36 mgd water right.

NOTE 9 – JOINT VENTURES (concluded)

In 1996, three public water utilities – The City of Everett, the Northshore Utility District (Northshore), and Woodinville Water District (Woodinville) – formed the SRRWA, and acquired Weyerhaeuser's water right to help meet water demands projected for the SRRWA service area. The Washington State Department of Ecology approved the water right transfer, with an instantaneous withdrawal rate of 36 mgd and an annual quantity of 23.7 mgd. Following completion of the water right change process and related litigation, the SRRWA has engaged in strategic planning, preliminary engineering, and costing work to assess capital project development and operational path issues. This work is ongoing and projected to achieve initial beneficial use of the SRRWA water right by 2021, unless an extension is requested and granted.

In December 2004, the District signed a fixed quantity long-term supply agreement with Seattle Public Utilities (SPU). The supply quantity in the 60-year agreement is sufficient to supply the District for the duration of the agreement. This gives the District ample time to develop the Weyco source for the future. The District's goal is to have supply from both regional systems (Seattle and Everett) for added reliability. Since the cost for planning is not significant, the partners have agreed to explore all possible ways to develop the new source over the coming years. Transmission systems would need to be built to deliver the water to Northshore and/or Woodinville. Portions of the existing transmission systems might be utilized, including the new Clearview pipeline and reservoir. However, additional new pipelines would still be needed to extend from Clearview to Northshore and Woodinville. Any use of the Clearview pipeline and reservoir would need to be negotiated with the Clearview Water Supply Agency, which owns those facilities.

In February of 2013, the District was informed by the City of Everett that the Washington State Auditor's Office asked them to reduce the amount capitalized for this joint venture. As such, the District was required to reduce the amount it had capitalized by its pro-rata share. This resulted in an immediate expensing in 2012 of $342,605 of previously capitalized amounts. After this adjustment, the capitalized amounts remaining on the District's books included land valued at $264,610 and construction in progress of $181,611.

NOTE 10 – RISK MANAGEMENT

The District is a member of the Washington Cities Insurance Authority (WCIA). Utilizing RCW Chapter 48.62 (self-insurance regulation) and RCW Chapter 39.34 (Interlocal Cooperation Act), nine cities originally formed WCIA on January 1, 1981. WCIA was created for the purpose of providing a pooling mechanism for

NOTE 10 – RISK MANAGEMENT (concluded)

jointly purchasing insurance, jointly self-insuring, and / or jointly contracting for risk management services. WCIA has a total of 153 Members.

New members initially contract for a three-year term, and thereafter automatically renew on an annual basis. A one-year withdrawal notice is required before membership can be terminated. Termination does not relieve a former member from its unresolved loss history incurred during membership.

Liability coverage is written on an occurrence basis, without deductibles. Coverage includes general, automobile, police, public officials' errors or omissions, stop gap, and employee benefits liability. Limits are $4 million per occurrence self insured layer, and $16 million per occurrence in the re-insured excess layer. The excess layer is insured by the purchase of reinsurance and insurance and is subject to aggregate limits. Total limits are $20 million per occurrence subject to aggregate sub-limits in the excess layers. The Board of Directors determines the limits and terms of coverage annually.

Insurance coverage for property, automobile physical damage, fidelity, inland marine, and boiler and machinery are purchased on a group basis. Various deductibles apply by type of coverage. Property insurance and auto physical damage are self-funded from the members' deductible to $750,000, for all perils other than flood and earthquake, and insured above that amount by the purchase of insurance.

In-house services include risk management consultation, loss control field services, claims and litigation administration, and loss analyses. WCIA contracts for the claims investigation consultants for personnel issues and land use problems, insurance brokerage, and lobbyist services.

WCIA is fully funded by its members, who make annual assessments on a prospectively rated basis, as determined by an outside, independent actuary. The assessment covers loss, loss adjustment, and administrative expenses. As outlined in the interlocal, WCIA retains the right to additionally assess the membership for any funding shortfall.

An investment committee, using investment brokers, produces additional revenue by investment of WCIA's assets in financial instruments which comply with all State guidelines.

A Board of Directors governs WCIA, which is comprised of one designated representative from each member. The Board elects an Executive Committee and appoints a Treasurer to provide general policy direction for the organization. The WCIA Executive Director reports to the Executive Committee and is responsible for conducting the day to day operations of WCIA.

NOTE 11 – PENDING LITIGATION

The District started a project in 2011 to install gravity sewer lines for the elimination of lift station No. 10. The construction involved underground tunneling or mining for the installation of new sewer pipes.

The contract was awarded to New West Development (NWD) as the general contractor. NWD subcontracted the tunneling work to Pacific Boring (PB). A dispute ensued relating to why PB's tunneling effort failed in early December 2011. PB's theory is that the presence of cobbles and boulders required PB to open the face of its tunnel boring machine (TBM) and that in doing so, excessive amounts of highly saturated soils flowed into the TBM, which had to be cleaned out and consequently caused a sink hole. PB contends that cobbles and boulders were not anticipated and that without the presence of cobbles and boulders, it could have mined through the wet soils without incident. NWD withheld a substantial portion of its payment to PB. For relief, PB filed suit against NWD for $2,000,000 and against the District for the retainage amount withheld per the District's contract with NWD. NWD is, in turn, suing the District for a like amount.

The detailed specifications of the contract documents instructed the Contractor to assume that it would encounter groundwater, cobbles and boulders. The contract specifications also required the Contractor to provide the design, methods and equipment that would remove and dispose of the groundwater, if necessary, and excavate and dispose of the cobbles and boulders. The project was bid as an auger boring project and the Contractor proposed an alternate method of open shield pipe jacking. The District agreed to this change with eight specific conditions, including the Contractor taking design responsibility for the alternate method of construction and the preservation of the original baseline and obstruction clauses.

The District believes these claims are without merit and expects this lawsuit to go to trial near the end of 2013. The District does not consider there to be a reasonable possibility of an unfavorable outcome with respect to this litigation, and as such, no contingent liability has been accrued.

ABOUT THE STATE AUDITOR'S OFFICE

The State Auditor's Office is established in the state's Constitution and is part of the executive branch of state government. The State Auditor is elected by the citizens of Washington and serves four-year terms.

Our mission is to work with our audit clients and citizens as an advocate for government accountability. As an elected agency, the State Auditor's Office has the independence necessary to objectively perform audits and investigations. Our audits are designed to comply with professional standards as well as to satisfy the requirements of federal, state, and local laws.

The State Auditor's Office employees are located around the state to deliver services effectively and efficiently.

Our audits look at financial information and compliance with state, federal and local laws on the part of all local governments, including schools, and all state agencies, including institutions of higher education. In addition, we conduct performance audits of state agencies and local governments and fraud, whistleblower and citizen hotline investigations.

The results of our work are widely distributed through a variety of reports, which are available on our Web site and through our free, electronic subscription service.

We take our role as partners in accountability seriously. We provide training and technical assistance to governments and have an extensive quality assurance program.

State Auditor	**Troy Kelley**
Chief of Staff	**Doug Cochran**
Director of State and Local Audit	**Chuck Pfeil, CPA**
Director of Performance Audit	**Larisa Benson**
Deputy Director of State and Local Audit	**Kelly Collins, CPA**
Deputy Director of State and Local Audit	**Jan M. Jutte, CPA, CGFM**
Deputy Director of State and Local Audit	**Sadie Armijo**
Deputy Director of Quality Assurance	**Barb Hinton**
Local Government Liaison	**Mike Murphy**
Public Records Officer	**Mary Leider**
Main number	**(360) 902-0370**
Toll-free Citizen Hotline	**(866) 902-3900**

Website	**www.sao.wa.gov**
Subscription Service	**https://www.sao.wa.gov/EN/News/Subscriptions**