Washington State Auditor's Office

Troy Kelley

Integrity • Respect • Independence

Financial Statements Audit Report

Northshore Utility District

King County

For the period January 1, 2013 through December 31, 2013

Published February 5, 2015

Report No. 1013579

Washington State Auditor
Troy Kelley

February 5, 2015

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

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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*

Northshore Utility District
King County
January 1, 2013 through December 31, 2013

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, 2013 and 2012, and the related notes to the financial statements, which collectively comprise the District's basic financial statements, and have issued our report thereon dated January 28, 2015.

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

January 28, 2105

Independent Auditor’s Report on Financial Statements

Northshore Utility District
King County
January 1, 2013 through December 31, 2013

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, 2013 and 2012, and the related notes to the financial statements, which collectively comprise the District’s basic financial statements as listed on page 8.

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, 2013 and 2012, 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.

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 9 through 13 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 January 28, 2015 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

January 28, 2015

Financial Section

Northshore Utility District
King County
January 1, 2013 through December 31, 2013

REQUIRED SUPPLEMENTARY INFORMATION

BASIC FINANCIAL STATEMENTS

MANAGEMENT DISCUSSION AND ANALYSIS

For the Year Ended December 31, 2013

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, 2013. We encourage readers to consider the information presented here in conjunction with the District's financial statements.

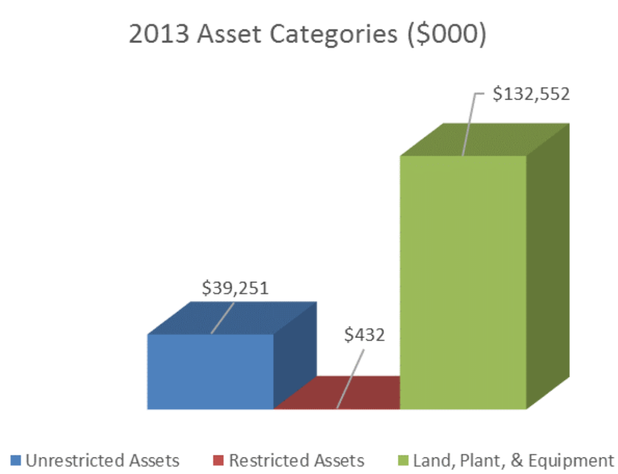
The financial position of the District has improved over prior years, which were mildly affected by an economic downturn and slow economic growth.

- The assets of the District exceeded its liabilities, creating a net position at the close of 2013 of $165,604,779 representing an increase of $6.97 million over 2012.

- As of the close of 2013, the District cash balance was $33,217,699 representing a decrease of $6.1 million from December 31, 2012.

The District had total operating revenues of $36,498,854 and operating expenses of $34,103,377 for the fiscal year ended December 31, 2013.

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:



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 $403,250 and $3,194,520 as of December 31, 2013, and 2012, respectively. In addition, the District considers its Section 125 bank balance as restricted funds, which amounted to $29,077 as of December 31, 2013. In 2013, the District totally paid off its bond obligations, thus the significant decrease in long term liabilities. Please refer to Note 6 of the financial statements.

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 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 in this report.

The overall financial condition of the District improved slightly over prior years, affected by an economic downturn, and remains strong, as indicated by continued increases in net position over 2012 and 2011. In recent prior years, the most significant financial impact of the recession and slow recovery had 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 $1,625,968 earned in 2013 compared to $1,455,629 in 2012, an increase of 11.7%. Between 2011 and 2012, these charges increased by 57%. During 2013 the District exceeded the pre-recession level of $1,600,372 in 2008. Investment rates of return began falling in 2007 and the figure for 2013 of .50% had not changed significantly since 2011.

Condensed Statements of Net Position

	2013	2012	2011	2013-2012 Change	Change %
Current, Restricted and Other Assets	$39,683,301	$45,572,149	$45,251,627	($5,888,848)	-12.9%
Capital Assets (net of depreciation)	132,551,502	122,530,659	120,511,877	10,020,843	8.2%
Total Assets	$172,234,803	$168,102,808	$165,763,504	$4,131,995	2.5%
Non-Current Liabilities	$4,147,067	$7,067,215	$5,760,017	($2,920,148)	-41.3%
Current Liabilities	2,482,957	2,402,572	2,503,135	80,385	3.3%
Total Liabilities	$6,630,024	$9,469,787	$8,263,152	($2,839,763)	-30.0%
Net Position					
Invested in capital assets, net of related debt	$127,991,988	$116,112,422	$115,552,943	$11,879,566	10.2%
Restricted Assets	432,327	3,194,519	4,282,015	(2,762,192)	-86.5%
Unrestricted Assets	37,180,464	39,326,080	37,665,394	(2,145,616)	-5.5%
Total Net Position	$165,604,779	$158,633,021	$157,500,352	$6,971,758	4.4%

The net position of the District increased $6.97 million from $158,633,020 in 2012 to $165,604,779 in 2013. In 2011, the District's net position was $157,500,352.

In 2013, the majority of the District's gross income (91%) 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

	2013	2012	2011	2013-2012 Change	Change (%)
Operating Revenues:					
Sewer	$21,656,724	$19,141,024	$18,393,221	$2,515,700	13.1%
Water	14,712,078	13,867,860	13,229,750	844,218	6.1%
Other	1,622,364	1,604,936	1,521,562	17,428	1.1%
Less discounts	(1,492,312)	(1,362,640)	(1,299,465)	(129,672)	9.5%
Non-Operating Revenues:					
Facility benefit charges	1,625,968	1,455,629	927,800	170,339	11.7%
Other	369,906	543,822	306,067	(173,916)	-32.0%
Total Revenues	$38,494,728	$35,250,631	$33,078,935	$3,244,097	9.2%
Operating Expenses	$34,103,377	$35,592,952	$32,305,125	($1,489,575)	-4.2%
Non-Operating Expenses	101,993	133,300	133,881	(31,307)	-23.5%
Total Expenses	$34,205,370	$35,726,252	$32,439,006	($1,520,882)	-4.3%
Income Before Plant Donation	$4,289,358	($475,621)	$639,929	$4,764,979	-1001.8%
Developer donated plant	2,682,400	1,608,290	1,201,009	1,074,110	66.8%
Change in Net Position	$6,971,758	$1,132,669	$1,840,938	$5,839,089	515.5%
Beginning Net Position	158,633,021	157,500,352	155,659,414	1,132,669	0.7%
Ending Net Position	$165,604,779	$158,633,021	$157,500,352	$6,971,758	4.4%

CAPITAL ASSETS AND DEBT ADMINISTRATION

By far the largest portion of the District's total assets (77%) is investment in capital assets (e.g. buildings, land, utility plant, equipment, and construction in progress). 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, 2013, the District's investment in capital assets for its activities, shown on the Statement of Net Position as Capital Assets, was $132,551,502 net of accumulated depreciation. This is an increase of $10.0 million (8.2%) from

December 31, 2012. 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.

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 twenty years. Instead of burdening today’s ratepayers with the total cost of improvements, all users of the system over the next twenty years will shoulder that cost. In 2008, Standard & Poor’s updated the District’s bond rating from “AA” to “AAA”. Please refer to Note 6 of the financial statements.

The District has historically sought Public Works Trust Fund (PWTF) 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 0.25% to 1.0%.

Notwithstanding 2013, 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. The total long-term debt principal outstanding as of December 31, 2013 was $4,147,067 consisting of only PWTF loans. See additional information in Note 6.

Comparative Statement of Net Position
As of December 31, 2013 and 2012

	2013	2012
ASSETS		
Current Assets		
Cash and cash equivalents	$32,785,372	$36,122,623
Accounts receivable	3,682,583	3,505,706
Estimated unbilled service revenue	1,726,787	1,581,765
Restricted Assets:		
Construction Fund:		
Cash and cash equivalents	337,374	2,094,546
Revenue Bond Fund:		
Cash and cash equivalents	65,876	1,099,974
Section 125 restricted cash	29,077	
Inventory	353,430	381,787
Other current assets - prepaid items	154,663	136,769
TOTAL CURRENT ASSETS	$39,135,162	$44,923,170
Non-current and Other Assets		
Assessments receivable	$265,202	$303,946
Installment contracts receivable	282,937	300,132
Unamortized bond discount and issuance costs	0	44,901
TOTAL NON-CURRENT AND OTHER ASSETS	$548,139	$648,979
Capital Assets		
Non-depreciable - Land and land rights	$2,637,576	$2,633,576
Non-depreciable - Construction in progress	18,826,454	10,880,965
Depreciable assets:		
Buildings	9,429,608	9,478,660
Data processing and office equipment	1,775,356	1,767,149
Engineering equipment and vehicles	4,950,252	4,619,844
Sewer utility plant	89,658,530	86,590,897
Water utility plant	84,856,934	82,060,892
Less: Accumulated depreciation	(79,583,208)	(75,501,324)
Total Capital Assets	$132,551,502	$122,530,659
TOTAL NON-CURRENT AND OTHER ASSETS	$133,099,641	$123,179,638
TOTAL ASSETS	$172,234,803	$168,102,808

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

Comparative Statement of Net Position
As of December 31, 2013 and 2012

	2013	2012
LIABILITIES		
Current Liabilities		
Accounts payable	$1,389,602	$1,459,716
Accrued employee benefits	311,882	222,702
Other liabilities	74,522	636
Current portion of State Public		
Trust Fund Loans	412,447	412,854
Payables from Restricted Assets		
Accounts payable	285,230	78,069
Accrued interest payable	9,274	23,595
Current portion of Revenue Bonds	0	205,000
TOTAL CURRENT LIABILITIES	$2,482,957	$2,402,572
Non-current Liabilities:		
State Public Trust Fund Loans	$4,147,067	$4,567,215
Payables from Restricted Assets:		
Revenue Bonds	0	2,500,000
TOTAL PAYABLES - RESTRICTED ASSETS	$4,147,067	$7,067,215
TOTAL LIABILITIES	$6,630,024	$9,469,787
NET POSITION		
Invested in capital assets, net of related debt	$127,991,988	$116,112,422
Restricted assets - facilities construction, debt		
service and Section 125 bank account	432,327	3,194,519
Unrestricted assets	37,180,464	39,326,080
TOTAL NET POSITION	$165,604,779	$158,633,021
TOTAL LIABILITIES AND NET POSITION	$172,234,803	$168,102,808

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, 2013 and 2012

	2013	2012
OPERATING REVENUES		
Utility Sales - Sewer service	$21,656,724	$19,141,024
Utility Sales - Water service	14,712,078	13,867,860
Utility Sales - Street light service	421,294	417,757
Less: Discounts and adjustments	(1,492,312)	(1,362,640)
Net Utility Sales	$35,297,784	$32,064,001
Other Operating Revenue	1,201,070	1,187,179
Total Operating Income	$36,498,854	$33,251,180
OPERATING EXPENSES		
Sewage treatment charges	$13,888,215	$12,373,386
Water purchased for resale	4,967,354	4,933,403
Cost of street lighting	387,293	315,439
Maintenance	3,335,874	6,790,387
Administration - General	6,418,717	6,141,867
Depreciation	4,129,868	4,107,835
Property, Excise, and B&O Tax	976,056	930,636
Total Operating Expenses	$34,103,377	$35,592,953
OPERATING INCOME (LOSS)	$2,395,477	($2,341,773)
NON-OPERATING REVENUES (EXPENSES)		
Connection fees	$1,625,968	$1,455,629
Assessment interest income	37,594	51,876
Investment interest income	320,630	500,377
Gain (loss) from disposition of assets	11,682	(8,430)
Reimbursement agreement costs	0	0
Bond and loan interest expense	(57,092)	(128,642)
Bond discount, issuance, and registration costs	(44,901)	(4,658)
Total Non-operating Revenues	$1,893,881	$1,866,152
Income Before Capital Contributions	$4,289,358	($475,621)
Capital Contributions - Developer donated plant	2,682,400	1,608,290
CHANGE IN NET POSITION	$6,971,758	$1,132,669
TOTAL NET POSITION, January 1, 2013	158,633,021	157,500,352
TOTAL NET POSITION, December 31, 2013	$165,604,779	$158,633,021

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

Comparative Statement of Cash Flows

	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts for utility services	$36,261,252	$33,323,660
Payments to wholesale service providers	(19,046,251)	(17,344,443)
Payments for state and local taxes	(976,056)	(930,636)
Payments for payroll and related costs	(4,748,278)	(5,080,124)
Payments for administration and operations	(4,935,028)	(6,066,728)
Net cash provided by operating activities	$6,555,639	$3,901,730
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Purchase of capital assets - equipment	(74,767)	($169,971)
Purchase of system expansion	(11,394,761)	(6,112,142)
Purchase of land rights	45,052	0
Receipts from connection fees	1,625,968	1,452,820
Principal paid on capital debt	(3,125,555)	1,363,202
Interest paid on capital debt	(101,993)	(150,886)
Net receipts on disposal of capital assets	12,750	13,250
Net cash used in capital and related financing activities	($13,013,306)	($3,603,727)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Interest on investments	$320,629	$500,377
Interest on contracts	25,466	31,558
Interest on assessments	12,128	20,318
Net cash provided by investing activities	$358,223	$552,253
Net (decrease) increase in cash and cash equivalents	($6,099,444)	$850,256
Cash balance - beginning of year	39,317,143	38,466,887
Cash balance - end of year	$33,217,699	$39,317,143
NON-CASH INVESTING, CAPITAL AND FINANCING ACTIVITIES:		
Contribution of capital assets from developers *	$2,682,400	$1,608,290

* 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, 2013 and 2012

	2013	2012
RECONCILIATION OF OPERATING INCOME TO NET CASH FROM OPERATING ACTIVITIES		
Operating income	$2,395,477	($2,341,773)
Adjustments to reconcile operating income to net cash Provided by operating activities:		
Depreciation expense	4,129,868	4,107,835
Writeoff of assets in current year not impacting cash	0	1,827,375
Changes in assets and liabilities		
Increase in accounts receivable	(265,960)	72,481
Decrease in inventory	28,357	372,099
Increase in other current assets	(17,895)	(6,963)
Increase in accounts payable	122,726	(101,242)
Increase in accrued payroll benefits	89,180	(35,010)
Increase in other current liabilities	73,886	6,928
Net cash provided by operating activities	$6,555,639	$3,901,730

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 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 (NOTE: The District passed Resolution #2013-12-01 on 12/9/2013 to transfer $900,000 from its Maintenance Fund (KC-0010) to the Water Construction Fund (KC-3510). King County erroneously did not make that transfer until January of 2014. As such, this fund carried a credit balance as of the end of 2013.). The District also considers cash held in its Section 125 bank account as restricted funds.

Water Construction Fund	($504,762)
Sewer Construction Fund	$842,136
Bond Reserve Fund	$9,564
Debt Service Fund	$56,312
Section 125 Account	$29,077

f. Receivables

The District records receivables when billing takes place. The District takes advantage of its authority to file liens against properties with delinquent utility charge balances. Such liens are recorded with the King County Recorder's office and are maintained until the balances are paid in full. Interest is assessed on these accounts 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. Investments are stated at cost. For various risks related to the investments, see Deposits and Investments Note No. 2.

i. Compensated Absences

Compensated absences are absences for which employees will be paid, such as vacation and sick leave. The District records unused/accrued leaves 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 hours in unused/accrued 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 issued revenue bonds for long-term financing of capital improvements. These bonds were paid off entirely during 2013. See Note No. 6.

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 as system extensions. 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 its ex-officio treasurer, King County, to invest all its funds not required for immediate expenditure in the King County Investment Pool (Pool). As of December 31, 2013, the District had the following investments:

Year	Investment Type	Fair Value	Average Duration
2013	King County Investment Pool	$32,976,098	1.23 Years
2012	King County Investment Pool	$39,442,958	1.36 Years

NOTE 2 – DEPOSITS AND INVESTMENTS (concluded)

Impaired Investments: As of December 31, 2013, 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 principal is $192,145 and its fair value of these investments is $113,736.

Interest Rate Risk: As of December 31, 2013, the Pool's average duration was 1.23 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, 2013, 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, municipal securities (rated at least "A" by two NRSROs), commercial paper (rated at least the equivalent of "A-1" by two NRSROs), certificates of deposits issued by qualified public depositaries, 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.

NOTE 3 – CAPITAL ASSETS (continued)

Capital asset activity for the year ended December 31, 2013 was as follows:

	2013			
	Beginning Balance	Increase	Decrease	Ending Balance
Capital assets not being depreciated:				
Land & land rights	$2,633,577	$3,999	$0	$2,637,576
Construction in progress	10,880,965	14,483,121	(6,537,631)	18,826,455
Total capital assets not being depreciated	$13,514,542	$14,487,120	($6,537,631)	$21,464,031
Capital assets being depreciated:				
Buildings	$9,478,659	$0	($49,052)	$9,429,607
Data processing and office equipment	1,767,149	11,248	(3,041)	1,775,356
Engineering equipment and vehicles	4,619,844	330,408	0	4,950,252
Sewer utility plants	86,590,897	7,125,509	(4,057,876)	89,658,530
Water utility plants	82,060,892	8,131,448	(5,335,406)	84,856,934
Total capital assets being depreciated	$184,517,441	$15,598,613	($9,445,375)	$190,670,679
Less accumulated depreciation for:				
Buildings	($3,908,176)	($324,566)	$0	($4,232,742)
Equipment and vehicles	(5,342,907)	(455,841)	47,984	(5,750,764)
Sewer utility plants	(28,629,023)	(1,752,302)	0	(30,381,325)
Water utility plants	(37,621,218)	(1,597,159)	0	(39,218,377)
Total accumulated depreciation	($75,501,324)	($4,129,868)	$47,984	($79,583,208)
Total Capital Assets, net	$122,530,659	$25,955,865	($15,935,022)	$132,551,502

NOTE 3 – CAPITAL ASSETS (continued)

Capital asset activity for the year 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	$0	$0	$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	$0	$0	$9,478,659
Data processing and office equipment	1,711,263	55,886	0	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)	$0	($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)	0	(28,629,023)
Water utility plants	(36,065,245)	(1,555,973)	0	(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

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 2011, 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 2012. This amount was not considered material to the financial statements.

NOTE 4 – CONSTRUCTION IN PROGRESS

Construction in progress represents expenditures to date on capital projects, which were $18,826,454 in 2013 and $10,880,965 in 2012. Project details as of December 31, 2013, and 2012, were as follows:

PROJECT	2013	2012
Inglemoor Pump House Improvements	$6,376,810	$524,336
Lift Station 10 Rehabilitation	4,285,162	3,835,502
NUD Headquater Improvements	4,680,519	2,458,483
Northshore Ridge	964,795	960,097
Other Miscellaneous Projects	507,028	1,293,338
SPWP 68/HPD Geotech	427,112	0
High Profile Facility Rehabilitation	568,310	0
162/81 Road Repair & Main Replacement	331,493	0
Regional Water Authority (RWA)	181,612	181,611
CIP-Fleet Vehicles	93,518	357,410
133/88 Water Main Extension	89,625	0
NE 129 st/72 Ave NE Sewer Extension	77,831	0
145/100 Water Main Relacement	45,267	0
2010 Water Main Replacement Phase 2	44,513	44,513
CIPP Rehabilitation	42,478	0
Lift Station No. 3 Rehabilitation	41,147	0
Inglemoor Reservior 2 Damage Investigation and Repairs	38,905	0
PRV Rehabilitation	30,329	51,124

NOTE 4 – CONSTRUCTION IN PROGRESS (concluded)

PROJECT	2013	2012
133/72 Water Main Extension	$0	$570,126
Sewer System Improvements	0	362,820
City of Kenmore Culvert Replacement	0	129,222
124/116 Sewer and Water Main Replacement	0	63,688
Inglemoor Transmission Main	0	25,453
SR 522 West Phase Water Main	0	23,242
Total Construction in Progress	$18,826,454	$10,880,965

NOTE 5 – LEASE COMMITMENTS

The District had no lease commitments for the periods ended December 31, 2013 and 2012.

NOTE 6 – LONG-TERM DEBT

a. Revenue Bonds

As of December 31, 2012 the District had 2003 Revenue Bonds outstanding in the amount of $2,705,000. 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 consisted of term bonds maturing from 2004 to 2023. The bonds maturing in years 2004 through 2013 were not subject to optional redemption prior to maturity. Bonds maturing on or after May 1, 2014, were 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. As of December 31, 2012 the District had set aside $1,099,974 in restricted assets exclusively for debt service purposes. These restricted assets represented sinking funds and reserve requirements as contained in the bond indenture. There were other limitations and restrictions contained in the bond indenture, and the District was in total compliance.

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):

NOTE 6 – LONG-TERM DEBT (continued)

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 December 31, 2013 the District no longer had any outstanding bonded debt.

b. Junior Lien Loans

The District had junior lien loans of $4,559,514 as of December 31, 2013 and $4,980,069 as of December 31, 2012 from the Washington Public Works Trust Fund, including current portions of $412,447 for 2013 and $412,854 for 2012.

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

Year	Term in Years	Interest Rate	Proceeds Received	Loan Balance as of 12/31/13
1995	20	1.0%	$661,138	$69,593
1996	20	1.0%	1,896,300	302,938
2002	20	0.5%	408,000	195,075
2004	20	0.5%	862,570	503,217
2005	20	0.5%	878,454	554,813
2011	20	0.5%	3,105,000	2,933,878
			$7,811,462	$4,559,514
			Less current maturity	($412,447)
			Long-term portion	$4,147,067

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 equal annual installments.

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. Long-Term Debt Service Schedule

Year	Public Works Trust Fund Loans Principal	Public Works Trust Fund Loans Interest	Total Cash Flow
2014	$412,063	$17,327	$429,390
2015	412,447	14,993	427,440
2016	377,650	12,659	390,309
2017-2021	1,383,355	43,610	1,426,965
2022-2031	1,973,999	26,207	2,000,206
Total	$4,559,514	$114,796	$4,674,310

d. Changes in Long-Term Liabilities

During the years ended December 31, 2013 and 2012 the following changes occurred in long-term liabilities:

	Beginning Balance 1/1/2013	Additions	Reductions	Ending Balance 12/31/2013	Due Within One Year
Bonds Payable	$2,705,000	$0	($2,705,000)	$0	$0
Public Works Trust Fund Loans	$4,980,069	$0	($420,555)	$4,559,514	$412,447

	Beginning Balance 1/1/2012	Additions	Reductions	Ending Balance 12/31/2012	Due Within One Year
Bonds Payable	$2,905,000	$0	($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

NOTE 6 – LONG-TERM DEBT (concluded)

The District paid off a Public Works Trust Fund loan early during 2013. Because of this early repayment, the interest rate on the 2011 loan was dropped from 1% to .5%. The State converted $7,701 in interest payments on this loan to principal. For this reason, the total reduction in these loans during 2013 was $420,555 rather than the current amount payable reported in 2012 of $412,854.

NOTE 7 – PENSION PLAN

Substantially all District 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 GASB Statements 27, *Accounting for Pensions by State and Local Government Employers* and 50*, Pension Disclosures, an amendment of GASB Statements 25 and 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; employees of district and municipal courts; and employees of local governments. Membership also includes higher education employees not participating in higher education retirement programs. Approximately 49 percent of PERS salaries are accounted for by state employment. PERS retirement benefit provisions are established in Chapters 41.34 and 41.40 RCW 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.

NOTE 7 – PENSION PLAN (continued)

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 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 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.

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 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 2013, 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, in lieu of any retirement benefit, 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 from active status at any age with at least 30 years of service, at age 55 with 25 years of service, or at age 60 with at least 5 years of service. Plan 1 members retiring from inactive status prior to the age of 65 may receive actuarially reduced benefits.

NOTE 7 – PENSION PLAN (continued)

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.

PERS Plan 1 retirement benefits are actuarially reduced to reflect the choice, if made, of a survivor option.

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.

PERS Plan 1 provides for 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 worker's 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 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.

NOTE 7 – PENSION PLAN (continued)

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, if hired prior to May 1, 2013:

- 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.

PERS Plan 2 members hired on or after May 1, 2013 have the option to retire early by accepting a reduction of 5 percent for each year of retirement before age 65. This option is available only to those who are age 55 or older and have at least 30 years of service.

PERS Plan 2 retirement benefits are actuarially reduced to reflect the choice, if made, of a survivor option.

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 Chapter 41.34 RCW, employee contribution rates to the defined contribution component range from 5 percent to 15 percent of salaries, based on member choice. Members who do not choose a contribution rate default to a 5 percent rate. 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 contributions are invested in the Retirement Strategy Fund that assumes the member will retire at age 65.

For DRS’ Fiscal Year 2013, PERS Plan 3 employee contributions were $99.0 million, and plan refunds paid out were $69.4 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.

NOTE 7 – PENSION PLAN (continued)

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, and were hired before May 1, 2013, they have the choice of a benefit that is reduced by 3 percent for each year before age 65; or a benefit with a smaller (or no) reduction factor (depending on age) that imposes stricter return-to-work rules.
- If they have 30 service credit years, are at least 55 years old, and were hired after May 1, 2013, they have the option to retire early by accepting a reduction of 5 percent for each year before age 65.

PERS Plan 3 benefits are 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 members meeting specific eligibility requirements have options available to enhance their retirement benefits. Some of these options are available to their survivors.

A one-time duty-related death benefit is provided to the beneficiary or the estate of a PERS member who dies 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 member's covered employment, if found eligible by the Department of Labor and Industries.

NOTE 7 – PENSION PLAN (concluded)

There are 1,176 participating employers in PERS. Membership in PERS consisted of the following as of the latest actuarial valuation date for the plans of June 30, 2012:

Retirees and Beneficiaries Receiving Benefits		82,242
Terminated Plan Members Entitled to But Not Yet Receiving Benefits		30,515
Active Plan Members Vested		106,317
Active Plan Members Non-Vested		44,273
	Total	**263,347**

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.

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

The required contribution rates expressed as a percentage of current-year covered payroll, as of December 31, 2013, are as follows:

2013	**PERS Plan 1**	**PERS Plan 2**	**PERS Plan 3**
Employer (a)	9.21% (b)	9.21% (b)	9.21% (c)
Employee	6.00% (d)	4.92% (d)	(e)
2012			
Employer (a)	7.21% (b)	7.21% (b)	7.21% (c)
Employee	6.00% (d)	4.64% (d)	(e)

(a) The employer rates include the employer administrative expense fee currently set at 0.18%.

(b) The employer rate for state elected officials is 13.73% for Plan 1 and 9.21% 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 4.92% 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 ended December 31 were as follows:

	PERS Plan 1	PERS Plan 2	PERS Plan 3
2013	$4,912	$282,753	$6,726
2012	$4,557	$238,169	$11,906
2011	$5,150	$194,274	$9,914

NOTE 8 – PRIOR PERIOD ADJUSTMENTS

The District had no prior period adjustments for 2013 or 2012.

NOTE 9 – JOINT VENTURE

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.

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.

NOTE 9 – JOINT VENTURE (concluded)

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 Chapter 48.62 RCW (self-insurance regulation) and Chapter 39.34 RCW (Interlocal Cooperation Act), nine cities originally formed WCIA on January 1, 1981. WCIA was created for the purpose of providing a pooling mechanism for jointly purchasing insurance, jointly self-insuring, and/or jointly contracting for risk management services. WCIA has a total of 162 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.

NOTE 10 – RISK MANAGEMENT (concluded)

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 in the self-insured layer, and $16 million per occurrence in the reinsured 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 inter-local, 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.

At the end of 2013 this suit had not been resolved, however, the District believes these claims are without merit and expects this lawsuit to go to trial in early 2014. 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.

As a subsequent event, during February of 2014, the court ruled in favor of the District.

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.

We work with our audit clients and citizens to achieve our vision of government that works for citizens, by helping governments work better, cost less, deliver higher value, and earn greater public trust.

In fulfilling our mission to hold state and local governments accountable for the use of public resources, we also hold ourselves accountable by continually improving our audit quality and operational efficiency and developing highly engaged and committed employees.

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.

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 as well as fraud, state whistleblower and citizen hotline investigations.

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

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

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