

ORIGINAL

**BIG SKY COUNTY WATER &
SEWER DISTRICT NO. 363**

FINANCIAL STATEMENTS

JUNE 30, 2004 and 2003

Knaub & Company, P.C.

Certified Public Accountants

2066 Stadium Drive #102
Bozeman, Montana 59715

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COMMUNICATION WITH AUDIT COMMITTEE

To the Board of Directors

Big Sky County Water & Sewer District No. 363

We have audited the financial statements of **BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363** (The District) for the year ended June 30, 2004, and have issued our report thereon dated September 30, 2004. Professional standards require that we provide you with the following information related to our audit.

Our Responsibility under U.S. Generally Accepted Auditing Standards and OMB Circular A-133

As stated in our engagement letter dated September 9, 2004, our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute, assurance that the financial statements are free of material misstatement and are fairly presented in accordance with U.S. generally accepted accounting standards. Because an audit is designed to provide reasonable, but not absolute assurance and because we did not perform a detailed examination of all transactions, there is a risk that material misstatements may exist and not be detected by us.

In planning and performing our audit, we considered the District's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing opinion on the financial statements and not to provide assurance on the internal control over financial reporting. We also considered internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

As a part of obtaining reasonable assurance about whether the District's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit. Also, in accordance with OMB Circular A-133, we examined, on a test basis, evidence about the District's compliance with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* applicable to each of its major federal programs for the purpose of expressing an opinion on the District's compliance with those requirements. While our audit provides a reasonable basis for our opinion, it does not provide a legal determination on the District's compliance with those requirements.

Significant Accounting Policies

Management has the responsibility for selection and use of appropriate accounting policies. In accordance with the terms of our engagement letter, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the District are described in Note 1 to the financial statements. The accounting policy for fixed asset capitalization was increased to \$5,000 during 2004. We noted no transactions entered into by the District during the year that were both significant and unusual, and of which, under professional standards, we are required to inform you, or transactions for which there is a lack of authoritative guidance or consensus.

Accounting Estimates

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected.

Audit Adjustments

For purposes of this letter, professional standards define an audit adjustment as a proposed correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. An audit adjustment may or may not indicate matters that could have a significant effect on the District's financial reporting process (that is, cause future financial statements to be materially misstated). In our judgment, none of the adjustments we proposed, whether recorded or unrecorded by the District, either individually or in the aggregate, indicate matters that could have a significant effect on the District's financial reporting process.

One audit adjustment was made to adjust the deferred revenue account for \$12,561.

There were no significant "passed adjustments".

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the financial statements or the auditors' report. We are pleased to report that no such disagreements arose during the course of our audit.

Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the District's financial statements or a determination of the type of auditors' opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Issues Discussed Prior to Retention of Independent Auditors

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the District's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing our audit. We would like to commend the management of **BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363** for their conscientious effort during the year and throughout the audit.

This information is intended solely for the use of the Board of Directors and the management of **BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363** and is not intended to be and should not be used by anyone other than these specified parties.

Knaub & Company, P.C.

September 30, 2004

BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363

JUNE 30, 2004

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BIG SKY COUNTY WATER & SEWER DISTRICT No. 363

PO BOX 160670 • 561 LITTLE COYOTE RD • BIG SKY, MT 59716 • 406-995-2660 • FAX 406-995-3053 • Email - WSD363@GOMONTANA.COM

Management's Discussion and Analysis Fiscal Year 7/1/2003 -6/30/2004

The District is accounted for as an enterprise fund. As a result, the accounting is much the same as a for profit organization with the exception of state and federal income tax. The District is tax exempt. The basic financial statements produced by the District include the Balance Sheet, Statement of Revenue and Expenses, Statement of Changes in Fund Equity and Statement of Cash Flows. Each statement contains vital financial information regarding the District's financial position and overall financial stability. The balance sheet contains the assets, liabilities, and fund equity. The statement of revenue and expenses contain the detail of revenue sources and the detail of where the revenue was expended to provide the water and sewer services to the District. The statement of changes in fund equity shows the restricted and unrestricted portion of retained earnings and contributed capital and the net income for the current period and the previous period. The statement of cash flows provides the detail of cash sources and uses for Operating Activities, Non-capital Financing Activities, Capital Financing Activities and Investing Activities.

The total assets and total liabilities of the District increased as a result of the expansion of both the sewer system and water system. The sewer capital assets of the district increased from \$21,216,034 to \$29,340,658. The water capital assets increased from \$7,176,557 to \$10,328,510. The District's other assets decreased from \$1,629,564 to \$1,370,483 primarily as a result of the payment made for the Boyne Annual Settlement Agreement. This agreement stipulates among other things that Boyne will make a \$250,000 payment each April 1, through the year 2010.

The total long-term liabilities of both systems increased from \$9,696,828 to \$17,098,582. The District used low interest rate loans from State Revolving Loan Fund to finance both the water and sewer projects. The State Revolving Loans increased from \$8,104,354 to \$16,182,740. The current liabilities of the District increased from \$1,117,816 to \$1,837,024. This is a result of an increase in the current portion of the long-term debt and an increase in the performance bonds and retainage payable to the contractors who worked on both the water and sewer projects.

The total operating revenues of the District decreased to \$1,438,382 from \$1,677,273. The total sewer operating revenue was \$852,282. The total water operating revenue was \$586,100. The District has a plant investment charge on the sewer side but no water plant investment charge. The total restricted revenue of the District increased to \$1,613,132 from \$1,458,452. This was primarily due to the District's collection of property taxes into the restricted revenue category. The District received \$500,000 from the Big Sky Resort Tax Board for paying interest and principal on two of the State Revolving Fund loans and another \$83,400 for water related projects, primarily the new water tank by Hidden Village which received \$60,000. The District received \$264,468 in sewer plant investment fees for capital improvement and \$250,000 from Boyne on their annual payment agreement. The District also collected \$515,264 in tax receipts for payments on the new State Revolving Loans used to finance the new water tank and sewer treatment plant. The total revenue of the District including non-operating revenues (net) was \$2,608,068.



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The total operating expense for the District decreased to \$1,334,325 from \$1,441,194. This was primarily a result of a change in accounting estimate for the depreciation of plant assets. The total general and administrative expense increased to \$336,372 from \$319,238. The total sewer general and administrative increased to \$115,234 from \$99,251. Total sewer operation expense decreased to \$445,876 from \$519,660. The total water general and administrative expense increased to \$124,139 from \$106,972. The total water operation expense decreased to \$312,504 from \$396,073. Both the water and sewer operating expense reductions are due primarily to the change in accounting estimate used in the depreciation of the long-lived assets. The total non-operating expense net of revenues increased to \$443,446 from \$44,694.

The District received \$905,422 in donated capital assets. The donated capital assets are the water and sewer extensions as well as other infrastructure required to install and complete new construction projects and subdivisions within the District. All these assets were acquired by the District through formal transfer agreements recorded at the appropriate county office. The District also is given a one year warranty on these assets with a 10% deposit made by the developer.

The District's overall financial position is stable with sufficient reserves and financing sources available to fund both the operating and non-operating activities of the District. The District's operating revenue has been sufficient to cover all operating expenses in fiscal 2003-2004. In addition, the District has rate setting authority to insure sufficient operating revenue to cover operating expenses associated with both water and sewer operations. In the non-operating area the largest increase has been in the State Revolving Fund Loans which are backed by general obligation bonds paid through a mill levy on the District property owners each year. As a result, the District's financial position is not adversely affected by the new debt. However, the District is attempting to minimize the tax borne by the District property owners by using other sources to fund the new State Revolving Fund loans. The two main other sources include plant investment fees paid by new construction within the District and Resort Tax Funds which are sales tax receipts collected by the Resort Tax Board and used for community projects. Since, the growth in the District seems to be continuing at a healthy pace both of these sources of revenue used to pay the State Revolving Fund loan payments should continue at least in the near term.

The budget for fiscal 2003-2004 at year-end did not have any significant negative variations with the exception of non-operating expenses. In the case of the non-operating expenses there was not enough budgeted for interest expense on the new state revolving fund loans to cover the actual outlay. However, the loans were not yet closed and the interest and principal on these loans were paid by tax and other non-operating revenue sources that were sufficient to cover the variance. This negative variance will not have a future impact on the District's ongoing financial ability to meet its financial obligations. Generally, the actual revenue and expenses were in line with budget projections for 2003-04. The new sewer system which came on line in May 2004 will have to be monitored closely to evaluate the expenses estimated by the District engineers and the actual expense incurred.

The District has incurred an additional \$8,901,386 in State Revolving Fund loan obligations to expand both the water and sewer systems. As mentioned earlier, these loans are secured by general obligation bonds. The District intends on maintaining a stable mill levy on the property in the District and will utilize the available other resources to pay the principal and interest on these new loans. The new loans



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will not impact planned future capital outlays. The District has no new projects planned that would require any additional debt financing.

The District's current financial position is stable. There are no significant facts, decisions or conditions that are expected to have a significant effect on the financial position of the District or results of operations.

INDEPENDENT AUDITORS' REPORT

To the Board of Directors
Big Sky County Water & Sewer
District No. 363

We have audited the accompanying financial statements of Big Sky County Water & Sewer District No. 363 as of and for the years ended June 30, 2004 and 2003, as listed in the table of contents. These financial statements are the responsibility of the District's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Big Sky County Water & Sewer District No. 363, as of June 30, 2004 and 2003, and the results of its operations and cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

As described in Note 1, the District has implemented a new financial reporting model, as required by the provisions of GASB Statement No. 34, *Basic Financial Statements and Management's Discussion and analysis for State and Local Governments*, as of June 30, 2004.

The management's discussion and analysis on page 1 through 3 are not a required part of the basic financial statements, but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 4, 2003 on our consideration of the Big Sky County Water & Sewer District No. 363's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

Knaub & Company, P.C.

September 30, 2004

BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363

BALANCE SHEETS

JUNE 30, 2004 AND 2003

ASSETS

	<u>6-30-04</u>	<u>6-30-03</u>
Current assets:		
Cash and investments	\$ 2,970,381	2,758,263
Accounts receivable	384,918	496,648
Prepaid expenses	21,323	15,838
Water meter inventory	33,695	-
Boyne settlement - current portion	250,000	500,000
Notes receivable - current portion	<u>6,081</u>	<u>2,518</u>
Total current assets	<u>3,666,398</u>	<u>3,773,267</u>
Restricted cash and cash equivalents:		
Debt service fund	5,838	-
Restricted for future capital improvements	1,110,539	1,644,893
Retainage accounts	<u>622,488</u>	<u>332,939</u>
Total restricted cash and cash equivalents	<u>1,738,865</u>	<u>1,977,832</u>
Property and equipment, at cost:		
Fixed assets - sewer	29,340,658	21,216,034
Fixed assets - water	<u>10,328,510</u>	<u>7,176,557</u>
	39,669,168	28,392,591
Less: accumulated depreciation	<u>(5,066,491)</u>	<u>(4,694,958)</u>
Total property and equipment	<u>34,602,677</u>	<u>23,697,633</u>
Other assets:		
Notes receivable	126,564	132,082
Less: current portion	(6,081)	(2,518)
Boyne settlement receivable	1,500,000	2,000,000
Less: current portion	<u>(250,000)</u>	<u>(500,000)</u>
Total other assets	<u>1,370,483</u>	<u>1,629,564</u>
TOTAL ASSETS	\$ <u><u>41,378,423</u></u>	<u><u>31,078,296</u></u>

(Continued)

BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363

BALANCE SHEETS (Continued)

JUNE 30, 2004 AND 2003

LIABILITIES AND FUND EQUITY

	<u>6-30-04</u>	<u>6-30-03</u>
Current liabilities:		
Accounts payable and accrued expenses	\$ 160,868	158,103
Performance bonds and retainage payable	672,680	358,841
Compensated absences payable	44,177	37,007
Accrued health insurance claims payable	16,796	22,851
Current portion of long-term debt	<u>942,503</u>	<u>541,014</u>
Total current liabilities	<u>1,837,024</u>	<u>1,117,816</u>
Long-term liabilities:		
Deferred revenue	1,626,564	1,882,082
State revolving fund loans	16,182,740	8,104,354
Office building loan	177,143	182,585
Backhoe loan	54,638	68,821
Less: current portion of long-term debt	<u>(942,503)</u>	<u>(541,014)</u>
Total long-term liabilities	<u>17,098,582</u>	<u>9,696,828</u>
Fund equity:		
Contributed capital - unrestricted	3,363,110	3,363,110
Contributed capital - RID assets	885,272	885,272
Retained earnings - unrestricted	16,455,570	14,037,438
Retained earnings - restricted	<u>1,738,865</u>	<u>1,977,832</u>
Total fund equity	<u>22,442,817</u>	<u>20,263,652</u>
TOTAL LIABILITIES AND FUND EQUITY	<u>\$ 41,378,423</u>	<u>31,078,296</u>

(Concluded)

BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363

STATEMENTS OF REVENUE AND EXPENSES

FOR THE YEARS ENDED JUNE 30, 2004 AND 2003

	<u>6-30-04</u>	<u>6-30-03</u>
OPERATING REVENUE:		
Sewer services	\$ 852,282	1,036,906
Water services	<u>586,100</u>	<u>640,367</u>
 Gross operating revenue	 <u>1,438,382</u>	 <u>1,677,273</u>
 OPERATING EXPENSES:		
General and administrative:		
Meetings	1,481	1,068
Directors' expense	4,908	4,450
Salaries	153,643	146,980
Payroll taxes and benefits	59,027	53,892
Utilities	4,018	3,217
Janitorial	3,523	3,436
Computer software	5,498	3,263
Office supplies and expense	4,777	9,486
Telephone	5,235	5,600
Postage and shipping	8,134	7,994
Advertising	2,456	673
Insurance	51,534	45,451
Dues and subscriptions	655	948
Vehicle expenses	3,465	4,554
Interest expense		10
Legal fees	11,842	14,095
Computer maintenance	3,017	3,842
Audit expense	5,915	5,890
Bank service charges	703	629
State annual filing fee	675	675
Miscellaneous	1,331	1,076
GIS Mapping and other consulting fees	4,184	559
Office building repair & maintenance	<u>551</u>	<u>1,450</u>
 Total general and administrative	 <u>336,572</u>	 <u>319,238</u>

(Continued)

BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363

STATEMENTS OF REVENUE AND EXPENSES

FOR THE YEARS ENDED JUNE 30, 2004 AND 2003

OPERATING EXPENSES (Continued):

	<u>6-30-04</u>	<u>6-30-03</u>
Sewer general and administrative:		
Salaries and wages	83,547	71,772
Payroll taxes and employee benefits	28,365	24,845
Dues and subscriptions	210	148
Telephone	2,692	2,413
Office supplies	420	23
Publications	-	50
	<hr/>	<hr/>
Total sewer general and administrative	115,234	99,251
	<hr/>	<hr/>
Sewer Plant Expense:		
Fuel - equipment & vehicles	3,920	4,512
Vehicle repair and maintenance	5,880	2,051
Insurance	1,422	1,148
Utilities	82,518	46,712
Chemicals	38,313	35,166
Stream water quality monitoring	1,383	1,955
Waste water monitoring	13,484	13,182
Lab testing equipment	421	120
Safety equipment	1,829	261
Operating supplies	840	469
Discharge permit fees	750	-
Sewer repairs and maintenance	10,032	9,044
Maintenance and repairs - building and grounds	21,852	13,326
Tools	1,393	901
Jetting	15,073	14,486
Video taping	3,547	3,869
Engineering	5,902	2,534
Miscellaneous	699	580
Depreciation expense	236,618	369,344
	<hr/>	<hr/>
Total sewer plant expense	445,876	519,660
	<hr/>	<hr/>

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BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363

STATEMENTS OF REVENUE AND EXPENSES

FOR THE YEARS ENDED JUNE 30, 2004 AND 2003

OPERATING EXPENSES (Continued)

	<u>6-30-04</u>	<u>6-30-03</u>
Water general and administrative:		
Salaries and wages	85,097	75,318
Payroll taxes and employee benefits	32,070	25,324
Dues and subscriptions	927	862
Telephone	1,941	1,616
Publications	344	452
Office supplies	158	-
Public water supply fees	3,602	3,400
	<hr/>	<hr/>
Total water general and administrative	124,139	106,972
	<hr/>	<hr/>
Water plant expense:		
Vehicle expenses	6,398	5,269
Fuel - equipment	1,661	414
Utilities and garbage	83,478	74,309
Lab fees	2,158	3,455
Equipment rental	675	86
Small equipment	2,388	982
Tools	1,705	-
Interest expense	-	90
Repairs and maintenance	48,716	41,062
Leak detection and engineering	-	7,206
Miscellaneous	699	581
Special projects	4,560	8,415
Depreciation	154,112	246,474
Professional services	5,954	7,730
	<hr/>	<hr/>
Total water plant expense	312,504	396,073
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Total expenses	1,334,325	1,441,194
	<hr/>	<hr/>
Operating income	104,057	236,079
	<hr/>	<hr/>

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BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363

STATEMENTS OF REVENUE AND EXPENSES

FOR THE YEARS ENDED JUNE 30, 2004 AND 2003

	<u>6-30-04</u>	<u>6-30-03</u>
NONOPERATING REVENUE (EXPENSES):		
Other nonoperating revenue	54,275	18,909
Rental income	600	600
Interest income - restricted	29,638	53,890
Interest income - unrestricted	38,126	60,021
Interest expense	(548,551)	(177,814)
Source water protection project	(4,959)	-
Loss on disposition of assets	<u>(12,575)</u>	<u>(300)</u>
Total nonoperating revenue (expenses)	<u>(443,446)</u>	<u>(44,694)</u>
RESTRICTED REVENUE		
Restricted for bond payments	500,000	500,000
Tax receipts for bond payments	515,264	-
Restricted for capital improvements	514,468	950,037
Restricted resort tax funds	<u>83,400</u>	<u>8,415</u>
Total restricted revenue	<u>1,613,132</u>	<u>1,458,452</u>
Donated capital assets	<u>905,422</u>	<u>2,861,222</u>
NET INCOME	\$ <u><u>2,179,165</u></u>	<u><u>4,511,059</u></u>

(Concluded)

BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363

STATEMENTS OF CHANGES IN FUND EQUITY

FOR THE YEARS ENDED JUNE 30, 2004 AND 2003

	<u>Contributed Capital</u>		<u>Retained Earnings</u>		<u>Total</u>
	<u>Unrestricted</u>	<u>RID Assets</u>	<u>Unrestricted</u>	<u>Restricted</u>	
Beginning balances, July 1, 2002	\$ 3,363,110	885,272	8,626,978	2,877,233	15,752,593
Net income	0	0	3,052,608	1,458,451	4,511,059
Satisfaction of restrictions	<u>0</u>	<u>0</u>	<u>2,357,852</u>	<u>(2,357,852)</u>	<u>0</u>
Ending balances, June 30, 2003	\$ 3,363,110	885,272	14,037,438	1,977,832	20,263,652
Net income	0	0	536,395	1,642,770	2,179,165
Satisfaction of restrictions	<u>0</u>	<u>0</u>	<u>1,881,737</u>	<u>(1,881,737)</u>	<u>0</u>
Ending balances, June 30, 2004	<u>\$ 3,363,110</u>	<u>885,272</u>	<u>16,455,570</u>	<u>1,738,865</u>	<u>22,442,817</u>

BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363

STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED JUNE 30, 2004 AND 2003

	<u>6-30-04</u>	<u>6-30-03</u>
Increase (Decrease) in Cash and Cash Equivalents:		
CASH FLOWS FROM OPERATIONS:		
Receipts from customers	\$ 1,787,537	1,519,803
Payments to suppliers	(229,940)	(231,855)
Payments to employees	<u>(440,634)</u>	<u>(389,198)</u>
Net cash provided by operating activities	<u>1,116,963</u>	<u>898,750</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Other sewer non-operating revenue	54,275	18,909
Source water protection project	(4,959)	-
Rental income - lower office	<u>600</u>	<u>600</u>
Net cash provided by noncapital financing activities	<u>49,916</u>	<u>19,509</u>
CASH FLOWS FROM CAPITAL FINANCING ACTIVITIES:		
Principal paid on long-term debt	(842,625)	(359,469)
Proceeds from long-term debt (SRF)	8,901,386	4,261,386
Interest paid	(548,551)	(177,913)
Resort tax revenue	583,400	508,415
Sewer plant investment fees	264,468	700,036
Boyne payment restricted for capital improvements	250,000	250,000
Tax receipts for bond payments	515,264	-
Proceeds from disposal of fixed assets	12,575	16,830
Acquisition of fixed assets	(10,402,927)	(7,633,566)
Payment received on notes receivable	<u>5,518</u>	<u>4,275</u>
Net cash flows used in capital financing activities	<u>(1,261,492)</u>	<u>(2,430,006)</u>

(Continued)

BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363

STATEMENTS OF CASH FLOWS (Continued)

FOR THE YEARS ENDED JUNE 30, 2004 AND 2003

	<u>6-30-04</u>	<u>6-30-03</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Interest income	<u>67,764</u>	<u>113,911</u>
Net cash provided by investing activities	<u>67,764</u>	<u>113,911</u>
Net decrease in cash	(26,849)	(1,397,836)
Cash and cash equivalents, beginning of year	<u>4,736,095</u>	<u>6,133,931</u>
Cash and cash equivalents, end of year	<u>\$ 4,709,246</u>	<u>4,736,095</u>
As reported in the accompanying balance sheet:		
Unrestricted cash and cash equivalents	\$ 2,976,219	2,758,263
Restricted cash and cash equivalents	<u>1,733,027</u>	<u>1,977,832</u>
	<u>\$ 4,709,246</u>	<u>4,736,095</u>
Noncash transactions consist of the following:		
Contributed capital from developers	<u>\$ 905,422</u>	<u>\$ 2,861,222</u>

(Continued)

BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363
STATEMENTS OF CASH FLOWS - INDIRECT WORKSHEET
FOR THE YEARS ENDED JUNE 30, 2004 AND 2003

	<u>6-30-04</u>	<u>6-30-03</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 104,057	236,079
Adjustments to reconcile operating income to net cash provided (used) by operating activities:		
Depreciation	390,730	615,818
Interest expense	-	100
Gain (loss) on disposal of fixed assets	(12,575)	(300)
(Increase) decrease in current assets:		
Accounts receivable	111,730	92,530
Prepaid expenses	(5,485)	2,635
Water meter inventory	(33,695)	-
Other receivables	250,000	(250,000)
Increase (decrease) in current liabilities:		
Accounts payable	2,765	(143,526)
Retainages payable	313,839	343,524
Compensated absences payable	7,170	13,789
Accrued health insurance claims payable	(6,055)	(4,856)
Deferred revenue collected	(5,518)	(7,043)
	<u>1,012,906</u>	<u>662,671</u>
Net cash provided by operating activities	\$ <u>1,116,963</u>	\$ <u>898,750</u>

(Concluded)

BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 and 2003

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

Big Sky County Water & Sewer District No. 363 (the District) was created by resolution by the Board of County Commissioners of Gallatin County, Montana, and Madison County, Montana, on August 3, 1993 and August 4, 1993, respectively. The District was created for the purpose of constructing, repairing, operating, managing, maintaining and acquiring a sanitary sewer facility on the West Fork of the West Gallatin River, Gallatin County, Montana. The District acquired Lone Mountain Springs, water district, as part of a settlement agreement reached with Boyne USA on July 25, 1997. The District is governed by a Board of Directors elected by members of the District and establishes its own budget independent of any other government entity so it is therefore considered to be a primary government. The daily affairs of the District are conducted under the supervision of the District's general manager. The District serves approximately 2,200 customers.

Basis of Accounting

The District is considered a proprietary governmental unit. As such, its activities are similar to those found in the private sector where determination of net income is necessary or useful to sound financial administration. Goods and services are provided to outside parties therefore making it an enterprise activity. As a proprietary/enterprise entity, the activities are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities associated with the operation are included on the balance sheet. Fund equity is segregated into contributed capital and retained earnings components. Proprietary/enterprise operating statements present increases (e.g., revenues) and decreases (e.g., expenses) in net total assets. The accrual basis of accounting is utilized by the District. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Pursuant to GASB Statement 20 "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting", the District follows GASB guidance as applicable to proprietary funds and FASB Statements and Interpretations, Accounting Principles Board Opinions and Accounting Research Bulletins issued on or before November 30, 1989 that do not conflict with or contradict GASB pronouncements.

GASB 34 was implemented for the year ended June 30, 2004. The June 30, 2003 statement of cash flows was re-stated to the direct method as required.

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Cash and Investments

Under the District's investment policy, the District is restricted to investing funds in specific types of deposit and investment instruments. All cash and investments held by the District that have a maturity of one year or less are presented as cash equivalents in the Statement of Cash Flows. Management considers all cash and certificates of deposit to be cash and cash equivalents. This differs from generally accepted accounting principles which requires a three-month maturity; however, the difference is not material. The following are the types of permitted deposits and investments: Interest bearing savings accounts, certificates of deposit, and time deposits insured by the Federal Deposit Insurance Corporation or which are fully collateralized. Deposits in excess of the FDIC insurance limits were collateralized by pledged securities. Restricted amounts are detailed in Note 2. Investments are stated at the lower of aggregate cost or market value.

Investments in the State Short-Term Investment Pool (STIP) are carried at amortized cost. STIP is a 2a-7 like pool that is managed by the State of Montana and is not registered with the Securities and Exchange Commission (SEC) as an investment company, but nevertheless operates in a manner consistent with the SEC's Rule 2a-7 of the Investment Company Act of 1940. GASB Statement No. 31 allows reporting of investments in such pools at amortized cost.

Fixed Assets

Capital outlays for property, plant and equipment are recorded as capital assets when incurred. All purchased fixed assets are valued at historical cost. Fixed assets contributed are recorded at their estimated fair market values or historical cost if fair market value is not reasonably determinable. Depreciation of fixed assets is calculated using the straight-line method with estimated useful lives as follows:

Office building	39 years
Water and sewer system and equipment	7 - 75 years
Vehicles	5 years
Computer equipment and software	3 - 5 years

Maintenance and repair costs are expensed as incurred. Replacements which improve or extend the lives of fixed assets are capitalized. Proceeds received from government or other grantors, for the purchase or construction of fixed assets, are credited to income. All interest costs associated with new construction are capitalized. Capitalized interest was \$86,343 in 2003.

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

User Fees and Accounts Receivable

Property owners are assessed sewer and water fees annually based on the number of single family equivalent units. The District is currently in the process of converting to a metering system. No allowance has been made for uncollectible accounts because the District believes that all accounts will be collected. The District may turn over any delinquent accounts to the County Treasurer for collection.

Resort Taxes

Applications requesting funds from resort taxes are reviewed by the Big Sky Resort Tax Advisory Board. Expenses paid from the resort tax proceeds are included in operating expenses in the Statement of Revenue and Expenses.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Tax Exempt Status

The District is a municipal corporation and, therefore, is not liable for federal and state income taxes pursuant to Internal Revenue Code 501(c)(1).

Risk Management

The District faces a considerable number of risks of loss, including:

- a. damage to and loss of property and contents
- b. environmental damage
- c. workers' compensation; i.e., employee injuries

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Risk Management (Continued)

A variety of methods is used to provide insurance for these risks. Commercial insurance policies, transferring all risks of loss, except for relatively small deductible amounts, are purchased for property and content damage.

Workers' compensation insurance coverage is provided through the State Fund.

The District has limited insurance coverage for potential losses due to environmental damages. The amounts of any potential future losses are unknown. At the present time, the District is unaware of any potential future loss due to environmental damages.

The District has the following coverage under its insurance policies:

General liability	\$ 10,000,000
Personal injury	10,000,000
Employer benefits liability	10,000,000
Failure to supply	10,000,000
Limited pollution	10,000,000
Aggregate coverage	20,000,000
Building and contents	3,712,600
Public officials liability	10,000,000
Earthquake	15,000,000

Economic Dependency

Big Sky County Water & Sewer District receives a vast majority of its revenue from resort tax revenue collected by the Resort Tax District, and the user fees charged to the property owners. During fiscal year 2004 and 2003, \$500,000 and \$500,000, respectively, of the resort tax revenue was used to pay principal and interest on the general obligation bonds.

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

2. CASH AND INVESTMENTS

The District began investing in the state short-term investment pool (STIP) in 2000. The following is a summary of cash and cash equivalents as of June 30, 2004 and 2003:

	<u>2004</u>	<u>2003</u>
Unrestricted	\$ 2,685,450	2,476,462
Debt service fund	5,838	0
Restricted for capital improvements	1,110,539	1,644,893
Restricted - Retainage and construction performance bonds	<u>622,488</u>	<u>332,939</u>
	4,424,315	4,454,294
 Investment in STIP - unrestricted	 <u>284,931</u>	 <u>281,801</u>
 Total cash and investments	 \$ <u>4,709,246</u>	 <u>4,736,095</u>

The District's deposits are categorized below by the level of credit risk. Category 1 includes deposits insured or collateralized with securities held by the District. Category 2 includes deposits collateralized with securities held by the financial institution's trust department or agency in the District's name. Category 3 are deposits that are collateralized with securities held by the pledging financial institution or its trust department or agent, but not in the District's name.

	<u>Category</u>			
	<u>1</u>	<u>2</u>	<u>3</u>	<u>Total</u>
2004 - Cash and cash equivalents \$	<u>205</u>	<u>-</u>	<u>4,424,110</u>	\$ <u>4,424,315</u>
2003 - Cash and cash equivalents \$	<u>4,216</u>	<u>-</u>	<u>4,450,078</u>	\$ <u>4,454,294</u>

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

3. CHANGES IN FIXED ASSETS

	<u>Balance</u> <u>7/1/03</u>	<u>Additions</u>	<u>Retirements</u>	<u>Transfers</u>	<u>Balance</u> <u>6/30/04</u>
Land	\$ 1,063,038	-	-	-	1,063,038
Land easements	57,500	617	-	-	58,117
Office building	458,653	-	-	-	458,653
Sewer assets	13,636,323	388,330	(31,772)	236,114	14,228,996
Sewer construction in progress	6,058,021	8,004,179	-	(472,228)	13,589,971
Water assets	7,038,552	103,192	-	236,114	7,377,858
Water construction in progress	<u>80,504</u>	<u>2,812,031</u>	<u>-</u>	<u>-</u>	<u>2,892,535</u>
Total	\$ <u>28,392,591</u>	<u>11,308,349</u>	<u>(31,772)</u>	<u>-</u>	<u>39,669,168</u>

4. OUTSTANDING DEBT

The following is a summary of long-term debt at June 30, 2004 and 2003:

	<u>2004</u>	<u>2003</u>
Variable rate note payable to American Bank of Montana dated April 7, 2000 to finance the new office building, secured by the property. Payable in monthly installments of \$1,048 over 25 years. The rate at June 30, 2004 was 4.0%.	\$ 177,143	182,585
4.3% note payable to Caterpillar Financial Services Corporation for the purchase of a backhoe for \$83,032. Payable in 37 monthly payments of \$1,414 until July, 2005.	54,638	68,821
4% State Revolving Loan #1 dated May 28, 1996 for \$5,513,000 with the Department of Natural Resources and Conservation of the State of Montana under the Wastewater Treatment Works Revolving Fund Program; for the design, construction, and installation of mandated improvements to the District's wastewater treatment system, satisfying the Interim Action Work Plan mandated by the Montana Water Quality Bureau. Payable in 33 semi-annual installments of approximately \$232,000 until January 1, 2013.	3,312,000	3,633,000

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

4. OUTSTANDING DEBT (Continued)

General Obligation Bonds

4% State Resolving Loan #2 dated December 11, 1997 for \$417,000 with the Department of Natural Resources and Conservation of the State of Montana under the Wastewater Treatment Works Revolving Fund Program; for wastewater treatment system; payable in 30 semi-annual installments of approximately \$19,000 until January 1, 2013.	267,000	293,000
4% State Revolving Fund (DNRC Revolving Loan Program) Series 2002 dated September 24, 2002 for \$7,000,000 for the purpose of constructing a wastewater treatment plant. Funds advanced as of June 30, 2003 totaled \$3,353,390. Payable in 40 semi-annual installments of approximately \$260,000 until July 1, 2023.	6,766,000	3,593,390
4% State Revolving Fund (DNRC Drinking Water Revolving Loan Program) Series 2002 dated September 24, 2002 for the purchase and installation of water meters. Payable in 42 semi-annual installments of approximately \$39,000 until July 1, 2023.	516,000	534,000
3.75% State of Montana General Obligation Bonds, Wastewater Revolving Fund Program totaling \$6,500,000, dated October 1, 2003 to finance construction of the water treatment plant. Payable in 40 installments of approximately \$232,000 until July 1, 2023. Amount advanced at June 30, 2004 was \$3,667,374.	3,443,374	-

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

4. OUTSTANDING DEBT (Continued)

4% State Revolving Fund (DNRC Drinking Water Revolving Loan Program) Series 2003 dated May 20, 2003 for the construction of a water tank. Total loan commitment \$1,966,000. Funds advanced as of June 30, 2003 totaled \$50,964. Payable in 42 semi-annual installments of approximately \$72,000 until July 1, 2024.

	<u>1,878,366</u>	<u>50,964</u>
	16,414,521	8,355,760
Less: current portion	<u>(942,503)</u>	<u>(541,014)</u>
	\$ <u>15,472,018</u>	<u>7,814,746</u>

The general obligation bonds are to be repaid semi-annually through 2013 with resort tax revenue appropriated to the District by the counties as well as the mill levy approved in 2004. The appropriation will not exceed the lesser of \$500,000 or 50% of the total amount of the annual resort tax revenue collected in any fiscal year.

June 30, 2004

	<u>Balance</u> <u>6/30/2003</u>	<u>Additions</u>	<u>Repayment</u>	<u>Balance</u> <u>6/30/2004</u>	<u>Current</u> <u>Portion</u>
State Revolving Loan #1	\$ 3,633,000	-	(321,000)	3,312,000	335,000
State Revolving Loan #2	293,000	-	(26,000)	267,000	27,000
SRF Treatment Plant	3,593,390	3,406,610	(234,000)	6,766,000	244,000
SRF Water Meters	534,000	-	(18,000)	516,000	18,000
SRF Water Tank	50,964	1,827,402	-	1,878,366	66,000
SRF Treatment Plant	-	3,667,374	(224,000)	3,443,374	232,000
Backhoe	68,821	-	(14,183)	54,638	14,911
American Bank Office Bldg.	182,585	-	(5,442)	177,143	5,592
	\$ <u>8,355,760</u>	<u>8,901,386</u>	<u>(842,625)</u>	<u>16,414,521</u>	<u>942,503</u>

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

4. OUTSTANDING DEBT (Continued)

June 30, 2003

	<u>Balance</u> <u>6/30/2002</u>	<u>Additions</u>	<u>Repayment</u>	<u>Balance</u> <u>6/30/2003</u>	<u>Current</u> <u>Portion</u>
State Revolving Loan #1	\$ 3,942,000	-	(309,000)	3,633,000	321,000
State Revolving Loan #2	317,000	-	(24,000)	293,000	26,000
SRF Treatment Plant	-	3,593,390	-	3,593,390	120,000
SRF Water Meters	-	534,000	-	534,000	18,000
SRF Water Tank	-	50,964	-	50,964	33,000
Backhoe	-	83,032	(14,211)	68,821	14,284
American Bank Office Bldg.	<u>190,687</u>	<u>-</u>	<u>(8,102)</u>	<u>182,585</u>	<u>8,730</u>
	\$ <u>4,449,687</u>	<u>4,261,386</u>	<u>(355,313)</u>	<u>8,355,760</u>	<u>541,014</u>

Annual principal and interest payments on all long-term debt required until maturity are as follows:

	<u>Principal</u>	<u>Interest</u>
2005	\$ 942,503	748,481
2006	1,003,547	709,668
2007	1,002,057	671,224
2008	1,039,304	631,387
2009	1,083,561	588,951
2010-2014	5,327,037	2,283,927
2015-2019	3,375,596	1,363,597
2020-2024	<u>2,640,916</u>	<u>414,562</u>
Total	\$ <u>16,414,521</u>	<u>7,411,797</u>

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

4. OUTSTANDING DEBT (Continued)

Sewer System General Obligation Bonds - Debt Restrictions

- a. The District must establish a debt service fund for money to be set aside to pay the debt of the SRF loan.
- b. Liability insurance must be carried.
- c. All fund properties, buildings, equipment, and fixtures must be adequately insured with a reputable carrier.
- d. The District must maintain adequate accounting records.
- e. The District may invest money in securities which are fully and unconditionally guaranteed by the U.S. Government.
- f. The Sewer Fund must be audited on an annual basis.
- g. The District was in compliance with the bond covenants at June 30, 2004 and 2003.

5. DEFERRED REVENUE

Changes in deferred revenue were as follows:

	<u>Balance</u> <u>6/30/04</u>	<u>Additions</u>	<u>Revenue</u> <u>Recognized</u>	<u>Balance</u> <u>6/30/04</u>
Boyne settlement	\$ 1,750,000	-	(250,000)	1,500,000
Big Sky Chapel	15,000	-	(3,000)	12,000
Farmhouse	<u>117,082</u>	<u>-</u>	<u>(2,518)</u>	<u>114,564</u>
	\$ <u>1,882,082</u>	<u>-</u>	<u>(255,518)</u>	<u>1,626,564</u>

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

5. DEFERRED REVENUE (Continued)

	<u>Balance</u> <u>6/30/02</u>	<u>Additions</u>	<u>Revenue</u> <u>Recognized</u>	<u>Balance</u> <u>6/30/03</u>
Boyne settlement	\$ 2,000,000	-	(250,000)	1,750,000
Big Sky Chapel	16,325	-	(1,325)	15,000
Farmhouse	<u>122,800</u>	<u>-</u>	<u>(5,718)</u>	<u>117,082</u>
	\$ <u>2,139,125</u>	<u>-</u>	<u>(257,043)</u>	<u>1,882,082</u>

6. CONTRIBUTED CAPITAL

Contributed capital consists of \$885,272 transferred from the RID, which operated before the District was formed in September of 1993, plus additional contributions by developers for new hook-ups. All assets are currently owned and depreciated by the District. Beginning in 2002, assets contributed by developers are recorded as income in accordance with GASB 33.

7. RETAINED EARNINGS - RESTRICTED

Retained earnings are restricted as follows:

	<u>2004</u>	<u>2003</u>
Restricted for retainages payable	\$ 622,488	332,939
Restricted for capital outlay	<u>1,110,539</u>	<u>1,644,893</u>
	\$ <u>1,733,027</u>	<u>1,977,832</u>

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

8. RETIREMENT PLANS

The District participates in a state-wide, cost-sharing multiple employer defined benefit retirement plan (Public Employees Retirement System (PERS)), which covers all employees, except certain part-time employees. The plan is established under State law and is administered by the State of Montana. The plan provides retirement, disability, and death benefits to plan members and beneficiaries.

The plan issues publicly available annual reports which include financial statements and required supplemental information for the plan. Those reports may be obtained from the following:

Public Employees Retirement System
PO Box 200131
1712 Ninth Avenue
Helena, MT 59620-0131
(406) 444-3154

Contribution rates for the plan are required and determined by State law. The PERS rates for employees and employers expressed as a percentage of covered payroll, were as follows:

	<u>Employer</u>	<u>Employee</u>	<u>State of Montana</u>	<u>Total</u>
PERS - 2004	6.8%	6.9%	.1%	13.8%
PERS - 2003	6.8%	6.9%	.1%	13.8%
PERS - 2002	6.8%	6.9%	.1%	13.8%

The amounts contributed to the plan during the year ended June 30, 2004 and 2003, were equal to the required contribution. The amounts contributed by both the District and its employees (including additional voluntary contributions by employees as permitted by State law) were as follows:

	<u>Covered Wages</u>	<u>Employer</u>	<u>Employee</u>	<u>Total</u>
2004	\$ 295,484	20,093	20,388	40,481
2003	269,426	18,321	18,590	36,911
2002	259,724	17,661	17,921	35,582

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

9. COMMITMENTS AND CONTINGENCIES

Employee Health Insurance

The District carries outside health insurance for its employees which pays 50% of covered medical expenses effective January 1, 2000 (60% prior). The District pays an additional \$2,000 of covered expenses for each employee effective June 19, 2001. The maximum risk the District faces is \$2,000 per employee, for a total of \$12,000. The claims payable had the following activity:

		<u>Beginning Liability</u>	<u>Estimated Accrual</u>	<u>Claims Paid</u>	<u>Ending Liability</u>
2004	\$	22,851	15,606	21,661	16,796
2003	\$	27,707	14,717	19,573	22,851

Compensated Absences

Employees accrue vacation time at 10 hours per month (increasing to 12 hours after 10 years up to 16 hours after 21 years) and sick leave at 8 hours per month. Upon termination, unused sick time is paid at 25%. Unused vacation may not be accrued beyond two times the annual amount. Excess time must be used within 90 days of the next calendar year or be forfeited.

Compliance Order

On July 13, 1993, the Montana Water Quality Bureau issued a compliance order to the District imposing a moratorium restricting new hook-ups to the sewer system and requiring the District to upgrade the sewer facility to prevent seepage of sewage from the Big Sky sewer system treatment and disposal facility and resultant contamination of State ground waters. The District is required to comply with the requirements of the order or face penalties of up to \$25,000 for each day in which a violation occurs or a failure or refusal to comply continues. Under amendment #5 dated November 13, 2002, the wastewater treatment plant must be completed by September 30, 2004. The District met the State's compliance requirements through June 30, 2004.

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

9. COMMITMENTS AND CONTINGENCIES (Continued)

Boyne Litigation and Related Complaint Action

The District entered into a Settlement Agreement, dated July 25, 1997, with Boyne USA (Boyne), owner of the Big Sky Ski & Summer Resort and the Big Sky Owner's Association (BSOA). They agreed to settle the litigation regarding the actions of the parties related to the short- and long-term development of the sewer system for the Big Sky area. This case had been pending since 1991 in the Eighteenth Judicial District, Gallatin County, Montana. The District Court signed an order to dismiss the case on November 18, 1997. Boyne agreed to pay the District \$250,000 per year for a period of 13 years beginning April 1, 1998. The remaining amount due of \$1,750,000 at June 30, 2004 and 2003 is offset by deferred revenue of \$1,750,000 at June 30, 2003 and \$2,000,000 at June 30, 2002. The \$250,000 payment due April 1, 2003 was paid in November, 2003.

Acquisition of Lone Mountain Springs (LMS)

Part of the Settlement Agreement between the District and Boyne USA, Inc. was the transfer of the assets and certain liabilities of LMS to the District in 1998. The District's water operation is the former Lone Mountain Springs.

Greater Yellowstone Coalition, et al. v. Montana Department of Environmental Quality, Mark Simonich, Big Sky Water & Sewer District No. 363, (Montana Eighteenth Judicial District, Gallatin County, Cause No. DV-99-123.)

This action has not been dismissed but has been inactive for approximately two (2) years. The action was brought by the Plaintiffs challenging the approval process of the Department of Environmental Quality in the issuance of a permit allowing WSD No. 363 to discharge treated wastewater into the Gallatin River and to enjoin WSD No. 363 from discharging treated wastewater into the Gallatin River. On April 18, 2001, this case was stayed by the Court pending negotiations between WSD No. 363 and the Yellowstone Mountain Club for an agreement that would, in part, allow WSD No. 363 to dispose of treated wastewater through irrigation on real property owned by the Yellowstone Mountain Club and eliminate direct discharge to the Gallatin River. WSD No. 363's right to dispose of treated wastewater on Yellowstone Mountain Club real property was contingent upon voter approval of WSD No. 363's annexation of Yellowstone Mountain Club real property and voter approval of the bond financing necessary for the improvements required by the agreement. In the spring of 2002, the voters approved the annexation and the bond financing. The agreement between WSD No. 363 and Yellowstone Mountain Club has thus become final. In addition, installation of the physical infrastructure (pipes, pumps, etc.) for transferring the treated wastewater from the treatment facilities to the Yellowstone Mountain Club disposal site has been started and should be completed within a year or two.

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

9. COMMITMENTS AND CONTINGENCIES (Continued)

Greater Yellowstone Coalition, et al. v. Montana Department of Environmental Quality, Mark Simonich, Big Sky Water & Sewer District No. 363, (Montana Eighteenth Judicial District, Gallatin County, Cause No. DV-99-123.) (Continued)

Legal counsel for WSD No. 363 thinks that this case is ready to be dismissed. The contracts for the construction of the water and sewer improvements were awarded and the construction has been completed. It is unclear whether the Plaintiffs will make other requests before they will agree to dismiss this action. At this point, however, the District's liability exposure under the Plaintiffs' claims has generally been resolved.

Hall v. John Kircher, Boyne USA, Inc. and Big Sky County Water and Sewer District No. 363, (Montana Eighteenth Judicial District Court, Gallatin County, Cause No. DV-99-420.)

This declaratory judgment action was brought by the Plaintiff to dispute the imposition by WSD No. 363 of a surcharge of \$3,500.00 per SFE on a 64.1 SFEs appurtenant to certain tract of land pursuant to the July 27, 1997 Settlement Agreement signed by Boyne USA and WSD No. 363. The total amount at issue is \$224,350.00. The Complaint also alleges the following counts against Defendants Kircher and Boyne USA: breach of contract, negligent misrepresentation, fraud, unjust enrichment, punitive damages. Defendant WSD filed a counter claim for declaratory judgment against Plaintiff Sarah Hall and Defendant Boyne USA, Inc. An apparent settlement has been reached between the Plaintiff and Defendants Boyne USA and John Kircher. Defendants Boyne USA and John Kircher claim that WSD No. 363 is bound by their settlement with the Plaintiff. WSD No. 363 denies it is bound by the settlement. WSD No. 363's liability exposure in this case, however, is limited to its attorney's fees and costs, because even if the Plaintiff is not required to pay the surcharges, Boyne USA remains contractually obligated under the terms of the July 27, 1997 Settlement Agreement.

West Berlin Developers, LLC and Big Sky County Water and Sewer District No. 363

The District entered into an easement and water use agreement with West Berlin Developers, LLC on October 14, 1999. The agreement provides a permanent easement to the District for a water main that crosses through a commercial tract of land in Phase IV of the Summit View Subdivision, located in the SW ¼ of Section 20, Township 6 South, Range 3 East in Madison County. In exchange for the easement, the District agrees to sell surplus water to West Berlin Developers for a maximum of 15.53 Single Family Equivalents. This agreement was still in effect as of June 30, 2002. However, on September 4, 2002, the District notified West Berlin Developers of its intent to cancel the agreement. The Developers have two years to find other means of attaining water and sewer services.

BIG SKY COUNTY WATER AND SEWER DISTRICT NO. 363

NOTES TO FINANCIAL STATEMENTS (Continued)

JUNE 30, 2004 and 2003

9. COMMITMENTS AND CONTINGENCIES (Continued)

Yellowstone Mountain Club Agreement

On March 28, 2001, the District signed an agreement with the Yellowstone Mountain Club and other related entities owned by Tim Blixeth (Developer) for the sale of water, treatment of wastewater, and right to use land for the storage and disposal of treated wastewater. The District shall have the right to dispose of up to 160,000,000 gallons of treated wastewater per year on land owned by the Developer in exchange for a capital asset commitment of approximately \$18 million. The Developer will construct storage ponds and a golf course irrigation system totaling approximately \$6.6 million.

Obligation to Provide Future Sewer and Water Services

The District is obligated to provide water, sewage collection and treatment services to existing property owners presently connected to the system. Additionally, the District has incurred obligations to provide future wastewater collection and treatment services to certain of the original subdivisions as well as other commitments entered into either by agreement or legally mandated.

Remaining Balance on Contracts

As of June 30, 2004, the District is obligated to pay the following balances on contracts not yet completed:

Bodell Construction Co.	\$ 715,638
Allied Engineering Services, Inc.	11,512
HKM Engineering	<u>179,179</u>
Total	<u>\$ 906,329</u>

10. RELATED PARTY TRANSACTIONS

Packy Cronin and Skip Radick, Board members, are involved in the South Fork Development and The Pines/Deer Run Development, respectively. Gary McRae is employed by Spanish Peaks Development, LLC.

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

To the Board of Directors

Big Sky County Water & Sewer District No. 363

We have audited the financial statements of Big Sky County Water & Sewer District No. 363 as of and for the year ended June 30, 2004, and have issued our report thereon dated September 30, 2004. We conducted our audit in accordance with U.S. generally accepted auditing standards, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

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

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the District's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses.

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

This report is intended solely for the information and use of the Board of Directors of Big Sky County Water & Sewer District No. 363, management, the State of Montana, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Knaub & Company, P.C.

September 30, 2004

**AUDITORS' REPORT ON COMPLIANCE WITH REQUIREMENTS
APPLICABLE TO EACH MAJOR PROGRAM AND INTERNAL
CONTROL OVER COMPLIANCE IN ACCORDANCE WITH
OMB CIRCULAR A-133**

To the Board of Directors
Big Sky County Water & Sewer District No. 363

Compliance

We have audited the compliance of Big Sky Water & Sewer District No. 363 (the District), with the types of compliance requirements described in the *U. S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2004. The District's major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of the District's management. Our responsibility is to express an opinion on the District's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the District's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the District's compliance with those requirements.

In our opinion, Big Sky County Water & Sewer District No. 363 complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2004.

Internal Control Over Compliance

The management of the District is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered the District's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants that would be material in relation to a major federal program being audited may occur and not be detected with a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the audit committee, management, others within the organization, City Council, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Knaub & Company, P.C.

September 30, 2004

FOR THE YEAR ENDED JUNE 30, 2004

BIG SKY COUNTY WATER & SEWER DISTRICT NO. 363

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

FOR THE YEAR ENDED JUNE 30, 2004

Section I - Summary of Auditors' Results

Financial Statements

Type of auditors' report issued	unqualified
Internal control over financial reporting:	
Material weakness identified?	no
Reportable conditions identified not considered to be material weaknesses?	none reported
Noncompliance material to financial statements noted?	no

Federal Awards

Internal control over major programs:	
Material weakness identified?	no
Reportable condition identified not considered to be material weaknesses?	none reported
Type of auditors' report issued on compliance for major programs:	unqualified
Any audit findings disclosed that are required to be reported in accordance with Circular A-133, Section .510(a)?	no

Identification of major programs

66.458 Water Treatment Plant	\$ 7,073,984
66.458 Water Tank	\$ 1,827,402
Dollar threshold used to distinguish between Type A and Type B programs	\$ 300,000
Auditee qualified as low-risk auditee?	no

<u>Financial Statement Findings:</u>	none
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<u>Federal Award Findings and Questioned Costs:</u>	none
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