NORTH CAROLINA ADVANCED ENERGY CORPORATION

Financial Statements

December 31, 1997 and 1996

(With Independent Auditors' Report)

OFFICIAL COPY

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Independent Auditors' Report

The Board of Directors
North Carolina Advanced Energy Corporation:

We have audited the accompanying statements of financial position of North Carolina Advanced Energy Corporation (the "Corporation") as of December 31, 1997 and 1996 and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Corporation as of December 31, 1997 and 1996, and the changes in net assets and cash flows for the years then ended in conformity with generally accepted accounting principles.

Batchelor, Tillery & Roberts, LLP

February 10, 1998

NORTH CAROLINA ADVANCED ENERGY CORPORATION

Statements of Financial Position

December 31, 1997 and 1996

	1997	1996
Assets		
Current assets:		
Cash and cash equivalents	$ 2,360,224	1,538,721
Receivables:		
Accounts receivable	520,852	527,398
Other	6,361	16,859
	527,213	544,257
Prepaid expenses and other assets	21,483	6,929
Total current assets	2,908,920	2,089,907
Equipment, furniture and fixtures	1,361,934	1,232,138
Less accumulated depreciation and amortization	(660,027)	(519,313)
	701,907	712,825
	$ 3,610,827	2,802,732
Liabilities and Net Assets		
Current liabilities:		
Accounts payable and accrued expenses	300,968	155,218
Deferred revenue	118,365	34,735
Total current liabilities	419,333	189,953
Commitments		
Net assets - Unrestricted	3,191,494	2,612,779
	$ 3,610,827	2,802,732

See accompanying notes to financial statements.

NORTH CAROLINA ADVANCED ENERGY CORPORATION

Statements of Activities

Years ended December 31, 1997 and 1996

	1997	1996
Revenues:		
Utility funding	$ 3,535,713	3,572,983
Interest	106,287	121,817
Other revenue	904,436	406,590
Total revenues	4,546,436	4,101,390
Expenses:		
Products and services	3,133,307	2,937,423
Corporate support services	834,414	1,353,266
Total expenses	3,967,721	4,290,689
Increase (decrease) in net assets	578,715	(189,299)
Net assets, beginning of year	2,612,779	2,802,078
Net assets, end of year	$ 3,191,494	2,612,779

See accompanying notes to financial statements.

NORTH CAROLINA ADVANCED ENERGY CORPORATION

Statements of Cash Flows

Years ended December 31, 1997 and 1996

	1997	1996
Operating activities:		
Increase (decrease) in net assets	$ 578,715	(189,299)
Adjustments to reconcile increase (decrease) in net assets *to net cash provided by (used in) operating activities:*		
Depreciation and amortization	249,066	152,056
Loss on sales of equipment	21,891	3,063
Changes in operating assets and liabilities:		
Receivables	17,044	(165,392)
Prepaid expenses and other assets	(14,554)	4,969
Accounts payable and accrued expenses	145,750	(102,957)
Unearned revenue	83,630	(193,422)
Net cash provided by (used in) operating activities	1,081,542	(490,982)
Investing activities:		
Purchases of equipment, furniture and fixtures	(260,561)	(386,020)
Proceeds from sales of equipment, furniture and fixtures	522	1,940
Net cash used in investing activities	(260,039)	(384,080)
Net increase (decrease) in cash and cash equivalents	821,503	(875,062)
Cash and cash equivalents, beginning of year	1,538,721	2,413,783
Cash and cash equivalents, end of year	$ 2,360,224	1,538,721

See accompanying notes to financial statements.

NORTH CAROLINA ADVANCED ENERGY CORPORATION

Notes to Financial Statements

December 31, 1997 and 1996

(1) Organization and Summary of Significant Accounting Policies

(a) Organization

North Carolina Alternative Energy Corporation (the "Corporation") was formed on April 18, 1980, as a nonprofit entity. During 1997, the Corporation changed its legal name to North Carolina Advanced Energy Corporation. Corporate goals are directed towards helping residential, commercial, and industrial customers improve the "return" on their energy investment. The Corporation has in the past and is now pursuing various broad-based programs that should help achieve these goals. With expertise in applied building science, industrial process technologies, and electric motors and drives, the Corporation provides extensive testing, training, and consulting to utilities and energy consumers.

Other related programs that have been undertaken by the Corporation include helping to shift demands for electricity to off-peak periods, educate consumers about energy, research alternatives to current electric generation technologies, develop more economic sources of electric power, increase system efficiency and load factors through conservation and load management, and demonstrate and promote efficient uses of electric power. The Corporation has received a ruling from the Internal Revenue Service that it is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code.

Approximately 80% of the Corporation's funding is derived from the ratepayers of four North Carolina investor-owned utilities and the state's twenty-eight electric cooperatives. Should the electric utilities and the Utilities Commission decide that collecting these funds was no longer either in the utilities' interest or in the interest of their customers, then this action could have a material adverse effect on the Corporation's operating results.

(b) Use of Estimates

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

(c) Cash Equivalents

The Corporation considers all highly liquid investments with a maturity of three months or less to be cash equivalents.

(1) Organization and Summary of Significant Accounting Policies, Continued

(d) Revenue Sources and Recognition

The funding from investor-owned utilities regulated by the North Carolina Utilities Commission ("Commission") is derived from a special charge authorized by the Commission that may be assessed to retail customers in North Carolina on the basis of kilowatt hour usage. Other in-state member organizations are charged for services rendered based on a charge to their customers of no less than 60% of the amount authorized by the Commission for regulated utilities.

(e) Deferred Revenues

The Corporation records deferred revenues for payments received from South Carolina and Virginia utility customers for Advanced Energy services that have not been requested by those customers as of year end.

(f) Equipment, Furniture and Fixtures

Equipment, furniture and fixtures are recorded at cost. Depreciation and amortization are computed on a straight-line basis over the estimated useful lives of the assets ranging from 5 to 10 years. Depreciation and amortization expense for the years ended December 31, 1997 and 1996 was $249,066 and $152,056, respectively.

(g) Product/Service Teams

Product/Service teams develop products and services and deliver them to customers. These teams work in the following areas: motors, industrial process technologies, HVAC, ground-source heat pumps, residential new construction (site-built), manufactured housing, and building diagnostics (residential and commercial). The Board of Directors approves the corporation's annual Business Plan, which includes the plans of each of the Product/Service Teams.

(h) Accounts Receivable

Accounts receivable consists of unconditional promises to give due in less than one year and receivables related to services provided to clients. Management uses the direct write-off method of accounting for uncollectible accounts. In the opinion of management, all accounts considered to be uncollectible as of December 31, 1997 and 1996 had been written off. Bad debt expense using the direct write-off method would not differ materially from bad debt expense calculated using the reserve method.

(1) Organization and Summary of Significant Accounting Policies, Continued

(i) Corporate Support Services

Corporate Support consists of corporate planning, business development, and corporate services which is made up of accounting, contracts, personnel, office functions, and information services. They provide corporate-level management and specialized support for the Corporation.

(j) Reclassifications

Certain amounts in 1996 have been reclassified to conform with 1997 classifications.

(2) Lease Commitments

The Corporation is obligated under an operating lease for the rental of office space which expires in September, 2006. Rent expense was $337,010 and 322,114 for the years ended December 31, 1997 and 1996, respectively.

Future minimum lease payments under the above operating lease is as follows:

Year ending December 31:	
1998	$ 342,189
1999	342,189
2000	342,189
2001	342,189
2002	342,189
Thereafter	1,254,692
	$ 2,965,637

(3) Retirement Plan

Effective January 1, 1982, the Corporation established a defined contribution retirement plan under Section 403(b) of the Internal Revenue Code. The plan benefits all employees meeting certain eligibility requirements. Employees are allowed to make contributions to the plan in addition to the Corporation's contribution which is based on an employee's level of annual compensation. Employees become 100% vested in the Corporation's contribution concurrent with meeting the eligibility requirements. Retirement expense for the years ended December 1997 and 1996 was $165,854 and $183,482, respectively.

(4) Credit Risk

Financial instruments which potentially subject the Corporation to concentration of credit risk consist primarily of cash and cash equivalents and receivables.

(4) Credit Risk, Continued

As of December 31, 1997, cash and cash equivalents consist of $1,600,000 in commercial paper and $738,864 in a repurchase agreement with a bank. As of December 31, 1996, cash and cash equivalents consist of $1,579,720 in commercial paper and $253,213 in a repurchase agreement with a bank.

Five North Carolina investor-owned utilities comprise 70% and 83% of the Corporation's receivables as of December 31, 1997 and 1996, respectively.

(5) Functional Expenses

Functional expenses consist of the following:

	Year ended December 31, 1997		
	Products/ Services	Corporate support services	Total
Salaries	$ 1,455,156	370,454	1,825,610
Fringe benefits	327,025	83,255	410,280
Travel	149,401	20,430	169,831
Materials and supplies	125,326	3,573	128,899
Equipment	108,784	80,188	188,972
Professional services	268,104	106,722	374,826
Other indirect expenses	255,002	81,521	336,523
Facilities	444,509	88,271	532,780
	$ 3,133,307	834,414	3,967,721

	Year ended December 31, 1996		
	Products/ Services	Corporate support services	Total
Salaries	$ 1,194,095	437,510	1,631,605
Fringe benefits	514,025	188,336	702,361
Travel	130,792	27,476	158,268
Materials and supplies	136,719	5,084	141,803
Equipment	116,463	30,557	147,020
Professional services	401,352	197,435	598,787
Other indirect expenses	148,551	326,161	474,712
Facilities	295,426	140,707	436,133
	$ 2,937,423	1,353,266	4,290,689