

WATERWOOD IMPROVEMENT ASSOCIATION, INC.

FINANCIAL STATEMENTS AND SUPPLEMENTARY INFORMATION

FOR THE YEAR ENDED DECEMBER 31, 2011

Kenneth C. Davis & Company, P.C.

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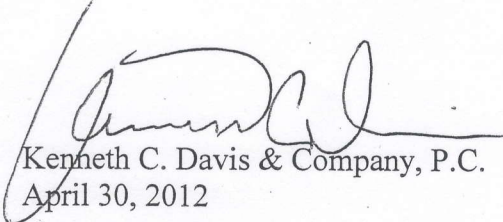
INDEPENDENT AUDITOR'S REPORT

Board of Directors of
Waterwood Improvement Association, Inc.

We have audited the accompanying balance sheet of Waterwood Improvement Association, Inc. as of December 31, 2011, and the related statement of revenues and expenses, and changes in members' equity and cash flows for the year then ended. These financial statements are the responsibility of the management of Waterwood Improvement Association, Inc. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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 Waterwood Improvement Association, Inc. as of December 31, 2011, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.



Kenneth C. Davis & Company, P.C.

April 30, 2012

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
BALANCE SHEET
December 31, 2011

ASSETS

Cash and cash equivalents, including interest-bearing deposits	\$	91,850
Annual charges receivable and accrued interest on delinquent receivables, less allowance for bad debts		447,020
Accrued interest receivable		123,565
Accounts receivable - other		5,000
Investments		7,781,526
Property and equipment, less accumulated depreciation		169,697
Other assets		273,130
TOTAL ASSETS	\$	<u>8,891,788</u>

LIABILITIES AND MEMBERS' EQUITY

Accounts payable	\$	10,762
Payroll taxes payable		482
Total Liabilities		<u>11,244</u>
Members' Equity		
Designated for current and future obligations		8,457,984
Accumulated other comprehensive income		422,560
Total Members' Equity		<u>8,880,544</u>
TOTAL LIABILITIES AND MEMBERS' EQUITY	\$	<u>8,891,788</u>

The accompanying notes are an integral part of these financial statements.

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
 STATEMENT OF REVENUES AND EXPENSES
 For the Year Ended December 31, 2011

REVENUES

Annual charges	\$ 557,055
Interest on delinquent annual charges	74,183
Recoveries	16,750
Investment income	351,813
Property transfer fees	1,900
Unrealized gain/(loss) on securities	314,743
Gain on sale of assets	4,724
Other income	195
Total Revenue	<u>1,321,363</u>

EXPENSES

Vehicle expense	20,019
Bad debts	194,921
Repairs and maintenance - buildings	855
Community events	3,499
EMS contract	93,450
Insurance	34,551
Grounds maintenance contract	105,181
Miscellaneous	1,574
Office expense	12,874
Salaries and payroll tax	232,095
Professional fees	29,026
Equipment rental	2,125
Road repair and maintenance	219,988
Taxes	7,776
Utilities and services	60,684
Depreciation	28,970
Bond amortization	53,670
Other expenses	1,530
Total Expenses	<u>1,102,788</u>

Excess Revenues Over Expenses	<u><u>\$ 218,575</u></u>
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The accompanying notes are an integral part of these financial statements.

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
STATEMENT OF CHANGES IN MEMBERS' EQUITY
For the Year Ended December 31, 2011

MEMBERS' EQUITY, BEGINNING OF YEAR	\$ 8,661,969
Excess Revenues Over Expenses	<u>218,575</u>
MEMBERS' EQUITY, END OF YEAR	<u><u>\$ 8,880,544</u></u>

The accompanying notes are an integral part of these financial statements.

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2011

CASH FLOWS FROM/(USED BY) OPERATING
ACTIVITIES:

Net Revenues Over Expenses	\$	218,575
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:		
Depreciation		28,970
Bad debt		194,921
(Increase)/decrease in:		
Member annual charges receivable		(317,442)
Interest receivable		2,054
Other receivables		(5,000)
Increase/ (decrease) in:		
Accounts payable		(8,112)
Payroll taxes		7
NET CASH FROM/(USED BY) OPERATING ACTIVITIES		113,973

CASH FLOW PROVIDED/(USED) BY INVESTING
ACTIVITIES:

Investments - purchases		(315,513)
Investments - sales/matured/called		456,116
Unrealized gain on securities		(314,743)
Bond amortization		53,670
NET CASH (USED)/PROVIDED BY INVESTING ACTIVITIES		(120,470)

CASH FLOW PROVIDED/(USED) BY FINANCING
ACTIVITIES:

Purchase of vehicle		(26,000)
NET CASH (USED)/PROVIDED BY FINANCING ACTIVITIES		(26,000)

NET INCREASE IN CASH AND CASH EQUIVALENTS (32,497)

CASH AND CASH EQUIVALENTS AT BEGINNING
OF YEAR 124,347

CASH AND CASH EQUIVALENTS AT END OF YEAR \$ 91,850

The accompanying notes are an integral part of these financial statements.

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE A – NATURE OF ORGANIZATION

Waterwood Improvement Association, Inc. (WIA) is a non-profit corporation organized for the purpose of promoting and developing the common good and social welfare of the homeowners of the Waterwood subdivision, including providing for the construction of utilities and the maintenance of roads, common areas, and other improvements. In addition, WIA provides security and EMS service for the Waterwood residents. The Waterwood development is located in San Jacinto County and is comprised of more than 1,000 acres of lots and developed home sites, in addition to the greenbelts, roads and other common areas. Currently, approximately 440 improved lots and 1,540 unimproved lots are serviced by WIA.

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The Association's governing documents provide certain guidelines for governing its financial activities. In accordance with generally accepted accounting principles, the financial statements have been prepared on the accrual basis. Revenues are recognized when they are earned and expenses are recognized when they are incurred.

Annual Charges

WIA is funded primarily through funds received from annual charges and investment portfolio income. In accordance with the provisions of the land deed covenants, annual charges are levied on all lot owners, with the exception of lots owned by governmental entities and those possessing developer rights. The annual charges are recognized on the active accounts as income at the time they are levied. The annual charges are levied each December 31, and if not paid by the following March 31, become delinquent and bear interest at the rate of ten percent per annum. Interest was assessed three times during 2011, in April, September and December, on delinquent accounts. WIA routinely files liens on lots with houses on which unpaid annual charges exist. Beginning in 2008, receivable accounts determined to be uncollectible were not expensed as bad debts after three years, as in prior years, but instead, all amounts due to WIA are maintained as accounts receivable and the amounts determined to be uncollectible are set up in an allowance for bad debts. Any changes to the allowance for bad debts account will be made by increasing or decreasing bad debt expense or recoveries for the amount of the change.

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

Property and Equipment

Real property and common areas acquired from the developer and related improvements to such property are not recorded in the Association's financial statements because those properties are directly associated with the unit (that is, common property without which the units could not be occupied and exterior property that is normally part of a freestanding unit). Common property owned by WIA and not capitalized includes designated park sites, roads, sidewalks, and greenbelts.

The Association capitalizes personal property at cost and depreciates it using the straight-line method over the estimated useful life.

Income Taxes

A qualifying homeowners' association may be taxed either as a homeowners' association or as a regular corporation. As a homeowners' association, annual charge income is exempt from taxation if certain elections are made, and the association is taxed only on its nonmembership income, such as bank or bond interest earnings, at regular federal corporate rates. In 2011, WIA qualified under Section 528 of the Internal Revenue Code as a homeowners association and has extended the filing of Form 1120-H.

Statement of Cash Flows

For purposes of reporting cash flows, all highly liquid investments with a maturity of three months or less are considered to be cash equivalents. This includes WIA's investment in the Morgan Stanley Money Market Fund which invests in instruments with a maturity of less than 90 days.

Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE C – MARKETABLE AND NONMARKETABLE SECURITIES

In 1994, WIA adopted SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, which requires classification of securities into one of three categories, depending on the entity's intent and ability to hold the security until maturity.

On February 1, 1994, WIA assisted the Waterwood Municipal Utility District (MUD) by refinancing \$2,590,000 in outstanding bonds with 4% interest. The final MUD bond matured on September 1, 2009. WIA plans to purchase some additional MUD bonds which are expected to be issued in 2012, which will be classified as "held to maturity" and carried at cost.

All of the bonds now held at December 31, 2011 are considered to be "available for sale" according to SFAS No. 115 and are recorded at fair market value.

Realized gains and losses are recorded in the statement of revenues and expenses in the period they are earned. Bond premium/discount is amortized by WIA using the effective-interest method required by SFAS No. 115 as calculated by the investment brokers, Morgan Stanley.

The aggregate cost and market values of the investment securities are summarized as follows:

Available-for-sale securities:

	Amortized <u>Cost</u>	<u>Market</u>	Cumulative Unrealized <u>Gains/(losses)</u>
State and municipal securities with AAA or AA ratings	\$ <u>7,358,966</u>	\$ <u>7,781,526</u>	\$ <u>422,560</u>

During the year ended December 31, 2011, two bonds were purchased, and five bonds were called. One bond was sold for a taxable gain in 2011 of \$4,224.

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE C - MARKETABLE AND NONMARKETABLE SECURITIES, continued

Net unrealized holding gains on available-for-sale securities in the amount of \$314,743 for the year ended December 31, 2011 have been included in accumulated other comprehensive income of \$422,560.

Maturities of available-for-sale debt securities at December 31, 2011 are as follows:

	<u>Estimated Fair Value</u>
Due in one year or less (before December 31, 2012)	\$ -
Due between January 1, 2013 and December 31, 2016 (1 to 5 years)	1,414,300
Due between January 1, 2017 and December 31, 2021 (5 to 10 years)	3,066,273
Due between January 1, 2022 and December 31, 2031 (10 to 20 years)	3,198,421
Due January 1, 2032 or after (20 years or more)	<u>102,532</u>
Total investment in available-for-sale securities	\$ <u>7,781,526</u>

Actual maturities may differ from contractual maturities because some borrowers have the right to call or prepay obligations with or without call or prepayment penalties. For purposes of this schedule, the actual maturity dates were used.

NOTE D - ASSESSMENTS AND ACCRUED INTEREST ON DELINQUENT RECEIVABLES

Balance, beginning of year	\$ 1,414,109
Plus: Assessments	557,055
Plus: Interest	74,183
Plus: Other	1,900
Less: Collections/Write offs	<u>(882,214)</u>
Balance, end of year	\$ <u>1,165,033</u>

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE D – ASSESSMENTS AND ACCRUED INTEREST ON DELINQUENT RECEIVABLES (continued)

WIA established an allowance for uncollectible accounts for delinquent assessments in 2008. The net accounts receivable for 2011 is shown below:

Accounts receivable	\$ 1,165,033
Less: Allowance for bad debts	<u>(718,013)</u>
Net accounts receivable	\$ <u>447,020</u>

This account is reviewed annually by WIA. Prior to 2008, all accounts receivable over three years old were written off and no allowance was used. The Bad Debt expense for 2011 was \$194,921.

As of December 31, 2010, National Recreational Properties Inc. (NRPI), a developer, owned 523 lots, but was in default with its lender, Capital Source Bank. During 2011, San Jacinto County took over the properties and sold them to Waterwood Partners, LLC in order to collect past due taxes. The fees previously owed by Capital Source Bank to WIA have been written off by WIA, but future fees are anticipated to be collected from the new owners.

NOTE E – COMMITMENT FOR LAND IMPROVEMENTS

Currently, all lots in the Waterwood subdivision have water and sewer connections, but approximately 200 lots in Park Forest do not have electricity service. According to the warranty deed, Section 2.12, after receipt of the tenth annual fee following the sale of the lot by the developer, and after payment of the capital improvement charge and approval of the Architectural Control Committee (by the issuance of a permit authorizing the construction of a lot improvement), and after furnishing evidence to the Board, WIA has an obligation to supply utility service to an individual lot owner within one year of proper notification to the Board.

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE F – CONTINGENT ACCOUNTS RECEIVABLE

On April 9, 2009, WIA filed a lawsuit against Waterwood National for the \$128,159 owed to WIA for security services and signs provided by WIA from 2001 to April 30, 2006, since no payments had been made by Waterwood National in satisfaction of this debt. A default judgment by the court was made in favor of Waterwood Improvement Association and will remain in effect for ten years (can be re-filed at that time) in the event the property is sold and the debt can be paid off. No receivable for this amount is currently recorded, due to the unlikelihood of collection in 2012.

NOTE G – PROPERTY, EQUIPMENT AND OTHER ASSETS

Property and equipment consists of the following categories:

	<u>Cost</u>
Autos	\$ 45,749
Office equipment	25,018
Other equipment	3,749
Common improvements	74,555
Buildings	<u>314,233</u>
	463,304
Less: Accumulated depreciation	<u>(293,607)</u>
Net cost	<u>\$ 169,697</u>

Other assets consist primarily of parkways, public areas (i.e. dump site), acreage, and one lot owned by WIA and are valued at \$273,130, of which \$250,000 represents a strip of land along the east side of Waterwood Parkway, approximately six miles long and 150 feet wide, which was purchased by WIA in order to maintain a no-cut zone in the entrance to the Waterwood subdivision.

NOTE H – FEDERAL INCOME TAX

WIA files Form 1120-H, a U.S. Income Tax Return for Homeowners Associations, annually. The investment policy of WIA encourages investing all bonds in tax-free rather than taxable securities, which is the primary reason for the minimal income tax liability.

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE I – DESIGNATED MEMBERS' EQUITY

Instead of specifically designating Members' Equity for particular purposes, WIA uses a five-year forecast of income and expenditures model in planning future requirements.

NOTE J – EMS SERVICES

WIA entered into a contract with Legacy Emergency Medical Services, effective January 1, 2012 (through December 31, 2013), for annual compensation of \$93,450 (\$7,788 monthly) to provide emergency medical service to all Waterwood residents.

NOTE K – RELATED PARTY TRANSACTIONS

Two members of the WIA Board of Directors were also members of the Board of Directors of the MUD until October 2011. No matters pertaining to the MUD were voted on in 2011, but the WIA/MUD board members abstained if a vote was taken. In addition, one member of the WIA Board of Directors is employed by WIA as a security employee. This Board member abstains from any vote regarding matters of security.

NOTE L – NEW HOMEOWNER ASSOCIATION REGULATIONS IN TEXAS

The State of Texas passed new regulations effective in 2011 and 2012 regarding Homeowners Associations. The WIA Board has passed appropriate resolutions to comply with these new regulations.

Required Supplementary Information

Required supplementary information includes financial information and disclosures required by the Governmental Accounting Standards Board but not considered a part of the basic financial statements.

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CERTIFIED PUBLIC ACCOUNTANTS

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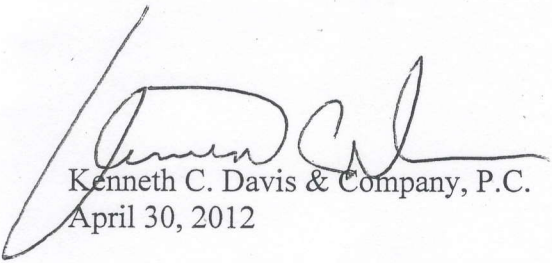
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INDEPENDENT AUDITORS'S REPORT ON
SUPPLEMENTARY INFORMATION

To the Board of Directors and Property Owners
Waterwood Improvement Association

The information included in the Schedule of Operating Fund Revenues and Expenses – Budget and Actual on pages 14-15 is presented only for supplementary analysis purposes. Such information (except for the budget information, which was compiled without audit from information that is the representation of management, on which we did not express an opinion or any other form of assurance) has been subjected to certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

The supplementary information on future major repairs and replacements on page 16 is not a required part of the basic financial statements of WIA but is supplementary information required by the American Institute of Certified Public Accountants. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.



Kenneth C. Davis & Company, P.C.
April 30, 2012

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
SCHEDULE OF OPERATING FUND REVENUES AND EXPENSES
BUDGET AND ACTUAL
For the Year Ended December 31, 2011

	2011		Variance Favorable (Unfavorable)
	<u>Budget</u>	<u>Actual</u>	
REVENUES			
Annual charges	\$ 557,180	\$ 557,055	\$ (125)
Interest on delinquent annual charges	45,000	74,183	29,183
Recoveries	25,000	16,750	(8,250)
Investment income	355,000	351,813	(3,187)
Property transfer fees	2,000	1,900	(100)
Unrealized gain/(loss) on securities	-	314,743	314,743
Gain on sale of assets	500	4,724	4,224
WNN ads	600	-	(600)
Other income	295	195	(100)
Total Revenue	<u>985,575</u>	<u>1,321,363</u>	<u>335,788</u>
EXPENSES			
Vehicle fuel	15,000	16,330	(1,330)
Vehicle repairs and maintenance	3,000	3,689	(689)
Bad debt expense	155,330	194,922	(39,592)
Fire station repairs and maintenance	500	241	259
Office building repairs & maintenance	1,500	614	886
Business licenses and permits	1,300	969	331
Decorations	250	26	224
Socials	4,000	3,473	527
EMS contract	93,450	93,450	-
Vehicle liability insurance	2,607	2,607	-
Employee medical insurance	9,500	8,116	1,384
Security liability insurance	3,010	3,010	-
D & O liability insurance	4,900	4,537	363
Building and property insurance	6,500	6,638	(138)
Workers compensation insurance	3,860	2,708	1,152
WVFD insurance	7,500	6,934	566
Grounds maintenance contract	117,000	105,181	11,819
Miscellaneous	12,000	1,574	10,426
Computer equipment and software	500	761	(261)
Dues and subscriptions	504	517	(13)
Janitorial	2,500	2,330	170
Postage and shipping	5,000	3,714	1,286

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
SCHEDULE OF OPERATING FUND REVENUES AND EXPENSES
BUDGET AND ACTUAL - continued
For the Year Ended December 31, 2011

	2011		Variance Favorable (Unfavorable)
	<u>Budget</u>	<u>Actual</u>	
Printing	3,500	2,318	1,182
Supplies	4,000	3,234	766
Salaries	214,000	214,720	(720)
Auditing/Accounting	10,750	10,750	-
Legal	10,000	18,276	(8,276)
Equipment rental	2,125	2,125	-
Road repairs and maintenance	200,000	219,988	(19,988)
Payroll taxes	17,650	17,374	276
Real estate taxes	6,500	7,776	(1,276)
Travel and meals	800	561	239
Alarm monitoring	400	364	36
Electricity	33,000	31,922	1,078
Garbage pickup	20,000	20,085	(85)
Telephone and communications	7,500	7,863	(363)
Water	600	451	149
Total Budgeted Expenses	<u>980,536</u>	<u>1,020,148</u>	<u>(39,612)</u>
EXCESS OF REVENUES/(EXPENSES) OVER MAJOR BUDGETED EXPENSES/REVENUES	<u>5,039</u>	<u>301,215</u>	<u>296,176</u>
OTHER BUDGETED EXPENSES			
Depreciation expense	32,000	28,970	3,030
Bond premium/discount amortization	48,000	53,670	(5,670)
Total Other-Budgeted Expenses	<u>80,000</u>	<u>82,640</u>	<u>(2,640)</u>
EXCESS OF REVENUES/(EXPENSES) OVER EXPENSES/REVENUES	<u>\$ (74,961)</u>	<u>\$ 218,575</u>	<u>\$ 293,536</u>

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
SUPPLEMENTARY INFORMATION ON FUTURE MAJOR REPAIRS AND
REPLACEMENTS (COMPILED)

At some time in the future, major repairs on the road surfaces may be required. The extent of any major repairs or resurfacing will have to be assessed on a case-by-case basis. San Jacinto County is responsible for all subdivision road maintenance as evidenced by an easement granted to the County in 1979. If WIA determines that an additional project is necessary, and additional funds, beyond current operating funds, are required to meet future needs, the Association can borrow money or delay the work until funds are available. The last complete resurfacing of all roads in 1992 cost WIA approximately \$1,500,000.