

WATERWOOD IMPROVEMENT ASSOCIATION, INC.

FINANCIAL STATEMENTS AND SUPPLEMENTARY INFORMATION

FOR THE YEAR ENDED DECEMBER 31, 2012

Davis, Heinemann & Company, P.C.

Certified Public Accountants

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INDEPENDENT AUDITOR'S REPORT

Board of Directors

Waterwood Improvement Association, Inc.

62 Waterwood

Huntsville, Texas 77320

Dear Board Members:

We have audited the accompanying financial statements of the Waterwood Improvement Association, Inc. (a non-profit organization), which are comprised of the balance sheet as of December 31, 2012, the related statements of revenues and expenses, changes in member's equity and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted the 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 misstatements.

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

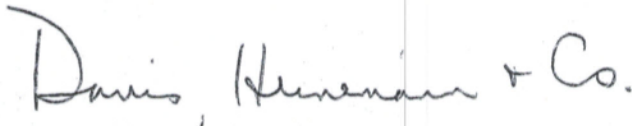
significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Waterwood Improvement Association, Inc. as of December 31, 2012, and the changes in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Sincerely,

A handwritten signature in cursive script that reads "Davis, Heinemann & Co." The signature is written in dark ink and is positioned above the printed name of the firm.

Davis, Heinemann & Company, P.C.
Certified Public Accountants
June 20, 2013

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
BALANCE SHEET
December 31, 2012

ASSETS

Cash and cash equivalents, including interest-bearing deposits	\$	92,879
Annual charges receivable and accrued interest on delinquent receivables, less allowance for bad debts		362,250
Accrued interest receivable		119,331
Accounts receivable - other		-
Investments		7,735,899
Property and equipment, less accumulated depreciation		144,040
Other assets		273,130
TOTAL ASSETS	\$	<u>8,727,529</u>

LIABILITIES AND MEMBERS' EQUITY

Accounts payable	\$	2,782
Accrued expenses		7,451
Deposits - capital improvement		2,000
Payroll taxes payable		459
Total Liabilities		<u>12,692</u>
 Members' Equity		
Designated for current and future obligations		8,266,674
Accumulated other comprehensive income		448,163
Total Members' Equity		<u>8,714,837</u>
 TOTAL LIABILITIES AND MEMBERS' EQUITY	\$	<u>8,727,529</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, 2012

REVENUES

Annual charges	\$ 701,694
Interest on delinquent annual charges	63,813
Recoveries	24,763
Investment income	339,390
Capital improvement charges	2,000
Property transfer fees	1,850
Change in unrealized gain/(loss)	25,603
Other income	3,604
Total Revenue	<u>1,162,717</u>

EXPENSES

Vehicle expense	26,599
Bad debts	549,079
Repairs and maintenance - buildings	4,051
Community events	7,642
EMS contract	93,450
Insurance	29,188
Grounds maintenance contract	114,743
Miscellaneous	3,217
Office expense	16,497
Salaries and payroll tax	245,031
Professional fees	16,381
Road repair and maintenance	44,520
Real estate taxes	7,451
Utilities and services	71,162
Depreciation	25,657
Bond amortization	53,110
Waterwood Volunteer Fire Department	12,796
Lease payments	6,000
Other expenses	1,850
Total Expenses	<u>1,328,424</u>

Excess Expenses Over Revenues	<u>\$ (165,707)</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, 2012

MEMBERS' EQUITY, BEGINNING OF YEAR	\$ 8,880,544
Excess Expenses Over Revenues	<u>(165,707)</u>
MEMBERS' EQUITY, END OF YEAR	<u><u>\$ 8,714,837</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, 2012

CASH FLOWS FROM/(USED BY) OPERATING
ACTIVITIES:

Net Expenses Over Revenues	\$ (165,707)
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:	
Unrealized gain	(25,603)
Depreciation	25,657
Amortization	53,110
Bad debt	438,135
(Increase)/decrease in:	
Member annual charges receivable	(353,365)
Interest receivable	4,234
Other receivables	5,000
Increase/ (decrease) in:	
Accounts payable	(7,980)
Accrued expenses	7,428
Deposits	2,000
NET CASH FROM/(USED BY) OPERATING ACTIVITIES	(17,091)

CASH FLOW PROVIDED/(USED) BY INVESTING
ACTIVITIES:

Investments - purchases	(451,880)
Investments - sales/matured/called	470,000
NET CASH (USED)/PROVIDED BY INVESTING ACTIVITIES	18,120

CASH FLOW PROVIDED/(USED) BY FINANCING
ACTIVITIES:

Purchase of vehicle	-
NET CASH (USED)/PROVIDED BY FINANCING ACTIVITIES	-

NET INCREASE IN CASH AND CASH EQUIVALENTS 1,029

CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	91,850
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 92,879

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 410 improved lots and 1,560 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 2012, in April, September and December, on delinquent accounts. WIA routinely files liens on lots with houses on which unpaid annual charges exist. 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 over \$1,500 at cost and depreciates it using the straight-line method over the estimated useful life. Lesser amounts are expensed.

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 taxable bond interest earnings, at regular federal corporate rates. In 2012, WIA qualified under Section 528 of the Internal Revenue Code as a homeowners' association and will file 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.

All of the bonds now held at December 31, 2012, 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:

	<u>Amortized Cost</u>	<u>Market</u>	<u>Cumulative Unrealized Gains/(losses)</u>
State and municipal securities with AAA or AA ratings	\$ <u>7,287,736</u>	\$ <u>7,735,899</u>	\$ <u>448,163</u>

During the year ended December 31, 2012, three bonds were purchased, and four bonds were called. No bonds were sold for realized gains/losses in 2012.

Net unrealized holding gains on available-for-sale securities in the amount of \$25,603 for the year ended December 31, 2012, have been included in accumulated other comprehensive income of \$448,163.

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE C - MARKETABLE AND NONMARKETABLE SECURITIES, continued

Maturities of available-for-sale debt securities at December 31, 2012, are as follows:

	<u>Estimated Fair Value</u>
Due in one year or less (before December 31, 2013)	\$ 585,660
Due between January 1, 2014 and December 31, 2017 (1 to 5 years)	1,772,892
Due between January 1, 2018 and December 31, 2022 (5 to 10 years)	1,663,965
Due between January 1, 2023 and December 31, 2032 (10 to 20 years)	3,488,925
Due January 1, 2033 or after (20 years or more)	<u>224,457</u>
Total investment in available-for-sale securities	\$ <u>7,735,899</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	\$ 1,165,033
Plus: Assessments	701,694
Plus: Interest	63,813
Less: Adjustments	(2,336)
Less: Collections/Write offs	<u>(409,806)</u>
Balance, end of year	\$ <u>1,518,398</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 2012 is shown below:

Accounts receivable	\$ 1,518,398
Less: Allowance for bad debts	<u>(1,156,148)</u>
Net accounts receivable	\$ <u>362,250</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 2012 was \$549,079.

As of December 31, 2012, Waterwood Partners owns 519 unimproved lots, of the 1,581 total undeveloped lots in Waterwood. Waterwood Partners made a \$16,000 payment for fees in January 2013, but have not made additional payments of fees owed. Any unpaid fees and interest thereon owed by Waterwood Partners and not paid during the current year are included in the allowance for uncollectible accounts. Negotiations are ongoing to create a plan to further develop Waterwood, which could increase landowner interest and create additional annual charge income for WIA if these lots are sold.

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 electric 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>(319,264)</u>
Net cost	<u>\$ 144,040</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 Allegiance Ambulance, 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

One member of the WIA Board of Directors is employed by WIA as a part-time security employee. This Board member abstains from any vote regarding matters of security.

NOTE L – EVALUATION OF SUBSEQUENT EVENTS

The Organization has evaluated subsequent events through June 20, 2013, the date which the financial statements were available to be issued.

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.

DAVIS, HEINEMANN & COMPANY, P.C.

CERTIFIED PUBLIC ACCOUNTANTS

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INDEPENDENT AUDITOR'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 15-16 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 17 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.

Davis, Heinemann & Co.

Davis, Heinemann & Company, P.C.

June 20, 2013

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
SCHEDULE OF OPERATING FUND REVENUES AND EXPENSES
BUDGET AND ACTUAL
For the Year Ended December 31, 2012

	2012		Variance Favorable (Unfavorable)
	Original <u>Budget</u>	<u>Actual</u>	
REVENUES			
Annual charges	\$ 590,000	\$ 701,694	\$ 111,694
Interest on delinquent annual charges	50,000	63,813	13,813
Recoveries	20,000	24,763	4,763
Investment income	350,000	339,390	(10,610)
Capital improvement charges	2,000	2,000	-
Property transfer fees	2,000	1,850	(150)
Fireworks donations	4,500	1,904	(2,596)
Gain on sale of assets	105,000	-	(105,000)
WNN ads	600	600	-
Other income	-	1,100	1,100
Total Revenue	<u>1,124,100</u>	<u>1,137,114</u>	<u>13,014</u>
EXPENSES			
Vehicle fuel	16,000	21,155	(5,155)
Vehicle repairs and maintenance	3,500	5,444	(1,944)
Bad debt expense	168,000	549,079	(381,079)
Fire station repairs and maintenance	500	642	(142)
Office building repairs & maintenance	2,500	3,409	(909)
Business licenses and permits	1,200	1,167	33
Fireworks	7,500	4,000	3,500
Decorations	2,000	145	1,855
Socials	3,500	3,497	3
EMS contract	93,450	93,450	-
Vehicle liability insurance	2,700	2,527	173
Employee medical insurance	7,500	3,797	3,703
Security liability insurance	3,100	3,020	80
Directors & officers liability insurance	4,700	4,537	163
Property and general liability insurance	6,800	6,849	(49)
Workers compensation insurance	2,800	1,746	1,054
WVFD insurance	7,200	6,712	488
Grounds maintenance contract	117,000	114,743	2,257
Miscellaneous	2,000	3,217	(1,217)
Dues and subscriptions	600	378	222
Computer equipment and software	1,000	1,425	(425)
Janitorial	2,500	2,695	(195)
Office machines	-	700	(700)

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
SCHEDULE OF OPERATING FUND REVENUES AND EXPENSES
BUDGET AND ACTUAL - continued
For the Year Ended December 31, 2012

	2012		Variance
	Original Budget	Actual	Favorable (Unfavorable)
Postage and shipping	4,000	3,603	397
Printing	3,000	2,690	310
Supplies	4,000	5,006	(1,006)
Salaries	220,000	226,838	(6,838)
Auditing/Accounting	10,750	10,750	-
Legal	20,000	5,631	14,369
Equipment rental	2,200	-	2,200
Road repairs and maintenance	50,000	44,520	5,480
Payroll taxes	18,000	18,193	(193)
Real estate taxes	8,000	7,451	549
Federal Income Tax	31,500	-	31,500
Travel and meals	600	683	(83)
Alarm monitoring	400	364	36
Electricity	33,000	32,003	997
Garbage pickup	21,000	30,181	(9,181)
Telephone and communications	8,000	8,235	(235)
Water	500	379	121
Waterwood Volunteer Fire Department	13,000	12,796	204
Lease payments	-	6,000	(6,000)
Contingency	10,000	-	10,000
Total Budgeted Expenses	<u>914,000</u>	<u>1,249,657</u>	<u>(335,657)</u>
EXCESS OF REVENUES/(EXPENSES) OVER MAJOR BUDGETED EXPENSES/REVENUES	<u>210,100</u>	<u>(112,543)</u>	<u>(322,643)</u>
OTHER BUDGETED EXPENSES			
Unrealized gain/(loss)	-	25,603	25,603
Depreciation expense	(26,000)	(25,657)	343
Bond premium/discount amortization	(54,000)	(53,110)	890
Total Other-Budgeted Expenses	<u>(80,000)</u>	<u>(53,164)</u>	<u>26,836</u>
EXCESS OF REVENUES/(EXPENSES) OVER EXPENSES/REVENUES	<u>\$ 130,100</u>	<u>\$ (165,707)</u>	<u>\$ (295,807)</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.