

WATERWOOD IMPROVEMENT ASSOCIATION, INC.

FINANCIAL STATEMENTS AND SUPPLEMENTARY INFORMATION

FOR THE YEAR ENDED DECEMBER 31, 2013

Davis, Heinemann & Company, P.C.

Certified Public Accountants

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INDEPENDENT AUDITOR'S REPORT

Board of Directors

Waterwood Improvement Association, Inc.

Huntsville, Texas 77320

Dear Board Members:

We have audited the accompanying financial statements of the Waterwood Improvement Association, Inc. (a non-profit organization), which comprise the balance sheet as of December 31, 2013, and the related statements of revenues and expenses, changes in members' 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, 2013, 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,

Davis, Heinemann & Co.

Davis, Heinemann & Company, P.C.
Certified Public Accountants
June 20, 2014

Financial Statements

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
BALANCE SHEET
December 31, 2013

ASSETS

Cash and cash equivalents, including interest-bearing deposits	\$ 83,053
Annual charges receivable and accrued interest on delinquent receivables, less allowance for bad debts	392,308
Accrued interest receivable	111,030
Investments	7,389,731
Property and equipment, less accumulated depreciation	137,289
Other assets	273,130
TOTAL ASSETS	<u>\$ 8,386,541</u>

LIABILITIES AND MEMBERS' EQUITY

Accounts payable	\$ 4,843
Capital improvement deposits	2,000
Accrued liabilities	7,331
Payroll taxes payable	427
Total Liabilities	<u>14,601</u>
 Members' Equity	
Designated for current and future obligations	8,303,782
Accumulated other comprehensive income	68,158
Total Members' Equity	<u>8,371,940</u>
 TOTAL LIABILITIES AND MEMBERS' EQUITY	 <u>\$ 8,386,541</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, 2013

REVENUES

Annual charges	\$ 752,470
Interest on delinquent annual charges	90,337
Recoveries	39,821
Investment income	336,294
Capital improvement charges	1,000
Property transfer fees	2,100
Unrealized gain/(loss) on securities	(380,005)
Gain on sale of assets	27,763
Other income	3,050
Total Revenue	872,830

EXPENSES

Vehicle expense	17,304
Bad debts	450,897
Repairs and maintenance - buildings	1,649
Licenses and fees	867
Community events	8,977
EMS contract	93,450
Insurance	31,670
Grounds maintenance contract	114,930
Miscellaneous	3,157
Office expense	18,827
Salaries and payroll tax	248,656
Professional fees	11,785
Equipment rental	2,467
Road repair and maintenance	33,690
Taxes	12,478
Travel and meals	497
Utilities and services	77,131
Depreciation	25,808
Bond amortization	51,023
Waterwood Volunteer Fire Department	4,464
Lease payments	6,000
Total Expenses	1,215,727

Excess Expenses Over Revenues	\$ (342,897)
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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, 2013

MEMBERS' EQUITY, BEGINNING OF YEAR	\$ 8,714,837
Excess Expenses Over Revenues	<u>(342,897)</u>
MEMBERS' EQUITY, END OF YEAR	<u>\$ 8,371,940</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, 2013

CASH FLOWS FROM/(USED BY) OPERATING
ACTIVITIES:

Net Expenses Over Revenues	\$ (342,897)
Adjustments to reconcile excess of expenses over revenues to net cash provided by operating activities:	
Unrealized (gain)/loss on securities	380,005
Realized gain on sale of vehicle	(3,054)
Depreciation	25,808
Bond amortization	51,023
 (Increase)/decrease in:	
Member annual charges receivable	(30,058)
Interest receivable	8,301
Increase/ (decrease) in:	
Accounts payable	2,061
Accrued liabilities	(120)
Payroll taxes	(32)
NET CASH FROM/(USED BY) OPERATING ACTIVITIES	<u>91,037</u>

CASH FLOW PROVIDED/(USED) BY INVESTING
ACTIVITIES:

Investments - purchases	(2,029,309)
Investments - sales (net of realized gain)	1,944,449
NET CASH (USED)/PROVIDED BY INVESTING ACTIVITIES	<u>(84,860)</u>

CASH FLOW PROVIDED/(USED) BY FINANCING
ACTIVITIES:

Purchase of vehicle	(27,003)
Trade in value of vehicle	11,000
NET CASH (USED)/PROVIDED BY FINANCING ACTIVITIES	<u>(16,003)</u>

NET DECREASE IN CASH AND CASH EQUIVALENTS	(9,826)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	92,879
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 83,053</u>

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. 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 2013, 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.

All of the bonds held at year end 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>7,321,573</u>	\$ <u>7,389,731</u>	\$ <u>68,158</u>

During the year ended December 31, 2013, twelve bonds were purchased, and twelve bonds were called or sold. Net realized gains in 2013 were \$24,708.

Net unrealized holding losses on available-for-sale securities in the amount of \$380,005 for the year ended December 31, 2013 have been included in accumulated other comprehensive income of \$68,158.

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, 2013 are as follows:

	<u>Estimated Fair Value</u>
Due in one year or less (before December 31, 2014)	\$ 200,566
Due between January 1, 2015 and December 31, 2018 (1 to 5 years)	686,476
Due between January 1, 2019 and December 31, 2023 (5 to 10 years)	1,551,743
Due between January 1, 2024 and December 31, 2033 (10 to 20 years)	2,902,308
Due January 1, 2034 or after (20 years or more)	<u>2,048,638</u>
Total investment in available-for-sale securities	<u>\$ 7,389,731</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	\$ 1,518,398
Plus: Assessments	752,470
Plus: Interest	90,337
Less: Adjustments	(4,479)
Less: Collections/Write offs	<u>(410,106)</u>
Balance, end of year	<u>\$ 1,946,620</u>

The annual fee for 2013 was \$375 (\$345 for 2012) for single family lots and \$500 for multi-family lots (\$455 in 2012).

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 2013 is shown below:

Accounts receivable	\$ 1,946,620
Less: Allowance for bad debts	<u>(1,554,312)</u>
Net accounts receivable	\$ <u>392,308</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 2013 was \$450,897.

As of December 31, 2013, Waterwood Partners owns 522 unimproved lots, of the 1,565 total undeveloped lots in Waterwood. Waterwood Partners were billed for fees on all lots owned and made a \$15,900 payment for fees in April 2014 for 2013 fees (\$16,000 in 2013 for 2012 fees), but have not made additional payments of fees owed. 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 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 2013.

NOTE G – PROPERTY, EQUIPMENT AND OTHER ASSETS

Property and equipment consists of the following categories:

	<u>Cost</u>
Autos	\$ 46,751
Office equipment	25,018
Other equipment	3,749
Common improvements	74,555
Buildings	<u>314,233</u>
Total Property and Equipment	464,306
Less: Accumulated depreciation	<u>(327,017)</u>
Net cost	\$ <u>137,289</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 (EMERGENCY MEDICAL 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 services 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 – SUBSEQUENT EVENTS

The EMS contract with Allegiance Ambulance expired on December 31, 2013 and was renewed with Allegiance Ambulance in 2014 for two years for \$96,253 annually (\$8,021 monthly).

The three year maintenance contract with JJJ Enterprises for \$114,743 expired on December 31, 2013. A new three-year contract with Julius Currie began January 1, 2014 through December 31, 2016 for \$117,000 annually (\$9,750 monthly).

Supplementary Information

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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 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, 2014

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
SCHEDULE OF OPERATING FUND REVENUES AND EXPENSES
BUDGET AND ACTUAL
For the Year Ended December 31, 2013

	2013		Variance Favorable (Unfavorable)
	<u>Budget</u>	<u>Actual</u>	
REVENUES			
Annual charges	\$ 690,000	\$ 752,470	\$ 62,470
Interest on delinquent annual charges	50,000	90,337	40,337
Recoveries	45,000	39,821	(5,179)
Investment income	335,000	336,294	1,294
Capital improvement charges	1,000	1,000	-
Property transfer fees	2,000	2,100	100
Unrealized gain/(loss) on securities	-	(380,005)	(380,005)
Fireworks donations	2,450	2,450	-
Gain on sale of assets	27,750	27,763	13
WNN ads	50	50	-
Other income	550	550	-
Total Revenue	<u>1,153,800</u>	<u>872,830</u>	<u>(280,970)</u>
EXPENSES			
Vehicle fuel	13,000	12,171	829
Vehicle repairs and maintenance	3,000	5,133	(2,133)
Bad debt expense	388,100	450,897	(62,797)
Fire station repairs and maintenance	1,000	584	416
Office building repairs & maintenance	2,000	1,065	935
Business licenses and permits	1,000	867	133
Fireworks	4,800	4,741	59
Decorations	500	364	136
Socials	4,000	3,872	128
EMS contract	93,450	93,450	-
Vehicle liability insurance	3,000	2,936	64
Employee medical insurance	3,500	3,207	293
Security liability insurance	3,000	3,443	(443)
Directors & officers liability insurance	4,700	4,537	163
Property and general liability insurance	8,000	7,287	713
Workers compensation insurance	4,000	3,682	318
WVFD insurance	7,000	6,578	422
Landscaping	300	187	113
Grounds maintenance contract	114,750	114,743	7
Miscellaneous	3,000	3,157	(157)
Dues and subscriptions	600	527	73
Computer equipment and software	1,500	1,597	(97)

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
SCHEDULE OF OPERATING FUND REVENUES AND EXPENSES
BUDGET AND ACTUAL - continued
For the Year Ended December 31, 2013

	2013		Variance Favorable (Unfavorable)
	<u>Budget</u>	<u>Actual</u>	
Janitorial	2,500	2,300	200
Postage and shipping	4,500	4,885	(385)
Printing	4,000	6,047	(2,047)
Supplies	4,000	3,471	529
Salaries	230,000	230,285	(285)
Auditing/Accounting	10,750	10,750	-
Legal	3,000	1,035	1,965
Equipment rental	2,500	2,467	33
Road repairs and maintenance	100,000	33,690	66,310
Payroll taxes	18,500	18,371	129
Real estate taxes	8,000	7,331	669
Federal Income Tax	10,000	5,147	4,853
Travel and meals	750	497	253
Alarm monitoring	400	364	36
Electricity	33,000	32,774	226
Garbage pickup	35,700	35,455	245
Telephone and communications	8,000	7,959	41
Water	600	579	21
Waterwood Volunteer Fire Department	13,000	4,464	8,536
Lease payments	6,000	6,000	-
Total Budgeted Expenses	<u>1,159,400</u>	<u>1,138,896</u>	<u>20,504</u>
EXCESS OF REVENUES/(EXPENSES) OVER MAJOR BUDGETED EXPENSES/REVENUES	<u>(5,600)</u>	<u>(266,066)</u>	<u>(260,466)</u>
OTHER BUDGETED EXPENSES			
Capital - car	27,000	-	27,000
Depreciation expense	26,000	25,808	192
Bond premium/discount amortization	54,000	51,023	2,977
Total Other-Budgeted Expenses	<u>107,000</u>	<u>76,831</u>	<u>30,169</u>
EXCESS OF REVENUES/(EXPENSES) OVER EXPENSES/REVENUES	<u>\$ (112,600)</u>	<u>\$ (342,897)</u>	<u>\$ (230,297)</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.