

WATERWOOD IMPROVEMENT ASSOCIATION, INC.

FINANCIAL STATEMENTS AND

SUPPLEMENTARY INFORMATION

For The Year Ended December 31, 2017

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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, 2017, 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, 2017, and the changes in its members' equity 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.
Huntsville, Texas

August 1, 2018

WATERWOOD IMPROVEMENT ASSOCIATION, INC.

BALANCE SHEET

As of December 31, 2017

ASSETS

Cash and cash equivalents, including interest-bearing deposits	\$	84,857
Annual charges receivable and accrued interest on delinquent receivables, less allowance for bad debts		430,000
Accrued interest receivable		73,297
Prepaid expense		21,959
Investments		6,012,583
Land		1,318,328
Property and equipment, less accumulated depreciation		542,753
TOTAL ASSETS	\$	<u>8,483,777</u>

LIABILITIES AND MEMBERS' EQUITY

Accounts payable and other accrued liabilities	\$	13,493
Capital improvement deposits		2,000
Payroll taxes payable		410
Short-term debt - line of credit		-
Total Liabilities		<u>15,903</u>
 Members' Equity		
Designated for current and future obligations		8,149,565
Accumulated other comprehensive income		318,309
Total Members' Equity		<u>8,467,874</u>
 TOTAL LIABILITIES AND MEMBERS' EQUITY	\$	<u>8,483,777</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, 2017

REVENUES

Annual charges	\$ 707,325
Interest on delinquent annual charges	120,704
Recoveries	30,171
Sign rental income	3,500
Investment income	278,926
Capital improvement charges	2,000
Property transfer fees	4,800
Unrealized gain/(loss) on securities	112,225
Donations	8,043
Other income	33,447
Total Revenues	1,301,141

EXPENSES

Vehicle expense	7,331
Bad debts	416,183
Repairs and maintenance - buildings	23,978
Licenses and fees	1,101
Community events	9,691
EMS contract	96,253
Insurance	36,095
Interest Expense	6,694
Grounds maintenance contract and landscaping	127,670
Miscellaneous	3,579
Office expense	23,757
Salaries and payroll tax	251,649
Professional fees	44,340
Pool maintainance	6,210
Road repair and maintenance	38,554
Golf course maintenance	48,000
Taxes	7,822
Travel and meals	553
Utilities and services	83,399
Depreciation	51,215
Bond amortization	27,005
Waterwood Volunteer Fire Department	36,705
Collection expense	-
Total Expenses	1,347,784

Excess Revenues Over Expenses	\$ (46,643)
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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, 2017

MEMBERS' EQUITY, BEGINNING OF YEAR	\$ 8,514,517
Excess Expenses Over Revenues	<u>(46,643)</u>
MEMBERS' EQUITY, END OF YEAR	<u>\$ 8,467,874</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, 2017

CASH FLOWS FROM/(USED BY) OPERATING
ACTIVITIES:

Net Revenues Over Expenses	\$	(46,643)
Adjustments to reconcile excess of expenses over revenues to net cash provided by operating activities:		
Unrealized (gain)/loss on securities		(112,225)
Realized (gain)/loss on donation of assets in settlement		(12,690)
Depreciation		51,215
Bond amortization		27,005
(Increase)/decrease in:		
Member annual charges receivable		45,000
Interest receivable		17,835
Increase/ (decrease) in:		
Accounts payable		(5,907)
Capital improvement deposits		2,000
Payroll taxes		(38)
NET CASH FROM/(USED BY) OPERATING ACTIVITIES		(34,448)

CASH FLOWS PROVIDED/(USED) BY INVESTING/FINANCING
ACTIVITIES:

Investments - purchases		-
Investments - sales		1,045,000
Building of park facilities		(325,050)
Payoff of short-term debt		(700,000)
NET CASH (USED)/PROVIDED BY INVESTING ACTIVITIES		19,950

NET INCREASE IN CASH AND CASH EQUIVALENTS		(14,498)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR		99,355
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$	84,857

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

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS
For the Year Ended December 31, 2017

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 common areas and other improvements. In addition, WIA provides security, EMS service, garbage pickup and fire department services for 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 greenbelts and other common areas. WIA has approximately 2,000 lots, of which approximately 400 are improved.

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 and other legal agreements, annual charges are levied on all lot owners, with the exception of lots owned by governmental entities, those possessing developer rights, those exempted under the terms of legal agreements with WIA, and those owned by WIA. 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. 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.

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). Greenbelts are an example of common property owned by WIA and not capitalized.

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 non-membership income, such as bank or taxable bond interest earnings and gain on sale of certain assets, at regular federal corporate rates. In 2017, 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.

NOTE C – MARKETABLE AND NONMARKETABLE SECURITIES

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. In addition, the Association has adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which describes the timing and ability of an entity to use fair value accounting.

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:

	Amortized <u>Cost</u>	<u>Market</u>	Cumulative Unrealized <u>Gains/(losses)</u>
State and municipal securities with AAA, AA, A and BAA ratings	\$ <u>5,694,274</u>	\$ <u>6,012,583</u>	\$ <u>318,309</u>

During the year ended December 31, 2017, no bonds were purchased and ten bonds were called for a net realized gain of \$1,834 in 2017.

Net unrealized holding gains on available-for-sale securities in the amount of \$112,225 for the year ended December 31, 2017 have been included in accumulated other comprehensive income of \$318,309.

Maturities of available-for-sale debt securities at December 31, 2017 are as follows:

	<u>Estimated Fair Value</u>
Due in one year or less (before December 31, 2017)	\$ -
Due between January 1, 2019 and December 31, 2022 (1 to 5 years)	122,413
Due between January 1, 2023 and December 31, 2027 (5 to 10 years)	539,025
Due between January 1, 2028 and December 31, 2037 (10 to 20 years)	2,046,947
Due January 1, 2038 or after (20 years or more)	<u>3,304,198</u>
Total investment in available-for-sale securities	\$ <u>6,012,583</u>

Actual maturities may differ from contractual maturities because nearly all 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	\$ 3,172,736
Plus: Assessments	707,325
Plus: Interest	120,704
Plus: Miscellaneous Other Billings	38,543
Less: Collections/Write offs	(1,099,871)
Less: Collection agency expense	<u>-</u>
Balance, end of year	\$ <u>2,939,437</u>

The annual fee for 2017 was \$500 for single family lots (\$500 in 2016) and \$630 for multi-family lots (\$630 in 2016).

WIA established an allowance for uncollectible accounts for delinquent assessments in 2008. The net accounts receivable at December 31, 2017 is shown below:

Accounts receivable	\$ 2,939,437
Less: Allowance for bad debts	<u>(2,509,437)</u>
Net accounts receivable	\$ <u>430,000</u>

This account is reviewed annually by WIA. The Bad Debt expense for 2017 was \$416,183.

As of December 31, 2015, WWP, meaning Waterwood Partners, LLC and any affiliate entities, including ILS (Investor Land Services), owned 531 of the 1,619 total undeveloped lots in Waterwood. Although WWP and ILS were billed for fees on all their lots, they made only nominal payments of fees owed.

In 2015, WIA sued WWP and ILS for the fees and interest owed. A settlement agreement to the lawsuit was reached by mediation in August 2016 which was officially recorded at the Courthouse in January 2018. Major terms of the settlement are as follows:

- 1) WWP and ILS will, upon the closing of the sale of each lot they own in the Waterwood subdivision, pay an amount equal to 15% of the gross sales price to WIA.
- 2) WWP and ILS will convey title to various lots in Park Forest Village without ready access to electricity to WIA, at no cost to WIA. In January 2017, 164 lots were transferred.

- 3) WWP and ILS will pay all future costs to develop undeveloped lots in Tournament Village, Piney Point, Fairway Village, and their remaining lots in Park Forest Village.
- 4) WIA will not bill WWP and ILS annual fees for lots they own for five years from 2016 through 2020.

Annual fees billed as of December 31, 2017, reflect the fact that WWP and ILS were not billed for the lots they owned (per the terms of the August 2016 settlement agreement).

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. In 2016, WIA estimates that two of these 200 lot holders have paid ten years of fees but have not met other requirements for electricity service, therefore, WIA did not have an obligation to provide electricity service in 2017.

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 2017.

NOTE G – LAND AND PROPERTY AND EQUIPMENT

Land and property and equipment consists of the following categories:

	<u>Cost</u>
Land	\$1,318,328
Autos	55,244
Office equipment	25,018
Other equipment	3,749
Common improvements	128,707
Buildings	<u>770,884</u>
Total Property and Equipment	2,301,930
Less: Accumulated depreciation	<u>(440,849)</u>
Net cost	<u>\$1,861,081</u>

Land consists primarily of parkways, public areas (i.e. dump site), acreage, and 165 lots owned by WIA and is valued at \$1,318,328, 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.

In 2016, WIA purchased, for \$1,006,513, the parkway right of way from FM 980 to Bob Christian Road, the parkway right of way from State Highway 190 to where the parkway becomes a two lane road, and the billboard, plus the land surrounding the billboard, located on the south side of State Highway 190 across from Waterwood Parkway. In addition, WIA obtained the right to control the posting of signs and placement of any items within 200 feet of the parkway right of way and within 200 feet of the rights of way of a number of other roads within Waterwood.

NOTE H – SHORT-TERM DEBT

The Association currently has a short-term line of credit of up to \$5,000,000, collateralized by its bond portfolio, which has been used for cash flow purposes. At December 31, 2017, the Association owed \$0 on the line of credit. During 2017, interest expense was \$6,694.

NOTE I – 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.

NOTE J – 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 K – EMS (EMERGENCY MEDICAL SERVICES)

WIA renewed its contract with Allegiance Ambulance, effective January 1, 2016 (through December 31, 2017), for annual compensation of \$96,253 (\$8,021 monthly) to provide emergency medical services to all Waterwood residents.

NOTE L – GROUNDS MAINTENANCE CONTRACT

The original 2017 maintenance contract was let for \$118,500 (\$9,875 per month) but expired October 22, 2017, due to performance issues with the contractor. Robert Metz was awarded the maintenance contract for the remainder of the original contract for \$9,193 a month through January 22, 2018. At that time, Timberlake Nursery received a three-year contract to provide grounds maintenance for \$9,073 per month, with additional services billed separately.

NOTE M – RELATED PARTY TRANSACTIONS

No related party transactions were noted during 2017.

NOTE N – SUBSEQUENT EVENTS

The Association had one subsequent event through August 1, 2018, which is the date the financial statements were available to be issued for events requiring recording or disclosure in the financial statements for the year ended December 31, 2017.

The lawsuit described in NOTE F was resolved in January 2018. Waterwood National built a new bulkhead in 2018 and the accounts receivable balance has been forgiven by WIA.

SUPPLEMENTARY INFORMATION



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 for the year ended December 31, 2017 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.

Sincerely,

Davis, Heinemann & Co.

Davis, Heinemann & Company, P.C.
August 1, 2018

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
SCHEDULE OF OPERATING FUND REVENUES AND EXPENSES
BUDGET AND ACTUAL - BUDGETARY BASIS
For the Year Ended December 31, 2017

	2017		Variance Favorable (Unfavorable)
	<u>Budget</u>	<u>Actual</u>	
REVENUES			
Annual charges	\$ 701,500	\$ 707,325	\$ 5,825
Interest on delinquent annual charges	60,000	120,704	60,704
Recoveries	75,000	30,171	(44,829)
Investment income	310,000	278,926	(31,074)
Sign Rental	3,000	3,500	500
Capital improvement charges	2,000	2,000	-
Property transfer fees	3,000	4,800	1,800
Unrealized gain/(loss) on securities	-	112,225	112,225
Fireworks donations	3,000	3,375	375
Park amenity donations	-	4,668	4,668
Receipt of lots - Park Forest	-	12,690	12,690
Other income	100	20,757	20,657
Total Revenue	1,157,600	1,301,141	143,541
EXPENSES			
Vehicle fuel	6,000	4,263	1,737
Vehicle repairs and maintenance	3,000	3,068	(68)
Collection expense (including sales tax)	1,000	-	1,000
Fire station repairs and maintenance	12,000	22,894	(10,894)
Office building repairs & maintenance	1,000	1,084	(84)
Business licenses and permits	1,500	1,101	399
Fireworks	5,000	5,000	-
Decorations	3,000	1,038	1,962
Socials	5,000	3,653	1,347
EMS contract	96,253	96,253	-
Vehicle liability insurance	3,400	4,027	(627)
Employee medical insurance	6,500	5,984	516
Security liability insurance	4,000	3,852	148
Directors & officers liability insurance	6,000	5,951	49
Property and general liability insurance	7,000	6,985	15
Workers compensation insurance	2,500	1,830	670
WVFD insurance	7,000	7,466	(466)
Interest	17,500	6,694	10,806
Landscaping	1,000	383	617
Grounds maintenance contract	118,525	127,287	(8,762)
Miscellaneous	3,000	3,579	(579)

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
SCHEDULE OF OPERATING FUND REVENUES AND EXPENSES
BUDGET AND ACTUAL - BUDGETARY BASIS - continued
For the Year Ended December 31, 2017

	2017		Variance
	<u>Budget</u>	<u>Actual</u>	Favorable (Unfavorable)
Dues and subscriptions	600	968	(368)
Computer equipment and software	1,000	1,164	(164)
Janitorial	2,000	2,038	(38)
Office machines	500	-	500
Postage and shipping	7,500	5,331	2,169
Printing	9,000	8,456	544
Supplies	4,500	5,800	(1,300)
Salaries	240,000	233,071	6,929
Auditing/Accounting	10,750	10,750	-
Legal	20,000	33,590	(13,590)
Pool maintenance	3,500	6,210	(2,710)
Road repairs and maintenance	75,000	38,554	36,446
Golf course maintenance	48,000	48,000	-
Payroll taxes	19,200	18,578	622
Real estate taxes	7,900	3,108	4,792
Federal income taxes	4,900	4,714	186
Travel and meals	1,000	553	447
Alarm monitoring	400	364	36
Electricity	38,000	38,839	(839)
Garbage pickup	35,000	35,513	(513)
Telephone and communications	8,000	7,931	69
Water	1,200	752	448
Waterwood Volunteer Fire Department	35,500	36,705	(1,205)
Bad debt expense	286,500	416,183	(129,683)
Total Budgeted Expenses	1,170,128	1,269,564	(99,436)
EXCESS OF REVENUES/(EXPENSES) OVER MAJOR BUDGETED EXPENSES/REVENUES			
	(12,528)	31,577	44,105
OTHER BUDGETED EXPENSES			
Depreciation expense	37,000	51,215	(14,215)
Bond premium/discount amortization	28,000	27,005	995
Total Other-Budgeted Expenses	65,000	78,220	(13,220)
EXCESS OF REVENUES/(EXPENSES) OVER EXPENSES/REVENUES			
	\$ (77,528)	\$ (46,643)	\$ 30,885

WATERWOOD IMPROVEMENT ASSOCIATION, INC.
SUPPLEMENTARY INFORMATION ON FUTURE MAJOR REPAIRS AND
REPLACEMENTS (COMPILED)
For the Year Ended December 31, 2017

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 the County will not fund the necessary work, 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 Association would only borrow money in the event that the County will not complete necessary improvements to the roads. The last complete resurfacing of all roads in 1992 cost WIA approximately \$1,500,000.