

# **HMC MANAGEMENT**

## ***Independent Auditor's Report And Financial Statements***

**Year Ended September 30, 2017**



**Hearthstone CPA Group**

Certified Public Accountants

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# Hearthstone CPA Group

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## **INDEPENDENT AUDITOR'S REPORT**

To the Board of Directors  
HMC Management

### **Report on the Financial Statements**

We have audited the accompanying financial statements of HMC Management which comprise the balance sheet, as of September 30, 2017 and the related statement of revenues, expenses and members' equity, and statement of 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 the financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and the maintenance of internal control relevant to the preparation and fair presentation of the 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 our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

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 HMC Management as of September 30, 2017, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

**INDEPENDENT AUDITOR'S REPORT (Continued)**

**Disclaimer of Opinion on Required Supplementary Information**

Accounting principles generally accepted in the United States of America require that the supplementary information on pages 11 and 12 be presented to supplement the basic financial statements. Such information, although not a required part of the basic financial statements, is required by the Financial Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Information in the required supplementary information is the responsibility of management. We have not audited, reviewed, or compiled the required supplementary information, and we do not express an opinion, a conclusion, nor provide any assurance on it.

*Hearthstone CPA Group*

October 9, 2018

**HMC MANAGEMENT  
BALANCE SHEET  
SEPTEMBER 30, 2017**

**ASSETS**

Cash	
Operating account	\$ 114,860
Water account	68,762
	<u>183,622</u>
Investments- designated	1,027,101
Member assessments receivable - current	4,403
Prepaid expenses	60,619
Capital assets, net of depreciation	3,384,374
Member assessments receivable - non-current	<u>137,665</u>
Total Assets	<u><u>\$ 4,797,784</u></u>

**LIABILITIES AND MEMBERS' EQUITY**

Accounts payable	\$ 305,236
Accrued liabilities	20,536
Prepaid member assessments	53,525
Key Bank construction loan payable - dolphins	454,745
Deposits	11,888
Notes payable - USDA water distribution system	<u>1,248,794</u>
Total liabilities	<u>2,094,724</u>
Members' equity	
Undesignated	1,675,959
Board designated	<u>1,027,101</u>
	<u>2,703,060</u>
Total Liabilities and Members' Equity	<u><u>\$ 4,797,784</u></u>

The accompanying notes are an integral part of these financial statements

**HMC MANAGEMENT  
STATEMENT OF REVENUES, EXPENSES  
AND MEMBER'S EQUITY  
YEAR ENDED SEPTEMBER 30, 2017**

**REVENUES**

Member assessments	\$ 732,439
Ferry fees	197,401
Water	170,076
Investment income	5,683
Other income	45,379
	<u>1,150,978</u>

**EXPENSES**

Ferry	617,305
General and administrative	184,362
Water system	136,014
Piles, dolphins and ferry ramps	112,075
Parks	32,676
Roads	22,554
	<u>1,104,986</u>

<b>Excess of revenues over expenses</b>	<u>45,992</u>
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<b>Beginning members' equity</b>	2,694,866
<b>Prior Period Adjustment</b>	<u>(37,798)</u>

<b>Beginning members' equity, as restated</b>	<u>2,657,068</u>
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<b>Ending members' equity</b>	<u><u>\$ 2,703,060</u></u>
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**HMC MANAGEMENT  
STATEMENT OF CASH FLOWS  
YEAR ENDED SEPTEMBER 31, 2017**

**Increase (Decrease) In Cash**

**CASH FLOWS FROM OPERATING ACTIVITIES**

Excess of revenues over expenses	\$ 45,992
Adjustments to reconcile excess of revenues over expenses to net cash provided (used) by operating activities	
Depreciation	112,612
Change in operating assets and liabilities	
Member assessments receivable	(18,093)
Prepaid expenses	30,308
Accounts payable	(3,322)
Accrued liabilities	4,533
Prepaid member assessments	9,376
Deposits	<u>1,707</u>
Net cash provided (used) by operating activities	<u>183,113</u>

**CASH FLOWS FROM INVESTING ACTIVITIES**

Investments designated	(68,675)
Construction in progress	<u>(446,896)</u>
Net cash provided (used) by investing activities	<u>(515,571)</u>

**CASH FLOWS FROM FINANCING ACTIVITIES**

Construction loan	454,745
USDA note payable - water system	<u>(21,654)</u>
Net cash provided (used) by financing activities	<u>433,091</u>

Net increase in cash and cash equivalents 100,633

Cash and cash equivalents at beginning of year 82,989

Cash and cash equivalents at end of year \$ 183,622

**SUPPLEMENTAL CASH FLOW INFORMATION**

Cash paid for loan origination fees and interest	
Dolphin project loan origination fees	\$ 11,250
Dolphin project construction financing interest	13,371
USDA water distribution note interest	<u>31,624</u>
	<u><u>\$ 56,245</u></u>

Non cash investing and financing activity

Dolphin Project costs included in accounts payable \$ 286,382

The accompanying notes are an integral part of these financial statements

**HMC MANAGEMENT**  
**NOTES TO FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2017**

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Nature of Association and Activities**

HMC Management (the Association) was incorporated on May 1, 1958, in the State of Washington, as not-for-profit corporation. The Association operates and maintains the common property (including roads, parks, and water service) on Herron Island and the associated private ferry service and wharfs.

**Basis of Accounting**

The Association prepares its financial statements in accordance with generally accepted accounting principles. This basis of accounting involves the application of accrual accounting; consequently, revenues and gains are recognized when earned, and expenses and losses are recognized when incurred.

**Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Cash and Cash Equivalents**

For purposes of the statement of cash flows, the Association considers all highly liquid investments whose original maturity is three months or less to be cash equivalents.

**Investments**

Reserve assets have been invested in the Vanguard Treasury Money Market Fund (the fund) and are not considered a cash equivalent because management intends to hold these for more than one year. The fund invests solely in U.S. Treasury Securities which are backed by the full faith and credit of the U.S. Government. The average maturity typically ranges from 30-60 days and the fund maintains a dollar-weighted average maturity of 60 days, and the fund maintains a dollar-weighted average life of 120 days or less.

**Capital Assets and Depreciation**

The Association's policy for capitalizing assets in its balance sheet is to recognize (a) certain real and personal property to which it has title. The Association recognizes as capital assets the ferry, docks, equipment and, roads.

The Association owns 13 lots that are for common use by the organization and by members and four lots for undetermined future use or sale. Original acquisition costs were not available therefore the Association used lowest assessed values for 2001 through 2005 to fairly value the property. Additionally, HMC Management owns four tracts of land and beach front property for common use, but valuations are unknown.

Capitalized assets, except land, are being depreciated over their estimated useful lives using the straight-line method of depreciation.

**Member Assessments**

The Association's members are subject to annual assessments (\$1,928 per assessable unit in fiscal year end 2017) to provide funds for general operating expenses, future capital acquisitions, and major repairs and replacements. The annual base assessment for water in the fiscal year ended 2017 was \$216. Assessments and accounts receivable at the balance sheet date represent fees and other charges due from owners.



**HMC MANAGEMENT  
NOTES TO FINANCIAL STATEMENTS  
SEPTEMBER 30, 2017**

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Member Assessments, continued**

Any excess assessments at year end are retained by the Association for future use. If assessments are not sufficient, the Board of Directors, subject to the limitations of their authority described in the Association's governing documents, may have to increase regular assessments or pass special assessments.

**Taxes**

Homeowners' associations may be taxed either as homeowners' associations (Form 1120H) or as a regular corporation (Form 1120) by selecting the tax form that will yield the lowest tax. For the year ended September 30, 2017, the Association elected to file its income tax returns as a homeowners' association (Form 1120-H). In 2017 the Association's net investment income and other nonexempt income are subject to tax at a 30% rate. For the year ended September 30, 2017 there was no net taxable investment or nonexempt income.

The Association has adopted the recognition requirements for uncertain income tax positions as required by generally accepted accounting principles, with no cumulative effect adjustment required. Income tax benefits are recognized for income tax positions taken or expected to be taken in a tax return, only when it is determined that the income tax position will more-likely-than-not be sustained upon examination by taxing authorities. The Association has analyzed tax positions taken for filing with the Internal Revenue Service and all states where it operates. The Association believes that income tax filing positions will be sustained upon examination and does not anticipate any adjustments that would result in a material adverse effect on the Association's financial condition, results of operations or cash flows. Accordingly, the Association has not recorded any reserves, or related accruals for interest and penalties for uncertain income tax positions at September 30, 2017.

The Association is subject to routine audits by taxing jurisdictions; however, there are currently no audits in any tax periods in progress. The Association believes it is no longer subject to income tax examinations for fiscal years prior to 2013.

**Subsequent Events**

Subsequent events were evaluated through the report date, which is the date the financial statements were available to be issued. As of the report date, there were no additional subsequent events requiring disclosure.

**NOTE 2 – ASSESSMENTS RECEIVABLE**

The Association's policy is to retain legal counsel and place liens on the properties of homeowners whose assessments in accordance with the Association's by-laws and delinquent policies related thereto. It is the opinion of the board of directors that the Association will ultimately prevail against the homeowners whose assessments are delinquent unless the property is in foreclosure. In this situation the board of directors does not anticipate collecting the delinquent assessment.

The position of the Board of Directors is that the Association will ultimately prevail against the remaining non-current homeowners whose assessments and accounts are delinquent, (without lien filings). Accordingly, these accounts are reported at net realizable value.

**HMC MANAGEMENT  
NOTES TO FINANCIAL STATEMENTS  
SEPTEMBER 30, 2017**

**NOTE 3 – CAPITAL ASSETS**

Capital assets in the financial statements consist of the following:

	Estimated Useful Lives	
Land		\$ 55,600
Ferry and docks	15-60 years	2,426,820
Water system	40-80 years	1,826,357
Small boat docks	5-40 years	269,944
Roads	10-20 years	110,869
Office equipment	3-6 years	<u>40,128</u>
		4,729,718
Less accumulated depreciation		<u>(2,077,622)</u>
		2,652,096
Dolphin project construction in progress		<u>732,278</u>
		<u><u>\$ 3,384,374</u></u>

Depreciation expense for the year ended December 31, 2017 totaled \$112,612. Depreciation expense has been allocated to the departmental categories reported on the statement of activities.

**NOTE 4 – CONSTRUCTION LOAN PAYABLE – DOLPHIN PROJECT**

The Association secured a \$1,500,000 interim construction loan on April 12, 2017 from KeyBank National Association. Funds from this loan are being used to pay for the dolphin replacement project that commenced during the summer of 2017. The project engineer is PND Engineers, Inc. and the general contractor is American Construction Co., Inc. Beginning on June 1, 2017, payments of interest only will be made for 11 months until the sooner of May 1, 2018 or when paid in full. The interest rate is a variable rate based on the prime rate plus .075%. The initial interest rate was 4.75%, subsequently increasing to 5% on June 15, 2017. As of September 30, 2017 the Association has received construction loan advances for project costs totaling \$454,745, including accrued interest.

Construction was completed in the winter of 2018 and the interim construction loan was subsequently paid off with permanent financing obtained from USDA Natural Resources. Terms of the permanent financing commencing on October 25, 2018 are semi-annual payments for 40 years in the amount of \$10,238, including interest at 2.75%

**NOTE 5 - USDA Note Payable**

**Water Distribution System**

HMC signed a promissory note on March 22, 2013, with USDA Natural Resources for financing a new water distribution system to comply with state regulations. The note is payable semiannually (beginning September 2013) at 2.5 percent interest over 40 years. The amount payable semi-annually is \$26,639 which includes interest and principle. The note is for \$1,342,000 adjusted for one-time payments (\$410,780) and is secured by Association property which includes land, roads, and improvements. Such property is recorded as community property and does not have an associated value in Pierce County public assessor records. Therefore, this property does not appear on the Associations financial statements.

**HMC MANAGEMENT**  
**NOTES TO FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2017**

**NOTE 5 - USDA Notes Payable, (continued)**

Future principal maturities of the note payable are as follows:

Years Ending September 30,		
2018	\$	22,200
2019		22,760
2020		23,330
2021		23,920
2022		24,520
Thereafter		<u>1,132,064</u>
		<u>\$ 1,248,794</u>

**NOTE 6 – CONCENTRATION OF CREDIT RISK**

The Association maintains its cash balances in one financial institution. The cash on deposit is insured by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000. The Association may at times exceed the insured amounts however management does not believe it is not exposed to any significant credit risk to cash.

**NOTE 7 – FAIR VALUE INSTRUMENTS**

The Association adopted ASC 820 (formerly known as FASB Statement No. 157, "Fair Value Measurements") as of 2008. ASC 820 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurement. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement assumes that the transactions to sell the asset or transfer the liability occur in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market.

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels as follows: Level 1 – inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities the Organization has the ability to access. Level 2 – inputs are inputs (other than quoted prices included within level 1) that are observable for the assets or liability, either directly or indirectly. Level 3 – are unobservable inputs for the asset or liability and rely on management's own assumption about the assumptions that market participants would use in pricing the asset or liability.

**NOTE 8 – FUTURE MAJOR REPAIRS AND REPLACEMENTS**

The Association contracted with Association Reserves to conduct an "update no-site-visit reserve study" to estimate the remaining useful lives of the components of common property and current estimates of costs of major repairs and replacements that may be required in the future. The report dated May 2, 2017, covers the period beginning October 1, 2017 and expiring on September 30, 2018. The Association funds major repairs and replacements over the estimated useful lives of the components. Actual expenditures may vary from the estimated future expenditures and the variations may be material. Therefore, amounts accumulated in the replacement fund may not be adequate to meet all future needs for major repairs and replacements. If additional funds are needed, the Association has the right, subject to membership approval, to increase regular assessments, pass special assessments, or delay major repairs and replacements until funds are available.

**HMC MANAGEMENT  
NOTES TO FINANCIAL STATEMENTS  
SEPTEMBER 30, 2017**

**NOTE 9 – RETIREMENT PLAN**

The Association maintains a qualified 401(k) Profit Sharing Plan and Trust (the Plan) covering all employees who satisfy certain eligibility requirements. The Plan provides for those eligible employees to defer their salaries up to the statutory limits. The Association makes non-elective matching contributions on the first 2% of compensation deposited as elective contributions. In addition to the non-elective matching contributions, the Plan provides for elective discretionary contributions. During the year ended September 30, 2017 the Association made matching contributions totaling \$12,311

**NOTE 10 – PRIOR PERIOD ADJUSTMENT**

Beginning member's equity as of September 30, 2016, has been restated for the following corrections:

The USDA note balance as of September 30, 2016 was reported to be \$1,248,794 and the correct balance was \$1,270,448. Therefore beginning member's equity was reduced by \$21,795 to correct for the effect of this understatement.

Wages in the amount of \$16,003 were earned and payable as of September 30, 2016, however they were not accrued as a liability. Therefore beginning member's equity was reduced by \$16,003 to correct for the effect of this understatement.

## **REQUIRED SUPPLEMENTARY INFORMATION**

**HMC MANAGEMENT**  
**SCHEDULE OF FUTURE MAJOR REPAIRS AND REPLACEMENTS**  
**SEPTEMBER 30, 2017**  
**(Unaudited)**

Association reserves conducted an "update no-site-visit" reserve study to estimate the remaining useful lives and the replacement costs of the components of common property. The study compiles an inventory of all common area components and is used to determine which components are appropriate for reserve funding. The reserve study also projects future reserve spending requirements, assesses the adequacy of the current reserve funds and established a recommended reserve contribution. This study was updated on May 2, 2017.

The following table presents significant information about the common area components and estimated future cost requirements:

# Component		Useful Life (yrs)	Remaining Useful Life (yrs)	Current Average Cost
Site/Grounds/Recreation				
200	Asphalt Roads - Repair/Resurface	25	1	\$ 43,250
204	Gravel Roads/Lots - Maintain/Repair	5	2	46,350
350	Play Equipment - Replace	10	1	10,320
356	Basketball Court - Repair/Replace	30	26	19,100
370	Pavilion - Replace Roof	25	11	7,850
Small Boat Marina				
302	Small Boat Docks/Floats-Replace	30	14	127,500
306	Small Boat Dock Pilings - Replace	50	44	212,500
320	Small Boat Trestle/Ramp - Replace	30	14	87,500
336	Small Boat Gangway - Replace	30	14	7,700
Community Building				
410	Community Building Siding-Replace	50	38	22,800
430	Community Building Roof - Replace	40	25	18,000
460	Community Building Septic - Replace	50	15	10,320
Equipment				
540	Dust/Water Truck - Replace	12	1	16,000
Ferry System				
700	Ferry Terminals - Inspect/Repair	4	1	19,100
702	Ferry Terminals - Paint	12	10	180,500
704	Ferry Terminal Cables - Replace	6	3	29,200
706	Ferry Terminal Wood Decks - Replace	24	22	177,500
707	Ferry Terminal Structures - Replace	60	34	2,385,000
708	Ferry Ramp Dolphins-Future Replace	50	50	1,300,000
712	Ferry Ramp Generators - Replace	20	10	38,700
740	Ferry Vessel - Shipyard	2	1	92,700
744	Ferry Vessel - Overhaul Engines	5	1	38,800
746	Ferry Vessel - Replace Engines	50	46	167,000
755	Ferry Vessel-Overhaul Transmissions	5	1	14,400
757	Ferry Vessel-Replace Transmissions	25	21	33,400
760	Ferry Vessel - Replace	60	32	1,590,000
Professional/Special Projects				
940	Legal Contingency Fund	0	0	35,000
				<u>\$ 6,730,490</u>

**HMC MANAGEMENT**  
**SCHEDULE OF FUTURE MAJOR REPAIRS AND REPLACEMENTS**  
**SEPTEMBER 30, 2017**  
**(Unaudited)**

# Component		Useful Life (yrs)	Rem. Useful Life (yrs)	Current Average Cost
Capacity / Storage				
901	Well Pumps/Motors - Replace	30	25	\$ 18,000
904	Well Controls - Replace	30	25	5,000
910	Storage Tank, Concrete - Replace	80	68	212,800
912	Storage Tank, Interior - Clean	10	1	4,000
914	Storage Tank, Exterior - Clean	5	1	3,200
Boost				
920	Booster Pumps, 5 HP - Replace	20	15	16,000
922	Booster Pump, 15 HP - Replace	40	35	22,000
924	Booster Pumps VFD Control - Replace	20	15	16,000
Distribution				
940	Distribution Lines, 6"-8" - Replace	70	65	1,039,350
941	Distribution Lines, 2" - Replace	40	35	67,500
945	Service Connect/Lines - Replace	40	35	258,050
946	Service Meters - Replace	10	5	127,040
947	Service Meter Box/Setters - Replace	20	15	127,040
950	Pressure Reducing Valves - Replace	20	15	12,600
954	Blow-Out/Isolation Valves - Replace	30	25	38,000
958	Hydrants - Replace	40	35	157,850
Buildings / Site				
964	Building Roofs - Replace	40	36	3,300
967	Storage Shed, Vinyl - Replace	20	16	2,700
969	Building Electrical - Replace	30	25	10,500
970	Chain Link Fence - Replace	35	31	17,280
Systems / Equipment				
980	Generator, Emergency - Replace	50	7	50,000
999	Meter Reader System - Replace	6	1	5,500
Financial / Professional				
1006	SWSMP- Update	6	-	3,000
1013	Sanitary Survey- Update	5	3	2,000
				<u>\$ 2,218,710</u>