

INDEPENDENT AUDITOR'S REPORT
FOR
HMC MANAGEMENT - 2011

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HMC FINANCIAL STATEMENTS AUDITED BY:

MICHAEL KANDER CPA

MICHAEL KANDER CPA

7406 27TH Street West Suite 14, University Place, WA 98466

INDEPENDENT AUDITOR'S REPORT

Board of Directors
HMC Management
P.O. Box 119
Lakebay, WA 98349

Dear President and Members of the Board:

We have audited the accompanying Balance Sheet of HMC Management (a Washington State Homeowners Association) as of September 30, 2011 and 2010, and the related Statements of Revenues and Expenses (including the Functional Expense Schedule) and Cash Flows, and Changes in Members' Equity for the year then ended. These financial statements are the responsibility of HMC management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of HMC Management as of September 30, 2011 and 2010, and the results of operations for the year then ended in conformity with accounting principles generally accepted in the United States of America.

HMC Management has estimated the remaining lives and replacement costs of only the docks and dolphins but not all common property and, therefore, has not presented this information that accounting principles generally accepted in the United States of America has determined is required to supplement, although not required to be a part of, the basic financial statements. (See Note C)

Michael J. Kander, CPA
University Place, WA
February 2, 2012

HMC MANAGEMENT

Balance Sheet

As of September 30, 2011 and 2010

ASSETS	2011	2010
Current Assets		
Cash and Cash Equivalents (See Note A)		
Cash	\$ 103,788	\$ 98,748
Certificate of Deposit	1,055	1,030
Total Cash and Cash Equivalents	104,844	99,778
Accounts Receivable from Active Members	5,950	676
 Total Current Assets	 110,794	 100,454
Long Term and Other Assets		
Investment in Vanguard Funds (see Note B)	391,246	423,135
Land Acquired (not common use)	40,000	30,000
Delinquent Members Receivables, net (see Note D)	5,679	20,754
Prepaid Maintenance Expenses (See Note E)	78,699	-
Total Long Term Assets	515,624	473,889
Plant, Property and Equipment		
Land - Common Use (See Note A)	27,300	27,300
Fixed Assets		
Ferry/Docks	2,108,732	2,108,732
Water System	108,217	108,217
Small Boat Dock (Parks)	65,003	65,003
Roads	31,895	31,895
Office/Equipment	38,559	35,313
less Accumulated Depreciation	(1,474,229)	(1,424,931)
Total Net Fixed Assets	878,177	924,229
 Total Plant, Property, and Equipment, net	 905,477	 951,529
 TOTAL ASSETS	 \$ 1,531,895	 \$ 1,525,872
LIABILITIES AND MEMBERS' EQUITY		
LIABILITIES		
Short Term Liabilities		
Accounts Payable - Trade	15,159	16,332
Prepaid Assessments	26,930	18,648
Security Deposits	6,413	1,300
Total Short Term Liabilities	48,503	36,280
 TOTAL LIABILITIES	 \$ 48,503	 \$ 36,280

Continued

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See Independent Auditor's Report
The Accompanying Notes are an Integral Part of these Financial Statements

HMC MANAGEMENT

Balance Sheet

As of September 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
MEMBERS' EQUITY		
Unrestricted Balance	\$ 1,045,000	\$ 1,019,310
Board Designated for Capital and Major Repairs and Maintenance (See Note B)	<u>438,392</u>	<u>470,281</u>
TOTAL MEMBERS' EQUITY	<u>1,483,392</u>	<u>1,489,591</u>
TOTAL LIABILITIES AND MEMBERS' EQUITY	<u>\$ 1,531,895</u>	<u>\$ 1,525,872</u>

HMC MANAGEMENT
Statement of Revenues and Expenses
For the Years Ended September 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
REVENUES AND OTHER SUPPORT		
Member Assessments, gross (See Note A)		
Operations	\$ 593,575	\$ 534,400
Reserves	59,000	61,100
Total General Assessments	<u>652,575</u>	<u>595,500</u>
 Ferry Fees	 193,462	 163,009
Delinquent Accounts (Other Charges)	17,035	15,762
Miscellaneous	7,068	9,061
HMC Interest & Handling Charges	8,931	12,111
Interest Earned (All Accounts)	429	1,288
TOTAL REVENUES AND OTHER SUPPORT	<u>879,500</u>	- <u>796,732</u>
 EXPENSES BY DEPARTMENT (See Schedule 1)		
Ferry	544,198	487,706
Ferry Docks	51,639	86,530
Administration	176,263	194,053
Water	79,775	37,909
Parks	15,085	12,334
Roads	18,739	17,298
TOTAL EXPENSES	<u>885,699</u>	- <u>835,830</u>
 REVENUES EXCEEDING EXPENSES (LOSS)	 <u>(6,199)</u>	 <u>(39,098)</u>
 OTHER INCOME		
Gain on Installment Sale	-	11,146
TOTAL OTHER INCOME	<u>0</u>	<u>11,146</u>
 REVENUES EXCEEDING EXPENSES (LOSS)	 <u>\$ (6,199)</u>	 <u>\$ (27,952)</u>

HMC MANAGEMENT
Statement of Functional Expenses - Schedule 1
October 2010 - September 2011 with Comparative Totals for Prior Period (2010)

2011 EXPENSE	Ferry	Ferry Docks	--Department-- Administration	Water	Parks	Roads	2011 Total	2010 Total
Payroll (Wages, taxes, and benefits)	\$ 320,536		\$ 96,087	\$ 7,040	\$ 2,501		\$ 426,164	\$ 425,043
Repairs and Maintenance (See Note E)	59,276		682	4,370	4,871	14,034	83,233	55,717
Insurance	51,236	3,141	8,462				62,839	69,564
Ferry Fuel	64,559						64,559	59,845
Professional Services		37,689	46,526	54,291			138,506	74,687
Miscellaneous Service & Supplies	8,623	4,381	6,228	4,609	4,364	3,109	31,314	33,869
Taxes and DNR Lease	4,227		6,255	2,410			12,891	8,512
Postage, Printing, Copying			7,249				7,249	6,795
Utilities	542	1,992	3,547	2,727	837		9,645	9,376
Bad Debt Expense							-	6,000
Total Expenses by Department before Depreciation	508,999	47,203	175,035	75,446	12,573	17,144	836,400	749,408
Depreciation	35,199	4,436	1,228	4,329	2,512	1,595	49,299	86,422
Total Expenses by Department after Depreciation	\$ 544,198	\$ 51,639	\$ 176,263	\$ 79,775	\$ 15,085	\$ 18,739	\$ 885,699	\$ 835,830

HMC MANAGEMENT
Statement of Changes in Members' Equity
As of September 30, 2011 and 2010

	<u>Total Members' Equity</u>			
	<u>Capital Account</u>	<u>Operating Account</u>	<u>2011</u>	<u>2010</u>
MEMBERS' EQUITY				
BEGINNING OF YEAR	\$ 470,281	\$ 1,019,310	\$ 1,489,592	\$ 1,517,544
 Excess of Revenues over Expenses (Loss) before Other Income and Other Items	 -	 (6,199)	 (6,199)	 (39,098)
 Board Designated Transfers to Operating Account from Savings Reserves	 (31,889)	 31,889	 -	 -
 Allocation of Other Income - Gain on Installment Sale	 -	 -	 -	 11,146
 MEMBERS' EQUITY	 \$ 438,392	 \$ 1,045,000	 \$ 1,483,393	 \$ 1,489,592
END OF YEAR				

HMC Management
Statement of Cash Flows
For the Years Ended September 2011 and 2010

	<u>2011</u>	<u>2010</u>
OPERATING ACTIVITIES		
Net Income (Loss)	\$ (6,199)	\$ (27,858)
Adjustments to reconcile Net Income to net cash provided by operations: Increase(Decrease)		
Loss on Acquiring Land		
Depreciation	49,299	75,182
Delinquent Accounts Receivable, net (SEE NOTE D)	15,075	(6,019)
Accounts Receivable	(5,274)	(51)
Prepaid Maintenance Expenses (See Note XX)	(78,699)	-
Miscellaneous	(1,427)	(110)
Accounts Payable	(1,173)	6,105
Prepaid Assessments and Fees	8,282	2,779
Security Deposits, net	5,113	1,000
Net cash provided by Operating Activities	<u>(15,002)</u>	<u>51,028</u>
INVESTING ACTIVITIES		
Note Receivable	-	11,682
Gain/Deferred Gain on Note Receivable	-	(501)
Land Acquired (Exchange)	(10,000)	-
Capital Additions/Improvements	3,246	-
Net cash provided by Investing Activities	<u>(6,754)</u>	<u>11,181</u>
Transfers from (to) Investment Account (Reserves), net	<u>31,889</u>	<u>(61,337)</u>
Net cash used by Investing Activities	<u>31,889</u>	<u>(61,337)</u>
Net cash increase(decrease) for period	<u>10,133</u>	<u>872</u>
Cash at beginning of period	<u>99,778</u>	<u>98,906</u>
Cash at end of period	<u><u>\$ 104,844</u></u>	<u><u>\$ 99,778</u></u>

HMC MANAGEMENT
Notes to Financial Statements
For the Fiscal Year Ended September 30, 2011

NOTE A: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Nature of Activities

HMC Management was incorporated on May 1, 1958, in the State of Washington, as a homeowners' association. HMC Management operates and maintains the common property (including roads, parks, and water service) on Herron Island and the associated private ferry service and wharfs. HMC Management levies annual and special assessments on 396 "assessable" units. (Assessable units are adjacent, contiguous units that are owned by one member.)

Basis of Accounting

The financial statements have been prepared in accordance with generally accepted accounting principles and accordingly reflect all significant receivables, payables and other liabilities.

Disbursements from the operating account are generally at the discretion of the board. Disbursements from the reserve savings account may be generally made only for specific purposes designated by the board. (See Note B)

Cash and Cash Equivalents

HMC Management considers all highly liquid investments available for current use with an initial maturity of three months or less to be cash equivalents. The certificate of deposit is included in this asset category because it may be readily redeemed with an immaterial early withdrawal penalty.

Investments

The Vanguard Money Market Funds (Reserves) are considered as long-term assets because management intends to hold these for more than one year. The balance exceeds the Federal Depository Insurance Corporation coverage by approximately \$140,000. Management accepts this risk because Vanguard has not defaulted on any accounts.

Fixed Assets

The Company capitalizes property and equipment over \$1,000 and depreciates fixed assets and improvements over their useful life using straight-line depreciation methodology. At acquisition, the estimated useful life of the ferry and ferry docks were 20 years and 40 years respectively. The estimated useful life of capitalized equipment is five to seven years.

HMC MANAGEMENT
Notes to Financial Statements
For the Fiscal Year Ended September 30, 2011

Land

HMC Management owns 17 lots that are for common use by the organization and by members. Original acquisition costs were not available. The organization 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.

Member Assessments

HMC Management's members are subject to annual assessments (\$1650 per assessable unit in 2011) to provide funds for general operating expenses, future capital acquisitions, and major repairs and replacements. Assessments and accounts receivable at the balance sheet date represent fees due from active owners, excluding assessments on delinquent accounts. HMC Management considers these receivables (active members) as fully collectable and, accordingly, does not deem it necessary to establish an allowance for uncollectable accounts (active members). HMC Policy is to classify assessments older than 30 days as delinquent and to begin legal proceedings as soon as practical. See Note D for discussion of delinquent accounts.

Income Taxes

Homeowners' associations may be taxed either as homeowners' associations or as regular corporations. As a homeowner's association, most exempt function income, which consists primarily of member assessments, is not taxable.

Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires HMC Management to make estimates and assumptions that may affect the 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 reported period. Actual results could differ from those estimates.

Insurance

Management has elected to expense insurance costs when paid. This procedure does not significantly change the financial position or operating results.

HMC MANAGEMENT
Notes to Financial Statements
For the Fiscal Year Ended September 30, 2011

NOTE B – Board Designated Savings Reserves

These reserves are board designated and consist of investments to be held for the purpose of capital projects, major repairs, maintenance, and improvements (docks, ferry, roads, water), and legal and insurance reserves. These assets are held in a Vanguard Money Market account specified for those purposes and constitute a majority of the board designated members' equity. (See Note A)

NOTE C – Future Major Repairs and Replacements

HMC Management's governing documents do not require the accumulation of funds to finance estimated future major repairs and replacements. However, the budget includes a portion for reserves. HMC Management has not completed a study to determine the remaining useful lives of all components of common property and future associated costs of major repairs and replacement.

To fund future projects, HMC Management maintains reserves designated by the board for specific purposes. (See Note B) Whether these funds are sufficient to finance future major repairs and replacements, either directly or through borrowing, has not been determined.

The Board and membership have determined that the water distribution system needs replacing at a cost of \$2.2 million, in order to comply with recent Washington State laws. The project will be financed by a 40 year USDA loan, and construction is estimated to begin in early 2011. Accordingly, the Herron Island Water Utility (a not for profit organization) was formed to manage the water distribution system.

A marine engineering study completed in September 2010, concluded:

- The two steel draw spans need repairs at a cost of \$212,000, although a time line was not specified. The report classified these repairs as "high priority."
- The piles at the homeowners dock marina need replacing within the next two years at a cost of approximately \$250,000.
- The dolphins in place have a useful life of 10-15 years from 2010.

NOTE D – Delinquent Accounts

The position of the Board of Directors is that the Association will ultimately prevail against the remaining homeowners whose assessments and accounts are delinquent (without lien filings). No provision for bad debts was made for 2011, because of the significant reduction of bad debts in 2011.

HMC MANAGEMENT
Notes to Financial Statements
For the Fiscal Year Ended September 30, 2011

NOTE E – Loan Receivable

HMC Management paid a vendor for water utility expenses to be repaid from interim financing.

NOTE F – Recurring Scheduled Maintenance

Ferry maintenance is amortized over a two-year period for dry dock scheduled maintenance (\$91,948 total, \$45,974 each year), beginning FY2011, and over three years for the scheduled engine overhaul (\$34,523 total, \$11,508 each year), beginning FY2011.

NOTE F – Retirement Contributions

HMC Maintenance matches employees' contributions for their 401(k) retirement plan. In 2011 the company paid \$15,772, and in 2010, \$16,501 for these employee benefits.

NOTE G - Change of Accounting Principle

Management has elected to change the expensing of the dry dock and engine overhaul maintenance from when the obligation occurs to amortizing the recurring expense over the life of the maintenance, viz., 2 years for dry dock maintenance and 3 years for engine overhaul. (See Note F above.) No cumulative effect on the financials is reported because each major repair began anew in FY 2011. However, the *pro forma* expense for the dry dock and engine overhaul in FY2010 would have been \$56,330.

NOTE H – Federal and State Taxes

In general, the organization's tax returns may be selected for examination by tax authorities subject to a three-year statute of limitations for federal returns and four years for state tax returns.

NOTE I – Subsequent Events

No events otherwise affecting the financials were reported as of the report date.