

FINANCIAL STATEMENTS
AND
AUDITORS' REPORT

SALLAL WATER ASSOCIATION, INC.

December 31, 2011 and 2010

BLODGETT, MICKELSEN & NAEF, P.S.
CERTIFIED PUBLIC ACCOUNTANTS

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BLODGETT, MICKELSEN & NAEF, P.S.

CERTIFIED PUBLIC ACCOUNTANTS
QUINAULT POINT • 8203 W. QUINAULT AVE. #800
KENNEWICK, WA 99336

FERRIS NAEF C.P.A.
BRENT R. MICKELSEN C.P.A.
THOMAS W. BLODGETT C.P.A.

TELEPHONE: (509) 735-0379
FACSIMILE: (509) 735-0646

MEMBERS
WASHINGTON STATE SOCIETY
OF
CERTIFIED PUBLIC ACCOUNTANTS
AMERICAN INSTITUTE
OF
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITORS' REPORT

Board of Trustees
Sallal Water Association, Inc.

We have audited the accompanying statements of financial position of Sallal Water Association, Inc. (the Association) as of December 31, 2011 and 2010, the related statements of activities and cash flows, and the supplemental schedules of expenses for the years then ended. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. 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 the 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 positions of Sallal Water Association, Inc. as of December 31, 2011 and 2010, and the changes in its membership equity and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 6, 2012 on our consideration of Sallal Water Association, Inc.'s internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and important for assessing the results of our audit.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements of Sallal Water Association, Inc. taken as a whole. The accompanying schedule of expenses is presented for purposes of additional analysis, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

Blodgett, Mickelsen & Naef, P.S.

Kennewick, Washington

March 6, 2012

Sallal Water Association, Inc.

STATEMENTS OF FINANCIAL POSITION

December 31, 2011 and 2010

ASSETS		<u>2011</u>	<u>2010</u>
CURRENT ASSETS (note 1)			
Cash and cash equivalents - unrestricted	\$	577,865	\$ 372,635
Cash - restricted for King County permit fee		-	20,600
Certificates of deposit		428,149	426,040
Member receivables, net		87,943	91,692
Unbilled revenue		21,382	19,969
Prepaid expenses		7,478	5,040
Total current assets		<u>1,122,817</u>	<u>935,976</u>
PROPERTY AND EQUIPMENT, net of accumulated			
depreciation (notes 1, 2 and 3)		7,162,165	7,495,183
Construction work in process		8,989	8,212
		<u>7,171,154</u>	<u>7,503,395</u>
	\$	<u>8,293,971</u>	\$ <u>8,439,371</u>
LIABILITIES AND MEMBERSHIP EQUITY			
CURRENT LIABILITIES (note 4)			
Accounts payable	\$	13,040	\$ 14,419
Accrued business and payroll taxes		5,808	8,755
Accrued interest		19,447	19,801
Accrued vacation		27,225	28,638
Other current liabilities		9,737	13,044
Current portion of long-term debt		74,286	70,760
Total current liabilities		<u>149,543</u>	<u>155,417</u>
LONG-TERM DEBT, net of current portion (note 4)		3,240,432	3,314,718
COMMITMENT AND CONTINGENCIES (note 5)		-	-
MEMBERSHIP EQUITY (note 1)			
Membership certificates		1,800,214	1,802,314
Unrestricted net assets		3,103,782	3,166,922
		<u>4,903,996</u>	<u>4,969,236</u>
	\$	<u>8,293,971</u>	\$ <u>8,439,371</u>

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

Sallal Water Association, Inc.

STATEMENTS OF ACTIVITIES

Years ended December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
CHANGES IN UNRESTRICTED NET ASSETS (note 5)		
Public support and revenue		
Water distribution, storage and service fees	\$ 1,012,793	\$ 969,528
Interest income	3,368	7,690
Rent income - net	12,995	13,067
Operation, maintenance and management service fees, net of expenses of \$14,328 in 2011 and \$53,279 in 2010	45,052	45,367
Miscellaneous income	3,937	1,185
Total public support and revenue	<u>1,078,145</u>	<u>1,036,837</u>
Expenses		
Program services:		
Water distribution	765,563	896,022
Supporting services:		
General and administrative	375,722	395,545
Total expenses	<u>1,141,285</u>	<u>1,291,567</u>
Decrease in unrestricted net assets	(63,140)	(254,730)
NET ASSETS AT BEGINNING OF YEAR	<u>3,166,922</u>	<u>3,421,652</u>
NET ASSETS AT END OF YEAR	<u>\$ 3,103,782</u>	<u>\$ 3,166,922</u>

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

Sallal Water Association, Inc.

STATEMENTS OF CASH FLOWS

Years ended December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
(Decrease) in unrestricted net assets	\$ (63,140)	\$ (254,730)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation	346,899	343,236
Net operating changes in:		
Member receivables and unbilled revenue	2,336	(13,965)
Prepaid assets	(2,438)	(170)
Accounts payable and accrued liabilities	(9,400)	4,119
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>274,257</u>	<u>78,490</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase certificates of deposit	(2,109)	(6,116)
Purchase of property and equipment	(14,658)	(78,308)
NET CASH USED IN INVESTING ACTIVITIES	<u>(16,767)</u>	<u>(84,424)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Principal payments on long-term debt	(70,760)	(67,295)
Memberships redeemed	(2,100)	-
NET CASH USED IN FINANCING ACTIVITIES	<u>(72,860)</u>	<u>(67,295)</u>
NET INCREASE (DECREASE) IN CASH	184,630	(73,229)
Cash and cash equivalents, beginning of period	<u>393,235</u>	<u>466,464</u>
Cash and cash equivalents, end of period	<u>\$ 577,865</u>	<u>\$ 393,235</u>

Cash paid for interest for the years amounted to \$153,616 and \$157,081 for 2011 and 2010, respectively

NOTES TO FINANCIAL STATEMENTS

December 31, 2011 and 2010

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a. Nature of business

Sallal Water Association, Inc. (the "Association") is a not-for-profit association of property owners located in unincorporated southeastern King County, Washington, whose purpose is to provide water to its members.

b. Basis of presentation

The Association prepares the financial statements on the accrual basis. The Association is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets. The Association has no temporarily or permanently restricted net assets.

c. Cash and cash equivalents

For purposes of the statement of cash flows, cash and equivalents include time deposits, certificates of deposit, and all highly liquid debt instruments with original maturities of three months or less.

d. Certificates of deposit

Bank certificates of deposit with original maturities exceeding three months are considered investments and classified separately from cash and equivalents at their fair value.

e. Revenue recognition

The Association records revenue billed to its customers when the meters are read each month. In addition, the Association recognizes unbilled revenue, revenue from water services delivered but not yet billed. Revenues include monitoring taxes and public utility taxes totaling \$49,836 in 2011 and \$47,059 in 2010 which are remitted to state and local taxing authorities. Fees collected from new members are generally recognized as revenue when they are received or when considered non-refundable.

f. Credit risk

Financial instruments which potentially subject the Association to concentrations of credit risk consist principally of cash, cash equivalents and trade receivables. The Association places its cash deposits and cash investments with highly credit quality financial institutions and, by policy, generally limits the amount of credit exposure to any one financial institution. Concentrations of credit risk with respect to trade receivables are limited due to the Association's large number of customers. The Association believes it is not exposed to any significant credit risks.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2011 and 2010

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

g. Member receivables

Member receivables represent amounts billed for water services provided that have not yet been collected. The receivable is considered past due 20 days after the invoice due date and interest is charged on that past due amount. The Association has the option of suspending all rights and privileges, except voting rights, of the member if an account is more than 120 days past due.

h. Allowance for doubtful accounts

The Association uses the allowance method to account for uncollectible member receivables. The allowance for uncollectible accounts is \$0 since the Association's management has estimated the balance in member receivables to be all collectible.

i. Fair value of financial instruments

At December 31, 2011 and 2010, the estimated fair value of each class of the Cooperative's financial instruments either approximated carrying values or were not material.

j. Property and equipment

Property and equipment are recorded at cost if purchased and fair value at the date of acquisition, if received as a donation. Water districts are required to update and submit a comprehensive plan every six years to various authoritative agencies. It is the Association's policy to capitalize part of the cost of the comprehensive plan if new construction arises from the plan. Provision for depreciation of all items of property and equipment is computed on the straight-line method over the estimated useful lives of the assets: 20-40 years for wells, pumps and water distribution systems, and 5-10 years for furniture, fixtures and equipment.

k. Contributions in aid of construction

All contributions received by the Association involve improvements or additions to the existing water distribution system. Certain water service extensions are contributed by developers to the Association in exchange for membership certificates and the right to obtain water from the Association. The estimated costs of such extensions are added to property and equipment and the appropriate number of memberships are added to the membership certificates balance. Where the value of the extensions exceeds the value of certificates issued, the difference is recorded as a contribution in aid of construction and is added to the current year's revenues.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2011 and 2010

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

k. Contributions in aid of construction - continued

When the Association receives water system improvements contributed by developers where actual cost or confirmation of cost from developers is unavailable, the Association's management estimates the fair value of the contributions on the date of acquisition.

l. Membership certificates

Membership certificates are issued to members upon approval and execution of a membership agreement. During 2011, eight new certificates were obtained and one certificate was redeemed. There was no change in certificates in 2010. As of December 31, 2011, there were a total of 1,574 membership certificates.

m. Income taxes

The Association is exempt from federal income tax under Section 501(c)(12) of the Internal Revenue Code. The Association had no unrelated business taxable income in 2011 or 2010.

The Association adopted Accounting Standards Codification (ASC) 740-10, relating to accounting for uncertain tax positions. The Association does not have any uncertain tax positions. The Association files an exempt organization tax return in the U.S. federal jurisdiction and is no longer subject to examination by taxing authorities before 2008.

n. Accounting estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates that 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 the revenues and expenses during the reported period. Actual results could differ from those estimates.

o. Changes in presentation

Certain reclassifications have been made to the prior year's financial statements to conform to the current year's presentation. The reclassifications had no effect on the change in net assets or membership equity for either period.

p. Subsequent events

The Association has evaluated subsequent events through March 6, 2012, the date the financial statements were available to be issued.

Sallal Water Association, Inc.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2011 and 2010

NOTE 2 - PROPERTY AND EQUIPMENT

As of December 31, property and equipment consist of the following:

	<u>2011</u>	<u>2010</u>
Land	\$ 315,829	\$ 315,829
Easements	37,439	37,439
Wells, pumps and water distribution systems	11,316,917	11,308,401
Furniture, fixtures and equipment	<u>161,910</u>	<u>156,545</u>
	11,832,095	11,818,214
Less accumulated depreciation	<u>4,669,930</u>	<u>4,323,031</u>
	<u>\$ 7,162,165</u>	<u>\$ 7,495,183</u>

NOTE 3 - CONSTRUCTION WORK IN PROGRESS

As of December 31, Sallal Water Association, Inc. had construction projects in various stages of completion and had incurred the following costs:

	<u>2011</u>	<u>2010</u>
Tannerwood project	\$ 1,208	\$ 1,208
Cadman Reservoir and booster station	<u>7,781</u>	<u>7,004</u>
	<u>\$ 8,989</u>	<u>\$ 8,212</u>

NOTE 4 - LONG-TERM DEBT

As of December 31, long-term debt consisted of the follows:

	<u>2011</u>	<u>2010</u>
<u>Notes payable to the U.S. Dept. of Agriculture:</u>		
Payable in quarterly installments of \$5,688, including interest at 5%, maturing in 2019.	\$ 82,182	\$ 100,179
Payable in monthly installments of \$828, including interest at 6.875%, maturing in 2026.	91,441	94,958
Payable in monthly installments of \$879, including interest at 6.5%, maturing in 2028.	10,067	19,621

Sallal Water Association, Inc.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2011 and 2010

NOTE 4 - LONG-TERM DEBT - Continued

	<u>2011</u>	<u>2010</u>
Payable in monthly installments of \$368, including interest at 6.125%, maturing 2032.	\$ 51,547	\$ 52,765
Payable in monthly installments of \$1,406, including interest at 6.125%, maturing in 2032.	198,491	203,052
Payable in monthly installments of \$2,367, including interest at 4.75%, maturing 2042.	450,010	456,861
Payable in annual installments of \$131,528, including interest at 4.25%, maturing 2048.	<u>2,430,980</u>	<u>2,458,042</u>
	<u>3,314,718</u>	<u>3,385,478</u>
Less current portion	<u>74,286</u>	<u>70,760</u>
	<u>\$ 3,240,432</u>	<u>\$ 3,314,718</u>

Substantially all assets are pledged as security on the U.S. Dept. of Agriculture notes. The aggregate long-term debt maturing over the next five years is approximately as follows: 2012 - \$74,286; 2013 - \$67,385; 2014 - \$70,711; 2015 - \$74,751; 2016 - \$54,805; and succeeding years of \$2,972,780.

NOTE 5 - COMMITMENTS AND CONTINGENCIES

In 2008, the Association entered into a management, operation and maintenance services agreement with Wilderness Rim Association (WRA), a nonprofit corporation, which owns a water distribution system that serves approximately 634 homes in King County. The Association has agreed to provide certain services and operation of WRA's water system. WRA compensates the Association in accordance with the specific schedule of fees identified within the agreement. The agreement has been extended through 2012.

In 2010, the Association also entered into a water system services agreement with Rogers Group Properties I, LLC, which owns a water distribution system that serves Trucktown. The Association has agreed to provide certain maintenance and operation services in accordance with the agreement through April 2012. The net revenue for these contractual agreements is reported in the Statements of Activities under maintenance and management service fees.

Sallal Water Association, Inc.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2011 and 2010

NOTE 6 - EMPLOYEE RETIREMENT PLAN

The employees of the Association are covered under a 401(k) defined contribution plan that was established on May 1, 2003. All employees of the Association with service of over one year are eligible to participate in the plan. The Association pays an amount equal to the employee's contribution to the plan, up to 8% of the employee's salary. The Board can elect to make discretionary profit sharing contributions to the plan and elected to contribute 2% for each of the plan years ended December 31, 2011 and 2010. Total costs for 2011 and 2010 amounted to \$13,636 and \$16,994, respectively.

SUPPLEMENTAL INFORMATION

Sallal Water Association, Inc.

SCHEDULES OF EXPENSES

December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
WATER DISTRIBUTION:		
Depreciation	\$ 336,467	\$ 333,820
Interest	153,262	156,777
Salaries	95,424	123,457
Utilities	74,640	67,587
Business excise taxes	38,896	46,450
Payroll taxes and benefits	31,392	38,255
Operations, management and maintenance	23,031	99,674
Studies and assessments	7,279	15,174
Contracted engineering services	5,172	14,828
	<u>765,563</u>	<u>896,022</u>
GENERAL AND ADMINISTRATIVE:		
Salaries	128,387	131,897
Payroll taxes and benefits	72,219	76,390
Professional fees	51,253	62,363
Rent	40,181	40,178
Office and miscellaneous expenses	39,024	37,108
Insurance	16,343	18,766
Depreciation	10,432	9,416
Director reimbursement and meetings	9,776	10,868
Property taxes	8,107	8,559
	<u>375,722</u>	<u>395,545</u>
	<u>\$ 1,141,285</u>	<u>\$ 1,291,567</u>

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**REPORT ON INTERNAL CONTROL OVER FINANCIAL
REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON
AN AUDIT OF FINANCIAL STATEMENTS PERFORMED
IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS***

Board of Trustees
Sallal Water Association, Inc.

We have audited the financial statements of Sallal Water Association, Inc. (a nonprofit organization) as of and for the year ended December 31, 2011, and have issued our report thereon dated March 6, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered Sallal Water Association, Inc.'s internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Sallal Water Association, Inc.'s internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Association's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified certain deficiencies in internal control over financial reporting, described below that we consider

to be significant deficiencies in internal control over financial reporting. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

- The Association lacks adequate segregation of duties for some accounts and processes. The Association's management is aware of this deficiency and addresses it by putting compensating controls in place, such as management and board participation in authorizations and examinations.
- Company personnel prepare periodic financial statements and other financial information for internal use that meet the needs of management and the Board of Trustees. However, the Association does not have internal resources to prepare the full-disclosure financial statements required by GAAP for external reporting. The Association's management is aware of this deficiency and addresses it by obtaining our assistance in the preparation of the Association's annual financial statements. Management reviews and approves the completed statements and distributes them to the users.
- Documented bank reconciliations for the operating checking account need to be prepared on a monthly basis. The Association currently maintains a running balance of the checking account. The reconciliations should be reviewed and approved by someone other than the preparer.
- In order to protect the security of the Association's financial records, passwords into the computer systems and financial programs should be used and more frequent back-ups should be performed.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Sallal Water Association's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of management, others within the entity, the Board of Trustees, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Blodgett, Mickelsen & Naef, P.S.

Kennewick, Washington

March 6, 2012