

THE ISLAND WATER ASSOCIATION, INC.

FINANCIAL STATEMENTS

December 31, 1997 and 1996

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**SCHULTZ
CHAPEL
& CO. LLP**

CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Members
The Island Water Association, Inc.
Sanibel, Florida

We have audited the accompanying balance sheets of the Island Water Association, Inc. (the "Association"), as of December 31, 1997 and 1996, and the related statements of operations and system investment, and cash flows 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 audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits 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 audits provide 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 the Island Water Association, Inc. as of December 31, 1997 and 1996, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Schultz, Chapel & Co. LLP
Schultz, Chapel & Co., L.L.P.
January 26, 1998

THE ISLAND WATER ASSOCIATION, INC.
BALANCE SHEETS
DECEMBER 31,

	<u>1997</u>	<u>1996</u>
ASSETS		
PLANT PROPERTY		
Utility plant in service	\$ 27,399,400	\$ 26,099,300
Construction work in progress	<u>397,300</u>	<u>289,900</u>
	27,796,700	26,389,200
Less accumulated depreciation	<u>11,406,200</u>	<u>10,447,200</u>
Net plant property	<u>16,390,500</u>	<u>15,942,000</u>
CURRENT ASSETS		
Cash	275,300	364,000
Accounts receivable	324,200	339,800
Unbilled revenues	180,100	233,100
Prepayments and other	<u>112,900</u>	<u>100,700</u>
Total current assets	<u>892,500</u>	<u>1,037,600</u>
INVESTMENTS		
Participation certificates	<u>275,000</u>	<u>272,600</u>
BOARD RESTRICTED ASSETS		
Reserve fund, cash	392,000	499,200
Reserve fund, marketable securities	<u>1,976,100</u>	<u>1,299,500</u>
Total board restricted assets	<u>2,368,100</u>	<u>1,798,700</u>
RESTRICTED ASSETS		
457 retirement plan assets	74,200	40,900
Marketable securities	<u>300,000</u>	<u>300,000</u>
	<u>374,200</u>	<u>340,900</u>
	<u>\$ 20,300,300</u>	<u>\$ 19,391,800</u>

The accompanying notes are an integral part of these statements.

	<u>1997</u>	<u>1996</u>
CAPITALIZATION, LIABILITIES AND MEMBERS' CONTRIBUTIONS		
CAPITALIZATION		
Net revenues reinvested in the water system	\$ 6,084,600	\$ 5,363,800
Long-term debt, less current maturities	<u>2,167,900</u>	<u>2,220,700</u>
	<u>8,252,500</u>	<u>7,584,500</u>
CURRENT LIABILITIES		
Current maturities of long-term debt	52,800	47,400
Accounts payable and accrued expenses	<u>400,300</u>	<u>295,100</u>
Total current liabilities	<u>453,100</u>	<u>342,500</u>
MEMBERS' CONTRIBUTIONS IN AID OF CONSTRUCTION	<u>11,594,700</u>	<u>11,464,800</u>
	<u>\$ 20,300,300</u>	<u>\$ 19,391,800</u>

THE ISLAND WATER ASSOCIATION, INC.
 STATEMENTS OF OPERATIONS AND SYSTEM INVESTMENT
 For the Years Ended December 31,

	<u>1997</u>	<u>1996</u>
OPERATING REVENUES	\$ 4,664,300	\$ 4,572,900
OPERATING COSTS		
Operations	1,275,700	1,213,400
Maintenance	620,200	634,200
Administration	1,125,200	1,029,500
Depreciation	<u>938,300</u>	<u>914,300</u>
	<u>3,959,400</u>	<u>3,791,400</u>
Operating Income	<u>704,900</u>	<u>781,500</u>
OTHER INCOME AND EXPENSES		
Interest	149,900	120,900
Other	51,900	76,300
Loss on sale of securities	<u>-</u>	<u>(21,300)</u>
	<u>201,800</u>	<u>175,900</u>
Income before interest charges	<u>906,700</u>	<u>957,400</u>
INTEREST CHARGES ON LONG-TERM DEBT	248,100	253,100
Less interest capitalized into capital projects	<u>62,200</u>	<u>48,700</u>
	<u>185,900</u>	<u>204,400</u>
Net Income	720,800	753,000
NET REVENUES REINVESTED IN THE WATER SYSTEM		
Beginning of year	<u>5,363,800</u>	<u>4,610,800</u>
End of Year	<u>\$ 6,084,600</u>	<u>\$ 5,363,800</u>

The accompanying notes are an integral part of these statements.

THE ISLAND WATER ASSOCIATION, INC.
 STATEMENTS OF CASH FLOWS
 For the Years Ended December 31,

	<u>1997</u>	<u>1996</u>
CASH FLOWS PROVIDED BY (USED IN)		
OPERATING ACTIVITIES		
Cash received from customers	\$ 4,763,800	\$ 4,586,700
Cash paid to suppliers and employees	(2,907,400)	(2,820,700)
Interest received	149,900	120,900
Interest paid (net of amount capitalized)	<u>(185,900)</u>	<u>(204,400)</u>
Net cash flows provided by operating activities	<u>1,820,400</u>	<u>1,682,500</u>
CASH FLOWS PROVIDED BY (USED IN)		
INVESTING ACTIVITIES		
Capital expenditures (including capitalized interest of \$62,200 and \$48,700 for 1997 and 1996, respectively)	(1,407,500)	(1,527,500)
Purchases of marketable securities	(1,626,600)	(1,100,300)
Redemption of marketable securities	950,000	968,800
Proceeds from the sale of assets	21,000	-
Investments in participation certificates	<u>(2,400)</u>	<u>(3,800)</u>
Net cash flows used in investing activities	<u>(2,065,500)</u>	<u>(1,662,800)</u>
CASH FLOWS PROVIDED BY (USED IN)		
FINANCING ACTIVITIES		
Payment of debt	(47,400)	(42,400)
Increase in members' contributions in aid of construction	<u>129,900</u>	<u>159,300</u>
Net cash flows provided by financial activities	<u>82,500</u>	<u>116,900</u>
Net (decrease) in cash	(162,600)	136,600
CASH, beginning of year	<u>904,100</u>	<u>767,500</u>
CASH, end of year	<u>\$ 741,500</u>	<u>\$ 904,100</u>

NON-CASH INVESTING AND FINANCING ACTIVITIES

During the year ended December 31, 1996, the Association received title to a distribution system from Chruchwood Estates in the form of a contribution in aid of construction at a value of \$84,000.

The accompanying notes are an integral part of these statements.

THE ISLAND WATER ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS
December 31, 1997 and 1996

NOTE 1 - ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Organization

The Island Water Association, Inc. (the "Association") is a not-for-profit organization exempt from federal and state income taxes under Internal Revenue Code Section 501(c)(4). The Association provides water to commercial and residential structures on Sanibel and Captiva islands, two barrier islands located in Southwest Florida.

Each connection for the services rendered by the Association entitles the subscriber to one membership certificate. At any meeting of the members of the Association, each member shall be entitled to only one vote, regardless of the number of certificates of membership held.

Significant Accounting Policies

Regulatory agency and franchise

On July 16, 1996, the Association was granted a 20 year franchise by the Board of County Commissioners of Lee County, Florida (the County) and the City of Sanibel (the City). This franchise agreement requires that the Sanibel City Council approve any rate changes requested by the Association. The agreement also allows either the City or the County to purchase the property of the Association at the then fair market value and requires the Association to give the City or the County the first right of refusal regarding the sale of the Association's property.

Utility plant in service

Utility plant in service is recorded at cost. Depreciation is provided over the estimated useful lives of the assets, using the straight-line method. The cost of depreciable plant assets retired, plus the cost of removal, less any sale proceeds, is charged against accumulated depreciation.

Estimates

Management uses estimates and assumptions in preparing these financial statements in accordance with generally accepted accounting principles. Those estimates and assumptions affect the reported amounts of assets and liabilities, and the reported revenues and expenses. Actual results could vary from the estimates that were used.

THE ISLAND WATER ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS
December 31, 1997 and 1996

NOTE 1 - ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)

Significant Accounting Policies (Continued)

Marketable securities

Marketable securities consist entirely of U.S. Treasury Securities and are carried at market value. These securities are not considered to be cash equivalents.

Unbilled revenues

Unbilled revenues represent revenues between the last dates of the cycle billings and year-end.

Investments

The Association is required to invest in participation certificates in the National Bank for Cooperatives, as a requirement of its debt agreement. The Association recognizes income from this investment on the accrual basis. This method records income and increases the Association's invested amount, based on the patronage dividends declared by the Bank. Refer to Note 3 for a more complete explanation of these participation certificates.

Allowance for funds used during construction

Interest is capitalized on funds used during construction at the weighted average rate paid by the Association on its long-term debt.

Members' contributions in aid of construction

Members' contributions in aid of construction consists of connection fees received from members and distribution lines contributed to the Association by real estate developers since the inception of the Association. These distribution lines are valued at an estimate of the developers' costs and are added to the Association's transmission and distribution plant.

THE ISLAND WATER ASSOCIATION, INC.
 NOTES TO FINANCIAL STATEMENTS
 December 31, 1997 and 1996

NOTE 1 - ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)

Significant Accounting Policies (Continued)

Cash and cash equivalents

For the purpose of the statement of cash flows, the Association considers funds subject to immediate withdrawal by check to be cash equivalents. The Association also has on deposit with commercial banks amounts in excess of the FDIC insurance amounts.

For statement of cash flows purposes the cash balance is comprised of the following:

Cash Balances		
Unrestricted	\$275,300	\$364,000
Restricted	392,000	499,200
Cash 457 plan	<u>74,200</u>	<u>40,900</u>
	<u>\$741,500</u>	<u>\$904,100</u>

NOTE 2 - UTILITY PLANT IN SERVICE

Utility plant in service consists of the following:

	<u>1997</u>	<u>1996</u>
Source of supply plant	\$ 3,242,700	\$ 3,206,400
Pumping plant	767,500	748,000
Water treatment plant	7,133,300	6,838,800
Transmission and distribution plant	12,651,800	11,801,900
General plant	<u>3,604,100</u>	<u>3,504,200</u>
	<u>\$27,399,400</u>	<u>\$26,099,300</u>

THE ISLAND WATER ASSOCIATION, INC.
 NOTES TO FINANCIAL STATEMENTS
 December 31, 1997 and 1996

NOTE 3 - LONG-TERM DEBT

Long-term debt consists of the following:

	<u>1997</u>	<u>1996</u>
11.22% mortgage note payable in quarterly installments of \$62,825 including interest, due April, 2014	\$1,861,200	\$1,900,100
9.90% mortgage note payable to a financial institution, monthly payments of principal and interest in the amount of \$3,824, final payment due April, 2014	<u>359,500</u>	<u>368,000</u>
	2,220,700	2,268,100
Less current maturities	<u>52,800</u>	<u>47,400</u>
	<u>\$2,167,900</u>	<u>\$2,220,700</u>

Maturities of long-term debt are as follows:

<u>December 31,</u>	
1998	\$ 52,800
1999	58,900
2000	65,600
2001	73,100
2002	81,500
Thereafter	<u>1,888,800</u>
	<u>\$2,220,700</u>

Substantially all assets are pledged as collateral for long-term debt.

The agreements with the National Bank for Cooperatives calls for the Association to maintain a cash or marketable securities balance of \$300,000 to be used for repair or replacement of plant assets, payments of principal and interest, and for expansion of plant assets with prior lender approval. The agreement precludes the Association from entering into other indebtedness and requires certain working capital and tangible net worth ratios be maintained.

THE ISLAND WATER ASSOCIATION, INC.
NOTES TO FINANCIAL STATEMENTS
December 31, 1997 and 1996

NOTE 3 - LONG-TERM DEBT (Continued)

The loan agreement provides for a penalty if the loan is paid off prior to maturity. The penalty approximates the net present value of the difference between current market interest rates and the debt's stated rate. At the end of 1997 and 1996, the approximate amount of the penalty would have been \$635,800 and \$516,500, respectively.

The Association is required to purchase Participation Certificates in the National Bank for Cooperatives. These certificates are required by the Farm Credit Act of 1971 and the Bank's capital plan, as adopted by its Board of Directors, and represent capital ownership by the Association in the Bank. Additionally, the Association is allocated income from these participation certificates based on the Bank's profitability.

NOTE 4 - PENSION PLAN

The Association established a defined-contribution pension plan covering substantially all employees on November 1, 1979. This plan requires the Association to contribute annually an amount equal to 10% of each employee's salary plus an additional 5.7% of any salary in excess of the social security taxable wage base. The Association's contributions for 1997 and 1996 were approximately \$122,300 and \$117,100, respectively.

The Association has another retirement plan that is a deferred compensation agreement with its supervising personnel under the Internal Revenue Code (IRC) section 457. This IRC code allows for employees to defer a portion of their salary until retirement. The Delaware Group of Mutual Funds is administering the plan. The cumulative amount contributed through December 31, 1997 was \$59,500. The market value of the investments purchased with these contributions was \$74,200 at December 31, 1997.

During 1997, the Association adopted another defined contribution savings plan under Section 401(k) of the Internal Revenue Code (IRC) for all eligible employees. This plan allows employees to defer up to 8% of their income on a pretax basis, subject to IRC limitations, through payroll contributions. In accordance with the provisions of the plan, the Association may elect to match 100% of employee contributions up to a maximum amount of 5% of gross pay.

For the year ended December 31, 1997 the Association recorded expense for the matching contributions of \$57,100.

THE ISLAND WATER ASSOCIATION, INC.
 NOTES TO FINANCIAL STATEMENTS
 December 31, 1997 and 1996

NOTE 5 - STATEMENTS OF CASH FLOWS

Presented below is the reconciliation of net income to net cash provided by operating activities.

RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>1997</u>	<u>1996</u>
Net income	\$ <u>720,800</u>	\$ <u>753,000</u>
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	938,300	914,200
Loss on sale of investment securities	-	21,300
(Increase) decrease in:		
Accounts receivable	15,600	(109,400)
Unbilled revenues	53,000	59,400
Prepayments and other	(12,200)	(14,200)
Increase (decrease) in:		
Accounts payable and accrued expenses	<u>104,900</u>	<u>58,200</u>
	<u>1,099,600</u>	<u>929,500</u>
Net cash provided by operating activities	<u>\$1,820,400</u>	<u>\$1,682,500</u>