

THE ISLAND WATER ASSOCIATION, INC.

FINANCIAL STATEMENTS

December 31, 2003 and 2002

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David L. Schultz, CPA,* ABV
Clifford Chaipel, CPA*
Martin A. Redovan, CPA,* CVA
Russell T. Baker, CPA*



*Regulated by the State of Florida

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, 2003 and 2002, 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 auditing standards generally accepted in the United States of America. 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, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.


Schultz, Chaipel & Co., L.L.P.
January 29, 2004

12660 World Plaza Lane
Fort Myers, Florida 33907
(239) 939-5333
Fax: (239) 939-4682
E-Mail: scc@swflcpa.com
Website: www.swflcpa.com

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

ASSETS	<u>2003</u>	<u>2002</u>
PLANT PROPERTY		
Utility plant in service	\$ 37,947,800	\$ 36,824,600
Construction work in progress	<u>121,100</u>	<u>39,000</u>
	38,068,900	36,863,600
Less accumulated depreciation	<u>15,772,300</u>	<u>14,697,800</u>
Net plant property	<u>22,296,600</u>	<u>22,165,800</u>
CURRENT ASSETS		
Cash - operating	668,500	921,800
Accounts receivable	333,500	402,800
Unbilled revenues	173,200	176,300
Prepayments and other	<u>127,900</u>	<u>156,000</u>
Total current assets	<u>1,303,100</u>	<u>1,656,900</u>
INVESTMENTS		
Participation certificates	<u>380,100</u>	<u>354,700</u>
BOARD RESTRICTED ASSETS		
Reserve fund, cash	228,100	553,700
Reserve fund, marketable securities	<u>5,895,100</u>	<u>5,154,600</u>
Total board restricted assets	<u>6,123,200</u>	<u>5,708,300</u>
RESTRICTED ASSETS		
457 retirement plan assets	51,300	53,700
Marketable securities	<u>600,000</u>	<u>600,000</u>
Total restricted assets	<u>651,300</u>	<u>653,700</u>
	<u>\$ 30,754,300</u>	<u>\$ 30,539,400</u>

The accompanying notes are an integral part of these statements.

CAPITALIZATION, LIABILITIES AND MEMBERS' CONTRIBUTIONS	<u>2003</u>	<u>2002</u>
CAPITALIZATION		
Net revenues reinvested in the water system	\$ 10,872,200	\$ 10,543,100
Long-term debt, less current maturities	<u>5,244,100</u>	<u>5,539,000</u>
Total capitalization	<u>16,116,300</u>	<u>16,082,100</u>
CURRENT LIABILITIES		
Current maturities of long-term debt	314,600	304,200
Accounts payable and accrued expenses	<u>292,900</u>	<u>408,200</u>
Total current liabilities	<u>607,500</u>	<u>712,400</u>
MEMBERS' CONTRIBUTIONS IN AID OF CONSTRUCTION		
	<u>14,030,500</u>	<u>13,744,900</u>
	<u>\$ 30,754,300</u>	<u>\$ 30,539,400</u>

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

	<u>2003</u>	<u>2002</u>
OPERATING REVENUES	<u>\$ 5,388,500</u>	<u>\$ 5,635,400</u>
OPERATING COSTS		
Operations	1,385,500	1,396,800
Maintenance	735,200	749,600
Administration	1,583,300	1,715,200
Depreciation	<u>1,105,900</u>	<u>1,114,300</u>
	<u>4,809,900</u>	<u>4,975,900</u>
Operating Income	<u>578,600</u>	<u>659,500</u>
OTHER INCOME		
Interest and earnings from investments	184,800	204,300
Other	<u>31,200</u>	<u>142,900</u>
	<u>216,000</u>	<u>347,200</u>
Income before interest charges	<u>794,600</u>	<u>1,006,700</u>
INTEREST CHARGES ON LONG-TERM DEBT	476,700	489,400
Less interest capitalized into capital projects	<u>(11,200)</u>	<u>(30,200)</u>
	<u>465,500</u>	<u>459,200</u>
Net Income	329,100	547,500
NET REVENUES REINVESTED IN THE WATER SYSTEM		
Beginning of year	<u>10,543,100</u>	<u>9,995,600</u>
End of year	<u>\$ 10,872,200</u>	<u>\$ 10,543,100</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>2003</u>	<u>2002</u>
CASH FLOWS PROVIDED BY (USED IN)		
OPERATING ACTIVITIES		
Cash received from customers	\$ 5,575,100	\$ 5,778,800
Cash paid to suppliers and employees	(3,795,400)	(3,924,300)
Interest received	175,400	249,600
Interest paid (net of amount capitalized)	<u>(461,300)</u>	<u>(455,000)</u>
Net cash flows provided by operating activities	<u>1,493,800</u>	<u>1,649,100</u>
 CASH FLOWS PROVIDED BY (USED IN)		
INVESTING ACTIVITIES		
Capital expenditures (including capitalized interest of \$11,200 and \$30,200 for 2003 and 2002, respectively)	(1,251,200)	(1,540,600)
Purchases of marketable securities	(4,350,000)	(2,600,000)
Redemption of marketable securities	3,525,000	1,850,000
Net investments in participation certificates	<u>-</u>	<u>(28,700)</u>
Net cash flows used in investing activities	<u>(2,076,200)</u>	<u>(2,319,300)</u>
 CASH FLOWS PROVIDED BY (USED IN)		
FINANCING ACTIVITIES		
Payment of debt	(284,500)	(287,200)
Proceeds from long-term debt	-	1,400,000
Increase in members' contributions in aid of construction	<u>285,600</u>	<u>358,300</u>
Net cash flows provided by financial activities	<u>1,100</u>	<u>1,471,100</u>
 Net increase (decrease) in cash	 (581,300)	 800,900
 CASH, beginning of year	 <u>1,529,200</u>	 <u>728,300</u>
 CASH, end of year	 <u>\$ 947,900</u>	 <u>\$ 1,529,200</u>

The accompanying notes are an integral part of these statements.

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 is 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.

The Association is subject to various commitments, contingencies and restrictions due to obtaining permits from the state of Florida and from the South Florida Water Management District.

Utility plant in service

Utility plant in service is recorded at cost or at fair value if the assets are contributed to the Association from a developer. Depreciation is provided over the estimated useful lives of the classes of 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.

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 (Co-Bank) 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.

Cash and cash equivalents

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

THE ISLAND WATER ASSOCIATION, INC.
 NOTES TO FINANCIAL STATEMENTS
 December 31, 2003 and 2002

NOTE 1 - ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)

Significant Accounting Policies (Continued)

Cash and cash equivalents (Continued)

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

	<u>2003</u>	<u>2002</u>
Cash balances		
Operating	\$668,500	\$ 921,800
Restricted	228,100	553,700
Cash 457 plan	<u>51,300</u>	<u>53,700</u>
	<u>\$947,900</u>	<u>\$1,529,200</u>

NOTE 2 - UTILITY PLANT IN SERVICE

Utility plant in service consists of the following:

	<u>2003</u>	<u>2002</u>
Source of supply plant	\$ 7,495,400	\$ 7,495,400
Pumping plant	827,000	826,800
Water treatment plant	8,791,100	8,505,300
Transmission and distribution plant	17,282,900	16,524,500
General plant	<u>3,551,400</u>	<u>3,472,600</u>
	<u>\$37,947,800</u>	<u>\$36,824,600</u>

NOTE 3 - LONG-TERM DEBT

Long-term debt, all of which is payable to Co-Bank, consists of the following:

	<u>2003</u>	<u>2002</u>
11.22% mortgage note payable in quarterly installments of \$62,825 including interest, final payment due April 2014	\$1,531,300	\$1,587,100

THE ISLAND WATER ASSOCIATION, INC.
 NOTES TO FINANCIAL STATEMENTS
 December 31, 2003 and 2002

NOTE 3 - LONG-TERM DEBT (Continued)

	<u>2003</u>	<u>2002</u>
9.90% mortgage note payable, monthly payments of principal and interest in the amount of \$3,824, final payment due April 2014	286,300	301,700
6.75% mortgage note payable which financed the drilling of a deep injection well, monthly principal payment of \$10,000 plus interest, final payment due December 2024.	2,520,000	2,640,000
7.03% mortgage note payable which financed the repair of the deep injection well, monthly principal payment of \$7,778 plus interest, final payment due December 2016	1,221,100	1,314,400
	5,558,700	5,843,200
Less current maturities	<u>314,600</u>	<u>304,200</u>
	<u>\$5,244,100</u>	<u>\$5,539,000</u>

Maturities of long-term debt are as follows:

<u>December 31,</u>	
2004	\$ 314,600
2005	326,200
2006	339,200
2007	353,600
2008	369,800
Thereafter	<u>3,855,300</u>
	<u>\$5,558,700</u>

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

The agreements with Co-Bank calls for the Association to maintain a cash or marketable securities balance of \$600,000 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.

NOTE 3 - LONG-TERM DEBT (Continued)

The loan agreements provide for a penalty if the loans are 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 2003 and 2002, the approximate amount of the penalty was \$939,900 and \$930,600, respectively.

The Association is required to purchase Participation Certificates in Co-Bank. 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 PLANS

In mid-2003, the Association combined its two previously-offered retirement plans into one overall "safe harbor 401(k) plan." This plan allows for two types of retirement funding. One type is a fixed-rate contribution, covering substantially all employees. This type of benefit 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 2003 and 2002 were approximately \$174,000 and \$174,800, respectively for this portion of the plan.

The second type of retirement funding is a salary deferral savings plan with limited company match. This type of benefit allows employees to defer salary up to the maximum allowed by the limitations imposed by the Internal Revenue Code through payroll deductions. In accordance with the provisions of the plan, the Association will match 100% of employee contributions up to a maximum amount of 5% of gross pay and the Association will also match 50% of any deferral amount over 5%, but not more than 10% of gross pay. For the years ended December 31, 2003 and 2002, the Association recorded expense for the matching contributions of \$109,300 and \$92,500, respectively.

The Association has also established another retirement plan, which 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 ISLAND WATER ASSOCIATION, INC.
 NOTES TO FINANCIAL STATEMENTS
 December 31, 2003 and 2002

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>2003</u>	<u>2002</u>
Net income	\$ <u>329,100</u>	\$ <u>547,500</u>
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	1,105,900	1,114,300
Net unrealized security losses	108,600	45,300
Proceeds from the sale of assets	14,500	6,200
(Increase) decrease in:		
Accounts receivable	69,300	23,800
Unbilled revenues	3,100	(29,500)
Prepayments and other	(49,500)	(26,400)
Increase (decrease) in:		
Accounts payable and accrued expenses	<u>(87,200)</u>	<u>(32,100)</u>
	<u>1,164,700</u>	<u>1,101,600</u>
Net cash provided by operating activities	<u>\$1,493,800</u>	<u>\$1,649,100</u>