

THE ISLAND WATER ASSOCIATION, INC.

FINANCIAL STATEMENTS

December 31, 2005 and 2004

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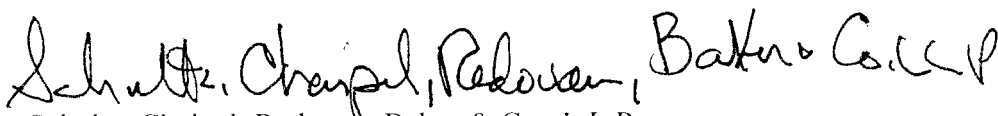
INDEPENDENT AUDITORS' REPORT

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, 2005 and 2004, 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, 2005 and 2004, 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, Redovan, Baker & Co., L.L.P.
January 27, 2006

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

ASSETS	<u>2005</u>	<u>2004</u>
PLANT PROPERTY		
Utility plant in service	\$ 40,414,000	\$ 39,077,900
Construction work in progress	109,700	394,900
	<u>40,523,700</u>	<u>39,472,800</u>
Less accumulated depreciation	17,954,700	16,959,700
Net plant property	<u>22,569,000</u>	<u>22,513,100</u>
CURRENT ASSETS		
Cash - operating	579,200	609,000
Accounts receivable	344,700	322,500
Amount due from FEMA	-	250,000
Unbilled revenues	150,700	198,300
Prepayments and other	146,400	121,400
Total current assets	<u>1,221,000</u>	<u>1,501,200</u>
INVESTMENTS		
Participation certificates	<u>426,400</u>	<u>404,800</u>
BOARD RESTRICTED ASSETS		
Reserve fund, cash	7,100	431,800
Reserve fund, marketable securities	5,455,700	5,253,100
Total board restricted assets	<u>5,462,800</u>	<u>5,684,900</u>
RESTRICTED ASSETS		
Marketable securities	<u>600,000</u>	<u>600,000</u>
Total restricted assets	<u>600,000</u>	<u>600,000</u>
	<u>\$ 30,279,200</u>	<u>\$ 30,704,000</u>

The accompanying notes are an integral part of these statements.

CAPITALIZATION, LIABILITIES AND MEMBERS' CONTRIBUTIONS	<u>2005</u>	<u>2004</u>
CAPITALIZATION		
Net revenues reinvested in the water system	\$ 10,343,200	\$ 10,952,500
Long-term debt, less current maturities	<u>4,559,000</u>	<u>4,898,200</u>
Total capitalization	<u>14,902,200</u>	<u>15,850,700</u>
CURRENT LIABILITIES		
Current maturities of long-term debt	339,200	326,200
Accounts payable and accrued expenses	<u>301,300</u>	<u>274,800</u>
Total current liabilities	<u>640,500</u>	<u>601,000</u>
LONG-TERM LIABILITIES		
Accrued post employment health insurance liability	<u>241,000</u>	<u>-</u>
Total long-term liabilities	<u>241,000</u>	<u>-</u>
MEMBERS' CONTRIBUTIONS IN AID OF CONSTRUCTION		
	<u>14,495,500</u>	<u>14,252,300</u>
	<u>\$ 30,279,200</u>	<u>\$ 30,704,000</u>

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

	<u>2005</u>	<u>2004</u>
OPERATING REVENUES	<u>\$ 5,209,700</u>	<u>\$ 5,451,700</u>
OPERATING COSTS		
Operations	1,546,600	1,602,400
Maintenance	866,700	804,200
Administration	2,150,000	1,808,800
Depreciation	<u>1,141,900</u>	<u>1,187,400</u>
	<u>5,705,200</u>	<u>5,402,800</u>
Operating Income (Loss)	<u>(495,500)</u>	<u>48,900</u>
OTHER INCOME		
Interest and earnings from investments	101,300	56,800
FEMA grant	-	250,000
Other	<u>150,000</u>	<u>151,200</u>
	<u>251,300</u>	<u>458,000</u>
Income (loss) before interest charges	<u>(244,200)</u>	<u>506,900</u>
INTEREST CHARGES ON LONG-TERM DEBT	425,300	452,600
Less interest capitalized into capital projects	<u>(60,200)</u>	<u>(26,000)</u>
	<u>365,100</u>	<u>426,600</u>
Net Income (Loss)	(609,300)	80,300
NET REVENUES REINVESTED IN THE WATER SYSTEM		
Beginning of year	<u>10,952,500</u>	<u>10,872,200</u>
End of year	<u>\$ 10,343,200</u>	<u>\$ 10,952,500</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>2005</u>	<u>2004</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received-customers and operating activities	\$ 5,613,500	\$ 5,564,100
Cash paid-suppliers and employees	(4,320,600)	(4,230,800)
Earnings from investments	177,000	103,400
Interest paid (net of amount capitalized)	<u>(365,200)</u>	<u>(426,600)</u>
Net cash flows provided by operating activities	<u>1,104,700</u>	<u>1,010,100</u>
 CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures (including capitalized interest of \$60,200 and \$26,000 for 2005 and 2004, respectively)	(1,197,900)	(1,375,100)
Purchases of marketable securities	(3,117,700)	(2,544,500)
Redemption of marketable securities	<u>2,839,400</u>	<u>3,143,700</u>
Net cash flows used in investing activities	<u>(1,476,200)</u>	<u>(775,900)</u>
 CASH FLOWS FROM FINANCING ACTIVITIES		
Payment of debt	(326,200)	(334,300)
Increase in members' contributions in aid of construction	<u>243,200</u>	<u>193,000</u>
Net cash flows used in financial activities	<u>(83,000)</u>	<u>(141,300)</u>
 Net increase (decrease) in cash	(454,500)	92,900
 CASH, beginning of year	<u>1,040,800</u>	<u>947,900</u>
 CASH, end of year	<u>\$ 586,300</u>	<u>\$ 1,040,800</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 amounts consist 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, 2005 and 2004

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>2005</u>	<u>2004</u>
Cash balances		
Operating	\$579,200	\$ 609,000
Restricted	<u>7,100</u>	<u>31,800</u>
	<u>\$586,300</u>	<u>\$ 1,040,800</u>

NOTE 2 - UTILITY PLANT IN SERVICE

Utility plant in service consists of the following:

	<u>2005</u>	<u>2004</u>
Source of supply plant	\$ 7,524,600	\$ 7,524,600
Pumping plant	939,300	911,200
Water treatment plant	9,217,900	9,135,500
Transmission and distribution plant	19,034,800	17,908,300
General plant	<u>3,697,400</u>	<u>3,598,300</u>
	<u>\$40,414,000</u>	<u>\$39,077,900</u>

NOTE 3 - LONG-TERM DEBT

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

	<u>2005</u>	<u>2004</u>
11.22% mortgage note payable in quarterly installments of \$62,825 including interest, final payment due April 2014	\$1,333,100	\$1,427,300

THE ISLAND WATER ASSOCIATION, INC.
 NOTES TO FINANCIAL STATEMENTS
 December 31, 2005 and 2004

NOTE 3 - LONG-TERM DEBT (Continued)

	<u>2005</u>	<u>2004</u>
9.90% mortgage note payable, monthly payments of principal and interest in the amount of \$3,824, final payment due April 2014	250,600	269,300
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.	2,280,000	2,400,000
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	<u>1,034,500</u>	<u>1,127,800</u>
	4,898,200	5,224,400
Less current maturities	<u>339,200</u>	<u>326,200</u>
	<u>\$4,559,000</u>	<u>\$4,898,200</u>

Maturities of long-term debt are as follows:

December 31,

2007	\$ 353,600
2008	369,800
2009	387,700
2010	407,800
Thereafter	<u>3,040,100</u>
	<u>\$4,559,000</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 2005 and 2004, the approximate amount of the penalty was \$552,900 and \$859,500, 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 contributory plan, covering substantially all employees. 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 2005 and 2004 were approximately \$204,700 and \$171,600, respectively for this portion of the plan.

The second type of retirement funding is a salary deferral savings plan with limited company match. This portion of the plan 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, 2005 and 2004, the Association recorded expense for the matching contributions of \$128,500 and \$114,100, respectively.

NOTE 5 - POST EMPLOYMENT BENEFIT PLAN

In 2005 the Association instituted a retirement health insurance benefit plan covering all employees. The health care plan is funded 100% by the Association and provides for the reimbursement of so called “Medi-Gap” insurance premiums for retired employees and their spouses over the age of 65 for the remainder of their lifetime.

Generally accepted accounting principles require that the cost of a post employment benefit such as this be recognized over the term of the employee’s period of employment. The initial implementation for this type of plan creates a past service cost element for the cost of the program incurred before the actual implementation of the benefit. This past service cost is being recognized as a part of the yearly expense of the benefit. Recognizing the past service costs in this method approximates a straight line method of recognition.

The Association is accruing a yearly amount that will ultimately equal the present value of the anticipated liability when employees retire. The calculation of this anticipated liability is based on a detailed list of employees currently employed by the Association, their anticipated retirement dates and their life expectancies based on actuarial tables provided by the government. The calculations include a general inflation factor of 4% and an annual health insurance cost increase of 6%.

The plan is unfunded and will be paid for out of current operations as payments are required.

The expense amount recognized in 2005 is \$241,000. The estimated amounts to be paid in total for each of the following five year periods are:

Years 2006 through 2010	\$12,200
Years 2010 through 2015	\$67,500
Years 2016 through 2020	\$159,500

THE ISLAND WATER ASSOCIATION, INC.
 NOTES TO FINANCIAL STATEMENTS
 December 31, 2005 and 2004

NOTE 6 - STATEMENTS OF CASH FLOWS

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

RECONCILIATION OF NET INCOME (LOSS) TO NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>2005</u>	<u>2004</u>
Net income	\$ <u>(609,300)</u>	\$ <u>80,300</u>
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	1,141,900	1,187,400
Unrealized security losses	75,800	42,800
Participation credits received from CoBank	(21,600)	(24,700)
(Increase) decrease in:		
Accounts receivable	227,800	(25,100)
Amount due from FEMA	-	(250,000)
Unbilled revenues	47,600	11,000
Prepayments and other	(25,000)	6,500
Increase (decrease) in:		
Accounts payable and accrued expenses	<u>267,500</u>	<u>(18,100)</u>
	<u>1,714,000</u>	<u>929,800</u>
Net cash provided by operating activities	<u>\$1,104,700</u>	<u>\$1,010,100</u>