

**HARBOR VIEW HOMEOWNERS ASSOCIATION, INC.**

**FINANCIAL STATEMENTS**

**YEAR ENDED DECEMBER 31, 2004**

Prepared by Donald D. Graff, C.P.A., a P.C.,  
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July 28, 2005

Mr. Jack *Rose*  
Fax: 282-7666  
Pages to follow: 11

In Re: Harbor View Condominium Association, Inc.  
2003 Corporation Income Tax Returns

Dear Jack:

As we discussed recently, I believe a serious, possibly irreversible error may have occurred in the preparation of the 2003 corporation income tax returns. Specifically, income of \$102,488. may have been improperly excluded from the computation of taxable income (2003 form 1120, Schedule M-1, line 7). The effect of the potential error is an understatement of federal and state income taxes of \$25,905. Interest and penalties to-date would approximate \$4,000., thus the total contingency is \$30,000.

The statement five attachment to the 2003 form 1120 describes the exclusion of income as "exempt function income-HOA \$102,488." Exempt function income is a concept defined in the Internal Revenue Service regulations for code section 528 dealing with the tax treatment of homeowners associations. In order for a homeowners association to take advantage of the tax benefits provided by section 528, it must make an election by filing Form 1120-H prior to the due date, including extensions, of the income tax return. A form 1120-H was not filed, therefore the tax benefits of section 528 do not apply to the 2003 tax return, instead, the complex regular tax provisions of the code and regulations are applicable to the computation of taxable income. It is not possible to file an amended Form 1120-H presently, since an election was not filed timely.

The most important regulation associated with the filing of a regular Form 1120 is Internal Revenue Ruling 70-604. It provides for the exclusion of excess membership income from taxable income if the homeowners association elects to either return the excess funds to the members or apply the excess income to the next year's assessments (a rollover). The rollover election must be approved by the association members, not just the board, and be made prior to the filing of the year's tax return. Typically, the resolution to cover how owners want to dispose of excess operating funds is approved at the annual meeting. I am not aware of an election by the members to apply the excess funds for 2003 to the subsequent year, 2004, and if indeed no election was approved, this regulation cannot be relied upon for the filing of the 2003 tax return. Did the members approve an election to rollover excess funds?

Internal Revenue Code Section 118 provides an exclusion from gross income with respect to any contribution of money to the capital of the taxpayer. "Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income". (Rev. Rul. 118-1). The Statement of Revenues, Expenses and Changes in Fund Balance for the year ended December 31, 2003 (page six) reports association dues of \$278,075. as operating income. There is no separate financial reporting of any amounts having been credited to surplus or to a special account. Similarly, there is no separate reporting of operating and reserve account expenses. Likewise, the Statement of Cash Flows, as reported on page seven, fails to distinguish between operating income, contributions to capital, and reserve fund revenue and expenses. Since the financial statements do not report any revenue as contributions to capital, nor separately report operating account and reserve account revenue and expense, I believe it is unlikely that IRC section 118 could be relied upon as a basis to exclude the unsubstantiated amount of \$102,488.

I think the appropriate course of action is to provide Paillet, Meunier and LeBlanc with a copy of my letter and request an explanation of their basis for the exclusion from income of \$102,488. A timely resolution of this matter is critical due to the possibility that an unfavorable audit by the Internal Revenue

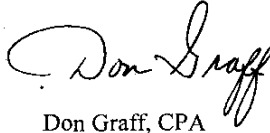
July 28, 2005

Service or the State of Louisiana may subject the association to substantial back taxes, penalties and interest.

I've attached some of my research for your review. I am sending a copy of this letter to Debbie Popoff of Wagner & Truax so she will be informed of this matter.

Additionally, 385 shares of SPDR Trust Units were sold on February 13, 2003 for a consideration of \$31,246.50. The funds were credited to the Schwab One account. These securities were purchased on two occasions: February 22, 2000 for \$30,447.14 and on April 17, 2000 for \$21,979.95, resulting in a total cost of \$52,427.09. A loss of \$21,180.59 was realized on February 13, 2003, however the financial statements report a loss on the sale of securities of \$2,722. (page six). The proceeds from the sale appear not to be reported on the Statement of Cash Flows. Was the sale of these securities omitted from the 2003 financial statements and tax returns?

Very truly yours,

A handwritten signature in black ink that reads "Don Graff". The signature is written in a cursive style with a large, looping initial "D".

Don Graff, CPA

**HARBOR VIEW HOMEOWNERS ASSOCIATION, INC.**

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ACCOUNTANT'S COMPILATION REPORT

To the Board of Directors  
Harbor View Homeowners Association, Inc.

We have compiled the accompanying Balance Sheet of Harbor View Homeowners Association, Inc. as of December 31, 2004, and the related Statements of Revenue and Expenses and Changes in Fund Balance and Cash Flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. We have not audited or reviewed the accompanying financial statements and supplementary information and, accordingly, do not express an opinion or any other form of assurance on them.

*Donald D. Graff CPA, a P.C.*

Harahan, Louisiana  
August 22, 2005

**HARBOR VIEW HOMEOWNERS ASSOCIATION, INC.**

**BALANCE SHEET**

AS OF DECEMBER 31, 2004

(With Comparative Totals for 2003)

	2004			2003
	Operating Fund	Replacement Fund	Total	Total
<b>ASSETS</b>				
<i>Current Assets:</i>				
Cash and equivalents	\$67,533	12,923	80,456	95,866
Schwab Investments		37,916	37,916	37,707
<b>Total current assets</b>	<b>67,533</b>	<b>50,839</b>	<b>118,372</b>	<b>133,573</b>
<i>Property &amp; Equipment(at cost):</i>				
Common area improvements	21,166	0	21,166	21,166
Furniture & Fixtures	6,494	0	6,494	6,494
Machinery & Equipment	9,747	0	9,747	9,747
<b>Subtotal</b>	<b>37,407</b>	<b>0</b>	<b>37,407</b>	<b>37,407</b>
Less: Accumulated depreciation	28,814	0	28,814	23,748
<b>Net property &amp; equipment</b>	<b>8,593</b>	<b>0</b>	<b>8,593</b>	<b>13,659</b>
<b>TOTAL ASSETS</b>	<b>\$76,126</b>	<b>\$50,839</b>	<b>\$126,965</b>	<b>\$147,232</b>
<b>LIABILITIES &amp; FUND BALANCE</b>				
<i>Current Liabilities:</i>				
Employment taxes payable	257	0	257	1,456
Income taxes payable	1,233	0	1,233	0
Dues liability	0	0	0	1,014
Security deposits	6,274	0	6,274	6,274
Current maturities of notes payable	66,454	0	66,454	0
<b>Total current liabilities</b>	<b>74,218</b>	<b>0</b>	<b>74,218</b>	<b>8,744</b>
<i>Non-current liabilities:</i>				
Note Payable-Regions Bank	233,959	0	233,959	0
Less: current maturities(see above)	66,454	0	66,454	0
<b>Total non-current liabilities</b>	<b>300,413</b>	<b>0</b>	<b>300,413</b>	<b>0</b>
<b>Total liabilities</b>	<b>374,631</b>	<b>0</b>	<b>374,631</b>	<b>8,744</b>
<b>FUND BALANCE</b>				
Members' Equity (-Deficit)	-298,505	50839	-247,666	138,488
<b>TOTAL LIABILITIES &amp; FUND BALANCE</b>	<b>\$76,126</b>	<b>\$50,839</b>	<b>126,965</b>	<b>147,232</b>

See accountant's compilation report and notes to financial statements

**HARBOR VIEW HOMEOWNERS ASSOCIATION, INC.**  
**STATEMENTS OF REVENUES AND EXPENSES**  
**AND CHANGES IN FUND BALANCES**  
**FOR THE YEAR ENDED DECEMBER 31, 2004**  
(With Comparative Totals for 2003)

	<b>2004</b>			<b>2003</b>
<b>REVENUES</b>	<u>Operating Fund</u>	<u>Replacement Fund</u>	<u>Total</u>	<u>Total</u>
Member Assessments	\$294,565	0	294,565	278,075
Laundry Income	4,733	0	4,733	0
Other income	2,705	306	3,011	7,144
Late fees	882	0	882	0
Interest Received	88	209	297	293
Loss on sale of securities	0	0	0	-2,722
<b>TOTAL REVENUES</b>	<b>\$302,973</b>	<b>515</b>	<b>303,488</b>	<b>282,790</b>
<b>EXPENSES</b>				
General & Administrative(Page 9)	78,651	0	78,651	88,302
Repairs & Maintenance (Page 10 )	61,668	0	61,668	52,962
Plant & Operations (Page 9)	29,476	0	29,476	37,290
Construction Costs	0	344,167	344,167	0
Engineering & Testing	0	34,063	34,063	0
Interest expense	0	2,410	2,410	0
Income taxes	1,233	0	1,233	0
Depreciation expense	5,066	0	5,066	1,453
<b>TOTAL EXPENSES</b>	<b>176,094</b>	<b>380,640</b>	<b>556,734</b>	<b>180,007</b>
Excess (Deficit) of revenues over expenses	126,879	-380,125	-253,246	102,783
Beginning fund balances	45,483	93,005	138,488	35,705
Transfer to Replacement Fund	-104,000	104,000		
Loan Proceeds-Regions Bank	0	233,959		
<b>ENDING FUND BALANCES</b>	<b>\$68,362</b>	<b>50,839</b>	<b>-114,758</b>	<b>138,488</b>

See accountants compilation report and notes to financial statements

**HARBOR VIEW HOMEOWNERS ASSOCIATION, INC.**  
**STATEMENT OF CASH FLOWS**  
**YEAR ENDED DECEMBER 31, 2004**

**Cash Flows from Operating Activities:**

Revenues in Excess of Expenses-Operating Fund(Page 5) \$126,879

Adjustments to reconcile expenses in excess of  
revenue to net cash provided by operating activities:

Depreciation expense	\$5,066	
Increase in Income Taxes	\$1,233	
Decrease in due liability	-1,014	
Decrease in employment taxes payable	-1,198	
Total adjustments		<u>4,087</u>
Net cash provided by operating activities		130,966

**Cash flow from financing activities:**

Loan proceeds-Regions Bank	\$233,959	
Interest paid	-2,410	
Net cash provided by financing activities		231,549

**Cash flow from investing activities:**

Construction costs	-378,230	
Investment income	208	
Other income	306	
Net cash used by investing activities		<u>-377,716</u>

Net decrease in cash and equivalents -15,201

Cash and equivalents, beginning of year 133,573

**CASH AND EQUIVALENTS, END OF YEAR** \$118,372

See accountant's compilation report and notes to financial statements



**HARBOR VIEW HOMEOWNERS ASSOCIATION, INC.**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2004**

**NOTE A – ORGANIZATION**

Harbor View Homeowners Association, Inc. (the Association) was organized on April 4, 1983 as a nonprofit corporation to function as a condominium association for the 101 unit Harbor View Condominium in New Orleans, Louisiana. The primary function of the Association is to provide for the efficient and effective administration of the condominium including all common areas.

Common Areas – As provided in the Declaration of Condominium, each unit owner owns an undivided share in the common elements of the condominium. In conformity with industry practice, the Association recognizes the following common property as assets:

- a) Common personal property used by the Association in operating, preserving, maintaining, repairing and replacing common property and providing other services.
- b) Common real property to which the Association has title and that it can dispose of for cash while retaining the proceeds or that is used to generate significant cash flows from members on the basis of usage or from nonmembers.

Accordingly, the Association recognized equipment as assets at cost on the date it was acquired. Other common property, including sidewalks, swimming pools, building roofs, and parking areas, is not recognized as assets.

**NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

A summary of the significant accounting policies consistently applied in the preparation of the accompanying financial statements follows.

**Fund Accounting**

The Association uses fund accounting, which requires that fund, such as operating funds and funds designated for future major repair and replacement costs, be classified separately for accounting and reporting purposes. The disbursements from the operating fund are generally at the discretion of the Board of Directors and management and are used for operating expenses. The disbursements from the replacement fund may only be utilized in accordance with the establish purposes for accumulation. These replacement disbursements are comprised of building painting, roof resurfacing, pavement resurfacing, swimming pool, sealants and other building and grounds replacements.

**Cash and Cash Equivalents**

For purposes of reporting cash flows, the Association considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. The Association has no policy requiring collateral or other security to support its deposits, although all deposits with banks are federally insured up to \$100,000 under FDIC protection. The Association places its cash with a high credit quality financial institution and does not believe it is exposed to any significant credit risk on cash and cash equivalents.

**HARBOR VIEW HOMEOWNERS ASSOCIATION, INC.**  
**NOTES TO FINANCIAL STATEMENTS**  
**AS OF DECEMBER 31, 2004**

Assessments Receivable

Association members are subject to monthly assessments to provide funds for the Association's operating expenses and future repairs and replacements. Income and expenses are allocated equally to each unit owner. Assessments receivable at the balance sheet date represent fees due from unit owners. The Association's policy is to retain counsel and place liens on the properties of unit owners whose assessments are sixty days or more delinquent.

Use of Estimates

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

Income Taxes

The Association elected to file a form 1120-H, Homeowners Association income tax return, for the 2004 tax year. Federal and state income taxes payable as of December 31, 2004 was \$1,124. and \$109., respectively.

Property and Equipment

Property and equipment is stated at original cost with depreciable lives, as summarized below:

	December 31, <u>2004</u>	Depreciable <u>Lives</u>
Common Area Improvements	\$ 21,166.	3 years
Furniture and Fixtures	6,494.	3 years
Machinery and Equipment	9,747.	3 years
Less: Accumulated Depreciation	<u>(28,814.)</u>	
Total	<u>\$ 8,593.</u>	

**HARBOR VIEW HOMEOWNERS ASSOCIATION, INC.**  
**EXPENSE SCHEDULES**  
**YEAR ENDED DECEMBER 31,**

**SCHEDULE OF GENERAL & ADMINISTRATIVE EXPENSES**

	<u>2004</u>	<u>2003</u>
Insurance	\$29,494	34,852
Salaries & Employment Taxes	23,701	32,897
Management Fees	8,750	0
Accounting	4,576	4,450
Miscellaneous	3,335	2,772
Telephone	2,786	3,116
Office Supplies	2,092	1,577
Parking	1,200	1,000
Taxes & Licenses	579	1,923
Uniforms	456	0
Legal & Professional	338	1,500
Postage	328	409
Entertainment	284	285
Advertising	252	0
Bank Charges	226	402
Contract Labor	145	1,325
Interest Expense	109	0
Supplies	0	1,794
	-----	-----
Total General and Administrative Expenses	\$78,651	\$88,302
	=====	=====

**SCHEDULE OF PLANT & OPERATIONS EXPENSES:**

Utilities-Water	\$10,314	13,363
Utilities-Electric	10,029	14,927
Trash Collection & Cleaning	5,977	5,274
Pool Service & Supplies	2,416	3,050
Cleaning Supplies	741	676
	-----	-----
Total Plant and Operations Expenses	\$29,476	\$37,290
	=====	=====

**See accountant's compilation report and notes to financial statements**

**HARBOR VIEW HOMEOWNERS ASSOCIATION, INC.**  
**SCHEDULE OF REPAIRS & MAINTENANCE EXPENSES**  
**YEAR ENDED DECEMBER 31,**

	<u>2004</u>	<u>2003</u>
Salaries & Wages	\$22,344	24,750
Pest Control	8,713	225
Electrical	6,118	0
Painting	5,992	64
Elevators	4,774	4,367
Gardening	2,470	4,656
Plumbing	2,287	1,457
Hardware Supplies	2,140	2,300
Garage Columns	1,694	0
Carpentry	1,385	635
Repairs & Maintenance	1,317	777
Fire Alarm	521	305
Iron Work	495	943
Drywall	485	\$0
Miscellaneous	319	4,220
Keys & Locks	266	-6
Siding	257	0
Gates	90	3,435
Heating/Air Conditioning	0	276
Roofing	0	75
Tiles	0	4,483
	-----	-----
Total Repairs and Maintenance Expenses	\$61,668	\$52,962
	=====	=====

See accountant's compilation report and notes to financial statements