

August 14, 2017

To the Board of Directors
Clearwood Community
21603 N. Clearwood Blvd S.E.
Yelm, WA 98597

We have audited the financial statements of Clearwood Community for the year ended December 31, 2016, and have issued our report thereon dated August 14, 2017. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards and *Government Auditing Standards*, as well as certain information related to the planned scope and timing of our audit. We have communicated such information in our response to your request for audit. Professional standards also require that we communicate to you the following information related to our audit.

Significant Audit Findings

Accounts Receivables Collections, Write-offs & Write-downs:

I noted significant improvements over the prior year. This is no longer a significant audit finding.

Other Matters – Reserve Funds:

The Association's reserve funds are underfunded at levels which put the community at a high risk of requiring large special assessments in both the near-term and long-term future.

The most critical issue facing Clearwood, at December 31, 2016, water reserves on hand were not sufficient to finance the estimated costs of the new well which is currently in progress. Based on the information provided to me by members of Clearwood's finance committee, board members and staff, the December 31, 2016 water reserves of approximately \$311,000 represents less than half of the estimated remaining cost of the project. Even with an additional \$250,000 in base rate revenues from fiscal year 2017, there are not sufficient water reserves to finance the project.

Borrowing from the general reserves or the general operating fund is at best a temporary fix, as the general reserve fund is also underfunded and the general operating resources are already limited as evidenced by the FY 2016 Operating fund net deficit of \$261,462 (Net Surplus of approximately \$63,000 if depreciation is excluded from expenses).

Based on the recently updated Reserve fund studies, I noted several items which illustrate the critical situation the community must address. The following information is unaudited as such information is beyond the scope of my audit. However, this situation was deemed to be of such a critical nature to the future financial viability of the organization, that I believe the Board and the community as a whole must develop and implement a short-term and long-term strategy immediately or risk potentially devastating financial consequences.

Water Reserves:

Represents a projection of the reserve funds and future reserve funding needs at December 31, 2016:

- 95% underfunded
- \$0.3 million funded estimated
- \$5.5 million dollars underfunded from need
- \$185 per year per lot (\$250 thousand total) current annual assessment
- \$760 one-time special assessment (\$1 million), plus \$350 per lot regular Assessment (\$474 thousand total) with annual inflation increases needed to fully fund the reserves.

Alternatively, the community could address future major repairs and replacements through a series of special assessments as expenditures occur. However, this is generally not advisable for the following reasons:

- Funds may not be available for major emergencies when they occur resulting in extended periods of inadequate or unsafe drinking water supplies.
- Future special assessments may not be approved as needed.
- Such large special assessments may not be economically feasible for many members resulting in collections occurring over a several years.

General Reserves:

Represents a projection of the reserve funds and future reserve funding needs at December 31, 2016:

- 41% underfunded
- \$1.75 million funded (estimated)
- \$1.2 million dollars underfunded from need
- \$145 per year per lot (\$196 thousand total) current annual assessment
- \$275 per lot regular Assessment (\$373 thousand total) with annual inflation increases needed to fully fund the reserves.

- Minimum assessment to keep reserve fund balance above \$0 over the next thirty years = \$183 per lot with annual inflation increases needed.

Alternatively, the community could address future major repairs and replacements through a series of special assessments as expenditures occur. However, this is generally not advisable for the following reasons:

- Funds may not be available for major repairs and replacements resulting in a reduction in the quality of life and value of property.
- Future special assessments may not be approved as needed.
- Such large special assessments may not be economically feasible for many members resulting in collections occurring over several years.

Contingency Fund:

As noted in the prior audit, Clearwood has established various “reserve” funds which may be unnecessary. Some, such as the wood fund, have been addressed by the board subsequent to year end. However, there is one fund, the contingency fund, which has been a subject of discussion among the board and community members.

The contingency “fund” represents the net surplus of operating funds accumulated over the years. Each year funds any annual surplus is transferred into this fund. Such a transfer philosophy is arbitrary and possibly unnecessary. Furthermore, such a transfer policy does not adequately address the cash flow needs of the Association’s throughout the year.

I understand the board has obtained a legal opinion that this fund is not legally mandated. I also understand there are legitimate purposes for a “Contingency” type fund. However, it is my opinion that the current structure of the fund appears to be confusing (based on numerous questions posed during the audit) and too restrictive.

Currently, the use of these funds may require annual budget approval of the membership. Without such approval, the board may not be able to address emergency situations as they arise.

Therefore, I recommend the accumulated surplus of operating resources should not be segregated from other currently acquired operating resources. Instead, the accumulated operating resources should continue to be deemed available for operations, subject to the approved budget. A portion of these accumulated unrestricted resources may be placed in an operating contingency fund based on estimated need. This is a more objective funding process for the fund.

I recommend an operating contingency fund be established which would provide the necessary resources to be available for emergencies such as a water main break, earthquake, fire, storm damage, and other types of expenditures that cannot be anticipated in the annual budget approved by the membership. Such a fund should provide the board with the authority to expend these resources on unforeseen emergencies, without a membership vote.

I recommend a minimum balance be established which must be placed in the fund at the beginning of each fiscal year. Annual replenishments would not require membership approval unless there are no unrestricted resource available to transfer. If an increase in excess of the minimum funding requirement, were deemed necessary, such increase would require a membership vote.

The legal requirements of establishing such a fund are beyond my expertise, however, the conceptual nature of such a fund is a “best business” practice.

Qualitative Aspects of Accounting Practices:

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by Clearwood Community are described in Note 1 to the financial statements. No significant changes to accounting policies were adopted and the application of existing policies was not changed during 2016. We noted no transactions entered into by the Organization during the year for which there is a lack of authoritative guidance or consensus.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management’s knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimate affecting the financial statements was:

- Management’s estimate of the allowance for uncollectible accounts receivable. We evaluated the key factors and assumptions which should be used to develop the allowance for doubtful accounts and as noted above believe the accounting records used as a basis for preparing financial statements includes a misstatement which is both material and pervasive to the financial statements.

Difficulties Encountered in Performing the Audit:

We encountered no significant difficulties in dealing with management in performing our audit; however, a significant amount of time was required to review and evaluate management’s write-offs of bad debts and estimate of uncollectible accounts.

Corrected and Uncorrected Misstatements:

Professional standards require us to accumulate all misstatements identified during the audit, other than those that are clearly trivial, and communicate them to the appropriate level of management. The following describe such adjustments:



Davis Accounting Tax & Audit Services

123 Fir Street NE
Olympia, WA. 98506

1. During our audit we evaluated the collectability of the accounts receivables balance remaining on the books. Based on this evaluation and our discussions with management, it was determined that an additional \$11,607 of accounts receivables were likely uncollectible and were charged to bad debt expense using the allowance for doubtful accounts method of accounting.
2. Additionally, we proposed adjustments to the various fund balance accounts to account for the net change in reserve balance during the year. We deemed these journal entries to be a year end housekeeping adjustment and not a significant error.

Disagreements with Management:

For purposes of this letter, a disagreement with management is a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit. We do not consider the previously described misstatements as a disagreement with management as they concur with our findings and have agreed to make the necessary adjustments.

Management Representations:

We will request certain representations from management that will be included in the management representation letter upon completion of the audit. The audit has not been completed pending discussion with the finance committee on how to address the issues raised in this letter.

Management Consultations with Other Independent Accountants:

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the Organization's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. We are unaware of any such consultations.

Other Audit Findings or Issues

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the Organization's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.



Davis Accounting Tax & Audit Services

123 Fir Street NE
Olympia, WA. 98506

Other Matters:

With respect to the supplementary information that will accompany the financial statements, we will make certain inquiries of management and evaluate the form, content, and methods of preparing the information to determine that the information complies with U.S. generally accepted accounting principles, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We will compare and reconcile the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

This information is intended solely for the use of the Board of Directors and management of Clearwood Community and is not intended to be, and should not be, used by anyone other than these specified parties.

Very truly yours,

Davis Accounting Tax & Audit Services