

Financial Statements

**Kahana Falls Interval
Owners Association**

**For the Year Ended
December 31, 2008**

Kahana Falls Interval Owners Association

Contents

December 31, 2008

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Independent Auditor's Report

Board of Directors
Kahana Falls
Interval Owners Association
Kahana, Maui, Hawaii

We have audited the accompanying balance sheet of Kahana Falls Interval Owners Association as of December 31, 2008 and the related statement of revenue, expenses and fund balances, cash flows, and other operating income and expenses for the year 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 audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit 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 audit provides 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 Kahana Falls Interval Owners Association as of December 31, 2008 and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The supplemental information on future major repairs and replacements on page 11 is not a required part of the basic financial statements of Kahana Falls Interval Owners Association, but is supplemental information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

As more fully described in Note 14, subsequent to the issuance of the Association's 2008 financial statement and our report thereon dated May 8, 2009, we became aware that those financial statements incorrectly reflected the prepaid assessments and assessment revenues. In our original report we expressed an unqualified opinion on the 2008 financial statements, and our opinion on the revised statements, as expressed herein, remains unqualified.

FITZGERALD & ASSOCIATES, INC. CPAs

Redlands, California
June 16, 2009

Kahana Falls Interval Owners Association

Balance Sheet December 31, 2008

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	<u>Operating Fund</u>	<u>Replacement Fund</u>	<u>Total</u>
Assets			
Cash, including interest-bearing deposits (Note 4)	\$ 556,820	\$ 157,135	\$ 713,955
Accounts receivable - net (Note 5)	52,993	-	52,993
Prepaid expenses (Note 6)	3,233	-	3,233
Property and equipment-net (Note 7)	9,329	-	9,329
Total assets	<u>\$ 622,375</u>	<u>\$ 157,135</u>	<u>\$ 779,510</u>
Liabilities and Fund Balances			
Accounts payable	\$ 14,519	\$ -	\$ 14,519
Due to Kahana Falls AOA	20,995	-	20,995
Accrued expenses (Note 8)	74,165	-	74,165
Income tax payable	1,486	-	1,486
Note payable (Note 9)	9,371	-	9,371
Prepaid assessments	589,848	-	589,848
Total liabilities	<u>710,384</u>	<u>-</u>	<u>710,384</u>
Fund balances (deficits)	<u>(88,009)</u>	<u>157,135</u>	<u>69,126</u>
Total liabilities and fund balances	<u>\$ 622,375</u>	<u>\$ 157,135</u>	<u>\$ 779,510</u>

The accompanying notes are an integral part of these financial statements.

Kahana Falls Interval Owners Association

Statement of Revenue, Expenses, and Fund Balances For the Year Ended December 31, 2008

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	<u>Operating Fund</u>	<u>Replacement Fund</u>	<u>Total</u>
Revenue			
Member assessments	\$ 1,573,710	\$ 248,220	\$ 1,821,930
Rental income	66,024	-	66,024
Interest income	-	8,800	8,800
Other income (Schedule)	133,429	-	133,429
Total revenue	<u>1,773,163</u>	<u>257,020</u>	<u>2,030,183</u>
Expenses			
Bad debt expense	113,484	-	113,484
Depreciation expense	3,110	-	3,110
Employee benefits	257,274	-	257,274
General excise and tot tax	161,021	-	161,021
Housekeeping	399,551	-	399,551
Income tax expense	1,486	-	1,486
Legal and professional	11,071	-	11,071
Facilities			
Maintenance	50,085	-	50,085
Utilities	-	-	-
General and administrative			
Services (Schedule)	471,790	-	471,790
Supplies	30,852	-	30,852
Salaries and related	200,324	-	200,324
Repairs and replacements	-	194,976	194,976
Total expenses	<u>1,700,048</u>	<u>194,976</u>	<u>1,895,024</u>
Excess revenue (expenses)	73,115	62,044	135,159
Fund balance (deficit) - beginning	<u>(161,124)</u>	<u>95,091</u>	<u>(66,033)</u>
Fund balance (deficit) - ending	<u>\$ (88,009)</u>	<u>\$ 157,135</u>	<u>\$ 69,126</u>

The accompanying notes are an integral part of these financial statements.

Kahana Falls Interval Owners Association

Statement of Cash Flows For the Year Ended December 31, 2008

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	<u>Operating Fund</u>	<u>Replacement Fund</u>	<u>Total</u>
Cash Flows From Operating Activities			
Excess revenue (expenses)	\$ 73,115	\$ 62,044	\$ 135,159
Noncash items included in excess revenue (expenses) -			
Depreciation	3,110	-	3,110
Changes in:			
Accounts receivable	(17,940)	-	(17,940)
Interfund receivable	14,287	(14,287)	-
Prepaid expenses	(500)	-	(500)
Accounts payable	(81,573)	-	(81,573)
Due to Kahana Falls AOA	1,993	-	1,993
Accrued expenses	(111,309)	-	(111,309)
Income tax payable	1,486	-	1,486
Prepaid assessments	94,632	-	94,632
	<u> </u>	<u> </u>	<u> </u>
Net cash provided (used) by operating activities	<u>(22,699)</u>	<u>47,757</u>	<u>25,058</u>
Cash Flows From Financing Activities			
Payments on note payable	<u>(2,448)</u>	<u>-</u>	<u>(2,448)</u>
Net cash provided (used) by financing activities	<u>(2,448)</u>	<u>-</u>	<u>(2,448)</u>
Net increase (decrease) in cash	(25,147)	47,757	22,610
Cash - beginning of year	<u>581,967</u>	<u>109,378</u>	<u>691,345</u>
Cash - end of year	<u>\$ 556,820</u>	<u>\$ 157,135</u>	<u>\$ 713,955</u>

The accompanying notes are an integral part of these financial statements.

Kahana Falls Interval Owners Association

Combined Statement of Other Operating Income and Expenses For the Year Ended December 31, 2008

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	<u>Total</u>
Other Income	
Handling fees	\$ 3,895
Transient occupancy tax	95,237
General excise tax	17,019
Other	<u>17,278</u>
Total other income	<u>\$ 133,429</u>
General and Administrative Services	
Insurance	\$ 6,312
Interest	831
Postage and freight	7,772
Printing	15,857
Audit, tax and accounting fees	41,137
Management fees	203,853
Reservation fees	50,423
Taxes and licenses	3,035
Other general and administrative	<u>142,570</u>
Total general and administrative services	<u>\$ 471,790</u>

The accompanying notes are an integral part of these financial statements

Kahana Falls Interval Owners Association

Notes to Financial Statements December 31, 2008

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1. Organization and Other Matters

Kahana Falls Interval Owners Association (IOA) is a nonprofit mutual benefit corporation organized in Hawaii in March 1992 and is governed by a member-elected Board of Directors. The Association is responsible for the operation and maintenance of 70 timeshare apartment units. The property is located in Kahana, Hawaii on the island of Maui.

2. Significant Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the reporting date and revenues, and expenses during the reporting period. Actual results could differ from those estimates.

The Association's governing documents provide guidelines for managing its financial activities. To ensure compliance with limitations and restrictions on the use of financial resources, the Association maintains its records using fund accounting. They classify transactions for accounting and reporting purposes in funds established according to their nature and purpose.

Operating Fund - This fund is used to account for the financial resources available for the general operations of the Association.

Replacement Fund - This fund is used to account for financial resources designated for future major repairs and replacements.

Members pay a portion of their Association dues for reserve expenses, generally major repairs and replacements. The Association deposits these funds in a separate interest-bearing account. See Note 10 for a further discussion of reserves.

The Association considers all temporary cash investments with maturity of three months or less to be cash equivalents.

Interest-bearing deposits consist of certificates of deposit stated at market value which approximates cost.

Members are subject to annual assessments to provide funds for operating expenses and future major repairs and replacements. Assessments receivable at the reporting date represent amounts due from members. See Note 5 for additional details on assessments receivable amounts.

Kahana Falls Interval Owners Association

Notes to Financial Statements December 31, 2008

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2. Significant Accounting Policies (concluded)

The Association conforms to industry practice in recognizing real property and common areas as assets. Based on this practice, the Association only capitalizes property to which it has title and to which the board of directors has discretion to dispose of the property and retain the proceeds for the Association's use. Other real property and common areas are owned by the members in common and not by the Association and therefore are not capitalized. Depreciation is calculated using the straight-line method over the 7-year estimated useful life of the asset. Repairs, replacements and improvements of common property are expensed as incurred. See Note 7 for additional information on property and equipment.

Prepaid assessments consist of members annual assessments received in advance. The Association recognizes these amounts as income when they are earned in the subsequent year.

3. Income Taxes

The Association may elect to be taxed as either a time-share association or a regular corporation. The Association elected to be taxed as a regular corporation for the year ended December 31, 2008. Under that election, the Association is subject to federal and state income tax only on income derived from non-member sources such as interest and rental income.

The Association uses the same accrual accounting methods to report income for tax and financial purposes. No material differences exist in the recognition of revenues and expenses, which result in deferred income taxes.

4. Cash and Cash Equivalents

Cash and cash equivalents at the reporting date consist of the following amounts:

Operating Fund	
US Bank – checking	\$186,172
Bank of Hawaii – checking	13,479
American Security Bank – money market account	260,169
American Security Bank – certificate of deposit	95,000
Petty cash	<u>2,000</u>
Total Operating Fund	<u>\$556,820</u>
Replacement Fund	
Wachovia Securities – money market account	\$841
Wachovia Securities – certificate of deposit	76,000
American Security Bank – money market account	<u>80,294</u>
Total Replacement Fund	<u>\$157,135</u>

Kahana Falls Interval Owners Association

Notes to Financial Statements December 31, 2008

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5. Accounts Receivable

Accounts receivable at the reporting date consist of the following amounts:

Regular assessments	\$139,093
Other receivables	27,384
Allowance for doubtful accounts	<u>(113,484)</u>
Net accounts receivable	<u>\$52,993</u>

6. Prepaid Expenses

Prepaid expenses at the reporting date consist of the following amounts:

Insurance	\$3,171
Other prepaid expenses	<u>62</u>
Total prepaid expenses	<u>\$3,233</u>

7. Property and Equipment

Property and equipment at the reporting date consist of the following amounts:

Laundry equipment	\$47,612
Vehicle	15,549
Accumulated depreciation	<u>(53,832)</u>
Net property and equipment	<u>\$9,329</u>

8. Accrued Expenses

Accrued expenses at the reporting date consist of the following amounts:

State Excise and TAT taxes payable	\$11,055
Accrued vacation	35,681
Accrued other	<u>27,429</u>
Total accrued expenses	<u>\$74,165</u>

Kahana Falls Interval Owners Association

Notes to Financial Statements December 31, 2008

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9. Note Payable

A note payable to Bank of Hawaii, secured by a 2007 Chevrolet Colorado, payable in 60 monthly installments of \$273.97, including interest at 7.755% per annum, maturing March 2, 2012

\$9,371

The following is a schedule of future principal payments under the terms of the note as of December 31, 2008:

December 31, 2009	\$2,654
2010	2,867
2011	3,098
2012	<u>752</u>
Total principal payments	<u>\$9,371</u>

10. Future Major Repairs and Replacements

The Association's governing documents require that funds be accumulated for future major repairs and replacements. These unrestricted funds, which amount to \$157,135, are generally not available for operating purposes.

The Association conducted a study in January 2009 to estimate the remaining lives and replacement costs of the common property components. Actual expenditures may vary from the estimates, and the variations may be material. Amounts reserved may not be sufficient to meet future replacement cost requirements. When replacement funds are needed, the Board may elect to increase monthly assessments, levy special assessments, or delay replacements until funds are available. See page 11 for additional information on future major repairs and replacements.

11. Related Party Transactions

The Association reimbursed Kahana Falls Association of Apartment Owners (AOAO), a related organization, which is responsible for the maintenance and operation of the common areas, for certain shared costs incurred by the AOAO. During the reporting period, the Association reimbursed the AOAO \$181,109 and at December 31, 2008, owed the AOAO \$20,995.

A member of the Association's Board of Directors is the president of SCI Enterprises, which is the general partner of Kahana Falls, Ltd., which is the developer of Kahana Falls Resort. At December 31, 2008, Kahana Falls, Ltd. owned 2 intervals and owed the Association \$-0-

Kahana Falls Interval Owners Association

Notes to Financial Statements December 31, 2008

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11. Related Party Transactions (continued)

Certain members of the Board of Directors of the Kahana Falls Association of Apartment Owners are also members of the Board of Directors of the Interval Owners Association.

The Association entered into an agreement with Trading Places International (TPI), to provide certain rental and membership sales services. TPI collects the rental income and remits the income to the Association net of its commissions and fees. At December 31, 2008, TPI owed the Association \$17,325.

12. Supplemental Cash Flow Disclosures

For the reporting periods, cash flows from operating activities include state and federal income tax payments of \$3,990 for the year ended December 31, 2008.

13. Commitments and Contingencies

The Association entered into a three-year management agreement with Trading Places International (TPI) beginning May 1, 2008 and expiring May 1, 2011. The contract automatically renews for successive additional three-year terms unless terminated earlier by majority of the members within a ninety-day window before the expiration of the current term. TPI will provide administrative, financial, and accounting services for the Association.

The Hawaii State Department of Taxation (DOT) has conducted an audit of Kahana Falls IOA and has taken the position that due to the method which was used to collect the maintenance fees (the IOA collecting all funds and then distributing them to the AOAO) that all of the maintenance fees received by the IOA on behalf of the AOAO is subject to General Excise Tax. The DOT has made an assessment of tax, penalties and interest against the IOA and the IOA has appealed that assessment. The appeal is still pending and the outcome of the matter is unknown at the reporting date. However, if the state assesses the taxes, the IOA could owe as much as \$245,000 in General Excise taxes, penalties and interest.

14. Other

Subsequent to the issuance of the Association's financial statements, management became aware that the amount of reported prepaid assessments was understated and the amount of assessment revenues was overstated. The adjustment of these items in the revised financial statements has the effect of increasing liabilities by \$41,086 at December 31, 2008, and decreasing net income for the year ended December 31, 2008 by \$41,086.

Supplemental Information

**Kahana Falls Interval
Owners Association**

**Supplemental Information on Future Major
Repairs and Replacements
December 31, 2008**

The Association conducted a study January 2009 to estimate the remaining useful lives and replacement costs of the components of common property. Replacement costs were based on the estimated costs to repair or replace the common property components at the date of the study. The Association has assessed the present condition of all common property components and estimated replacement costs relying upon Board members, management company representatives, outside contractors and service representatives. Estimated annual funding has been calculated using the cash flow method with provisions for annual inflation at 2.25% and interest earnings at 3.5%.

The following information is based on the study and presents significant information about the components of common property.

Component	Estimated Remaining Useful Life (Years)	Current Replacement Cost	Estimated 2009 Funding Requirement	Reserve Expenditures For the Year Ended 12/31/08	Replacement Cash Balance at 12/31/08
Appliances	12-20	\$ 62,160	\$ 7,804	\$ (17,757)	\$ 34,828
Bedrooms	8-24	406,100	50,985	(13,646)	227,535
Buildings	8-20	219,400	27,545	(53,667)	122,928
Cabinets	10-15	129,500	16,258	-	72,558
Carpets	5-11	258,600	32,467	(5,627)	144,892
Case Goods	6	10,540	1,323	(3,594)	5,905
Electronics	8-15	125,200	15,718	(3,871)	70,149
Furniture	5-15	361,080	45,333	(5,908)	202,311
Miscellaneous	6-20	127,120	15,960	(41,003)	71,224
Plumbing	10-25	251,200	31,538	(19,775)	140,746
Soft Goods	5-9	125,050	15,700	(30,128)	70,065
Cash deficit	-	-	-	-	(1,006,006)
Totals		\$ 2,075,950	\$ 260,631	\$ (194,976)	\$ 157,135

See accountants' report.