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Board of Directors
Santa Margarita Water District

**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND OTHER MATTERS AND ON
INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL
STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS***

We have audited the financial statements of the Santa Margarita Water District (District) as of and for the year ended June 30, 2011, and have issued our report thereon dated September 23, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the District's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. **The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.**

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the District's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the District's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the District's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all the deficiencies in the internal control that might be deficiencies, significant deficiencies or material weaknesses. **We did not identify any deficiencies in internal controls over financial reporting that we consider to be material weaknesses, as defined above.**

This report is intended solely for the information of the Board of Directors, management of the District, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Mayer Hoffman McCann P.C.

Irvine, California
September 23, 2011

SANTA MARGARITA WATER DISTRICT

Financial Statements

Year Ended June 30, 2011

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SANTA MARGARITA WATER DISTRICT

Financial Statements

Year ended June 30, 2011

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Board of Directors
Santa Margarita Water District

INDEPENDENT AUDITORS' REPORT

We have audited the accompanying statements of net assets of the Santa Margarita Water District (the "District") as of June 30, 2011 and the related statements of revenues, expenses and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the District's management. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year summarized comparative financial information has been derived from the District's financial statements as of and for the year ended June 30, 2010. The report dated September 3, 2010 expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. 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 the Santa Margarita Water District as of June 30, 2011, 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 information identified in the accompanying table of contents as *management's discussion and analysis* is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of supplementary information. However, we did not audit the supplementary information and express no opinion on it.

Board of Directors
Santa Margarita Water District
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In accordance with *Governmental Auditing Standards*, we have also issued our report, dated September 23, 2011, on our consideration of the District's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Mary Hoffman Malcom, P.C.

Irvine, California
September 23, 2011

MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the Santa Margarita Water District's (the "District") annual financial report presents management's discussion and analysis of the District's financial performance during the fiscal year ended June 30, 2011. Please read it in conjunction with the District's financial statements and accompanying notes that begin on page 13.

Financial Highlights

- Cash and investments of \$165.3 million on June 30, 2011 represents a decrease of \$18.5 million (10.0%) compared to the \$183.8 million in cash and investments at June 30, 2010.
- The capital asset balance of \$522.2 million at June 30, 2011 increased \$16.0 million (3.2%) compared with the prior year balance of \$506.2 million primarily as a result of costs incurred to purchase or construct capital assets totaling \$32 million and contributed facilities with an estimated fair value of \$0.5 million. The increases were partly offset by depreciation expense recognized of \$15.5 million and \$1.0 million in dispositions and retirements.
- The change in net assets in fiscal 2011 amounted to \$8.5 million (2.3%), which consisted of net income of \$8.0 million and contributed facilities valued at \$0.5 million.

Overview of the Financial Statements

This annual financial report consists of two parts, Management's Discussion and Analysis and the basic financial statements, including notes to the financial statements. The District's financial statements offer key, high-level financial information about the District's activities.

The District is a self-supporting entity that follows enterprise fund accounting and presents its financial statements on the accrual basis of accounting. The enterprise fund concept is similar to how private business enterprises are financed and operated.

The statements of net assets include information on all of the District's assets and liabilities with the difference between assets and liabilities reported as net assets. Changes in net assets may serve as a useful indicator of whether the financial position of the District is improving or deteriorating.

The statement of revenues, expenses and changes in net assets present information regarding how the District's net assets changed during the fiscal years ended June 30, 2011 and 2010. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs and amounts are measurable, regardless of the timing of related cash flows.

Financial Statement Analysis

The following is a summary of the District's assets, liabilities and net assets comparing fiscal year 2011 with fiscal year 2010:

	Fiscal Year 2011	Fiscal Year 2010	Increase (Decrease)	Percent Increase (Decrease)
Current and other assets	\$185,971,642	\$207,887,574	\$(21,915,932)	-10.5%
Capital assets, net	<u>522,217,405</u>	<u>506,228,108</u>	<u>15,989,297</u>	3.2%
Total assets	<u>708,189,047</u>	<u>714,115,682</u>	<u>(5,926,635)</u>	-0.8%
Long-term debt outstanding	301,049,589	316,516,696	(15,467,107)	-4.9%
Other liabilities	<u>22,735,781</u>	<u>21,712,389</u>	<u>1,023,392</u>	4.7%
Total liabilities	<u>323,785,370</u>	<u>338,229,085</u>	<u>(14,443,715)</u>	-4.3%
Invested in capital assets, net of related debt	282,408,781	264,454,925	17,953,856	6.8%
Restricted for debt service	28,313,381	29,739,339	(1,425,958)	-4.8%
Unrestricted	<u>73,681,515</u>	<u>81,692,333</u>	<u>(8,010,818)</u>	-9.8%
Total net assets	<u>384,403,677</u>	<u>375,886,597</u>	<u>8,517,080</u>	2.3%
Total liabilities and net assets	<u>\$708,189,047</u>	<u>\$714,115,682</u>	<u>\$(5,926,635)</u>	-0.8%

The District's total assets decreased \$5.9 million (0.8%) to \$708.2 million compared with the prior year of \$714.1 million primarily due to an decrease in current and miscellaneous assets of \$21.9 million and as a result of an increase in capital assets of \$16.0 million as described in the financial highlights section above.

Long-term debt outstanding decreased \$15.4 million (4.9%) to \$301.1 million compared with the prior year of \$316.5 million. The net decrease is primarily due to a net decrease in State Water Resource Control Board Loan of \$0.8 million, and a decrease in Reservoir Capacity Obligation of \$0.7 million, a net decrease of \$0.2 million in connection with reimbursement agreements and principal payments/amortizations of \$13.7 million.

Other liabilities increased \$1.0 million (4.7%) to \$22.7 million at June 30, 2011 due to a decrease in interest payable, of \$0.1 million, and an increase of \$1.1 million in accounts payable, accrued payroll deferred revenue, customer deposits and benefits retentions and construction deposits.

Net assets increased \$8.5 million (2.3%) to \$384.4 million in fiscal 2011 due to increase to income before capital contributions of approximately \$8.0 million and contributed facilities valued at \$0.5 million.

The following table summarizes revenues, expenses and changes in net assets comparing fiscal year 2011 with fiscal year 2010:

	<u>Fiscal Year 2011</u>	<u>Fiscal Year 2010</u>	<u>Increase (Decrease)</u>	<u>Increase (Decrease)</u>
Revenues:				
Water sales	\$ 27,522,866	\$ 28,653,367	\$ (1,130,501)	-3.9%
Sanitation sale service charge	15,600,334	16,693,371	(1,093,037)	-6.5%
Property taxes-ad valorem	31,116,868	32,913,507	(1,796,639)	-5.5%
Investment income	2,348,104	4,531,146	(2,183,042)	-48.2%
Other income	13,418,273	10,041,842	3,376,431	33.6%
Rental Income	<u>1,116,498</u>	<u>1,046,218</u>	<u>70,280</u>	6.7%
Total revenues	<u>91,122,943</u>	<u>93,879,451</u>	<u>(2,756,508)</u>	-2.9%
Expenses:				
Depreciation and amortization	15,920,180	15,920,805	(625)	0.0%
Other operating expenses	53,260,371	52,062,726	1,197,645	2.3%
Interest expense	<u>13,979,495</u>	<u>14,826,211</u>	<u>(846,716)</u>	-5.7%
Total expenses	<u>83,160,046</u>	<u>82,809,742</u>	<u>350,304</u>	0.4%
Income before contributed capital	7,962,897	11,069,709	(3,106,812)	-28.1%
Contributed capital	<u>554,183</u>	<u>2,245,263</u>	<u>(1,691,080)</u>	-75.3%
Change in net assets	8,517,080	13,314,972	(4,797,892)	-36.0%
Beginning net assets	<u>375,886,597</u>	<u>362,571,625</u>	<u>13,314,972</u>	3.7%
Ending net assets	<u>\$384,403,677</u>	<u>\$375,886,597</u>	<u>\$ 8,517,080</u>	2.3%

The District earned total revenues of \$91.1 million in fiscal year 2011 which is an decrease of \$2.8 million (2.9%) compared with the prior year's total revenues of \$93.9 million. The net decrease is due to a decrease in water sales, sanitation sales service charge, property tax revenue investment income of \$6.2 million and a \$3.4 million increase in other income.

The District incurred \$15.6 million and \$15.9 million in interest expense and \$1.6 million and \$1.1 million in capitalized interest for the years ended June 30, 2011 and 2010, respectively. This resulted in net interest expense of \$14.0 million for 2011 compared to net interest expense of \$14.8 million in the prior year. The combined decrease in net interest expense of \$0.8 million is due to a decrease in interest expense based on bond debt service requirements.

Capital Assets and Debt Administration

Capital Asset

At June 30, 2011, the District had a total of \$772.9 million invested in a broad range of infrastructure and related assets. This total represents an overall increase of \$31.2 million (4.2%) over the prior year total of \$741.7 million; the following table summarizes the changes in capital assets comparing fiscal 2011 with fiscal 2010:

	<u>Fiscal Year</u> 2011	<u>Fiscal Year</u> 2010	<u>Increase</u> <u>(Decrease)</u>	<u>Percent</u> <u>Increase</u> <u>(Decrease)</u>
Water plant	\$311,985,754	\$307,872,340	\$4,113,414	1.3%
Sewer plant	176,754,574	173,614,159	3,140,415	1.8%
Contributed facilities	193,951,545	193,269,282	682,263	0.4%
Administration building	9,672,668	9,409,114	263,554	2.8%
Operational equipment	11,697,164	11,516,956	180,208	1.6%
Miscellaneous/master plan	825,478	783,558	41,920	5.3%
Construction-in-progress	59,028,369	36,521,485	22,506,884	61.6%
CIP contributed	220,560	361,634	(141,074)	-39.0%
Land Administration building	3,663,266	3,226,243	437,023	13.5%
Land	<u>5,148,656</u>	<u>5,148,656</u>	<u>-</u>	0.0%
Total capital assets	<u>\$772,948,034</u>	<u>\$741,723,427</u>	<u>\$31,224,607</u>	4.2%

Additional information regarding the District's capital assets can be found in the Note 4 of this report.

The following table summarizes the changes in capital debt between fiscal year 2011 and fiscal year 2010:

	<u>Fiscal Year 2011</u>	<u>Fiscal Year 2010</u>	<u>Increase (Decrease)</u>	<u>Percent Increase (Decrease)</u>
Bonds Payable:				
Improvement District No.1	\$ 25,000	\$ 450,000	\$ (425,000)	-94.4%
Improvement District No.2	14,955,000	18,165,000	(3,210,000)	-17.7%
Improvement District No.3	21,630,000	22,780,000	(1,150,000)	-5.0%
Improvement District No.4	144,470,000	151,835,000	(7,365,000)	-4.9%
Improvement District No.8	415,000	505,000	(90,000)	-17.8%
Community Facilities				
District 99-1 (Talega)	98,425,000	100,090,000	(1,665,000)	-1.7%
Deferred credit and charges on advance refunding	<u>(3,868,019)</u>	<u>(4,040,556)</u>	<u>172,537</u>	-4.3%
Total Bonds Payable	<u>276,051,981</u>	<u>289,784,444</u>	<u>(13,732,463)</u>	-4.7%
Notes payable	12,831,276	13,663,214	(831,938)	-6.1%
Reservoir capacity obligations	1,477,058	2,158,349	(681,291)	-31.6%
Reimbursement agreements	<u>10,689,274</u>	<u>10,910,689</u>	<u>(221,415)</u>	-2.0%
	<u>\$301,049,589</u>	<u>\$316,516,696</u>	<u>\$(15,467,107)</u>	-4.9%

Additional information on the District's long-term debt can be found in Note 5.

Contacting the District's Financial Management

This financial report is designed to provide our customers, investors and creditors with an overview of the District's financial operations and condition. If you have questions about this report or need additional information, you may contact the District's Director of Finance at P.O. Box 7005, Mission Viejo, California 92690-7005.

SANTA MARGARITA WATER DISTRICT

Statement of Net Assets

June 30, 2011

(With Comparative Data as of June 30, 2010)

	<u>2011</u>	<u>2010</u>
ASSETS:		
Current Assets:		
Cash and investments (Note 2):		
Undesignated	\$ 51,845,236	\$ 54,873,563
Designated	30,778,677	31,140,501
Accounts receivable, water and sewer (Note 3)	5,301,768	5,721,215
Accounts receivable, other (Note 3)	2,207,135	5,383,881
Accrued interest receivable	416,553	633,095
Taxes receivable	647,410	660,169
Inventories	1,442,009	1,451,089
Deposits and prepaid expenses	1,594,821	819,115
Total current assets	94,233,609	100,682,628
Noncurrent Assets:		
Restricted:		
Cash and investments (Note 2)	82,712,051	97,762,914
Deposits and prepaid expenses	1,859,033	1,412,833
Accrued interest receivable	254,598	413,190
Taxes receivable	4,125,025	4,396,683
Total restricted assets	88,950,707	103,985,620
Capital assets, not depreciable (Note 4)	68,910,851	45,258,018
Capital assets, net of accumulated depreciation of \$250,730,629 (2011) and \$235,495,319 (2010) (Note 4)	454,156,554	460,970,090
Total capital assets	523,067,405	506,228,108
Bond issuance costs, net of accumulated amortization of \$7,746,523 (2011) and \$7,314,522 (2010)	2,787,326	3,219,326
TOTAL ASSETS	\$ 709,039,047	\$ 714,115,682

(Continued)

SANTA MARGARITA WATER DISTRICT

Statement of Net Assets

(Continued)

	<u>2011</u>	<u>2010</u>
LIABILITIES:		
Current liabilities:		
Accounts payable	\$ 12,514,190	\$ 12,001,293
Accrued payroll and benefits	1,863,592	1,707,713
Customer deposits	309,554	280,539
Interest payable	5,613,014	5,719,423
Retentions payable and construction deposits	2,435,431	2,003,421
Bonds payable and notes payable current portion (Note 5)	15,529,570	14,736,937
Reservoir capacity obligation current portion (Note 5)	718,762	681,291
Total current liabilities	38,984,113	37,130,617
Long-term liabilities (Note 5):		
Bonds payable	276,051,981	289,784,444
Notes payable	12,831,276	13,663,214
Reservoir capacity obligation	1,477,058	2,158,349
Reimbursement agreement advances	4,857,193	5,003,173
Interest payable on reimbursement agreements	5,832,081	5,907,516
	301,049,589	316,516,696
Less amount due within one year	(16,248,332)	(15,418,228)
Total long-term liabilities	284,801,257	301,098,468
Total liabilities	323,785,370	338,229,085
Commitments and contingencies (Note 11)		
NET ASSETS:		
Invested in capital assets, net of related debt	283,258,781	264,454,925
Restricted for debt service	28,313,381	29,739,339
Unrestricted (Note 1)	73,681,515	81,692,333
Total net assets	385,253,677	375,886,597
TOTAL LIABILITIES AND NET ASSETS	\$ 709,039,047	\$ 714,115,682

See accompanying notes to financial statements.

SANTA MARGARITA WATER DISTRICT
Statement of Revenues, Expenses and Changes in Net Assets
Year Ended June-30, 2011.
(With Comparative Data for Year Ended June 30, 2010)

	<u>2011</u>	<u>2010</u>
OPERATING REVENUES:		
Water sales	\$ 27,522,866	\$ 28,653,367
Sanitation sales service charge	15,600,334	16,693,371
Utility billing charges	722,208	709,257
Construction revenue	208,086	11,065
Other income	4,424,449	2,146,099
TOTAL OPERATING REVENUES	48,477,943	48,213,159
OPERATING EXPENSES:		
Water purchases	21,185,215	21,236,768
Power	4,204,479	4,457,427
Maintenance and operation	440,267	400,051
Regional facilities	1,257,311	917,472
Sewage treatment	3,351,879	3,047,929
Operating general	1,847,191	1,897,521
Repair and maintenance	3,829,607	4,652,062
Employee cost	13,548,863	12,682,205
Customer relations	431,618	419,491
General and administrative	2,273,941	2,351,800
Depreciation and amortization	15,920,180	15,920,805
TOTAL OPERATING EXPENSES	68,290,551	67,983,531
OPERATING INCOME (LOSS)	(19,812,608)	(19,770,372)
NONOPERATING REVENUES (EXPENSES):		
Property taxes-ad valorem	31,116,868	32,913,507
Capacity lease income	8,913,530	7,149,921
Investment income	2,348,104	4,531,146
Rental income	1,116,498	1,046,218
Connection fees	-	25,500
Other expense	(890,000)	-
Interest and debt service (Note 1)	(13,979,495)	(14,826,211)
TOTAL NONOPERATING REVENUES (EXPENSES)	28,625,505	30,840,081
INCOME BEFORE CAPITAL CONTRIBUTIONS	8,812,897	11,069,709
CAPITAL CONTRIBUTIONS:		
Contributed facilities (Notes 1 and 4)	541,189	349,875
Capital grants	12,994	1,895,388
TOTAL CAPITAL CONTRIBUTIONS	554,183	2,245,263
CHANGE IN NET ASSETS	9,367,080	13,314,972
TOTAL NET ASSETS - beginning of the year	375,886,597	362,571,625
TOTAL NET ASSETS - end of the year	\$ 385,253,677	\$ 375,886,597

See accompanying notes to financial statements.

SANTA MARGARITA WATER DISTRICT

Statement of Cash Flows

Year Ended June 30, 2011

(With Comparative Data for Year Ended June 30, 2010)

	<u>2011</u>	<u>2010</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from customers	\$ 44,501,956	\$ 44,819,857
Payment to suppliers	(39,521,437)	(35,241,139)
Payment to employees	(13,392,984)	(12,618,998)
Other receipts	7,827,693	2,096,571
Net cash provided by operating activities	<u>(584,772)</u>	<u>(943,709)</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Property taxes received	5,987,585	5,590,346
Net cash provided by noncapital financing activities	<u>5,987,585</u>	<u>5,590,346</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition and construction of capital assets	(29,704,123)	(15,862,607)
Proceeds from bonds	-	36,205,000
Principal paid on long-term debt	(15,418,229)	(52,952,368)
Interest and fiscal agent fees paid on long-term debt	(15,784,937)	(14,186,167)
Debt-related property taxes received	25,413,700	27,185,909
Capital grants received	12,994	1,895,388
Water and sewer connection fees received	-	25,500
Capacity lease income	8,913,530	7,149,921
Net cash (used for) capital and related financing activities	<u>(26,567,065)</u>	<u>(10,539,424)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Interest received on investments	1,762,279	2,907,390
Proceeds from sale and maturity of investment securities	180,352,482	204,565,815
Purchase of investment securities	(155,938,135)	(167,621,795)
Net cash provided by investing activities	<u>26,176,626</u>	<u>39,851,410</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	5,012,374	33,958,623
CASH AND CASH EQUIVALENTS - beginning of year (Note 1)	<u>62,092,827</u>	<u>28,134,204</u>
CASH AND CASH EQUIVALENTS - end of year	<u>\$ 67,105,201</u>	<u>\$ 62,092,827</u>

(Continued)

SANTA MARGARITA WATER DISTRICT

Statement of Cash Flows-

(Continued)

	<u>2011</u>	<u>2010</u>
RECONCILIATION OF CASH AND CASH EQUIVALENTS TO AMOUNTS REPORTED ON STATEMENT OF NET ASSETS:		
Reported on Statement of Net Assets:		
Cash and investments - non-restricted, undesignated	\$ 51,845,236	\$ 54,873,563
Cash and investments - non-restricted, designated	30,778,677	31,140,501
Cash and investments - restricted	82,712,051	97,762,914
	<u>165,335,964</u>	<u>183,776,978</u>
Less investments not meeting the definition of cash and cash equivalents	<u>(98,230,763)</u>	<u>(121,684,151)</u>
CASH AND CASH EQUIVALENTS - end of year	<u><u>\$ 67,105,201</u></u>	<u><u>\$ 62,092,827</u></u>
 RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES:		
Operating income (loss)	\$ (19,812,608)	\$ (19,770,372)
Adjustments to reconcile operating income (loss) to net cash provided by operating activities:		
Depreciation and amortization	15,920,180	15,920,805
Other nonoperating items:		
Rental income	1,116,498	1,046,218
Other expense	(890,000)	-
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable, water and sewer	419,447	(1,234,825)
(Increase) decrease in accounts receivable, other	3,176,746	(1,095,746)
(Increase) decrease in inventories	9,080	(267,173)
(Increase) decrease in deposits and prepaid expenses	(1,221,906)	(1,825,474)
Increase (decrease) in accounts payable - current	512,897	6,232,029
Increase (decrease) in accrued payroll and benefits	155,879	63,207
Increase (decrease) in customer deposits	29,015	(9,878)
Increase (decrease) in deferred revenue	-	(2,500)
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u><u>\$ (584,772)</u></u>	<u><u>\$ (943,709)</u></u>
 SUPPLEMENTAL DISCLOSURE OF NONCASH CAPITAL AND RELATED FINANCING AND INVESTING ACTIVITIES:		
Contributed facilities (Notes 1 and 4)	<u>\$ 541,189</u>	<u>\$ 349,875</u>
Unrealized gain (loss) on investments	<u>\$ 960,959</u>	<u>\$ 2,208,600</u>
Amortization of premium on advance refunding (Note 5)	<u>\$ 2,087,964</u>	<u>\$ 1,632,340</u>
Amortization of accounting loss on advance refunding (Note 5)	<u>\$ 2,260,501</u>	<u>\$ 1,644,910</u>

See accompanying notes to financial statements.

SANTA MARGARITA WATER DISTRICT

Notes to Financial Statements

Year ended June 30, 2011

1. Summary of Significant Accounting Policies

Organization

Santa Margarita Water District (the "District") was established on December 23, 1964 under provisions of the California Water District Law (Section 34000, et seq. of the California Water Code). At the time of its formation, the District encompassed approximately 41,400 acres. Its area has been expanded to approximately 62,700 acres through a series of annexations (and one de-annexation). Individual improvement districts (of which there are presently 14) and a community facilities district function as operating units and provide a basis for the design and adoption of plans of work, authorization and sale of bonds and determination of user charges and assessments imposed by the District to cover the cost of services.

Uniform Accounting System

Separate accounts are maintained for each improvement district and community facilities district. This system permits separate accounting for each established improvement district and community facilities district for the purposes of complying with applicable legal provisions, Board of Directors resolutions and other requirements.

Basis of Accounting and Reporting Entity

The District reports its activities as an enterprise fund, which is used to account for operations that are financed and conducted in a manner similar to a private business enterprise, wherein the intent of the District is that the costs of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges and property taxes. An enterprise fund is accounted for using the economic resources measurement focus and the accrual basis of accounting. This means that all assets and liabilities (whether current or noncurrent) associated with the activity are included on the statement of net assets. The statement of revenues, expenses and changes in net assets reflects revenues in the accounting period in which they are earned and measurable and expenses are recognized in the period incurred and measurable. For financial reporting purposes, all of the funds of the District have been consolidated and all significant interfund accounts and transactions have been eliminated.

The criteria used in determining the scope of the reporting entity for financial reporting purposes are: (1) financial interdependency, (2) selection of governing authority, (3) designation of management, (4) ability to significantly influence operations, and (5) accountability for fiscal matters. The District is a primary government with no component units.

SANTA MARGARITA WATER DISTRICT

Notes to Financial Statements

(Continued)

1. Summary of Significant Accounting Policies, (Continued)

Contributed Facilities

In accordance with Governmental Accounting Standards Board Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions* ("GASB No. 33") and GASB No. 34, *Basic Financial Statements – and Management's Discussion and Analysis - for State and Local Government*, the District reports facilities contributed by developers at their estimated fair value as a separate component of the statement of revenues, expenses and changes in net assets. The District has recognized contributed facilities of \$541,189 and \$349,875 for the years ended June 30, 2011 and 2010, respectively.

Accounting and Financial Reporting Requirements

The District follows the pronouncements of the Governmental Accounting Standards Board ("GASB") in its accounting and financial reporting. In addition, the District follows the pronouncements of all applicable Financial Accounting Standards Board ("FASB") Statements and Interpretations, Accounting Principles Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedure issued on or before November 30, 1989, unless they conflict with or contradict GASB pronouncements. As allowed under GASB No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Government Entities That Use Proprietary Fund Accounting*, the District has elected not to apply pronouncements issued by the FASB after November 30, 1989.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of June 30, 2011 and 2010, and revenues and expenses for the years then ended. Actual results may significantly differ from those estimates in the near term.

Capital Assets

Capital assets are valued at historical cost or estimated historical cost if actual cost is not available. Donated assets which consist of tract facilities and other capital assets contributed by developers are recorded as contributed facilities based on cost information furnished by developers. Depreciation of capital assets is charged as an expense against operations. Depreciation is recorded using the straight-line method based on estimated lives which range from 4 to 75 years, consisting primarily of operational equipment over 4 to 12 years; water plant, power plant and administration building over 40 years; and mains and other conduits over 60 to 75 years. Assets over \$5,000 are considered capital in nature.

SANTA MARGARITA WATER DISTRICT

Notes to Financial Statements

(Continued)

1. Summary of Significant Accounting Policies, (Continued)

Inventories

Inventories consist of water held in reservoirs, water meters, pipe, meter boxes and other materials required to maintain the District's water and sewer system. Non-water related inventories are recorded at historical cost. Water inventory is valued at average cost per acre foot through the Municipal Water District of Orange County.

Restricted Assets

Amounts shown as restricted assets are to be used for specified purposes, such as servicing general obligation bond debt and the construction of capital assets. Such assets have been restricted by either bond indenture, law or contractual obligations.

Bond Reserve Requirements

The District is required to hold monies in a reserve fund based on bond covenants. At June 30, 2011, the District had \$3,905,377 for the 1999 CFD and \$6,678,125 for the 2007 CFD.

Current Liabilities Payable from Restricted Assets

Certain liabilities (including the current portion of bonds payable) have been classified as current liabilities payable from restricted assets because they will be paid from restricted assets.

Operating Revenues and Expenses

Operating revenues and expenses represent revenue earned and the related costs incurred to provide water and sanitation services to District customers.

Property Taxes

Property tax in California is levied in accordance with Article 13A of the State Constitution at 1% of the countywide assessed valuations. This 1% is allocated pursuant to state law to the appropriate units of local governments. In addition, the District assesses property taxes for payments of bond principal and interest and long-term lease obligations for water importation.

Property tax revenue is generally recognized in the fiscal year in which taxes have been levied.

SANTA MARGARITA WATER DISTRICT

Notes to Financial Statements

(Continued)

1. Summary of Significant Accounting Policies, (Continued)

The property tax calendar is as follows:

Lien date:	January 1
Levy date:	July 1
Due date:	First installment - November 1 Second installment - February 1
Delinquent date:	First installment - December 10 Second installment - April 10

Taxes are collected by the County of Orange and are remitted to the District periodically according to the following schedule (dates and percentages may vary slightly from year to year).

November 09	10%
December 08	10%
December 22	30%
January 19	5%
March 15	7%
April 26	31%
May 24	5%
July 12	2%

Interest

The District incurs interest charges on bonds and notes payable. Certain interest is capitalized as a component cost of facilities under construction and amortized over the useful life of the facilities. Interest incurred and capitalized during the year ended June 30, 2011 totaled \$15,629,650 and \$1,650,155, respectively, and \$15,937,783 and \$1,111,572, respectively, during the year ended June 30, 2010.

Cash and Investments

During the year ended June 30, 2011, the District modified its method of defining cash and cash equivalents to a method that is common within the industry. The District has defined cash and cash equivalents to include the following:

	<u>2011</u>	<u>2010</u>
Deposits	\$ 3,412,302	\$ 3,760,467
Money market funds	<u>63,692,899</u>	<u>58,332,360</u>
Total	<u>\$67,105,201</u>	<u>\$62,092,827</u>

SANTA MARGARITA WATER DISTRICT

Notes to Financial Statements

(Continued)

1. Summary of Significant Accounting Policies, (Continued)

Cash and Investments, (Continued)

The District records cash and investments at fair value. All demand deposits and certificates of deposit held by a bank are entirely insured or collateralized with securities having a market value of at least 10% in excess of the total amount of funds on deposit.

Bond Issuance Costs

Bond issuance costs are included as deferred charges on the accompanying statements of net assets and are being amortized over the term of each bond issue by the bonds outstanding method (Note 5).

Deferred Charge/Credit on Advance Refunding

The advance refunding of certain bonds in 1994, 1997, 1999, 2003 and 2009 and the subsequent partial refunding of the 1994 Series bonds resulted in refunding gains and losses. Such gains and losses are included in bonds payable on the accompanying statements of net assets and are amortized over the shorter of the maturity of the refunding debt or the remaining maturity of the refunded debt (Note 5).

Compensated Absences

Full-time employees earn from 152 hours to 272 hours per year, depending on their length of employment. General leave may be accumulated to a maximum of twice the employee's annual entitlement or 400 hours, whichever occurs first. Eligible part-time employees accrue general leave pro-rata based on the number of hours worked in a regular workweek divided by 40 hours. All accrued and unused general leave is paid to the employee upon termination of employment or retirement. The cost of vested or accumulated general leave is recorded as an expense as benefits accrue to the employees.

Arbitrage Rebate Payable

Internal Revenue Code Section 148, under the Tax Reform Act of 1986, requires that certain interest earnings in excess of interest costs of tax-exempt debt on bonds and tax revenue anticipation notes be rebated to the United States Government. The arbitrage rebate represents the difference between interest earned over a five-year period and the cost of tax-exempt debt. Internal Revenue Regulations Section 1.148 provides guidance in the calculation of the arbitrage liability. As of June 30, 2011 the District determined there are no material liabilities to report.

SANTA MARGARITA WATER DISTRICT

Notes to Financial Statements

(Continued)

1. Summary of Significant Accounting Policies, (Continued)

Income Taxes

As a governmental entity, the District is exempt from income taxation under provisions of the Internal Revenue Code and related state statutes; accordingly, no provision for income taxes has been provided.

Net Assets

Net assets of the District are categorized as invested in capital assets, net of related debt, restricted for capital projects, restricted for debt service and unrestricted. Net assets invested in capital assets, net of related debt, represent the capitalized cost of capital assets, net of depreciation and the related outstanding debt balances. Restricted net assets represent net assets that are constrained by externally imposed requirements of creditors (such as through debt covenants), laws or regulations of other governments or imposed by law through constitutional provisions or enabling legislation. All net assets not categorized as net assets invested in capital assets, net of related debt, restricted for capital projects or restricted for debt service are included in unrestricted net assets, including amounts reserved in accordance with designations by the Board of Directors.

As of June 30, 2011 and 2010, unrestricted net assets consist of the following:

	<u>Balance at June 30, 2010</u>	<u>Additions</u>	<u>Deletions</u>	<u>Balance at June 30, 2011</u>
Designations:				
Alternate water solutions reserve	\$ 5,000,000	\$ -	\$ -	\$ 5,000,000
Capital repair and Maintenance reserve	6,355,335	2,319,000	(1,401,766)	7,272,569
Capital replacement reserve	2,506,947	51,171	(500,000)	2,058,118
Insurance contingency	300,000	-	-	300,000
Operating construction reserve	3,983,967	-	(409,801)	3,574,166
Rate stabilization fund	9,000,000	-	-	9,000,000
Regional facility debt service	<u>3,994,253</u>	<u>208,089</u>	<u>-</u>	<u>4,202,342</u>
Total designations	31,140,502	2,578,260	(2,311,567)	31,407,195
Nondesignated	<u>50,551,831</u>	<u>-</u>	<u>(8,277,511)</u>	<u>42,274,320</u>
Total unrestricted net assets	<u>\$81,692,333</u>	<u>\$2,578,260</u>	<u>\$(10,589,078)</u>	<u>\$73,681,515</u>

SANTA MARGARITA WATER DISTRICT

Notes to Financial Statements

(Continued)

1. Summary of Significant Accounting Policies, (Continued)

Write-off of Uncollectible Accounts

The District writes off all delinquent amounts under \$50 after 45 days. Amounts over \$50 are sent to collections and are written off after 5 weeks of being sent to collections.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

Comparative Data

Selected information regarding the prior year has been included in the accompanying financial statements. The information included in the accompanying financial statements for the prior year has been presented for comparison purposes only and does not represent a complete presentation in accordance with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the District's prior year financial statements, from which this selected financial data was derived.

2. Cash and Investments

Deposits and investments are reported in the accompanying statement of net assets as follows:

Cash and investments, undesignated	\$ 51,845,236
Cash and investments, designated	30,778,677
Restricted cash and investments	<u>82,712,051</u>
	<u>\$165,335,964</u>

Deposits and investments consisted of the following at June 30, 2011:

Deposits	\$ 3,412,302
Investments	<u>161,923,662</u>
	<u>\$165,335,964</u>

SANTA MARGARITA WATER DISTRICT

Notes to Financial Statements

(Continued)

2. Cash and Investments, (Continued)

Investments Authorized by the California Government Code and the District's Investment Policy

The table below identifies the investment types that are authorized for the District by the California Government Code and the District's investment policy. The table also identifies certain provisions of the California Government Code (or the District's investment policy, if more restrictive) that address interest rate risk and concentration of credit risk. This table does not address investments of debt proceeds held by bond trustee that are governed by the provisions of debt agreements of the District, rather than the general provisions of the California Government Code or the District's investment policy.

<u>Investment Types Authorized by State Law</u>	<u>Authorized By Investment Policy</u>	<u>*Maximum Maturity</u>	<u>*Maximum Percentage of Portfolio</u>	<u>*Maximum Investment In One Issuer</u>
Local Agency Bonds	No	N/A	N/A	None
U.S. Treasury Obligations	Yes	5 years	None	None
U.S. Agency Securities	Yes	5 years	None	None
Banker's Acceptances	Yes	180 days	40%	30%
Commercial Paper	Yes	270 days	25%	10%
Negotiable Certificates of Deposit	Yes	5 years	20%	None
Non-Negotiable Certificates of Deposit	Yes	5 years	40%	None
Repurchase Agreements	No	N/A	N/A	N/A
Reverse Repurchase Agreements	No	N/A	N/A	N/A
Medium-Term Notes	Yes	5 years	30%	None
Mutual Funds	Yes	N/A	20%	10%
Money Market Mutual Funds	Yes	N/A	20%	10%
Mortgage Pass-Through Securities	No	N/A	N/A	N/A
County Pooled Investment Funds	No	N/A	N/A	N/A
Local Agency Investment Fund (LAIF)	Yes	N/A	None	None
JPA Pools (other investment pools)	No	N/A	N/A	N/A

* Based on state law requirements or investment policy requirements, whichever is more restrictive.

SANTA MARGARITA WATER DISTRICT

Notes to Financial Statements

(Continued)

2. Cash and Investments, (Continued)

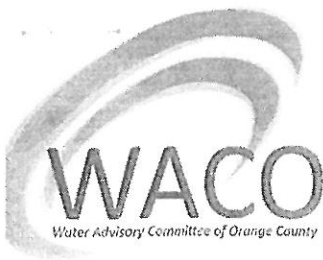
Investments Authorized by Debt Agreements

Investment of debt proceeds held by bond trustee are governed by provisions of the debt agreements, rather than the general provisions of the California Government Code or the District's investment policy. The table below identifies the investment types that are authorized for investments held by bond trustee. The table also identifies certain provisions of these debt agreements that address interest rate risk and concentration of credit risk.

<u>Authorized Investment Type</u>	<u>Maximum Maturity</u>	<u>Maximum Percentage Allowed</u>	<u>Maximum Investment in One Issuer</u>
U.S. Treasury Obligations	None	None	None
U.S. Agency Securities	None	None	None
Banker's Acceptances	180 days	None	None
Commercial Paper	270 days	None	None
Money Market Mutual Funds	N/A	None	None
Investment Contracts	None	None	None
Certificates of Deposit	365 days	None	None
Local Agency Bonds	None	None	None
Reverse/Repurchase Agreements	None	None	None
Local Agency Investment Fund	None	None	None

Disclosures Relating to Interest Rate Risk

Interest rate risk is the risk that changes in market interest rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest rates. One of the ways that the District manages its exposure to interest rate risk is by purchasing a combination of shorter term and longer term investments and by timing cash flows from maturities so that a portion of the portfolio is maturing or coming close to maturity evenly over time as necessary to provide the cash flow and liquidity needed for operations.



September 9, 2011

Mailing Address

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Officers

Chair

Hon. Larry McKenney
Moulton Niguel Water District

Vice Chair

Hon. Shawn Dewane
Mesa Consolidated Water District

Mr. Phil Isenberg
Chair
Delta Stewardship Council
980 Ninth Street, Suite 1500
Sacramento, CA 95814

Re: Comments on the Fifth Draft Delta Plan

Dear Chair Isenberg:

On behalf of the Water Advisory Committee of Orange County (WACO), I am writing to express our organization's concern with the Fifth Staff Draft of the Delta Plan ("Plan"). Though each staff draft of the Plan has shown improvement, we believe that the current fifth draft is still inadequate to achieve the co-equal goals of improved water supply reliability and Delta ecosystem health.

WACO was formed in 1983 to facilitate the discussion and debate of water issues among Orange County policymakers and water professionals and to advocate the Orange County water community's position on issues impacting our water supply. The committee is comprised of elected officials and management staff from many Orange County water agencies and cities, as well as engineers, attorneys, consultants, and other professionals who work with the Orange County water community, and residents and community group members who share a common interest in water issues.

Collectively, the public agency officials who attend the WACO meetings represent more than 3 million Orange County residents, businesses and other water users.

Many Orange County agencies and other stakeholders agree with the concerns raised recently by the Ag-Urban Coalition, that the Delta Plan should focus on integrating existing efforts and authorities—including the Bay Delta Conservation Plan—rather than creating a new regulatory scheme, that the Delta Plan needs to create a more definite path forward both for water supply and environmental restoration in the Delta, and that the Delta Plan should not be focused on remote management decisions that should be made locally.

Of particular concern to Orange County is that the Plan appears to avoid resolving the predictability of water supply through the Delta. The staff drafts have consistently exhibited an imbalanced approach favoring ecological goals over water supply, rather than co-equal goals. This is illustrated most obviously in the overarching theme of the current draft that water supplies from the Delta cannot be made more certain, but should certainly be expected to decrease over time. One specific manifestation of this idea is the suggestion that ecological flows will have to be set as a regulatory matter before further supply or supply reliability measures can be addressed. This "flows first" approach is not consistent with the idea of co-equal goals.

...continued



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Water Advisory Committee of Orange County
Comments on 5th Staff Draft Delta Plan
September 9, 2011
Page 2/2

Additionally, the “flows first” approach puts too much responsibility for managing environmental effects on diversions, rather than recognizing the scientifically accepted reality that many other stressors have profound effects on the Delta as an ecosystem. These include food web alteration associated with nitrogen discharges, predation by non-native species, and hydromodification resulting from land use practices in the Delta. While the draft Plan includes recommendations to further study these other stressors, it does not recognize as a matter of science or policy that addressing the other stressors could affect the necessary flows for ecological health in the Delta.

In contrast to the Plan’s failure to address water supply reliability through the Delta, the Plan is quite detailed about local water supply actions that should be taken. The Plan would require the development of Water Supply Reliability Elements in Urban Water Management Plans that would detail how water suppliers will sustain and improve regional self-reliance and reduce reliance on the Delta. A sufficient plan would have to address how specific programs and projects would be implemented over a 20-year planning period to improve conservation, efficiency, and regional water supply development. Sound regional planning is laudable, and Orange County is more than up to the challenge. However, since Orange County agencies and others in Southern California currently have no choice but to continue to invest significant public funds in water supply from the Delta, the Delta Plan should explore ways that the State could promote the fulfillment of its goal of reducing reliance on the Delta by alleviating the burden of water users of paying both for Delta supplies and alternative supplies.

Another specific financial concern in Orange County is the approach the Plan takes to economic development in the Delta. The Council has taken the view, based on statutory language about protecting the Delta as an evolving place, that protecting the Delta is essentially a third co-equal goal. Moreover, the Plan goes further and casts this as ensuring the economic development of the Delta region. This third co-equal goal surpasses the legal duty and authority of the Council, and certainly implies additional economic obligations for the rest of California that are unrelated to the co-equal goals and inconsistent with both the “beneficiary pays” concept and the appropriate level of local control. WACO urges great caution and circumspection in this regard.

Thank you for the opportunity to provide feedback.

Sincerely,



Larry McKenney

Chair

Water Advisory Committee of Orange County