



THIRD LAGUNA HILLS MUTUAL

Financial Statements and Supplementary Information

December 31, 2018 and 2017

(With Independent Auditors' Report Thereon)

THIRD LAGUNA HILLS MUTUAL

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Independent Auditors' Report

The Board of Directors
Third Laguna Hills Mutual:

Report on the Financial Statements

We have audited the accompanying financial statements of Third Laguna Hills Mutual (the Mutual), which comprise the balance sheets as of December 31, 2018 and 2017, and the related statements of operations, comprehensive income, changes in members' equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Third Laguna Hills Mutual as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended, in accordance with U.S. generally accepted accounting principles.



Other Matter

Required Supplementary Information

U.S. generally accepted accounting principles require that the information included in schedule 1 on future major repairs and replacements be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Financial Accounting Standards Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audits of the financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

KPMG LLP

Irvine, California
April 5, 2019

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Balance Sheets

December 31, 2018 and 2017

| Assets | 2018 | 2017 |
|--|---------------|-------------|
| Cash and cash equivalents (note 3) | \$ 1,894,801 | 1,132,948 |
| Accounts receivable and interest receivable, net of allowance for doubtful accounts of \$551,915 in 2018 and \$537,702 in 2017, respectively | 442,470 | 361,072 |
| Receivable from Golden Rain Foundation of Laguna Woods (note 5) | 1,527,661 | 1,735,193 |
| Prepaid expenses | 195,117 | 260,788 |
| Total current assets | 4,060,049 | 3,490,001 |
| Investments and restricted cash (note 3) | 29,260,565 | 28,617,275 |
| Beneficial interest in Golden Rain Foundation of Laguna Hills Trust (note 2(h)) | 5,460,742 | 5,603,792 |
| Equity Interest in Golden Rain Foundation of Laguna Woods (note 2(h)) | 36,986,050 | 36,657,849 |
| Total assets | \$ 75,767,406 | 74,368,917 |
| Liabilities and Members' Equity | | |
| Liabilities: | | |
| Accounts payable and accrued expenses | \$ 2,604,255 | 2,137,572 |
| Amounts payable for accrued compensation | 646,315 | 873,829 |
| Assessments and charges paid in advance | 756,376 | 681,482 |
| Total current liabilities | 4,006,946 | 3,692,883 |
| Total liabilities | 4,006,946 | 3,692,883 |
| Members' equity | 71,760,460 | 70,676,034 |
| Total liabilities and members' equity | \$ 75,767,406 | 74,368,917 |

See accompanying notes to financial statements.

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Statements of Operations

Years ended December 31, 2018 and 2017

| | <u>2018</u> | <u>2017</u> |
|---|---------------------|-------------------|
| Revenue: | | |
| Member assessments: | | |
| Operating | \$ 31,954,846 | 30,830,053 |
| Golden Rain Foundation of Laguna Woods restricted funds (note 5) | 1,464,480 | 1,757,376 |
| Restricted funds (note 3) | <u>13,154,417</u> | <u>13,396,056</u> |
| Total member assessments | <u>46,573,743</u> | <u>45,983,485</u> |
| Other revenue: | | |
| Chargeable services revenue | 977,603 | 330,901 |
| Laundry | 132,633 | 113,421 |
| Investment income | 486,123 | 379,923 |
| Lease and resale processing fees | 410,125 | 387,399 |
| Miscellaneous | <u>426,785</u> | <u>234,274</u> |
| Total other revenue | <u>2,433,269</u> | <u>1,445,918</u> |
| Total revenue | <u>49,007,012</u> | <u>47,429,403</u> |
| Expenses: | | |
| Reimbursement to managing agent for compensation and related costs | 13,052,566 | 12,104,496 |
| Operating materials and supplies | 1,342,619 | 1,220,172 |
| Utilities and telephone | 5,530,064 | 5,357,872 |
| Professional fees | 123,280 | 119,342 |
| Legal fees | 427,069 | 230,869 |
| Repairs and maintenance | 10,090,033 | 8,197,336 |
| Insurance | 1,267,140 | 1,172,771 |
| Golden Rain Foundation of Laguna Woods operating expenses (note 5) | 14,293,450 | 13,423,751 |
| Payments to Golden Rain Foundation of Laguna Woods restricted funds (note 5) | 1,464,480 | 1,757,376 |
| Other | <u>350,403</u> | <u>349,788</u> |
| Total expenses | <u>47,941,104</u> | <u>43,933,773</u> |
| Net income before other changes | 1,065,908 | 3,495,630 |
| Other changes: | | |
| Unrealized gain (loss) from voting interest in Golden Rain Foundation of Laguna Woods | 328,201 | (48,639) |
| Loss from beneficial interest in Golden Rain Foundation of Laguna Hills Trust | <u>(143,050)</u> | <u>(145,969)</u> |
| Net income | <u>\$ 1,251,059</u> | <u>3,301,022</u> |

See accompanying notes to financial statements.

THIRD LAGUNA HILLS MUTUAL
Statements of Comprehensive Income
Years ended December 31, 2018 and 2017

| | <u>2018</u> | <u>2017</u> |
|---|----------------------------|-------------------------|
| Net income | \$ 1,251,059 | 3,301,022 |
| Other comprehensive loss: | | |
| Unrealized loss on available-for-sale investments arising during the year, net: | | |
| Unrealized holding losses arising during the period | <u>(166,633)</u> | <u>(111,551)</u> |
| Comprehensive income | <u><u>\$ 1,084,426</u></u> | <u><u>3,189,471</u></u> |

See accompanying notes to financial statements.

THIRD LAGUNA HILLS MUTUAL

Statements of Changes in Members' Equity

Years ended December 31, 2018 and 2017

| | Memberships | | Changes | Total members' equity |
|--|--------------------|---------------|----------------|------------------------------|
| | Number | Amount | | |
| Members' equity, December 31, 2016 | 6,102 | \$ 610,200 | 66,876,363 | 67,486,563 |
| Net income | — | — | 3,301,022 | 3,301,022 |
| Unrealized loss on available-for-sale investments, net | — | — | (111,551) | (111,551) |
| Members' equity, December 31, 2017 | 6,102 | 610,200 | 70,065,834 | 70,676,034 |
| Net income | — | — | 1,251,059 | 1,251,059 |
| Unrealized loss on available-for-sale investments, net | — | — | (166,633) | (166,633) |
| Members' equity, December 31, 2018 | 6,102 | \$ 610,200 | 71,150,260 | 71,760,460 |

See accompanying notes to financial statements.

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Statements of Cash Flows

Years ended December 31, 2018 and 2017

| | <u>2018</u> | <u>2017</u> |
|---|---------------------|--------------------|
| Cash flows from operating activities: | | |
| Net income | \$ 1,251,059 | 3,301,022 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Loss from beneficial interest in Golden Rain Foundation of Laguna Hills Trust | 143,050 | 145,969 |
| Amortization of investment premium and discount, net | (2,586) | 30,496 |
| Unrealized (gain) loss from voting interest in Golden Rain Foundation of Laguna Woods | (328,201) | 48,639 |
| Effect of changes in operating assets and liabilities: | | |
| Accounts and accrued interest receivable | (81,398) | (1,526) |
| Prepaid expenses | 65,671 | (90,258) |
| Receivable from Golden Rain Foundation of Laguna Woods | 207,532 | (926,131) |
| Payable for accrued compensation | (227,514) | 60,382 |
| Accounts payable and accrued expenses | 466,683 | 414,109 |
| Member assessments paid in advance | 74,894 | 61,942 |
| Net cash provided by operating activities | <u>1,569,190</u> | <u>3,044,644</u> |
| Cash flows from investing activities: | | |
| Purchases of held-to-maturity investments | (17,780,931) | (14,915,205) |
| Maturities of held-to-maturity investments | 18,869,770 | 3,983,154 |
| Proceeds from payments and maturities of available-for-sale investments | 3,191,222 | 2,034,014 |
| Purchases of available-for-sale investments | (3,593,081) | (3,256,231) |
| (Deposits to) withdrawals from restricted funds, net | <u>(1,494,317)</u> | <u>7,639,893</u> |
| Net cash used in investing activities | <u>(807,337)</u> | <u>(4,514,375)</u> |
| Net increase (decrease) in cash and cash equivalents | 761,853 | (1,469,731) |
| Cash and cash equivalents, beginning of year | <u>1,132,948</u> | <u>2,602,679</u> |
| Cash and cash equivalents, end of year | <u>\$ 1,894,801</u> | <u>1,132,948</u> |

See accompanying notes to financial statements.

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Notes to Financial Statements

December 31, 2018 and 2017

(1) Organization

(a) General

Third Laguna Hills Mutual (the Mutual), a nonprofit mutual benefit corporation, was formed to manage, operate, and maintain 6,102 condominium housing units (manors or common property) for the benefit of its members. These manors are a part of Laguna Woods Village, Laguna Woods, California (the Village), a housing development consisting of 12,736 manors and various community facilities.

The Mutual is a corporate member of Golden Rain Foundation of Laguna Woods (GRF), a nonprofit mutual benefit corporation. The individual Mutual members have a right to the use of facilities owned or held in trust by GRF, appurtenant to their membership in the Mutual. GRF, as trustee, holds title to certain community facilities in trust for the benefit of all Mutuals that are a part of the Village (the Village Mutuals).

The Mutual is a member of Village Management Services, Inc. (VMS), an affiliated California nonprofit mutual benefit corporation. VMS was formed to provide management services under contract for GRF and the Mutuals. No management fee is paid to VMS (note 5).

(b) Assessments

The Mutual receives, on a monthly basis, assessments from its members (member assessments) to conduct its operations and to fund certain reserve accounts as discussed in note 2(g). For 2018 and 2017, the members were assessed Mutual basic monthly assessments of \$628.42 and \$619.86, respectively, per manor per month, for direct and Mutual shared operating costs, Mutual reserve contributions, and GRF shared operating expenses and restricted funds. The Mutual basic monthly assessment does not include surcharges for those manors with common laundry facilities, elevators, and/or Garden Villa recreation rooms.

The total assessed to the members of the Mutual for Mutual basic costs and surcharges and GRF costs was \$46,573,743 and \$45,983,485, respectively, in 2018 and 2017.

(2) Significant Accounting Policies

(a) Basis of Presentation

The accompanying financial statements have been prepared on the accrual basis of accounting.

(b) Comprehensive Income

Accounting Standards Codification (ASC) Topic 220, *Comprehensive Income*, establishes standards for the reporting and display of comprehensive income. Comprehensive income is defined as all changes in an entity's equity, except changes resulting from transactions with owners. It differs from

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net income, in which certain items currently recorded to equity would be part of comprehensive income. Changes in accumulated other comprehensive income was as follows for 2018 and 2017:

| | | Unrealized loss on securities, net |
|---|----|---|
| Ending balance, December 31, 2016 | \$ | (275,541) |
| Net current period other comprehensive loss | | <u>(111,551)</u> |
| Ending balance, December 31, 2017 | | (387,092) |
| Net current period other comprehensive loss | | <u>(166,663)</u> |
| Ending balance, December 31, 2018 | \$ | <u><u>(553,755)</u></u> |

(c) Cash and Cash Equivalents

For purposes of reporting cash flows, the Mutual considers all highly liquid investments with an original maturity of three months or less to be cash and cash equivalents.

(d) Investments and Restricted Cash and Investments

The Mutual accounts for investments and restricted funds under the provisions of ASC Topic 320, *Investments – Debt and Equity Securities*. This statement requires the Mutual to classify and account for investments in equity securities that have readily determinable fair values, and for all debt securities, into three categories: (1) debt securities that the Mutual has the positive intent and the ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost; (2) debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings; and (3) debt and equity securities not classified as held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported as other comprehensive income.

The Mutual restricts a portion of member assessments to finance reserves set aside as restricted funds. Disbursements from restricted funds may be made only in accordance with the purpose established. Interest income earned on restricted funds is retained within the respective fund. Additions to the funds are determined each years as outlined in the annual business plan.

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Notes to Financial Statements

December 31, 2018 and 2017

(e) Fair Value Measurements

The Mutual has adopted the provisions of ASC Topic 820, *Fair Value Measurement*, for fair value measurements of financial assets and financial liabilities and for fair value measurements of nonfinancial items that are recognized or disclosed at fair value in the financial statements on a recurring basis. ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction among market participants at the measurement date. ASC Topic 820 also establishes a framework for measuring fair value and expands disclosures about fair value measurements (note 3).

(f) Property

The Mutual has adopted the provisions of ASC Topic 972, *Real Estate – Common Interest Realty Associations, Subtopic 360, Property, Plant, and Equipment*, for the accounting for common real property acquired. As such, common real property directly associated with units is expensed when incurred. Common real property not directly associated with units is capitalized when the Mutual can dispose of the property at the discretion of its board of directors and retain the proceeds or when the property is used to generate significant cash flows from members on the basis of usage or from nonmembers.

(g) Future Major Repairs and Replacements

A study was conducted by the Company in 2018 to estimate the remaining useful lives and current replacement costs of certain major components of common property. This study also considered future replacement costs of these certain major components based on the estimated useful lives, assuming a 2.5% inflation factor. The board of directors has a policy to plan additional fund contributions over the estimated useful lives of the components (on a current-cost basis) based on an annual analysis of the adequacy of the funds. Under the assumption that certain buildings would not be completely replaced within the next 30 years, replacement funds are not provided for those community facilities. Actual replacement costs when expended may vary from the estimated future expenditures considered in the fund analysis, and the variations may be material. If additional monies are needed, the Mutual has the right to adjust the monthly assessment, impose special assessments, or delay expenditures as appropriate.

(h) Interests in Golden Rain Foundation of Laguna Woods and Golden Rain Foundation of Laguna Hills Trust

The Mutual reports its 47.91% interest in GRF based on the non-Trust net assets of GRF to reflect the significant influence the Mutual exercises over GRF through its voting interest in accordance with ASC Topic 323, *Investments – Equity Method and Joint Ventures*. Such interest totaled \$36,986,050 and \$36,657,849 at December 31, 2018 and 2017, respectively.

The Mutual also has a beneficial interest in Golden Rain Foundation of Laguna Hills Trust (the Trust), which holds certain community facilities in trust for the Village Mutuals. The Mutual's beneficial interest is calculated based on the Mutual's "trusteed sums," defined as the original contribution amounts as stated in the trust agreement, and totals \$5,460,742 and \$5,603,792, respectively, at December 31, 2018 and 2017.

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Notes to Financial Statements

December 31, 2018 and 2017

The Third Laguna Hills Mutual's interest in Golden Rain Foundation and Golden Rain Foundation Trust consists of its respective ownership of the following:

| | <u>2018</u> | <u>2017</u> |
|---|----------------------|-------------------|
| Cash and cash equivalents | \$ 4,110,259 | 6,820,716 |
| Receivables | 1,543,311 | 973,163 |
| Income tax receivable | 45,407 | 22,315 |
| Other current assets | 1,870,881 | 2,116,454 |
| Restricted funds and investments | 23,869,568 | 22,728,249 |
| Property and equipment, net | 55,538,601 | 53,694,564 |
| Community facilities, net | 11,522,516 | 11,876,861 |
| Intangible assets, net | 282,184 | 328,385 |
| Total assets | <u>\$ 98,782,727</u> | <u>98,560,707</u> |
| Accounts payable and accrued liabilities | \$ 5,971,734 | 5,230,466 |
| Payables to Laguna Woods Mutuals | 3,380,132 | 3,815,138 |
| Deferred income | 537,493 | 952,408 |
| Total liabilities | <u>9,889,359</u> | <u>9,998,012</u> |
| Members' equity in Golden Rain Foundation of Laguna Woods | 77,196,713 | 76,511,695 |
| Noncontrolling interest in consolidated trust | 11,696,655 | 12,051,000 |
| Total equity | <u>88,893,368</u> | <u>88,562,695</u> |
| Total liabilities and equity | <u>\$ 98,782,727</u> | <u>98,560,707</u> |
| Third Laguna Hills Mutual's 47.91% interest in Golden Rain Foundation of Laguna Woods | \$ 36,986,050 | 36,657,849 |

(i) **Income Taxes**

The Mutual provides for income taxes in accordance with ASC Topic 740, *Income Taxes*. ASC 740 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a threshold of more likely than not for recognition of tax benefits of uncertain tax positions taken or expected to be taken in a tax return. ASC 740 also provides related guidance on measurement, derecognition, classification, interest and penalties, and disclosure. Management believes that no uncertain tax positions requiring accrual or disclosure existed at December 31, 2018 and 2017. The open years for federal and state tax assessments are 2015–2018 for federal and 2014–2018 for California.

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Notes to Financial Statements

December 31, 2018 and 2017

(j) *Concentration of Credit Risk*

The Mutual had cash balances of \$1,827,227 and \$997,829, respectively, and restricted cash balances of \$1,494,317 and \$0, respectively, at December 31, 2018 and 2017, maintained in a commercial bank and that consist of cash on deposit. At December 31, 2018 and 2017, all noninterest-bearing deposit transaction accounts are Federal Deposit Insurance Corporation insured up to a maximum of \$250,000, per depositor, per insured bank, for each account ownership category.

The Mutual also maintained a money market fund of \$67,574 and \$135,119, respectively, at December 31, 2018 and 2017, which was Securities Investor Protection Corporation insured up to the maximum of \$500,000 per institution.

(k) *Use of Estimates*

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates 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 reporting period. Actual results could differ from those estimates.

(l) *Reclassifications*

Certain reclassifications have been made to the 2017 comparative information to conform to the 2018 financial statement presentation.

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Notes to Financial Statements

December 31, 2018 and 2017

(3) Cash and Cash Equivalents, and Investments and Restricted Cash

The Mutual's investments and restricted cash are presented as follows on the accompanying balance sheets at December 31, 2018 and 2017:

| | <u>2018</u> | <u>2017</u> |
|---|----------------------|-------------------|
| Restricted cash | \$ 1,494,317 | — |
| Restricted investments: | | |
| Available for sale (at fair value): | | |
| U.S. Treasury Notes | 7,744,278 | 6,983,497 |
| Government National Mortgage Association securities (GNMAs) | 3,489,276 | 4,095,813 |
| Corporate Bonds | <u>4,657,046</u> | <u>4,579,686</u> |
| Total restricted investments at fair value | 15,890,600 | 15,658,996 |
| Held to maturity (at amortized cost): | | |
| U.S. Treasury Notes | <u>11,875,648</u> | <u>12,434,695</u> |
| Total restricted investments at amortized cost | <u>11,875,648</u> | <u>12,434,695</u> |
| Total restricted cash and restricted investments | 29,260,565 | 28,093,691 |
| Unrestricted investments: | | |
| Held to maturity (at amortized cost): | | |
| U.S. Treasury Notes | <u>—</u> | <u>523,584</u> |
| Total restricted cash and investments | <u>\$ 29,260,565</u> | <u>28,617,275</u> |

The Mutual follows the provisions of ASC 820 for fair value measurements for financial assets and liabilities and nonfinancial items that are recognized at fair value in the financial statements on a recurring basis. ASC 820 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical investments that the Mutual has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the investment, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the investment.

The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level of input that is significant to the fair value measurement.

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Notes to Financial Statements

December 31, 2018 and 2017

The Mutual's cash and cash equivalents and investments that are measured at fair value on a recurring basis as reflected on the accompanying balance sheets at December 31, 2018 and 2017 are as follows:

| | | 2018 | | |
|---|----|-------------------|------------------|-------------------|
| | | Level 1 | Level 2 | Total |
| Cash and cash equivalents | \$ | 1,894,801 | — | 1,894,801 |
| Investments and restricted cash: | | | | |
| Available for sale: | | | | |
| Restricted cash | | 1,494,317 | — | 1,494,317 |
| U.S. Treasury notes | | 7,744,278 | — | 7,744,278 |
| GNMAs | | — | 3,489,276 | 3,489,276 |
| Corporate bonds | | — | 4,657,046 | 4,657,046 |
| Total investments and restricted cash | | <u>9,238,595</u> | <u>8,146,322</u> | <u>17,384,917</u> |
| Total cash and cash equivalents and restricted cash | \$ | <u>11,133,396</u> | <u>8,146,322</u> | <u>19,279,718</u> |
| | | | | |
| | | 2017 | | |
| | | Level 1 | Level 2 | Total |
| Cash and cash equivalents | \$ | 1,132,948 | — | 1,132,948 |
| Investments and restricted cash: | | | | |
| Available for sale: | | | | |
| U.S. Treasury notes | | 6,983,497 | — | 6,983,497 |
| GNMAs | | — | 4,095,813 | 4,095,813 |
| Corporate bonds | | — | 4,579,686 | 4,579,686 |
| Total investments and restricted cash | | <u>6,983,497</u> | <u>8,675,499</u> | <u>15,658,996</u> |
| Total cash and cash equivalents and restricted cash | \$ | <u>8,116,445</u> | <u>8,675,499</u> | <u>16,791,944</u> |

Investments held to maturity comprised U.S. Treasury notes, totaling \$11,875,648 and \$12,958,279 were carried at cost at December 31, 2018 and 2017, respectively. Fair value of such investments totaled \$11,873,702 and \$12,941,407 at December 31, 2018 and 2017, respectively, and were considered Level 1 in the fair value hierarchy.

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Notes to Financial Statements

December 31, 2018 and 2017

The Mutual's investments are classified as either available for sale or held to maturity and are summarized as follows:

| | <u>Amortized cost</u> | <u>Gross unrealized gains</u> | <u>Gross unrealized loss</u> | <u>Estimated fair value</u> |
|-----------------------|---------------------------|---------------------------------------|--------------------------------------|---------------------------------|
| At December 31, 2018: | | | | |
| Available for sale | \$ 16,444,326 | 30,582 | (584,308) | 15,890,600 |
| Held to maturity | 11,875,648 | — | (1,946) | 11,873,702 |
| | | | | |
| | <u>Amortized cost</u> | <u>Gross unrealized gains</u> | <u>Gross unrealized loss</u> | <u>Estimated fair value</u> |
| At December 31, 2017: | | | | |
| Available for sale | \$ 16,046,088 | 73,431 | (460,523) | 15,658,996 |
| Held to maturity | 12,958,279 | — | (16,872) | 12,941,407 |

For the valuation of investments, the Mutual used significant other observable inputs, particularly dealer market prices for comparable investments as of the valuation date or December 31, 2018 and 2017 and are, therefore, classified as Level 2 securities in the fair value hierarchy. There were no significant transfers into or out of Levels 1 or 2 for the years ended December 31, 2018 and 2017.

Investments as of December 31, 2018 and 2017 have the following scheduled maturities:

| | <u>2018</u> | |
|---------------------------|---------------------------|---------------------------------|
| <u>Available for sale</u> | <u>Amortized cost</u> | <u>Estimated fair value</u> |
| Available for sale: | | |
| One to five years | \$ 12,282,052 | 12,178,008 |
| Five to ten years | 2,299,413 | 2,041,561 |
| More than ten years | 1,862,861 | 1,671,031 |
| | <u>\$ 16,444,326</u> | <u>15,890,600</u> |
| <u>Held to maturity</u> | | |
| Held to maturity: | | |
| Within one year | \$ 11,875,648 | 11,873,702 |

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December 31, 2018 and 2017

| | 2017 | |
|---------------------------|----------------------|-------------------------|
| | Amortized cost | Estimated fair value |
| Available for sale | | |
| Available for sale: | | |
| One to five years | \$ 10,320,267 | 10,346,894 |
| Five to ten years | 3,873,638 | 3,644,715 |
| More than ten years | 1,852,183 | 1,667,387 |
| | <u>\$ 16,046,088</u> | <u>15,658,996</u> |
| Held to maturity | | |
| Held to maturity: | | |
| Within one year | \$ 12,958,279 | 12,941,407 |

The Mutual determines realized gains and losses based on the specific-identification method. There were no sales of available-for-sale investments in 2018 and 2017.

Restricted cash and investments consist of the following reserve funds:

| | Replacement funds | Garden villa recreation room fund | Disaster fund | Unappropriated expenditures fund | Total |
|--|----------------------|---|--------------------|--|---------------------|
| Balances, December 31, 2016 | \$ 13,991,710 | 116,718 | 7,757,066 | 2,379,453 | 24,244,947 |
| Member assessments | 10,334,256 | 59,616 | 2,196,720 | 805,464 | 13,396,056 |
| Net investment income and other contributions | 205,201 | 1,593 | 104,870 | 27,801 | 339,465 |
| Excess of prior year surplus | — | — | — | 408,845 | 408,845 |
| Expenditures | <u>(7,992,232)</u> | <u>(114,288)</u> | <u>(1,330,427)</u> | <u>(858,675)</u> | <u>(10,295,622)</u> |
| Balances, December 31, 2017 | 16,538,935 | 63,639 | 8,728,229 | 2,762,888 | 28,093,691 |
| Member assessments | 10,334,256 | 59,616 | 2,028,305 | 732,240 | 13,154,417 |
| Net investment income and other contributions | 259,345 | 1,518 | 138,269 | 45,267 | 444,399 |
| Expenditures | <u>(10,363,054)</u> | <u>(63,474)</u> | <u>(1,677,999)</u> | <u>(327,415)</u> | <u>(12,431,942)</u> |
| Balances, December 31, 2018 | <u>\$ 16,769,482</u> | <u>61,299</u> | <u>9,216,804</u> | <u>3,212,980</u> | <u>29,260,565</u> |

(a) Replacement Funds

Replacement funds were established to provide reserves for replacement of common property, roofs, elevators, and certain equipment that were originally included in the cost of individual manors purchased by the residents. Monthly member assessments for these funds are included in member assessments restricted funds in the accompanying statements of operations.

THIRD LAGUNA HILLS MUTUAL

Notes to Financial Statements

December 31, 2018 and 2017

(b) Garden Villa Recreation Room Fund

This fund was established to provide funds for maintaining the Garden Villa recreation rooms. Monthly member assessments for this fund are included in member assessments-restricted funds in the accompanying statements of operations.

(c) Disaster Fund

The disaster fund was established to reserve for contingencies and emergency expenditures or catastrophic damages not covered by insurance, including insurance policy deductibles. Monthly member assessments for this fund are included in member assessments-restricted funds in the accompanying statements of operations.

(d) Unappropriated Expenditures Fund

The unappropriated expenditures fund was established to provide funds for payment of authorized expenses not specifically provided for in the annual business plan. Monthly member assessments for this fund are included in member assessments-restricted funds in the accompanying statements of operations.

(4) Income Taxes

The Mutual is considered a homeowners' association for federal and state income tax purposes and is liable for tax on nonexempt function net income. There was no provision (benefit) for income taxes for the years ended December 31, 2018 and 2017.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2018 and 2017 are presented below:

| | <u>2018</u> | <u>2017</u> |
|------------------------------------|--------------------|------------------|
| Deferred tax assets: | | |
| IRC Section 277 loss carryforwards | \$ 388,894 | 388,894 |
| Net operating loss carryforwards | <u>626,174</u> | <u>586,175</u> |
| Total gross deferred tax assets | 1,015,068 | 975,069 |
| Less valuation allowance | <u>(1,015,068)</u> | <u>(975,069)</u> |
| Total deferred tax assets | \$ <u>—</u> | <u>—</u> |

The valuation allowance for deferred tax assets as of December 31, 2018 and 2017 was \$1,015,068 and \$975,069, respectively. The net change in the total valuation allowance for the years ended December 31, 2018 and 2017 was an increase of \$39,999 and \$18,901, respectively. Based upon the level of historical taxable income and projections for future taxable income over periods, which the deferred tax assets are deductible, management believes it is more likely than not that the Mutual will not realize the benefits of the deductible differences. As such, the Mutual recorded a full valuation allowance against the deferred tax assets at December 31, 2018 and 2017.

THIRD LAGUNA HILLS MUTUAL

Notes to Financial Statements

December 31, 2018 and 2017

At December 31, 2018, the Mutual has federal and state net operating loss carryforwards of \$193,927 and \$6,337,548 available to offset future federal and state taxable income, respectively. At December 31, 2017, the Mutual has federal and state net operating loss carryforwards of \$193,927 and \$5,885,063 available to offset future federal and state taxable income, respectively. The federal and state carryforward amounts expire in varying amounts between 2018 and 2036.

Income tax expense differed from the amounts computed by applying the U.S. federal income tax rate of 21% and 34% as of December 31, 2018 and 2017, respectively, to pretax income primarily as a result of the increase to the valuation allowance, the variance in tax rates applied to temporary differences in the prior and current year, and other minor adjustments.

(5) Related Parties

As discussed in note 1, the Mutual is a corporate member of GRF and a member of VMS, all related entities. The accompanying financial statements include assessments to GRF for operating expenses and restricted funds as well as a receivable due from GRF for assessments collected by GRF not yet remitted to the Mutual. The accompanying financial statements also include amounts paid and owed to VMS as managing agent for compensation and related costs.

(6) Pension Plans

Village Management Services, Inc. makes contributions to two union-sponsored, multiemployer, defined-benefit pension plans (covering most union employees) in accordance with a negotiated labor contract between VMS and the labor union. In the event these plans are either terminated or VMS withdraws from the plans, VMS may be required to contribute additional amounts under the provisions of the Employee Retirement Income Security Act of 1974. Such amounts would be reimbursed by GRF and the Mutuals. However, no such termination of or withdrawal from the plans is currently contemplated.

During 2018 and 2017, VMS sponsored a 401(k) plan covering all eligible employees. Employee contributions to the plan are at the participants' discretion. In 2016, VMS made contributions into the plan for eligible nonunion employee participants. The Mutuals and GRF are not responsible for the management or ultimate funding of the 401(k) plan beyond the agreed-upon annual contributions.

Amounts contributed by VMS to these plans in 2018 and 2017, and reimbursed by the Mutual, totaled \$331,261 and \$324,117, respectively, for the defined-benefit pension plans and \$52,766 and \$67,537, respectively, for the 401(k) plan.

(7) Contingencies

The Mutual is involved in various legal matters arising in the normal course of business. In the opinion of management, the liability, if any, will not have a material effect on the Mutual's financial position.

(8) Subsequent Events

Subsequent events have been evaluated through April 5, 2019, which is the date the financial statements were available to be issued.

SUPPLEMENTARY INFORMATION

THIRD LAGUNA HILLS MUTUAL

Future Major Repairs and Replacements

December 31, 2018

(Unaudited)

The Company conducted a study in 2018 to estimate the remaining useful lives and current replacement costs of major components of common property, except for certain land improvements, buildings, and building improvements for which major repair and replacement funds are not provided, as these items are expected to last the life of the community or to be maintained from general operating and/or preventive maintenance funds. The estimates were determined from past experience and from information obtained from certain contractors.

The following table is based on the Company's study of its common property:

| Major components | Estimated useful lives (in years) | Estimated remaining useful lives (in years) | Estimated current replacement costs | Estimated funding requirement as of December 31, 2018 |
|--|---|--|--|--|
| Roofs: | | | | |
| Built up | 25 | 15 | \$ 26,785,036 | 10,621,421 |
| Metal | 40 | 12 | 2,356,800 | 1,639,479 |
| Preventive maintenance | 20 | 11 | 1,448,505 | 674,447 |
| Tile | 40 | 15 | 16,660,774 | 10,420,641 |
| Walls | Various | Various | 9,805,261 | 3,364,539 |
| Foundations and structures | 30 to 60 | 3 to 15 | 146,209,100 | 15,798,767 |
| Laundry | 10 to 25 | 5 to 9 | 1,875,648 | 722,086 |
| Elevators | 20 to 40 | 1 to 28 | 8,553,633 | 5,313,445 |
| Paving | 5 to 30 | 2 to 12 | 17,154,249 | 6,333,245 |
| Plumbing | 35 to 70 | 6 to 22 | 81,143,450 | 7,923,147 |
| Paint – Exterior | 10 | 3 to 5 | 18,096,909 | 9,912,480 |
| Paint – Prior to paint dry rot | 10 | 5 | 9,943,320 | 5,237,423 |
| Tree maintenance | 3 | 1 | 1,641,563 | 704,622 |
| Other | 5 to 50 | 2 to 25 | 29,808,745 | 10,522,093 |
| | | | <u>\$ 371,482,993</u> | <u>89,187,835</u> |
| Replacement fund balance as of December 31, 2018 | | | \$ | 16,769,342 |

The Board voted to contribute \$10,334,256 to the replacement funds in 2018. The contribution is included in the 2018 assessments at \$140 per manor per month, plus \$2 per manor per month for units with common laundry facilities. Actual replacement costs when expended may vary and the variations may be material.

As the reserve study is a projection, the estimated lives and costs of components will likely change over time depending on a variety of factors such as (i) future inflation rates, (ii) levels of maintenance applied by future boards, unknown defects in materials that may lead to premature failures, remaining useful lives, etc. As a result, some components may experience longer lives while others will experience premature failures. Some components may cost less at the time of replacement while others may cost more. To adequately plan for future expenditures, the Board has adopted via resolution a 30-Year Funding Plan that projects contributions to and disbursements from the reserves over the next thirty years, without falling below a minimum threshold in the reserve balance.

Reserves receive monies through assessments and net interest earned on invested fund balances.

See accompanying independent auditors' report.