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WESTERN HILLS WATER DISTRICT

FINANCIAL STATEMENTS

JUNE 30, 2010 and 2009

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TABLE OF CONTENTS

	Page No.
Management’s Discussion and Analysis	I - IV
Independent Auditors’ Report	1
Statements of Net Assets	2
Statements of Revenues, Expenses and Changes in Net Assets	3
Statements of Cash Flows	4
Notes to Financial Statements	5 – 14

Western Hills Water District
MANAGEMENT'S DISCUSSION AND ANALYSIS
For Year Ending June 30, 2010

This section of the District's annual financial report presents our analysis of the District's financial performance during the fiscal year that ended on June 30, 2010. Please read it in conjunction with the Basic Financial Statements, which follow this section.

FINANCIAL HIGHLIGHTS

- The District's total assets decreased by $359 thousand, or 0.6%, to $57.0 million.
- During the year the District's operating revenue increased by 76.8% to $941 thousand, while operating expenses increased by 20.4% to $3.5 million.
- Net assets decreased by $1.52 million to $(7.51) million.

OVERVIEW OF THE FINANCIAL STATEMENTS

The discussion and analysis are intended to serve as an introduction to Western Hills Water District's basic financial statements. The District's MD&A is comprised of five components: Net Assets, Financial Statements, Capital Assets, Long-Term Debt and Subsequent Event- Bankruptcy of Developer. This report also contains other supplementary information based on these statements.

BASIC FINANCIAL STATEMENTS

The Statement of Net Assets includes all of the District's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to District creditors (liabilities). It also provides the basis for computing rate of return, evaluating the capital structure of the District and assessing the liquidity and financial flexibility of the District.

The Financial Statements of the District report information about the District using accounting methods similar to those used by private section companies. These statements offer short and long-term financial information about its activities.

Capital assets, shown in Table 3, inform our bondholders that Western Hills Water District is spending their bond money in a manner that is consistent with increasing the assets that will ensure the company's overall future health.

Long-term debt has been secured by the special assessment on all property owned in this phase. These assessments will be charged through the year 2031. Even though the bonds are not the obligation of Western Hills Water District, the District has agreed to assume the accounting responsibility for these bonds.

FINANCIAL ANALYSIS OF THE DISTRICT

One of the most important questions asked about the District's finances is, "Is the District, as a whole better off or worse off as a result of the year's activities?" You can think of the District's net assets (the difference between assets and liabilities) as one way to measure financial health or financial position. Over time, increases or decreases in the District's net assets are one indicator of whether its financial health is improving or deteriorating. However, until a startup company has stabilized, there may be mitigating factors on why net assets tend to fluctuate up and down as shown in Table 1 below.

NET ASSETS

To begin our analysis, a summary of the District's Statement of Net Assets is presented in Table 1. As can be seen from the table below, net assets decreased by $1.52 million to $(7.51) million in fiscal year 2010. This decrease is a result of the following:

1. Assets decreased by $359 thousand, primarily due to depreciation of fixed assets and funding the current year's debt service on bonds payable.

2. Liabilities increased by $1.16 million, primarily due to a $2.6 million increase in current liabilities.

TABLE 1
Condensed Statements of Net Assets
(000)

	2010	2009
Current and Other Assets	$ 2,697	$ 2,586
Restricted Assets	6,370	6,116
Fixed Assets	46,326	46,973
Other Assets	1,592	1,669
Total Assets	**56,985**	**57,344**
Current Liabilities	10,777	8,226
Long-Term Debt	53,723	55,111
Total Liabilities	**64,500**	**63,337**
Net Assets	**$ (7,515)**	**$ (5,993)**

FINANCIAL STATEMENTS

Western Hill's financial statements are extremely lopsided on the expense side. This is due to the fact that Western Hills is a very new district and has very few customers. This will be the norm until residential and commercial projects are started and completed for this district. Please see 2010's challenges at the end of this report.

TABLE 2
Statement of Revenues & Expenses
For the Years ended June 30, 2010 and 2009
(000)

	2010	2009	Total % Change Fav/(Unfav)
Total Revenues	$ 941	$ 532	77.1%
Total Operating Expenses (less depreciation)	2,373	1,770	(42.8%)
Net Operating Loss Before Depreciation	**$ (1,432)**	**$ (1,238)**	**28.1%**

CAPITAL ASSETS

During 2010, the District invested $622 thousand in a new water treatment system.

TABLE 3
Capital Assets
(000)

	2010	2009	Dollar Change	Total Percent Change
Water Treatment Facilities	$ 11,338	$ 10,716	$ 622	5.8%
Pump Station & Well	3,058	3,058	0	0.0%
Aqueduct Turnout	746	746	0	0.0%
Wastewater Treatment Facility	28,104	28,104	0	0.0%
Other	11,258	11,356	(98)	0.9%
Subtotal	**54,504**	**53,980**	**524**	**1.0%**
Less Accumulated Depreciation	8,177	7,007	1,170	16.7%
Net Book Value	**$ 46,327**	**$ 46,973**	**$ (646)**	**(1.4%)**

LONG TERM DEBT

At year-end, the District had $55.1 million in long-term debt. This is a net decrease of $1.3 million from 2009, due to bond and note payments made during the year.

The District has outstanding general obligation debt stemming from Mello-Roos bonds issued in August 2001, December 2002, May 2004 and June 2005. The District’s current average cost of capital is 6.0% in outstanding debt, as shown on Table 4. Amortized discount and deferred loss on refunding are not included in the outstanding bond balance shown on Table 4.

TABLE 4

Outstanding Debt

	Debt Balance	Average Coupon Rate
General Obligation Bonds	$51,445	6.0%
Caterpillar Note Payable	$3,666	5.97%

2010 CHALLENGES AND A LOOK AT THE FUTURE:

Western Hills Water District's assets are notably in place as of June 30, 2010.

Financial operations are limited due to a small customer base. At this time, the water company receives its income from two golf courses, sixty acres of grapes and residential housing.

New income streams have been examined by the water district. A new water banking program with the Kern County Water Agency allowing the District to bank and sell excess water to other districts took effect in January 2010.

Western Hill's future projects include the pump station upgrades, water treatment plant filter system.

All in all it will take more than 10 years for Western Hills to be even close to breaking even. Due to the Bankruptcy of the developer, it had been a concern of Western Hills that it could not pay its operating expenses since the developer had been paying the shortfall. In light of the development being sold Western Hills will continue to keep paying its bills through the assumed obligation of the new owners.

CONTACTING THE DISTRICT'S FINANCIAL MANAGER

This financial report is designed to provide our customers, investors, and creditors with a general overview of the District's finances and to demonstrate the District's accountability for the money it receives.

If you have questions about this report or need additional financial information please contact Western Hills Water District.

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INDEPENDENT AUDITORS' REPORT

Board of Directors
Western Hills Water District
Patterson, California

We have audited the accompanying balance sheets of the Western Hills Water District (the "District") as of June 30, 2010 and 2009, the related statements of revenues and expenses and changes in retained earnings (deficit), and statements of cash flows for the years 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.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the State Controller's Audit Requirements for California Special Districts. 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 District as of June 30, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America, as well as accounting systems prescribed by the State Controller's office for special districts.

The accompanying financial statements have been prepared assuming the District will continue as a going concern. The District continues to experience significant losses. The operating results coupled with the bankruptcy of the project's developer (see Note 8) raise substantial doubt about the District's ability to continue as a going concern. As discussed in Note 9, the financial statements do not include adjustments that might result from the outcome of this uncertainty.

Cropper Accountancy Corporation
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July 10, 2013

WESTERN HILLS WATER DISTRICT
Statements of Net Assets
June 30, 2010 and 2009

ASSETS

	2010	2009
Current Assets		
Cash	$ 2,420,839	$ 2,339,415
Accounts receivable	-	125,393
Prepaid water charges	269,318	113,606
Meter inventory	6,480	7,680
Total current assets	2,696,637	2,586,094
Assets restricted for debt service, at current values		
Federated money market trust		
U.S. Treasury Obligations	6,369,947	3,771,847
U.S Treasury Notes, 3.5% due 12/15/09, par $2,311,000	-	2,343,955
Total restricted assets	6,369,947	6,115,802
Deferred bond costs, net of accummulated amortization of $533,348 and $476,042 for 2010 and 2009, respectively	1,592,038	1,669,344
Fixed Assets, net of accumulated depreciation of $8,177,417 and $7,007,173 for 2010 and 2009, respectively	36,309,145	36,857,863
Construction in progress	10,017,300	10,115,301
Total assets	$ 56,985,067	$ 57,344,404

LIABILITIES AND NET ASSETS

	2010	2009
Current Liabilities		
Accounts payable	8,302,768	$ 5,812,730
Accrued interest payable	1,074,901	1,082,466
Customer deposits	11,000	4,500
Other current liabilities	157	-
Current portion of FSC gov't loan	193,458	181,561
Current portion of bonds payable	1,195,000	1,145,000
Total current liabilities	10,777,284	8,226,257
Caterpillar FSC gov't loan, net of current portion	3,472,774	3,666,232
Bonds payable, net of current portion	50,250,000	51,445,000
Total liabilities	64,500,058	63,337,489
Net Assets		
Invested in net assets, net of related debt	(8,784,787)	(9,464,629)
Restricted net assets, bond and reserve funds	4,954,150	4,758,173
Unrestricted net assets	(3,684,354)	(1,286,629)
Total net assets	(7,514,991)	(5,993,085)
Total liabilities and net assets	$ 56,985,067	$ 57,344,404

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

WESTERN HILLS WATER DISTRICT

Statements of Revenues, Expenses and Changes in Net Assets

For the Years Ended June 30, 2010 and 2009

	2010	2009
Operating Revenue		
Water revenue		
Residential	249,511	$ 247,025
Golf course	523,671	125,853
Sewer and stormdrain	146,546	153,319
Construction	11,679	4,245
Winery	3,585	1,449
Other	5,725	282
Total operating revenues	940,717	532,173
Operating Expenses		
Labor and related expenses	152,668	159,797
Purchased water	643,627	546,349
Waste water hauling and disposal	167,357	158,172
Water treatment	574,189	372,122
Fuel/power for pump	353,312	11,263
Maintenance	54,433	119,279
Contractual services	266,577	261,203
Insurance	43,148	57,943
Licenses and fees	5,618	13,761
General and administrative	101,397	54,818
Depreciation	1,170,244	1,173,009
Bad debt expense	-	8,804
Other	10,530	6,971
Total operating expenses	3,543,100	2,943,491
Operating loss	(2,602,383)	(2,411,318)
Non-Operating Revenue (Expenses)		
Property taxes	4,566,710	4,434,058
Investment income	8,140	99,904
Other income	77,596	118,304
Interest on bonded indebtedness	(3,213,982)	(3,246,512)
Other interest expense	(239,811)	(144,486)
Bond related expenses	(40,870)	-
Amortization of bond expense	(77,306)	(77,306)
	1,080,477	1,183,962
Net loss	(1,521,906)	(1,227,356)
Total net assets at beginning of year	(5,993,085)	(4,765,729)
Total net assets at end of year	$ (7,514,991)	$ (5,993,085)

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

WESTERN HILLS WATER DISTRICT
Statements of Cash Flows
For the Years Ended June 30, 2010 and 2009

	2010	2009
Cash flows from operating activities		
Receipts from customers and users	$ 1,072,610	$ 460,584
Payments to suppliers of goods and services	114,295	(1,275,978)
Payments to employees and related benefits	(152,668)	(159,797)
Net cash provided by (used in) operating activities	1,034,237	(975,191)
Cash flows from capital and related financing activities		
Bond indebtedness retired	(1,145,000)	(1,100,000)
Decrease in advances to developer	-	1,246,210
Payments on Caterpillar loan	(181,561)	(326,054)
Fixed asset additions, including construction in progress	(523,525)	228,616
Payables relief obtained from creditors	-	118,304
Interest paid on bonded indebtedness	(3,221,547)	(3,262,216)
Other interest paid	(239,811)	(144,486)
Bond related expenses	(40,870)	-
Property taxes collected for debt	4,566,710	7,564,975
Recovery of bond costs	77,596	-
Net cash provided by (used in) capital and financing activities	(708,008)	4,325,349
Cash flows from investing activities		
Decrease (increase) in investments	(254,145)	(1,016,965)
Investment income received	8,140	99,904
Increase in meter inventory	1,200	-
Net cash used in investing activities	(244,805)	(917,061)
Net increase (decrease) in cash	81,424	2,433,097
Cash (outstanding checks in excess of cash) at beginning of year	2,339,415	(93,682)
Cash at end of year	$ 2,420,839	$ 2,339,415

Reconciliation of Operating Loss to Net Cash Provided By (Used In) Operating Activities:

	2010	2009
Net operating loss	$ (2,602,383)	$ (2,411,318)
Adjustments to cash used in operating activities:		
Depreciation expense	1,170,244	1,173,009
(Increase) decrease in assets		
Accounts receivable	125,393	(71,589)
Prepaid water charges	(155,712)	(45,890)
Increase (decrease) in liabilities		
Accounts payable	2,490,038	380,597
Meter set deposits	6,500	-
Taxes and insurance	157	-
Net cash provided by (used in) operating activities	$ 1,034,237	$ (975,191)

	2010	2009
Supplemental Disclosure of Non-Cash Transactions:		
Amortization of deferred bond costs	$ 77,306	$ 77,306

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

1. Summary of Significant Accounting Policies

The accounting policies of the Western Hills Water District (the "District") conform to accounting principles as applicable to governmental entities, which are classified as proprietary funds – business type, in the United States of America. The following is a summary of the more significant policies:

Reporting entity

For financial reporting purposes, in conformity with the Governmental Accounting Standards Board ("GASB") Codification Section 2100, defining the governmental reporting entity, the District includes all funds that are controlled by or dependent on the Board of Directors of the District. Since no other entities are controlled by or rely upon the District, the reporting entity consists solely of the District.

Diablo Grande Community Facilities District No.1 – Bond Issues (see Note 4)

In August 2001, the Western Hills Water District - Diablo Grande Community Facilities District No. 1 issued $21,000,000; in December 2002, issued $6,650,000; in May 2004 issued $20,000,000; and in January 2005 issued $9,350,000 in bonds pursuant to the Mello-Roos Community Facilities Act of 1982, as amended, for a total of $57,000,000 as of June 30, 2010. The bonds are secured by and payable from a pledge of special taxes to be levied on approximately 5,070 acres of real property within the boundaries of the District. The Bond provisions indicate that:

> *"Neither the faith and credit nor the taxing power of the water district, the County of Stanislaus, the State of California or any political subdivision thereof is pledged to the payment of the bonds. The bonds do not constitute a debt of the water district within the meaning of any statutory or constitutional debt limitation."*

Although the provisions indicate the bonds are not an obligation of the Western Hills Water District, the District has assumed the responsibility of accounting for the proceeds and the future debt service. The bond proceeds funded the acquisition of water and wastewater facilities by the District. The costs of water facilities incurred in prior years were contributed to the District by Diablo Grande LP (Diablo Grande), the developer of the Diablo Grande project. The bond proceeds, net of certain costs of issuance and debt reserve requirements, have been used or set aside for current and future facility improvements.

Fund accounting classification

The financial statements of the District are presented as those of an enterprise fund under the broad category of funds called proprietary funds which also includes internal service funds. Enterprise funds account for operations that are financed and operated in a manner similar to private business enterprises – where the intent is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered substantially through user charges. The acquisition of the physical plant facilities required to provide these goods and services, as indicated above, were initially financed by the developer, for the District, in anticipation of proceeds from the bond issue, which will further fund the additions to plant and equipment.

1. Summary of Significant Accounting Policies (continued)

Basis of accounting

Enterprise funds are accounted for on the flow of economic measurement focus using the accrual basis of accounting. Revenues are recognized when they are earned, and expenses are recognized when they are incurred.

The GASB is the designated standard-setting body establishing governmental accounting and financial reporting principles.

The District complies with generally accepted accounting principles (GAAP). GAAP includes all relevant Governmental Accounting Standards Board (GASB) pronouncements. In both the government-wide financial statements and the fund financial statements, GASBS No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements,* has been adopted. This statement incorporates pronouncements issued on or before November 30, 1989 into GASB authoritative literature. This includes pronouncements by the Financial Accounting Standards Board (FASB), Accounting Principles Board Opinions (APB), and the Accounting Research Bulletins of the American Institute of Certified Public Accountants' (AICPA) Committee on Accounting Procedure, unless those pronouncements conflict with or contradict with GASB pronouncements, in which case, GASB prevails. The more significant accounting policies are discussed in subsequent subsections of these Notes.

Cash and cash equivalents

For the purpose of the statement of cash flows, the District considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents, including short-term certificates of deposit. To date, only cash in bank is applicable.

Investments

State statutes authorize the District to invest in obligations of the U.S. Treasury, the Local Agency Investment Fund of the State of California (LAIF), commercial paper, corporate bonds and repurchase agreements.

Fixed assets

Fixed assets are carried at historical cost or estimated historical cost if actual cost is not available. Contributed assets will be recorded at cost or estimated fair value on the date contributed.

The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend asset lives are not capitalized.

Depreciation expense is provided on a straight-line basis over 30 to 40 years depending on the category.

1. Summary of Significant Accounting Policies (continued)

Operating vs. non-operating revenues

Revenues related to providing water supply to customers and users are classified as operating revenue in the Statement of Revenues and Expenses and Changes in Retained Earnings (Deficit). All other revenues, including property taxes, are classified as non-operating revenue.

Estimates in accounting

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 that affect the reported amounts of assets and liabilities, and consequently, the reported amounts of revenues and expenses in the financial statements. The District's estimates relate primarily to estimates of useful lives of fixed assets and the determination of an allowance for uncollectible receivables (for which there are none for June 30, 2010 or 2009). Actual results could differ from these estimates.

Reclassifications

To conform to the presentation in the current year financial statements, certain items in the comparative prior year financial statements have been reclassified.

2. Cash and Investments

The California Government Code requires California banks and savings and loan associations to secure a Public Agency's deposits by pledging government securities as collateral. The market value of pledged securities must equal at least 110% of deposits. California law also allows financial institutions to secure Public Agency deposits by pledging first trust deed mortgage notes having a value of 150% of the Public Agency's total deposits.

The cash balance (before outstanding checks) was held in two institutions at June 30, 2010, and the total balances in one institution exceeded the FDIC insured amount of $250,000 by $2,260,359. The June 30, 2010, investments in the US Treasury Money Market Trust of $6,369,947 were reflected on the balance sheet as assets restricted for debt services.

Credit Risk

Credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization. Presented below is the minimum rating by the California Government Code and the actual rating as of the year-end for each investment type.

Investment Type	Fair Value	Minimum Legal Rating	Not Required To Be Rated	Rating as of Year End AAA	A	Unrated
US Treasury Money Market	$ 6,369,947	N/A	$ 6,369,947	$ -	$ -	$ -

3. Fixed Assets

All purchased assets are valued at cost. In accordance with generally accepted accounting principles for proprietary entities, depreciation has been provided on the straight-line method over estimated useful lives of three to forty years.

The following reflects the changes in fixed assets for the year ended June 30, 2010:

	Balance June 30, 2009	Reclassifications & Additions	Balance June 30, 2010	Depreciable Life in Years
Water treatment facilities	$ 10,716,740	$ 621,526	$ 11,338,266	40
Pump station & well	3,057,844	-	3,057,844	30
Aqueduct turnout	745,802	-	745,802	40
Wastewater treatment facility	28,103,909	-	28,103,909	40
Back-up generators	1,192,610	-	1,192,610	15
Storm drain outfall line	2,446	-	2,446	40
Frog pond	10,803	-	10,803	30
Other	34,882	-	34,882	3 to 30
	43,865,036	621,526	44,486,562	
Accumulated depreciation	7,007,173	1,170,244	8,177,417	
Net book value	$ 36,857,863	$ (548,718)	$ 36,309,145	
Construction in progress	$ 10,115,301	$ (98,001)	$ 10,017,300	n/a

4. "Mello-Roos" Assessment District – Western Hills Water District - Diablo Grande Community Facilities District No. 1

Western Hills Water District - Diablo Grande Community Facilities District issued bonds totaling $21,000,000 in August, 2001, followed by $6,650,000 in December, 2002, $20,000,000 in May 2004 and $9,350,000 in January 2005. The total debt issued was $57,000,000. The proceeds are to fund facility assets. Interest rates on these bonds ranged from 2.25% to 5.7%.

The changes in the District's long-term obligations were as follows:

	Year Ended June 30, 2010	Year Ended June 30, 2009
Balance at beginning of year	$ 52,590,000	$ 53,690,000
Bonds issued	-	-
Principal payments	(1,145,000)	(1,100,000)
Balance at end of year	$ 51,445,000	$ 52,590,000
Due in one year	$ 1,195,000	$ 1,145,000

4. "Mello-Roos" Assessment District - Western Hills Water District - Diablo Grande Community Facilities District No. 1 (continued)

The following is a debt service schedule to maturity:

2001 Bond

Fiscal Year Ending June 30,	Interest	Principal	Total
2011	1,290,563	415,000	1,705,563
2012	1,266,494	435,000	1,701,494
2013	1,238,686	460,000	1,698,686
2014	1,206,861	490,000	1,696,861
2015	1,172,859	525,000	1,697,859
Thereafter	11,662,073	16,905,000	28,567,073
	$ 17,837,536	$ 19,230,000	$ 37,067,536

2002 Bond

Fiscal Year Ending June 30,	Interest	Principal	Total
2011	354,780	170,000	524,780
2012	345,917	180,000	525,917
2013	336,365	190,000	526,365
2014	324,675	200,000	524,675
2015	310,669	215,000	525,669
Thereafter	2,247,243	4,495,000	6,742,243
	$ 3,919,649	$ 5,450,000	$ 9,369,649

2004 Bond

Fiscal Year Ending June 30,	Interest	Principal	Total
2011	1,065,613	390,000	1,455,613
2012	1,047,200	405,000	1,452,200
2013	1,026,450	425,000	1,451,450
2014	1,004,575	450,000	1,454,575
2015	981,575	470,000	1,451,575
Thereafter	10,428,831	16,100,000	26,528,831
	$ 15,554,244	$ 18,240,000	$ 33,794,244

4. "Mello-Roos" Assessment District - Western Hills Water District - Diablo Grande Community Facilities District No. 1 (continued)

2005 Bond

Fiscal Year Ending June 30,	Interest	Principal	Total
2011	456,403	220,000	676,403
2012	447,578	235,000	682,578
2013	437,658	240,000	677,658
2014	426,750	250,000	676,750
2015	415,013	260,000	676,013
Thereafter	4,100,825	7,320,000	11,420,825
	$ 6,284,227	$ 8,525,000	$ 14,809,227

All Bonds

Fiscal Year Ending June 30,	Interest	Principal	Total
2011	3,167,358	1,195,000	4,362,358
2012	3,107,188	1,255,000	4,362,188
2013	3,039,158	1,315,000	4,354,158
2014	2,962,861	1,390,000	4,352,861
2015	2,880,116	1,470,000	4,350,116
Thereafter	28,438,975	44,820,000	73,258,975
	$ 43,595,656	$ 51,445,000	$ 95,040,656

Reserve requirement restrictions

The provisions of the "official statements" of the bond issues require the following restrictions:

Reserve fund

The District is required to maintain an amount equal to the lesser of as of June 30, 2010:

(a) 10% of the original principal: $5,700,000
(b) 100% of the maximum annual debt service on the bonds based on years ended September 1: $4,362,358
(c) 125% of the average annual debt service: $5,400,037

The purpose of this $4,362,358 reserve is to be used for debt service, if needed. Amounts in excess of the requirement, due to interest thereon, can be transferred to the Bond Fund to be used for current debt service. When the Reserve Fund exceeds the requirement to redeem the remaining outstanding bonds such excess shall be transferred to the District to be used for any lawful purpose.

4. "Mello-Roos" Assessment District - Western Hills Water District - Diablo Grande Community Facilities District No. 1 (continued)

Reserve requirement restrictions (continued)

Bond fund

The Bond Fund consists of amounts held in trust by the Fiscal Agent for payments to bond holders (debt service). Annual special taxes assessed and collected shall be set aside for the debt service. During the fiscal years through June 30, 2010, property taxes were received on assessed property totaling $27,197,792 from inception. Debt service payments totaled $28,908,393 in interest and principal. $2,302,393 has been applied out of special tax fund proceeds set aside for early short-term interest payments, leaving $26,606,000 to be paid out of the "Bond Fund." Thus, $591,792 of the taxes assessed remains in the Bond Fund set aside.

Special Tax Fund

An amount was provided out of the bond proceeds sufficient, when combined with interest earnings thereon and on amounts in the "Reserve Fund", to provide for interest due in the short term through September 2, 2005, shortly after the bond issue.

Improvement Fund

The remaining proceeds of the bond issue after allowing for costs of issuance were set aside to reimburse improvement costs of $17,106,638 (2001 issue), $5,493,887 (2002 issue), $17,483,719 (2004 issue), and $8,026,517 (2005 issue).

At June 30, 2010, the reserve requirements were as follows:

Reserve Fund	$ 4,362,358
Bond Fund	591,792
Total reserve requirement	$ 4,954,150
Funds set aside for debt service at June 30, 2010	$ 8,596,546

The indebtedness will be retired over a thirty-year period from assessed parcel taxes on the properties being developed, through the District.

5. Caterpillar Note Payable

In June of 2007, the District entered into a note agreement with Caterpillar Financial Services Corporation with the proceeds used for the government lease purchase of five Caterpillar generator sets packages with a SCADA system and four automatic transfer switches, all of which securitizes the agreement. The total amount borrowed under this agreement of $4,173,847 was originally payable in 102 equal monthly installments at 5.97% interest. The original agreement was amended on May 28, 2009, and again on June 15, 2012 to revise the payment schedule. The current rate of interest being charged on the outstanding balance is 6.16%.

5. Caterpillar Note Payable (continued)

The following is a debt service schedule to maturity for the Caterpillar note payable, including the effect of both amendments:

Fiscal Year Ending June 30,	Interest	Principal	Total
2011	226,542	193,458	420,000
2012	196,365	182,009	378,374
2013	206,693	244,437	451,130
2014	190,325	260,805	451,130
2015	172,861	278,269	451,130
Thereafter	613,060	2,507,254	3,120,314
	$ 1,605,846	$ 3,666,232	$ 5,272,078

6. Retained Earnings (Deficit) and Capital

The District's assets are substantially in place as of June 30, 2010. However, the operations including water revenue will not be fully realized until the development is completed. At June 30, 2010, the primary customers were the 2 golf courses, clubhouse/restaurant, vineyard and the first phase of residential development homeowners. The development plan includes a hotel, single family homes, condos and public facilities. Until it comes to fruition, the water revenue will not cover expenses. It is anticipated, but not guaranteed, that the deficit will be funded by the developer.

7. Related Parties

Diablo Grande LP– the former Developer, which was owned by two corporations and a limited liability company. All of the property in the District is currently owned by the successor Developer, World International LLC. The former Developer had contributed $8,206,193 to the District to acquire property and fund the deficit operation to date. As of June 30, 2010 and 2009, the entire balance due from Diablo Grande LP had been written of due to its bankruptcy. See Note 8.

World International LLC – the successor Developer, which acquired the property contained in the District through the bankruptcy proceedings of Diablo Grande LP. As of June 30, 2010 and 2009, the balance due to the successor Developer was $4,248,663 and $1,630,554, respectively.

8. Bankruptcy of Developer

On March 10, 2008 Diablo Grande, LP filed for Chapter 11 reorganization bankruptcy, and the assets of the company were eventually sold to World International LLC for $21,025,000 on October 7, 2008. As a result of this bankruptcy filing of the former Developer, the District determined that $1,700,153 of the outstanding receivable from Diablo Grande, LP was uncollectible, and recognized this expense in the Statement of Revenues and Expenses for the year ended June 30, 2005. In addition, $682,052 in special deposits that were held through Diablo Grande was forfeited through bankruptcy proceedings. The write-off of these special deposits was recognized as a $605,000 reduction in contributed capital on the Statement of Changes in Net Assets and a $77,052 decrease in investment income on the Statement of Revenues and Expenses for the year ended June 30, 2005.

Due to the liquidity problems created by the bankruptcy of the Developer, the District sought and obtained relief from various creditors during the year ended June 30, 2009. The relief obtained from creditors resulted in a total reduction in outstanding payables of $449,762, of which $331,458 of the decrease in payables was recorded as a reduction in construction in progress, since the related invoices had been capitalized as construction in progress in prior years. The remaining $118,304 of the decrease in payables was recorded as other income.

On April 27, 2010, the remaining balance in the District's Bank of the West account of $7,380 was transferred to the Diablo Grande LP Debtor in Possession account. District management was unaware of the transfer and did not authorize it; management is continuing to investigate to determine whether it can recoup any of these funds. This loss on the unauthorized transfer of District funds is included under other expenses on the Statements of Revenues, Expenses and Changes in Net Assets for the year ended June 30, 2010.

9. Payables Concentration

Of the total accounts payable of $8,302,766 at June 30, 2010, $4,248,663 was payable to World Industries LLC and $4,000,626 was a delinquent account payable to Veolia Water. Of the total accounts payable of $5,812,730 at June 30, 2009, $4,000,626 was a delinquent account payable to Veolia Water and $1,630,554 was payable to World Industries, LLC. As of July 10, 2013, Veolia Water has not pursued any litigation to collect the delinquent balance due from the District.

10. Going Concern

Continued operating losses coupled with the bankruptcy of the Developer raise doubts about the District's ability to continue as a going concern. The District's management is working with the new owner of the development to promote the completion of the development resulting in sales of homes which will provide property tax revenues necessary to repay the outstanding bonds and cover operating costs of the District.

11. Subsequent Events

In August of 2012, management of World Industries decided to write-off its outstanding receivable balance due from the District. The balance outstanding on the accounts payable to World Industries as of June 30, 2010 and 2009 was $4,248,613 and $1,630,554, respectively.

Subsequent events have been evaluated through July 10, 2013, which is the date the financial statements were available to be issued.