

**HARRIS COUNTY
IMPROVEMENT DISTRICT NO. 1**

HOUSTON, TEXAS

FINANCIAL REPORT

June 30, 2006

HARRIS COUNTY IMPROVEMENT DISTRICT NO. 1
FINANCIAL REPORT
TABLE OF CONTENTS

	Page
FINANCIAL SECTION	
Independent Auditors' Report	1
Management's Discussion and Analysis	2
Basic Financial Statements:	
Government-Wide Statements:	
Statement of Net Assets	7
Statement of Activities	8
Fund Financial Statements	
Balance Sheet – Governmental Funds	9
Reconciliation of the Governmental Funds Balance Sheet to the Statement of Net Assets	10
Statement of Revenues, Expenditures and Changes in Fund Balance – Governmental Funds	11
Reconciliation of the Statement of Revenues, Expenditures and Changes in Fund Balances of Governmental Funds to the Statement of Activities	12
Notes to the Financial Statements	13
Required Supplementary Information:	
General Fund– Schedule of Revenues, Expenditures and Changes in Fund Balance – Budget and Actual	23

FINANCIAL SECTION

11 Greenway Plaza, Suite 1515
Houston, TX 77046
(713) 621-1515
Fax: (713) 621-1570



2117 Post Office
Galveston, TX 77550
(409) 762-8380
Fax: (409) 762-1749

Independent Auditors' Report

Board of Directors
Harris County Improvement District No. 1
Houston, Texas

We have audited the accompanying financial statements of the governmental activities and each major fund of Harris County Improvement District No. 1 (the "District"), as of and for the year ended June 30, 2006, which collectively comprise the District's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the District's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the District's governmental activities and each major fund, as of June 30, 2006, and the respective changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis and budgetary comparison information on pages 2 through 6 and page 23 are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. The required supplementary information schedules are the responsibility of the District's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Null-Lairson, P.C.

Houston, Texas
September 8, 2006

Management's Discussion and Analysis

As management of the Harris County Improvement District No.1, we offer readers of the District's financial statements this narrative overview and analysis of the financial activities of the District for the fiscal year ended June 30, 2006.

Overview of the Financial Statements

This discussion and analysis are intended to serve as an introduction to the District's basic financial statements. The District's basic financial statements comprise three components: 1) government-wide financial statements, 2) fund financial statements and 3) notes to the financial statements. This report also contains required supplementary information in addition to the basic financial statements themselves.

Government-wide financial statements

The government-wide financial statements are designed to provide readers with a broad overview of the District's finances, in a manner similar to a private-sector business.

The statement of net assets presents information on all of the District's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator regarding the financial position of the District. Other factors that are not included in the financial statements, such as increased tax base in the District's boundaries, should be considered in evaluating the condition of the District's overall financial position.

The statement of activities presents information showing how the government's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods.

The government-wide financial statements can be found on pages 7-8 of this report.

Fund financial statements.

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The District, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the District's funds are considered governmental funds.

Governmental funds

Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements. Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

Management's Discussion and Analysis (continued)

Governmental funds (continued)

The District maintains three individual governmental funds. Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures and changes in fund balances for the general fund, the debt service fund and the capital projects fund, all of which are considered to be major funds.

The District adopts an annual appropriated budget for its general fund. A budgetary comparison statement has been provided for the general fund to demonstrate compliance with this budget.

The basic governmental fund financial statements can be found on pages 9-12 of this report.

Notes to the financial statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 13-22 of this report.

Government-wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. In the case of the District, net assets were negative at approximately \$2.93 million as of June 30, 2006. The principal reason for this deficit is the conveyance of approximately \$2 million in infrastructure improvements to the City of Houston's Right of Way. The District incurred long-term debt in 1999 for these improvements.

At year-end, the District had total assets of approximately \$12 million. Of this amount, approximately \$7.3 million consisted of cash and temporary investments and approximately \$4.8 million of capital assets.

Total liabilities were approximately \$15 million as of year-end. Of this amount, approximately \$14.7 million consisted of long-term debt and accrued interest. The balance of the liabilities consists of accounts payable and accrued expenses.

A schedule of net assets at June 30, 2006 and 2005 follows:

HARRIS COUNTY IMPROVEMENT DISTRICT #1		
NET ASSETS		
JUNE 30, 2006 and 2005		
AMOUNTS IN (000'S)		
	<u>2006</u>	<u>2005</u>
Current and other assets	\$ 7,263	\$ 8,268
Capital assets	4,796	5,412
Total Assets	<u>12,059</u>	<u>13,680</u>
Other liabilities	294	1,062
Long-term liabilities outstanding	14,695	15,221
Total Liabilities	<u>14,989</u>	<u>16,283</u>
Net assets:		
Invested in capital assets, net of related debt		
Restricted	860	751
Unrestricted	(3,790)	(3,355)
Total Net Assets	<u><u>\$(2,930)</u></u>	<u><u>\$(2,604)</u></u>

Management's Discussion and Analysis (continued)

Changes in net assets for the years ended June 30, 2006 and 2005 follows:

HARRIS COUNTY IMPROVEMENT DISTRICT #1		
CHANGES IN NET ASSETS		
<i>JUNE 30, 2006</i>		
<i>AMOUNTS IN (000'S)</i>		
	2006	2005
Revenues		
Program revenue		
Charges for services	\$ 2,678	\$ 2,333
General revenues		
Property taxes	3,539	3,271
Unrestricted investment earnings	339	169
Miscellaneous	25	25
Total Revenues	6,557	5,798
Expenses		
General and administrative	1,271	1,243
Traffic control	927	921
Maintenance and beautification	899	748
Uptown	96	96
Planning and engineering	96	67
Marketing and communications	250	210
Interest on Long-term debt	569	595
Economic development	72	41
Metro	1,505	2,439
Construction on behalf of the City of Houston	1,293	88
Total Expenses	6,883	6,448
Decrease in net assets	(326)	(650)
Net assets-beginning	(2,604)	(1,954)
Net Assets - Ending	\$ (2,930)	\$ (2,604)

Financial Analysis of the Government's Funds

As noted earlier, the District uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental funds

The focus of the District's governmental funds is to provide information on near-term inflows, outflows and balances of spendable resources. Such information is useful in assessing the District's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

As of the end of the current fiscal year, the District's governmental funds reported combined ending fund balances of approximately \$6.6 million, a decrease of \$219 thousand in comparison with the prior year. This decrease is due to capital expenditures for the Metro Shelter Project which was completed in this fiscal year and capital expenditures for the West Loop Greening project which began this fiscal period. Approximately \$1.87 million of this total constitutes unreserved fund balance, which is available for spending at the government's discretion. The remainder of fund balance is reserved to indicate that it is not available for new spending because it has already been committed 1) to fund authorized construction (approximately \$3.6 million) and 2) to pay debt service (approximately \$1.1 million).

The general fund is the chief operating fund of the District. At the end of the current fiscal year, unreserved fund balance of the general fund was approximately \$1.87 million. As a measure of the general fund's

Management's Discussion and Analysis (continued)

liquidity, it may be useful to compare both unreserved fund balance and total fund balance to total fund expenditures.

The District's general fund balance increased by \$122 thousand during the current fiscal year. This increase is due to greater tax revenues as appraised values were higher than budgeted.

The debt service fund has a total fund balance of approximately \$1.1 million, all of which is reserved for the payment of debt service. The increase in fund balance during the current year in the debt service fund was approximately \$71 thousand.

The capital projects fund has a total fund balance of approximately \$3.6 million, all of which is reserved for authorized construction. The net decrease in fund balance during the current year in the capital projects fund (approximately \$412 thousand) is related to capital expenditures for the West Loop Greening project and the completion of the Metro Shelter Project.

General Fund Budgetary Highlights

There were no differences between the original budget and the final budget. The differences in budget to actual were due primarily to an increase in certified appraised value for the District, and an increase in investment earnings due to more favorable interest rates in total approximately \$139 thousand.

Debt Administration

At the end of the current fiscal year, the District had total debt outstanding of approximately \$14.3 million.

Economic Factors and Next Year's Budgets and Rates

The District is a political subdivision of the State of Texas, created in 1987 by a special act of the 70th Texas Legislature. The District levies an ad valorem tax on real personal property within its boundaries. The tax rate for tax year 2006 was \$0.1435 per \$100 of assessed value. The tax rate will remain the same for tax year 2007, with expected revenues of approximately \$3.6 million.

Office space. Uptown has over 23 million square feet of office space. Overall, 2006 ad valorem values for the office sector have increased by 18% over the 2005 values. This is primarily because of the tremendous amount of leasing activity in the past four quarters. Net office space absorption has almost doubled in the last year, from 232,000 square feet to 402,000 square feet. One of the most active properties in the past year was Williams Tower, which reduced its availability to 64,000 square feet of contiguous available space, down from 500,000 square feet of contiguous space in 2004.

Uptown Houston's Class A office space occupancy is the highest the area has experienced since 2002, and it continues to increase. In the first quarter of 2006, the occupancy rate reached 85.7 percent, up more than 6.5 percent from the same time last year.

Retail. Uptown is synonymous with shopping and is known as a world-renowned center for retail. Overall, 2006 ad valorem values for the retail sector increased approximately 5% over 2005 values. This market continues to perform as The Galleria is now the fourth largest retail center in the United States. Uptown also has a 22-acre mixed-use development known as Boulevard Place breaking ground in late 2006. This development will feature over 400,000 square feet of upscale retail stores and restaurants.

According to CoStar's mid-year Retail Market Report, Uptown Houston's retail market has the lowest vacancy rate of any submarket in the region at 2.3%. Also, quoted lease rates were among the highest in the region at \$25 per square foot.

Management's Discussion and Analysis (continued)

Hotels. Uptown welcomed two new hotels in the past year, and two more are currently under construction. In total, there are now 31 first quality hotels in Uptown offering more than 7,000 rooms for guests. Ad valorem values for this sector have increased by 26% since last year.

The area's RevPAR (revenues per available room) are among the city's highest at \$100.40 (compared to \$86.51 from the same time last year). Uptown also one of the highest occupancy rates in the city at 74.9% (compared to 68.7% last year).

Residential. Uptown has seen seven new high-rise residential towers built in the past six years and occupancy rates are high at 93.6%. There are now over 30,000 residents in Uptown. Two condominium projects are currently under construction, and Trammell Crow Residential has just broken ground on Alexan Post Oak, which is an upscale, mid-rise apartment project at 1111 Post Oak Boulevard. Proposed opening date is third quarter 2007.

Requests for Information

This financial report is designed to provide a general overview of the District's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to 1980 Post Oak Blvd #1580, Houston, TX 77056.

HARRIS COUNTY IMPROVEMENT DISTRICT # 1
STATEMENT OF NET ASSETS
June 30, 2006

	Governmental Activities
	<u> </u>
ASSETS	
Cash and temporary investments	\$ 6,670,590
Receivables	247,088
Due from other governmental agencies	62,277
Prepaid	38,253
Deferred charges	244,408
Capital assets, net of depreciation	
Machinery and equipment	4,796,128
Total Assets	<u>12,058,744</u>
LIABILITIES	
Accounts payable and accrued expenses	294,036
Long-term liabilities	
Due within one year	
Bonds	535,000
Accrued interest	337,200
Due in more than one year	
Bonds	13,785,000
Compensated absences	37,529
Total liabilities	<u>14,988,765</u>
NET ASSETS	
Restricted for:	
Debt Service	859,755
Unrestricted	(3,789,776)
Total net assets	<u>\$ (2,930,021)</u>

See notes to the Financial Statements.

HARRIS COUNTY IMPROVEMENT DISTRICT # 1
STATEMENT OF ACTIVITIES
For the Year Ended June 30, 2006

<u>Functions/Programs</u>	<u>Expenses</u>	<u>Program Revenue Charges for Services</u>	<u>Net (Expense) Revenue and Changes in Net Assets Governmental Activities</u>
Governmental Activities			
General and administrative	\$ 1,271,479	\$ 541,291	\$ (730,188)
Traffic control	927,210		(927,210)
Maintenance and beautification	898,998		(898,998)
Uptown shuttle			
Planning and engineering	95,935		(95,935)
Marketing and communications	249,815		(249,815)
Interest on Long-term debt	569,123		(569,123)
Economic development	72,239		(72,239)
Metro	1,505,278	2,137,094	631,816
Construction on behalf of the City of Houston	1,293,001		(1,293,001)
Total governmental activities	<u>6,883,078</u>	<u>2,678,385</u>	<u>(4,204,693)</u>
	General revenues:		
	Taxes:		
			3,538,872
			339,366
			<u>3,878,238</u>
			(326,455)
			<u>(2,603,566)</u>
			<u>\$ (2,930,021)</u>

See notes to the Financial Statements.

HARRIS COUNTY IMPROVEMENT DISTRICT # 1
BALANCE SHEET
GOVERNMENTAL FUNDS
June 30, 2006

	<u>General Fund</u>	<u>Capital Projects</u>	<u>Debt Service</u>	<u>Total Governmental Funds</u>
ASSETS				
Cash and temporary investments	\$ 1,912,122	\$ 3,654,285	\$ 1,104,183	\$ 6,670,590
Taxes receivable, net	84,649		48,516	133,165
Due from other funds		148,522		148,522
Receivable from other governments	62,277			62,277
Other receivables		17,016		17,016
Due from others	88,784		8,123	96,907
Prepaid expenses	38,253			38,253
Total assets	<u>2,186,085</u>	<u>3,819,823</u>	<u>1,160,822</u>	<u>7,166,730</u>
 LIABILITIES AND FUND BALANCE				
Liabilities:				
Accounts payable	87,037	167,952		254,989
Retainage Payable		39,047		39,047
Due to other funds	148,522			148,522
Deferred revenue	84,649		48,516	133,165
Total liabilities	<u>320,208</u>	<u>206,999</u>	<u>48,516</u>	<u>575,723</u>
 Fund balances:				
Reserved for:				
Prepaid expenses				
Debt service			1,112,306	1,112,306
Authorized construction		3,612,824		3,612,824
Unreserved	1,865,877			1,865,877
Total fund balances	<u>1,865,877</u>	<u>3,612,824</u>	<u>1,112,306</u>	<u>6,591,007</u>
Total liabilities and fund balances	<u>\$ 2,186,085</u>	<u>\$ 3,819,823</u>	<u>\$ 1,160,822</u>	<u>\$ 7,166,730</u>

See notes to the Financial Statements.

HARRIS COUNTY IMPROVEMENT DISTRICT # 1
Reconciliation of the Governmental Funds Balance Sheet to the
Statement of Net Assets
June 30, 2006

Total fund balance, governmental funds \$ 6,591,007

Amounts reported for governmental activities in the Statement of Net Assets are different because:

Capital assets used in governmental activities are not current financial resources and, therefore, are not reported in this fund financial statement, but are reported in the governmental activities of the Statement of Net Assets 4,796,128

Certain other receivables are not available to pay current period expenditures and are therefore not reported in this fund financial statement, but are reported in the governmental activities of the Statement of Net Assets 133,165

Some liabilities are not due and payable in the current period and are not included in the fund financial statements, but are included in the governmental activities of the Statement of Net Assets. These are as follows:

Bonds payable and related discount	(14,075,592)
Accrued interest	(337,200)
Compensated absences	(37,529)
	<hr/>

Net Assets of Governmental Activities in the Statement of Net Assets \$ (2,930,021)

See notes to the Financial Statements.

HARRIS COUNTY IMPROVEMENT DISTRICT #1
STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN
FUND BALANCE - GOVERNMENTAL FUNDS
For the Year Ended June 30, 2006

	<u>General Fund</u>	<u>Capital Projects</u>	<u>Debt Service</u>	<u>Total Governmental Funds</u>
REVENUES				
Property Taxes	\$ 2,406,385	\$	\$ 1,137,524	\$ 3,543,909
Fees and fines		311,976		311,976
Intergovernmental	568,676	2,137,094		2,705,770
Investment earnings	61,984		30,199	92,183
Miscellaneous				
Total revenues	<u>3,037,045</u>	<u>2,449,070</u>	<u>1,167,723</u>	<u>6,653,838</u>
EXPENDITURES				
Current:				
Planning and engineering	95,935			95,935
Traffic control	333,523			333,523
Maintenance and beautification	873,363			873,363
General and administrative	1,290,031			1,290,031
Uptown shuttle				
Marketing and communications	249,815			249,815
Economic development	72,239			72,239
Debt Service:				
Principal			501,070	501,070
Interest and other charges		27	595,060	595,087
Capital Outlay		2,861,771		2,861,771
Total Expenditures	<u>2,914,906</u>	<u>2,861,798</u>	<u>1,096,130</u>	<u>6,872,834</u>
Excess (deficiency) of revenues over expenditures	<u>122,139</u>	<u>(412,728)</u>	<u>71,593</u>	<u>(218,996)</u>
Fund balances - beginning of year	1,743,738	4,025,552	1,040,713	6,810,003
Fund balances - End of Year	<u>\$ 1,865,877</u>	<u>\$ 3,612,824</u>	<u>\$ 1,112,306</u>	<u>\$ 6,591,007</u>

See notes to the Financial Statements.

HARRIS COUNTY IMPROVEMENT DISTRICT # 1

Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balances of Governmental Funds to the Statement of Activities

For the Year Ended June 30, 2006

Net change in fund balances - total governmental funds: \$ (218,996)

Amounts reported for Governmental Activities in the Statement of Activities are different because:

Governmental funds report outlays for capital assets as expenditures. However, in the Statement of Activities the costs of those assets is allocated over their estimated useful lives and reported as depreciation expense for the period. This is the amount by which depreciation exceeded capital outlay. (639,222)

Revenues in the statement of activities that do not provide current financial resources are not reported as revenues in the funds: 18,817

Governmental funds report bond proceeds as current financial resources. In contrast, the Statement of Activities treats the issuance of debt as a liability. Governmental funds report bond principal payments as an expenditures. In contrast, the Statement of Activities treats such expenditures as a reduction of long-term liabilities. Also, governmental funds report the effect of issuance costs, premiums, discounts, and similar items when debt is first issued whereas these amounts are deferred and amortized in the statement of activities.

Principal repayments 525,000
Bond issuance costs (13,579)

Some expenses reported in the statement of activities do not require the use of current financial resources and are not reported as expenditures in governmental funds. These are as follows:

Accrued interest not reflected on Governmental funds 4,393
Compensated absences (2,868)

Change in net assets of governmental activities \$ (326,455)

See notes to the Financial Statements.

HARRIS COUNTY IMPROVEMENT DISTRICT No. 1
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2006

NOTE 1 - CREATION OF DISTRICT

Harris County Improvement District No. 1 (the "District") was organized, created and established pursuant to an act of the Texas State Legislature, effective under the terms and provisions of Article III, Section 52 and Article XVI, Section 59 of the Texas Constitution. The Board of Directors held its organizational meeting on July 18, 1987. The first bonds were sold on June 23, 1993. See Note 7 for additional disclosure regarding significant legal provisions contained in the legislative act creating the District.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements of the District have been prepared in conformity with generally accepted accounting principles (GAAP) as applied to governmental units. The Government Accounting Standards Board (GASB) is the accepted standard setting body for establishing governmental accounting and reporting principles. The more significant of the government's accounting policies are described below.

A. Reporting Entity

The District is a political subdivision of the State of Texas, governed by an appointed board, and is considered a primary government. As required by accounting principles generally accepted in the United States of America, these financial statements have been prepared, based on considerations regarding the potential for inclusion of other entities, organizations or functions, as part of the District's financial reporting entity. Based on these considerations, no other entities, organizations or functions have been included in the District's financial reporting entity. Additionally, as the District is considered a primary government for financial reporting purposes, its activities are not considered a part of any other governmental or other type of reporting entity.

Considerations regarding the potential for inclusion of other entities, organizations or functions in the District's financial reporting entity are based on criteria prescribed by accounting principles generally accepted in the United States of America. These same criteria are evaluated in considering whether the District is a part of any other governmental or other type of reporting entity. The overriding elements associated with prescribed criteria considered in determining that the District's financial reporting entity status is that of a primary government are; that it has a separately elected governing body; it is legally separate; and it is fiscally independent of other state and local governments. Although not considered significant in the District's reporting entity evaluation, other prescribed criteria under accounting principles generally accepted in the United States of America include considerations pertaining to organizations for which the primary government is financially accountable; and, considerations pertaining to other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete.

The District's primary activities include managing and financing improvement projects and/or services benefiting the District. These activities include maintenance and beautification of the area, traffic control and transportation projects, special events for the holiday seasons, general planning and engineering, area marketing, major capital improvements and general and administrative services.

HARRIS COUNTY IMPROVEMENT DISTRICT No. 1
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2006

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

B. Government-Wide and Fund Financial Statements

The Government-wide financial statements (i.e. the Statement of Net Assets and the Statement of Activities) report information about the District as a whole. For the most part, the effect of interfund activity has been removed from these statements.

The Statement of Activities demonstrates the degree to which the direct expenses of a given function or segment is offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function or segment. Program revenue includes 1) charges to customers or applicants, who purchase, use or directly benefit from goods, services or privileges provided by a given function or segment and 2) grants and contributions that are restricted to meeting the operational or capital requirements of a particular segment. Taxes and other items not properly included among program revenues are reported as general revenues.

C. Measurement Focus, Basis of Accounting and Financial Statement Presentation

The Government-wide financial statements are reported using the *economic resources measurement focus* and the *accrual basis of accounting*. Revenues are recognized when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

GASB Statement No. 34 established standards for external financial reporting for all state and local governmental entities, which includes a statement of net assets and a statement of activities. It requires the reclassification of net assets into three components – invested in capital assets, net of related debt; restricted; and unrestricted. These classifications are as follows:

- Invested in capital assets, net of related debt – This component of net assets consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, notes or other borrowings.
- Restricted – This component of net assets consists of constraints placed on net asset use through external constraints imposed by creditors, grantors, contributors or laws or regulations of other governments or constraints imposed by law through contractual provisions or enabling legislation.
- Unrestricted net assets – This component of net assets consists of net assets that do not meet the definition of “restricted” or “invested in capital assets, net of related debt.”

Governmental fund financial statements are reported using the *current financial resources measurement focus* and the *modified accrual basis of accounting*. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available if they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose the District considers revenues to be available if they are collected within 60 days of the end of the current fiscal period. Expenditures are generally recorded when a liability is incurred, as under accrual accounting. However, debt service expenditures, as well as expenditures related to compensated absences and claims and judgments, are recorded only when payment is due.

HARRIS COUNTY IMPROVEMENT DISTRICT No. 1
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2006

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The District reports the following major governmental funds:

The *General Fund* is used to account for administrative operations of the District. The principal source of revenue is property taxes. Expenditures include all costs associated with the daily operations of the District.

The *Debt Service Fund* is used to account for the payment of interest and principal on all general long-term debt of the District. The primary source of revenue is provided by contract tax increment revenue.

The *Capital Projects Fund* is used to account for the expenditure of bond proceeds used in the construction of authorized improvement projects.

D. Cash and Temporary Investments

The District's cash and temporary investments consist of demand deposits and money market accounts. Money market accounts are stated at cost, which approximates their fair value.

E. Bond Discounts

In governmental fund types, bond discounts are recognized in the current period and are deferred and amortized in the Government-Wide Statement of Activities.

F. Use of Estimates

The preparation of financial statements, in conformity with generally accepted accounting principles, requires management to make estimates and assumptions that affect the amounts reported in the financial statements. Actual results could differ from those estimates.

G. Fund Equity

In the fund financial statements the District reserves or designates all or portions of fund equity in the various governmental fund financial statements. The unreserved fund balances for governmental funds represent the amount available for budgeting future operations. The reserved fund balances for governmental funds represent the amount that has been legally identified for specific purposes.

H. Budget

A non-appropriated budget is adopted for the General Fund. The budget is prepared using the same method of accounting as for financial reporting. Encumbrance accounting is not utilized.

I. Compensated Absences

The District's employees earn vacation leave, which may either be taken or accumulated, up to certain amounts, until paid upon termination or retirement. The amounts are recorded as a liability on the Statement of Net Assets.

HARRIS COUNTY IMPROVEMENT DISTRICT No. 1
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2006

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

J. Capital Assets

Capital assets are reported in the governmental activities column in the government-wide financial statements. The District defines capital assets with an initial, individual cost of \$5,000 and an estimated useful life in excess of one year. All purchased capital assets are valued at cost where historical records exist. Donated capital assets are valued at their estimated fair value on the date received. Assets are depreciated over their remaining useful lives using the straight line method.

<u>Asset</u>	<u>Estimated Useful Lives</u>
Machinery and Equipment	5 – 20 years

NOTE 3 - CASH AND TEMPORARY INVESTMENTS

Investment Policies

Applicable statutes allow the District to invest its funds in direct or indirect obligations of the United States, the State or any county, city, school district, or other political subdivision of the State. Funds may also be placed in certificates of deposit of the State or national banks or savings and loan associations (depository institutions). Related state statutes and provisions included in the District's bond resolutions require that all funds invested in depository institutions be covered by federal depository insurance and/or be secured in the manner provided by law for the security of public funds.

The District's governing board and administration have enacted policies to ensure compliance with state laws regarding deposit of District funds and maintain a formal depository agreement with their depository bank. The depository agreement provides for proper collateralization of funds, in accordance with state and federal statutes.

At year end, the carrying value of the District's cash and temporary investments (which approximates market value) was as follows:

	Carrying
	Value
Demand and time deposits	\$ 6,670,590
	\$ 6,670,590

Collateral is required for all bank deposits at 100% of deposits not covered by federal depository insurance. The District's deposits at year end were entirely covered by federal depository insurance or by acceptable collateral held by the District's agent in the District's name.

NOTE 4 – INTERFUND TRANSACTIONS

As of June 30, 2006 the General Fund owed the Capital Projects Fund \$148,522. This interfund receivable is considered to be a temporary loan and will be repaid during the following fiscal year.

HARRIS COUNTY IMPROVEMENT DISTRICT No. 1
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2006

NOTE 5 – RECEIVABLES

Amounts recorded as receivables as of June 30, 2006 for the government's major funds, including the applicable allowance for uncollectible accounts, are as follows:

	<u>General</u>	<u>Capital Projects</u>	<u>Debt Service</u>	<u>Total</u>
Receivables:				
Taxes	\$ 84,649		\$ 48,516	\$ 133,166
Other	88,783	17,016	8,123	113,922
	<u>\$ 173,432</u>	<u>\$ 17,016</u>	<u>\$ 56,639</u>	<u>\$ 247,088</u>

Allowance for doubtful accounts is considered to be immaterial and has not been recorded in the financial statements.

NOTE 6 – PROPERTY TAXES

On May 30, 1992, the voters of the District authorized the District's Board of Directors to levy taxes annually for use in financing general operations (maintenance tax) limited to \$0.25 per \$100 of assessed property valuation. The Harris County Central Appraisal District, if any, determines all property valuations and exempt status. The District's bond resolution requires that property taxes be levied for use in paying interest and principal on long-term debt and for use in paying costs incurred in assessment and collection of these taxes. Taxes levied for debt service and related costs are without limitation as to rate or amount.

The District has contracted with the Harris County Tax Assessor/Collector for its tax levy and collection functions. A tax lien attaches to properties within the District on January 1st of each year when property valuations for use in levying taxes are established. Taxes levied are generally billed in October and are due upon receipt of the tax bill. Penalty and interest are charged if taxes are not paid by January 31st. There is an additional 15% penalty charged on accounts delinquent after July 1st, which generally is payable to the District's delinquent tax attorney.

For the current year, the District levied property taxes of \$0.1435 per \$100 of assessed valuation of which \$0.0965 was allocated to general operations and \$0.0470 was allocated to debt service. The total tax levy was approximately \$3.5 million based on an adjusted taxable property valuation of approximately \$3.4 million for the 2005 tax year. The total tax levy was allocated to general operations and debt service in the amounts of \$2,369,594 and \$1,154,103, respectively.

HARRIS COUNTY IMPROVEMENT DISTRICT No. 1
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2006

NOTE 6 – PROPERTY TAXES (continued)

Taxes receivable at June 30, 2006, consist of the following:

Tax Year	General	Debt Service	Totals
2005	20,985	10,221	\$ 31,206
2004	11,037	5,375	\$ 16,412
2003	9,610	6,597	16,207
2002	7,539	5,096	12,635
2001	6,075	2,839	8,914
2000	8,661	4,245	12,906
1999	5,024	2,340	7,364
1998	3,783	1,931	5,714
1997	3,713	2,308	6,021
1996	3,822	3,593	7,415
1995	2,179	1,830	4,009
1994	1,762	1,251	3,014
1993	459	890	1,349
	<u>84,649</u>	<u>48,516</u>	<u>133,166</u>

NOTE 7 – CAPITAL ASSETS

A summary of activity for capital assets capitalized by the District for the year ended June 30, 2006 follows:

	Balance July 1, 2005	Additions	Deletions	Balance June 30, 2006
Governmental Activities				
Capital assets being depreciated:				
Machinery and equipment	\$ 12,960,759	\$ 23,853	\$	\$ 12,984,612
Total capital assets being depreciated	<u>12,960,759</u>	<u>23,853</u>	<u></u>	<u>12,984,612</u>
Less accumulated depreciation for:				
Machinery and equipment	<u>(7,549,262)</u>	<u>(639,222)</u>	<u></u>	<u>(8,188,484)</u>
Governmental activities capital assets, net	<u>\$ 5,411,497</u>	<u>\$ (615,369)</u>	<u>\$</u>	<u>\$ 4,796,128</u>

Depreciation was charged to functions of the District as follows:

Governmental activities:	
Traffic control	\$ 593,687
Marketing and communications	45,535
	<u>\$ 639,222</u>

HARRIS COUNTY IMPROVEMENT DISTRICT No. 1
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2006

NOTE 8 – LONG TERM DEBT

Payment of principal and interest on the bonds is to be provided from tax levies on properties within the District. As the bonds are unlimited tax bonds, no other funds of the District have been pledged for debt service requirements. Investment income realized by the Debt Service Fund, from investment of excess funds, will be used to pay outstanding bond principal and interest.

During the year ended June 30, 2006, the following changes occurred in long-term liabilities:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>	<u>Due within One year</u>	<u>Deferred Costs</u>
Governmental Activities						
Unlimited tax bonds	\$ 14,845,000	\$ -	\$ (525,000)	\$ 14,320,000	\$ 535,000	\$ 244,407
Compensated absences	34,661	44,487	(41,619)	37,529		14,075,593
	<u>\$ 14,879,661</u>	<u>\$ 44,487</u>	<u>\$ (566,619)</u>	<u>\$ 14,357,529</u>	<u>\$ 535,000</u>	<u>\$ 14,320,000</u>

The District incurred and expensed total interest of \$569,123 all of which was interest on long-term debt.

Annual debt service requirements to retire outstanding unlimited tax bonds are as follows:

Year Ending June 30,	Governmental Activities		
	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$ 535,000	\$ 550,073	\$ 1,085,073
2008	545,000	536,448	1,081,448
2009	565,000	522,779	1,087,779
2010	590,000	508,910	1,098,910
2011	610,000	493,433	1,103,433
2012	640,000	475,713	1,115,713
2013	675,000	455,900	1,130,900
2014	705,000	433,123	1,138,123
2015	745,000	408,600	1,153,600
2016	785,000	381,216	1,166,216
2017	830,000	351,557	1,181,557
2018	875,000	318,615	1,193,615
2019	920,000	282,806	1,202,806
2020	965,000	243,968	1,208,968
2021	1,015,000	203,008	1,218,008
2022	1,060,000	158,816	1,218,816
2023	1,105,000	111,348	1,216,348
2024	1,155,000	54,553	1,209,553
	<u>\$ 14,320,000</u>	<u>\$ 6,490,863</u>	<u>\$ 20,810,863</u>

HARRIS COUNTY IMPROVEMENT DISTRICT No. 1
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2006

NOTE 8 – LONG TERM DEBT (continued)

The following is a summary of the terms of obligations of unlimited tax bonds outstanding as of June 30, 2006:

Governmental Activities			Debt	Unamortized
Series	Original Issue	Interest Rate	Outstanding	Bond Issuance Cost
Unlimited Tax Bonds, Series 1999	\$ 2,000,000	5.00%-7.00%	\$ 1,755,000	\$
Unlimited Tax Improvement and Refunding Bonds, Series 2004	13,635,000	2.00%-5.00%	12,565,000	244,407
Total Governmental Activities			<u>\$ 14,320,000</u>	<u>\$ 244,407</u>

A summary of District Bonds authorized but unissued at June 30, 2006 follows:

Purpose	Date Authorized	Amount Authorized	Amount Unissued
Stimulation and development of transportation	05/30/92	\$ 75,000,000	\$ 59,915,000
Conservation and preservation of natural resources	05/30/92	25,000,000	22,005,000
Improvement projects payable from assessments	05/30/92	25,000,000	25,000,000
Improvement projects for economic diversification	11/20/93	25,000,000	25,000,000
		<u>\$ 150,000,000</u>	<u>\$ 131,920,000</u>

The District is in compliance with all significant requirements and restrictions contained in its bond resolution.

NOTE 9 - SIGNIFICANT LEGAL PROVISIONS OF LEGISLATIVE ACT CREATING THE DISTRICT

As discussed in Note 1 above, the District has been established pursuant to an act of the Texas State Legislature. Significant legal provisions of this act are summarized below.

A. District Boundaries

The Act provides specifically for boundaries of the District, which includes the Uptown Houston area. The Uptown Houston area is also known as the Galleria-Post Oak area in Houston, Texas. The District may annex additional land area in accordance with Chapter 54 of the Texas Water Code.

HARRIS COUNTY IMPROVEMENT DISTRICT No. 1
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2006

NOTE 9 - SIGNIFICANT LEGAL PROVISIONS OF LEGISLATIVE ACT CREATING THE DISTRICT (continued)

B. Texas Commission on Environmental Quality Involvement

The Act provides that the Texas Commission on Environmental Quality is to appoint District Directors. The Directors are to serve staggered four-year terms. Additionally, the Texas Commission on Environmental Quality must approve the issuance of any bonded indebtedness for the purposes of providing water, sewer or drainage facilities within the District. No other District activities are subject to the jurisdiction of the Texas Commission on Environmental Quality.

C. General and Specific Powers of the District

The Act provides general powers to the District subject to general laws and regulations of the state applicable to conservation and reclamation districts created under Article XVI, Section 59 of the Texas Constitution and road districts and road utility districts created pursuant to Article III, Section 52, of the Texas Constitution, including those conferred by Chapter 54 of the Water Code and Chapter 13, Acts of the 68th legislature, 2nd Called Session, 1984 (Article 6674r-1, Vernon's Texas Civil Statutes).

Additional specific powers and duties are provided for in the act, which include the financing of improvement projects and/or services for the benefit of the District. Specific types of improvement projects are provided for in the act and include the acquisition of land in connection with the improvements. Eminent domain powers are specifically prohibited by the act. Improvement projects and/or services may be financed in whole or in part by the levy and collection of special assessments or property taxes on property in the area. The act also provides that maintenance taxes may be levied after voter approval.

The Act provides for the method by which the District must petition, provide notice and hold public hearings prior to the financing of the improvement projects and/or services.

The Act also provides for the issuance of voter approved bonded indebtedness to finance improvement projects and/or services. Specific guidelines in the act provide for the repayment of bonds, which might be issued, as well as the use of bond proceeds, available security that can be pledged in issuing the bonds and refunding capabilities for outstanding bonds.

D. Director Bonds

The Act requires that each Director appointed execute a bond for \$10,000 payable to the District and conditioned on faithful performance of his or her duties. All bonds of the Directors shall be approved by the Board.

E. Other Provisions

Other significant provisions of the act include City of Houston approval requirements for issuance of bonds for all improvement projects, bonded indebtedness limits, contracting powers, dissolution procedures, director qualifications and procedural requirements regarding Board meetings and District business matters.

HARRIS COUNTY IMPROVEMENT DISTRICT No. 1
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2006

NOTE 10 - OPERATING AGREEMENT - UPTOWN HOUSTON ASSOCIATION

The District has entered into an operating agreement with Uptown Houston Association (the "Association"). The Association is a non-profit corporation formed to carry on maintenance and improvements in the Uptown Houston area. The governing boards of both the District and the Association have common members. It is the intent of both governing boards to maintain separately controlled operating entities. The agreement calls for the District to perform many of the functions previously performed by the Association, primarily the maintenance, enhancement and marketing of the Uptown Houston area. Additionally, the Association has granted the District the use of Association assets without charge to the District. A summary of the Association's financial position as of March 31, 2006, is as follows:

UPTOWN HOUSTON ASSOCIATION	
<i>MARCH 31, 2006</i>	
	\$
Current and other assets	25,174
Total Assets	<u>25,174</u>
Net assets:	
Unrestricted	25,174
Total Net Assets	<u>\$ 25,174</u>

NOTE 11 - PENSION PLAN

For the benefit of its employees, the District provides discretionary contributions to a simplified employee pension plan, meeting the requirements of Internal Revenue Code Section 408(k). For the year ended June 30, 2006, the District contributed \$62,167 to the plan.

NOTE 12 - RISK MANAGEMENT

The District is exposed to various risks of loss related to torts; theft of, damage to and destruction of assets; errors and omissions; personal injuries; and natural disasters. The risk of loss is covered by commercial insurance. There have been no significant reductions in insurance coverage. Settlement amounts have not exceeded insurance coverage for current year or the three prior years.

NOTE 13 - TAX INCREMENT REINVESTMENT ZONE

During the current and prior years, the District incurred certain planning expenditures related to the creation of Tax Increment Reinvestment Zone No. 16 of the City of Houston (TIRZ). The TIRZ is located on property generally within the District's service area. During the year ended June 30, 2006, the District received approximately \$535,206 from the TIRZ for reimbursement of administration costs, project management costs and traffic and mobility costs.

NOTE 14 - CONTRACTUAL COMMITMENTS

In October 2002, the District entered into a contract with the Houston-Galveston Area Council (HGAC) for a transit pilot project to provide convenient and frequent daytime internal transit service to add mobility alternatives for Uptown workers and residents. As of September 30, 2004, shuttle operations ceased and the contract terminated due to low ridership and Metros recent elimination of three direct bus routes to the area, which also negatively affected ridership.

REQUIRED SUPPLEMENTARY INFORMATION

HARRIS COUNTY IMPROVEMENT DISTRICT #1
GENERAL FUND
SCHEDULE OF REVENUES, EXPENDITURES AND
CHANGES IN FUND BALANCE - BUDGET AND ACTUAL
June 30, 2006

	Budgeted Amounts		Actual	Variance with Final Budget Positive / (Negative)
	Original	Final		
REVENUES				
Property Taxes	\$ 2,304,719	\$ 2,304,719	\$ 2,406,385	\$ 101,666
Intergovernmental	535,200	535,200	568,676	33,476
Shuttle program	33,300	33,300		(33,300)
Investment earnings	24,000	24,000	61,984	37,984
Miscellaneous				
Total revenues	2,897,219	2,897,219	3,037,045	139,826
EXPENDITURES				
Current:				
Planning and engineering	90,000	90,000	95,935	(5,935)
Traffic control	394,715	394,715	333,523	61,192
Maintenance and beautification	789,268	789,268	873,363	(84,095)
General and administrative	1,291,136	1,291,136	1,290,031	1,105
Uptown shuttle				
Marketing and communications	257,000	257,000	249,815	7,185
Economic development	75,100	75,100	72,239	2,861
Total Expenditures	2,897,219	2,897,219	2,914,906	(17,687)
Excess (deficiency) of revenues over expenditures			122,139	122,139
Revenue and other financing sources/(uses) over/(under) expenditures			122,139	122,139
Fund balances - beginning of year	1,568,467	1,568,467	1,743,738	175,271
Fund balances - End of Year	\$ 1,568,467	\$ 1,568,467	\$ 1,865,877	\$ 297,410