DISCLAIMER

PLEASE NOTE: There is reading material that is a pre-requisite to this course. We appreciate and are sensitive to time constraints in the lives of community association management professionals. However, if you choose not to do the pre-session reading or if you register shortly before the date of a course and have inadequate time to prepare, there is a possibility that you will not be able to successfully complete the examination relative to this course.

PARTICIPANT WORKBOOK

M-100
The Essentials of Community Association Management

community
ASSOCIATIONS INSTITUTE

PROFESSIONAL MANAGEMENT DEVELOPMENT PROGRAM

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Community Associations Institute (CAI) is a national, nonprofit 501(c)(6) association created in 1973 to provide education and resources to America's residential condominiums, cooperatives, and homeowner associations, and related professionals and service providers. The Institute is dedicated to fostering vibrant, responsive, competent community associations that promote harmony, community, and responsible leadership. CAI estimates that there are 250,000 community associations in the United States as of 2003, and the number will increase to 260,000 by the year 2004.

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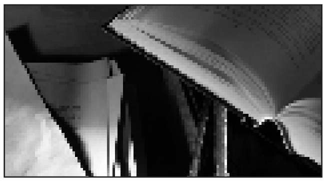
Any forms, checklists, or other samples contained in this course are included by way of example and are not intended to be utilized as a substitute for legal, accounting, or other professional advice where appropriate. If you use any form, checklist, or other sample in this manual, it may be necessary to tailor it to your particular community association's needs and requirements.



CHAPTER 5

BUDGETS AND RESERVES

KEY TERMS

Assessment, p. 101
Baseline funding, p. 104
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Chart of accounts, p. 106
Discretionary budget line items, p. 106
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Reserve cash flow statement, p. 111
Reserve formula, p. 111
Reserve Specialist, p. 110
Reserve study, p. 108
Revenue, p. 101
Special assessment, p. 101
Threshold funding, p. 105
VA, p. 99
Zero-base budgeting, p. 107

This chapter provides an overview of the role of budgets and reserves in community associations.

The chapter explains:

- Roles and responsibilities in the budget process
- Budgets and reserves and their use
- The sources of budget and reserve requirements
- Budget preparation
- Budget presentation

What You Will Learn

After reading and reviewing this chapter, you should be able to explain and understand:

- Roles and responsibilities in the budget process for the board of directors, the treasurer, the owners, and the manager
- The definition of a budget
- The role of a budget in a community association and its uses
- Sources of community association budget requirements
- Sources of revenue for a community association
- Types of expenses for a community association

- Reasons for maintaining a replacement fund
- Development of budget line items
- Preparation of an operating budget
- Preparation of a replacement fund budget
- Reconciliation of expenses and revenue
- Methods of budget presentation

Your community governing documents will define *formal* roles and responsibilities in the budget process. However, it is important for you to find out as soon as possible what people's *informal* expectations are—for everyone involved.

Become familiar with the budgetary roles and responsibilities of:

- The board of directors
- The treasurer
- The owners
- Yourself, as manager

Board of Directors

Most boards of directors are responsible for establishing, approving, and monitoring the community's budget. Although they have the power to establish a budget, most will delegate preparation authority to their manager.

When directors review a proposed budget, they should take into consideration:

- Legal requirements of state statutes and governing documents
- Owners' needs and desires (balancing mandatory and discretionary items—see page 106)
- Committee and owner feedback
- The need to reconcile revenue and expenses
- Any financial forecasts and analyses of past financial activity prepared by the manager

As the board has the power to approve the budget, you, as the manager, are responsible for providing all owners with a summary copy of the proposed budget *before* it is officially adopted by the board.

Treasurer

The community treasurer is usually responsible for seeing to it that the draft budget is prepared and reviewed. He or she will usually delegate initial preparation of the budget to the manager. Then the treasurer will usually review the draft budget with a finance committee.

It is important that the treasurer consult all committee chairpersons and invite owner input to ensure support.

Their participation and support would be especially important where a vote of owners is required or recommended for:

- A required increase in assessments (see page 101)
- Special assessments (see page 101)
- Major improvements (see page 102)
- Funding reserves (see pages 102-105)

Usually the treasurer presents the proposed budget to the owners at an open community meeting. Frequently, community governing documents require that an open meeting be held before the board adopts a budget.

Owners

Some states and some community governing documents require that the budget be passed by a vote of the owners. The preceding discussion explains when and why owners should be involved in *reviewing* the proposed budget—even when the board is responsible for its adoption.

Manager

As community manager, your formal budget responsibilities are more likely to appear in your contract than in the community's bylaws.

Even if neither the bylaws nor your contract spell out your budget responsibilities, informally you will be expected to:

- Prepare or be involved in the development of a draft budget
- Review it with the treasurer, finance committee if one exists, and ultimately the board and membership
- Revise it after any changes are made
- Mail a summary of the proposed budget to the owners before it is approved

INTRODUCTION TO THE BUDGET

This section explains:

- The definition of a budget
- Its role in community management
- How it is used

What is a Budget?

A **budget** is a financial plan for an organization—in this case, a community association. A budget provides an estimate of a community's revenue and expenses for a specified period of time. It is the first step in your community's financial operations.

The Role of a Budget in Community Management

A budget establishes:

- *What* services and programs the community will provide
- *When* they will be done
- *How* they will be done

In other words, a budget reflects a community's policy decisions about what will be accomplished and what will *not* be accomplished during the budget period.

How a Budget Is Used

A budget has many uses:

- It is a way for the community to plan its activities
- It is the basis for determining owner assessments (see Chapter 6)
- Together with financial reports (see Chapter 7), it is a means of controlling the community's financial operations
- It provides for continuity of community services
- It helps the community maintain its desired quality of life
- It helps to minimize the unexpected
- It provides an opportunity for a community to balance its needs and desires (mandatory and discretionary items, see page 106)

SOURCES OF BUDGET REQUIREMENTS

Budget items will vary from one community association to another. They also will vary from year to year for the same association.

Many budget items develop in the normal course of doing business. However, a number of budget items appear because they are required by:

- Federal laws and regulations
- State statutes, regulations, and court decisions
- Local laws and regulations
- The community's governing documents

Federal Laws and Regulations

Federal laws and regulations can lead to community expense items. For example, all community associations must conform to Internal Revenue Service requirements in the area of income and payroll taxes.

Federal agencies may also establish expense requirements that your community will have to meet. For example, in the environmental area, you may have to budget for oil tank testing, hazardous waste disposal, or chlorofluorocarbon (CFC) removal. Your community association may also be taking steps to conform to the requirements of the Americans With Disabilities Act (ADA).

Federally established secondary mortgage institutions may set requirements that your community association will have to meet if owners are to participate in their financing programs.

These agencies include:

- Federal National Mortgage Association (FNMA or Fannie Mae)
- Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac)
- Federal Housing Administration (FHA)
- Veterans' Administration (VA)

These agencies regulate and influence such items as the amount of insurance a community association must carry, procedures for financial operations, and requirements for the upkeep of property.

If you know you are regulated by a particular agency, contact that agency's local representative for more information on requirements that affect your community association's budget process. Or you can call your congress person's local office.

State Statutes, Regulations, and Court Decisions

As we said in Chapter 1, *most* states have statutes that enable the establishment of condominiums and corporations. Some states have statutes that enable the establishment of cooperatives or planned communities. In several states, these statutes require or regulate such community association budget items as reserves for replacement, audits, insurance, and the conduct of financial operations.

States may have other laws and regulations that apply to community associations and have budgetary implications. To find out about any applicable laws and regulations, call your attorney or local state legislator.

What a specific state statute says very often will override what your community's governing documents say. Check the state statute's wording carefully to determine its applicability to your community association. And in so doing, keep in mind that your community association's governing documents may not be current with the state statute that enables establishment of your type of association.

If your community association employs at least one person (you), it must follow all applicable state requirements for employers. This can result in such expense items as workers' compensation insurance and unemployment taxes.

State courts have also made decisions that affect the types of expenses community associations incur. For example, there have been "security" cases involving the adequacy of lighting, patrols, and off-duty police. There have been other cases involving parking and sign requirements, and there have been "slip-and-fall" cases involving the adequacy of snow removal. To find out more about the case law that applies to your community association, consult the *Community Association Law Reporter*, a monthly publication from Community Associations Institute reporting on current laws and legal decisions affecting community associations.

Local Laws and Regulations

Your local government may have codes, laws, and, possibly, taxes that your community association must meet. Any requirements in these areas will result in expense items for your community's budget.

For example, your local fire code may require such items as sprinkler systems, exit signs, fire extinguishers, or elevator inspections. Your local health and safety codes may require pool inspections, water quality tests, or mandatory procedures for sewage disposal or recycling.

Property taxes may or may not be levied on land commonly owned by the community association, depending on your state or local jurisdiction.

Governing Documents

The governing documents of your community:

- Define the property to be maintained by the community association
- Specify maintenance and service responsibilities and requirements

Maintenance and service items will appear in the "expenses" section of your community's budget (see next page).

BUDGET COMPONENTS

Before you begin reading this section, you may want to pull out a copy of your community budget to look at as you read through the following pages. The two main components of a community budget are revenue and expenses. The revenue and expense categories used in your budget must be the same categories used in your financial records, reports, and statements.

Revenue

Revenue consists of the collective items or amounts of income which, in the case of a community association, are appropriated for public expenses. The typical sources of revenue for a community association include:

1. **Owner assessments**: An **assessment** is the owner's financial obligation to the community association during a given period of time—usually one year. It covers the owner's share of the common expense. An annual assessment may be paid on a monthly, quarterly, or annual basis. Most of a community's revenue will come from owner assessments. (See Chapter 6 for more information on owner assessments.)

   Occasionally, special assessments may be levied. A **special assessment** is a one-time assessment often voted on by the owners to cover a major expense that was not included in the annual budget or replacement reserve.

2. **Interest**: A typical source of revenue for communities is interest or dividend earned on their cash savings and investments.

3. **Penalty fees**: Exampes include—fines for violating community rules and regulations, reimbursements for legal fees and lien filings, and late payment fees.

4. **User fees**: For example—parking space rentals, laundry machine use, guest privileges, swimming pool use, and move in-move out fees.

5. **Other revenue**: Other sources of revenue include—rent from commercial tenants, rent from lease of units, charges for resale packages, collection on insurance claims, legal settlements, easements, and antenna rental.

Expenses

Expenses consist of the cost of goods and services used to operate and maintain property. Typically, there are three types of expenses for community associations:

1. **Operating expenses:** Operating expenses are those items that occur on a regular basis—day to day, week to week, month to month, and year to year.

   For example—
   - Swimming pool management costs
   - Professional and administrative services (management, legal, accounting, insurance)
   - Utilities (electric, gas, water, oil)
   - Contract services (lawn maintenance, elevator, trash removal, janitorial services, painting)
   - Repairs (plumbing and pipe, electrical, door and lock)
   - Personnel costs (compensation and benefits for community employees)
   - Educational costs for employees and volunteers (courses, publications, membership in Community Associations Institute)

2. **Major improvement expenses:** Major improvement expenses consist of items that are not necessarily required, but are *added* to improve the overall welfare, safety, or life of the residents—or to enhance the value of the community association as reflected in the resale value of units.

   Improvements are different from maintenance, repairs, or replacements. They increase the life, usefulness, or value of a property. They are called *major* improvements because they typically last more than one year and involve a large amount of funding for the community association. Examples of major improvement expenses are the addition of a new tennis court, more picnic areas, or additional street lights.

3. **Replacement fund:** The establishment of a replacement fund is a community association expense that requires detailed explanation. Please see the next page.

REPLACEMENT FUND

The **replacement fund** consists of funds put aside—in reserve—for the *replacement* of major components of a community's common property. Typically, the replacement fund might be used to replace asphalt paving, concrete sidewalks, roofs, central heating and cooling plants, swimming pool, tennis courts, elevators, and many other varied property components. Revenue raised for *adding* a major item will be a major improvement expense. Revenue raised for *replacing* that item when it deteriorates will come from the replacement fund.

Major items that either come with the initial construction or are added later are placed on a replacement reserves schedule. The schedule is a framework for accumulating and spending the funds for replacing major components of the property. (See the sample replacement reserves calculation on page 112 for a sample schedule.) The funds are put aside over a period of time to ensure that adequate amounts are available to replace components when they need to be replaced either for deterioration or technological improvements. The components, cost to replace the components, and the remaining useful lives of the components will determine your reserves for replacement.

It is important to note that the Internal Revenue Service considers the expenditure of certain replacement funds for regular maintenance and repairs—such as painting—as an action that may expose the community association to possible taxation.

Until recently, community associations referred to the replacement fund as "replacement reserves," "reserves for replacement," or just "reserves." However, the *Common Interest Reality Associations Audit and Accounting Guide* prepared by the American Institute of Certified Public Accountants for community associations refers to these funds as a replacement fund.

Reasons for Maintaining a Replacement Fund

Because some items may not need to be replaced for several years, you—and the owners—may question the value of their contributions.

Here are some reasons for maintaining a replacement fund to convince you—and the owners—of the importance of budgeting reserves for replacement:

1. **Maintaining a replacement fund meets legal, fiduciary, and professional requirements.** A replacement fund may be required by:
   - Any secondary mortgage market in which your community association participates, e.g. Fannie Mae, Freddie Mac, FHA, VA
   - Your state's statutes, regulations, or court decisions
   - Your community's governing documents
   - Industry standards

2. **Maintaining a replacement fund provides for the planned replacement of major items.** Owners expect the community association to fulfill its obligations. At some point in time, the work will have to be done.

3. **Maintaining a replacement fund equalizes the contributions of old and new owners.** Major items deteriorate during use. Although a roof will be replaced when it is 25 years old, every owner who lived under that roof should pay a share of its replacement. Just as both old and new owners benefit from the presence of such an item, both contribute to it.

4. **Maintaining a replacement fund minimizes the need for special assessments.** Owners, especially those on fixed incomes, have limited resources. They may not be able to afford the large special assessments that would be required if reserves are insufficient to cover a major replacement. Special assessments have the reputation of being indicative of poor management.

5. **Maintaining a replacement fund enhances resale values.** Lenders and real estate agents are aware of what a replacement fund is and the ramifications for a new buyer if reserves for replacement are inadequate. Many states have reserves disclosure requirements for buyers into a community association. Some states require reserves for replacements and/or replacement reserve studies.

Funding Goals

The answer to the critical question of how much reserves is "enough" or "adequate" is not simple. Each association has different needs, so $100,000 may be excessive to one association but an extremely small amount to another.

One standard method of measuring the size of an association's replacement fund, providing information about how the fund measures up against the needs of the association, is the concept of **percent funded**. Percent funded allows an association to measure the *relative* size of their reserves as compared to a 'fully funded' reserve balance.

Depending on the association 's funding objectives, the association's funding plan can range from conservative to aggressive. Note that reliance on future special assessments is not considered part of a responsible funding plan. There are three distinct funding goals:

- **Baseline funding:** Establishing a reserve funding goal of keeping the reserve cash balance above zero (never purposefully running out of money or having special assessments). This is the most aggressive methodology, characterized by lower (typically) reserve contributions and reserve balances. This funding plan is also the riskiest of the three, with a greater potential for special assessments and/or bank loans when things do not go according to plan.

- **Full funding:** Setting a reserve funding goal of attaining and maintaining reserves at or near 100% funded. This is a conservative methodology, characterized by higher (typically) reserve contributions and higher reserve balances. This funding plan results in the least likelihood of special assessments and/or bank loans.

- **Threshold funding:** Establishing a reserve funding goal of keeping the reserve balance above a specified dollar or percent funded amount. Here a specific minimum figure is chosen (either a cash value or percent funded value) below which the reserve fund never drops. The threshold funding approach is often used to define an objective that results in more "safety net" funds available than under baseline funding, while not as conservative as fully funding. This funding plan typically falls between baseline funding and full funding in terms of the possibility of requiring special assessments and/or bank loans.

Funding plans are expected to project the revenue and expenses of the replacement fund for 20 or more years. Many associations include the effects of interest earned from their replacement funds 'on deposit' and the effect of inflation on projected future expenses. While interest earnings tend to reduce the effects of inflation, the two factors *do not* offset each other since interest is earned only on the reserve balance, while inflation affects the total replacement cost of all the reserve components.

BUDGET PREPARATION

A budget usually applies to a 12-month period.

For example—

- January 1 to December 31
- July 1 to June 30

Your community's budget should be approved at least 45 days in advance of the start of the fiscal or budget year. This will enable you to distribute copies of the approved budget to your owners before it goes into effect.

To meet approval and distribution deadlines, you will have to begin work on the next year's budget several months in advance. Before you begin work, pull together all the related documents and reports you and your community association's accountant have prepared over the past year. (For example—this year's budget, any comparison of actual expenses to budgeted expenses, any other financial reports or statements, bills paid over the past year.)

The budget should include estimated revenue and expenses, and a summary of the most recent reserve study. (For more information on reserve studies, see page 108.) This budget, a statement as to whether special assessments are contemplated, and a description of the association's collection policies, should be distributed to the members within the time frame stated above.

Development of Budget Line Items

Each line in a budget represents a different account or category of revenue or expense. This is why accounts are commonly called line items in a budget.

There are two types of expenditures in a community budget—mandatory line items and discretionary ones:

- **Mandatory line items**—These are items based on community and owner needs. They are requirements that the community is obligated to meet, e.g. income taxes, repairs, utilities, and maintenance.

- **Discretionary line items**—These are items based on owner, board, and committee desires. They are items people would like to have—given their values, lifestyle, and preferred level of service, e.g. social and recreational expenses, picnic areas, etc.

There are standard ways to describe common line items for community associations, as the sample on the next page illustrates. It consists of an excerpt from a chart of accounts for a condominium association.

A **chart of accounts** is an organized list of the titles, descriptions, and assigned numbers of all accounts in an organization's general ledger. The assigned number helps you locate the account. The title describes the purpose of the account.

There are three rules of thumb to keep in mind when selecting line items for your community's budget:

1. Select line items that reflect your community's activities
2. Select line items that will give your board the information it needs to plan and control your community's operations
3. Keep line items as simple as possible

Even though there are customary ways of listing common line items in a budget, your community association can decide how *detailed* a set of line items it wants to use.

It is very important that the same account numbers and names be used in the budget, the general ledger, and all financial reports. Without this consistency, it is impossible to get a clear picture of the community's financial operations over a period of time.

When you are *preparing* a draft budget, list your line items in as much detail as possible to help you assign costs. For example, utility line items may include: water-domestic, water-irrigation, sewer, electricity, streetlights, fuel oil, natural gas, steam, garbage, telephone, and cable TV. This same level of detail should appear in your community's financial records. (In order to prepare line items for specific types of goods and services, you may have to solicit bids and proposals, e.g. insurance, lawn maintenance, and pool management.)

EXCERPT FROM A CHART OF ACCOUNTS FOR A CONDOMINIUM ASSOCIATION

EXPENSES

Administrative
52310 Office Supplies and Expense
52490 Management Fee
52491 Audit Expense
52492 Legal Expense
52500 Staff Training and Development
52750 Insurance

Maintenance of Buildings and Grounds
62250 Plumbing Repairs
62420 Lawn Maintenance Service
62425 Snow Plowing Service
62510 Building Repair and Maintenance
62520 Janitorial Service

Personnel
63330 Maintenance Staff
63350 Swimming Pool Staff
63410 Service Coordinator
63520 Secretary
63750 Central Plant Engineer
63810 Payroll Taxes

Utilities
72250 Electricity
72430 Natural Gas
72460 Water and Sewer
72750 Fuel Oil

Reserves
81940 Asphalt
81950 Concrete
81960 Roofing
81970 Swimming Pool

However, when you prepare published copies of the adopted budget and any monthly or annual financial reports, it is appropriate to combine detailed line items under a more general one. For example, "utilities" might be the only line item that appears in place of the previous list.

Preparation of an Operating Budget

The section of a budget devoted to operating activities includes operating expenses and major improvement expenses—but not the replacement fund.

There are two basic methods of budget preparation:

1. **Zero-base budgeting:** With this method, all line items are set to zero and the amount of funds allotted to each must be justified.

2. **Historical trend budgeting:** This method begins with the assumption that existing line items are needed. The amount of funds allotted to each during the current year is adjusted for expected changes in the coming year. Sources of historical information include financial reports, existing contracts, and bills from the past year.

A highly effective approach to developing the operating activities section of a budget is to combine elements of both zero-base budgeting and historical trend budgeting. The zero-base approach keeps you from accepting this year's figures at face value. It requires you to analyze the reasons for the actual amounts spent. The actual dollar figure may be less or more than the budgeted figure because of circumstances you cannot assume will exist during the coming year. For example, lawn maintenance costs during a dry season will be low—but a community cannot assume that the coming year will be just as dry. The historical trend approach gives you information to start from when you develop your estimates for the coming year.

Preparation of a Replacement Fund Budget

To maintain the association's major common area assets, the board and manager must determine an appropriate level of income to segregate into a reserve account or replacement fund to offset the repair or replacement of those assets as they wear out during the life of the development. Without a plan (called a reserve study, see below), it is strictly a "hit or miss" proposition.

Usually, a separate section of the budget is prepared for a replacement fund. Zero-base budgeting is the only practical method for preparing a replacement fund budget. The reason is the lack of frequent cost comparisons for large, long-term items. The *Common Interest Reality Associations Audit and Accounting Guide* prepared by the American Institute of Certified Public Accountants for community associations has separate reporting requirements for replacement funds.

Reserve Study

Maintaining the association's common property is among the manager and board's highest responsibilities, and it takes a long range plan to prepare successfully for repair or replacement of the association's major common area assets. The reserve study is the plan by which the association expects to offset ongoing deterioration and prepare for inevitable future expenses. Reserve projects are typically the largest expenses that an association faces, and proper financial preparation takes many years.

A **reserve study** is a budget planning tool that considers the current status of the replacement fund and determines a stable and equitable funding plan to offset the anticipated future major common area expenditures. The reserve study can also be very useful for developing a replacement fund budget. The study addresses all items that the association must repair, replace, restore, or maintain. The study should contain at a minimum a statement of the remaining useful life of *each* item, an estimate of the *current* cost of repair, replacement, restoration, or maintenance of those items, and an estimate of the total annual contribution necessary to defray the cost of repair, replacement, restoration, or maintenance of those items after deduction of existing reserve funds. In essence, the study must include all items for which the community has long-term replacement responsibility.

Consequences of not having a reserve study—

- **Underfunding**: Special assessments, bank loans, deferred maintenance, or a combination of these
- **Overfunding**: Paying too much (more than owners "fair share"), for the benefit of future owners
- **Board member liability**: Exposure to claims of fiscal irresponsibility and loss of D&O insurance coverage

Reserve study benefits to community managers and board members—

- Fulfilling fiduciary responsibility
- Meet individual state requirements (for regulated states)
- Compliance with the American Institute of Certified Public Accountants' (AICPA) audit guide for community associations (An auditor must modify his or her report if the disclosure about funding is absent or inadequate.)
- Reduce personal liability from claims of financial mismanagement
- Save valuable time with prioritized business plan for capital repairs and replacements
- Effective communication tool to keep owners informed
- Reserve study can turn up items that haven't been budgeted in ongoing operations

Associations are constantly changing. As a reserve study is based upon facts at the time when the study was conducted, managers and boards should plan for an update of their reserve study on a regular basis—from one to three years—to ensure accuracy.

The manager and board should review its reserve study, particularly its funding plan, annually because the association's physical assets may deteriorate at different rates, interest and inflation rates change, and the association may change its reserve strategy from conservative to aggressive (or vice-versa). Associations should be encouraged to plan responsibly for the future with the valuable reserve study as a tool.

In addition, each replacement fund budget line item should be updated *each* year using *new* current cost, *new* estimated remaining life, and *new* funds on hand. If you update these line items each year, the interest earned on these reserve funds can be used to offset operating expenses.

Interest earned on the investment of reserve funds *can* be added to the reserves on hand. If you do not update your replacement fund budget each year, you *should* add its interest income directly into the reserves. This will help your replacement fund keep up with increases in prices due to inflation.

Reserve Specialist

Whenever possible, use an experienced, qualified person to prepare a reserve study because of the technical detail involved. If you feel you cannot afford to use a specialist or one is not available to you, you will have to pull together all the relevant information yourself. CAI's *A Complete Guide to Reserve Funding & Reserve Investment Strategies (Guide for Association Practitioners Series, Report #24)* can assist you.

CAI established the **Reserve Specialist (RS)** designation program to help community managers and board members identify qualified reserve study providers and to assist communities in developing their reserve study. Utilizing a Reserve Specialist means managers and boards can obtain proposals from competent reserve providers and make informed business decisions to responsibly fund their association's reserves.

What is the value of having the reserve study conducted by a Reserve Specialist?

- **Reduced liability exposure**: Community managers and board members can limit liability by relying on expert advice.

- **Independence**: No potential conflict of interest.

- **Focus**: Allows managers and board members to concentrate on running the association.

- **Credibility:** If the person or committee preparing the reserve study isn't credible enough to effect a change in the association's budget, it is a waste of time from the start.

- **Accuracy:** The Reserve Specialist does this year-round, and is well-versed in the implications of all the decision points.

Calculating Replacement Fund Budget Line Items

To calculate replacement fund budget line items, you will need the information from a reserve study and the amount of your current reserves for replacement. Use the following **reserve formula** to calculate each line item:

$$\frac{\text{Current Replacement Cost} - \text{Funds on Hand}}{\text{Remaining Useful Life in Years}} = \text{This Year's Budget Line Item}$$

On the next page you will find a sample replacement reserve calculation for a community's asphalt paving. Page 113 features an excerpt for asphalt paving from a 20-year reserve cash flow statement. A **reserve cash flow statement** shows the amount to be funded and the amount to be expended from the replacement fund over a given period of time. The charts illustrate the gradual replacement of an item (asphalt). Note also that an item can be replaced all at once.

Reconciliation of Expenses and Revenue

After you draft both your operating and replacement fund budgets for the coming year, you must reconcile your estimated expenses with your community's anticipated revenue. To **reconcile** means to bring together after a difference.

If estimated expenses exceed estimated revenue, you will have to weigh discretionary expense items against the probable impact of any increase in assessments—or a special assessment. On this basis, decide whether a reduction in expenses is appropriate—or an increase in revenue from assessments.

When reconciling expenses and revenue, be certain about the exact powers your board has to establish assessments. In some cases, it may be necessary to have a vote of your owners to approve an increase in assessments or to impose a special assessment.

BUDGET PRESENTATION

There are two questions to ask yourself when you are preparing to present a budget:

- What information will help my audience understand and accept my estimates of revenue and expenses?
- How can I present that information in an easy-to-understand format?

SAMPLE REPLACEMENT RESERVE CALCULATION

NOTE: *Current reserves for replacement of asphalt are $75,328.*

#81940 Asphalt Paving 30,000 square yards $16,359.00

YEAR	ITEM	SQ. YDS.	LOCATION	PRICE/ SQ. YD.	UNIT PRICE
2002	1 ½" Top.	7,500	11300-15	$5.00	$37,500.00
2003	Seal Coat	15,000	11316-85	1.00	15,000.00
2004	Seal Coat	7,500	11386-400; Rec Area	1.00	7,500.00
2005	Seal Coat	7,500	11300-15	1.00	7,500.00
2007	Seal Coat	15,000	11316-85	1.00	15,000.00
2008	Seal Coat	7,500	11386-400; Rec Area	1.00	7,500.00
2009	Seal Coat	7,500	11300-15	1.00	7,500.00
2011	Seal Coat	15,000	11316-85	1.00	15,000.00
2012	Seal Coat	7,500	11386-400; Rec Area	1.00	7,500.00
2013	Seal Coat	7,500	11300-15	1.00	7,500.00
2015	1 ½" Top.	15,000	11316-85	5.00	75,000.00
2016	1 ½" Top.	7,500	11386-400; Rec Area	5.00	37,500.00
2017	1 ½" Top.	7,500	11300-15	5.00	37,500.00
2019	Seal Coat	15,000	11316-85	1.00	15,000.00
2020	Seal Coat	7,500	11386-400; Rec Area	1.00	7,500.00
2021	Seal Coat	7,500	11300-15	1.00	7,500.00
					$307,500.00

For basketball court	15,000.00
For major patching before paving or sealing	80,000.00
	$402,500.00

$$\frac{\text{Current Replacement Cost} - \text{Funds on Hand}}{\text{Remaining Useful Life in Years}} = \text{This Year's Budget Line Item}$$

$$\frac{\$402{,}500 - \$75{,}328}{20 \text{ years}} = \$16{,}359.00$$

There are two common mistakes to avoid when presenting a budget:

- Neglecting to present any information on how estimates were developed.
- Presenting so much explanatory information that people are overwhelmed and confused.

When you are preparing to present your budget:

1. Identify the line items that your audience is likely to be interested in or question.

2. Identify any comparisons or trends that would help your audience understand why your estimate is what it is.

3. Decide whether a table or a visual presentation such as a pie chart or bar graph will most clearly demonstrate what is happening with the numbers.

EXCERPT FROM A SAMPLE 20-YEAR RESERVE CASH FLOW STATEMENT

#81940 ASPHALT

BALANCE 12/31/01	$75,389
FUNDING 2002	16,359
EXPENSES 2002	37,500
BALANCE 12/31/02	54,248
FUNDING 2003	16,359
EXPENSES 2003	15,000
BALANCE 12/31/03	55,607
FUNDING 2004	16,359
EXPENSES 2004	7,500
BALANCE 12/31/04	64,466
FUNDING 2005	16,359
EXPENSES 2005	7,500
BALANCE 12/31/05	73,325

On the following pages, we've included samples of three different ways to present historical information on line items to support budget estimates for the coming year. We use utilities as the sample because they are major expenses for community associations.

1. **Line graph**—The line graph on the next page plots the *actual* utility expenses for a community association from 2003 through 2011. More importantly, it compares utility expenses to the community association's total cash and reserves for the same period. *What conclusions can you draw from this line graph?*

2. **Bar graph**—The bar graph on page 115 plots the utility expenses for another community association from 2007 through 2012. This graph allows the reader to see the changes in utility expenses over a six-year period. It also shows how these utility expenses compare to expenses for trash and landscaping and grounds during the same period. *What conclusions about utility expenses can you draw from this bar graph?*

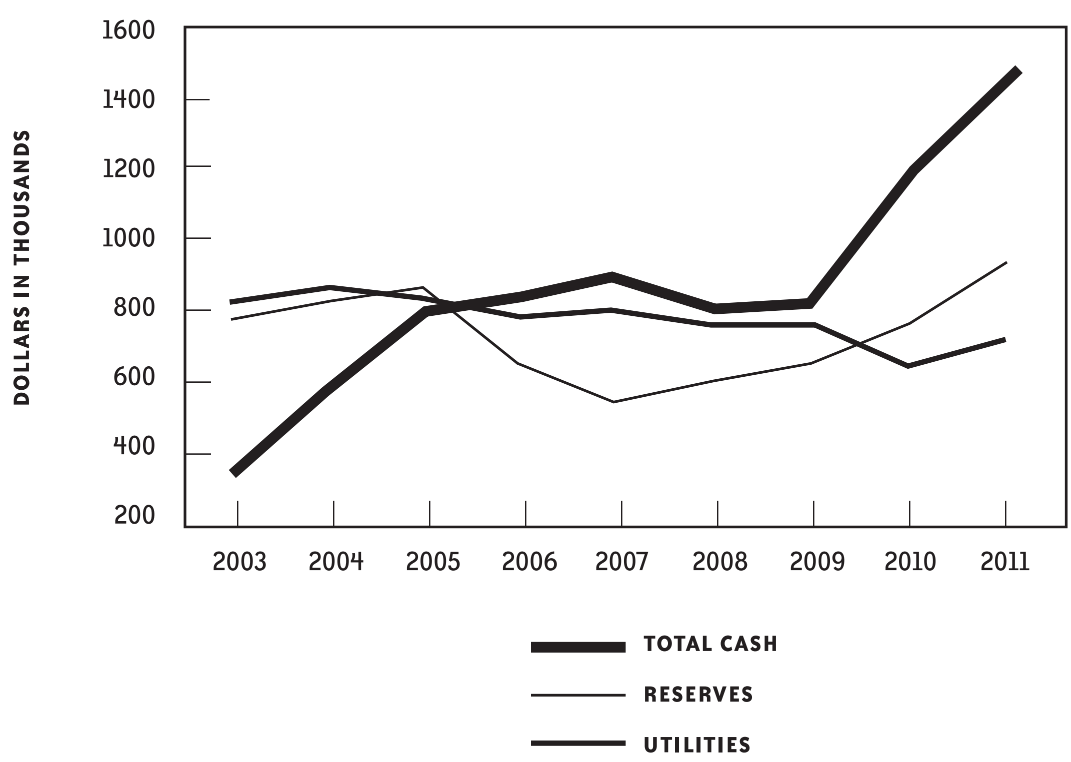
3. **Table**—The table on the following page provides a utility analysis for a third community association's electricity use. The table includes historical data on kilowatt-hours used. It also presents a comparison of budgeted and actual use and costs for 2011.

Notice how the past four years of use were averaged to create an estimate of the number of kilowatt-hours to budget for in 2011. An average of past use is a more reliable estimate than one based on a percent increase in the past year's use. You can never be sure how typical a single year is.

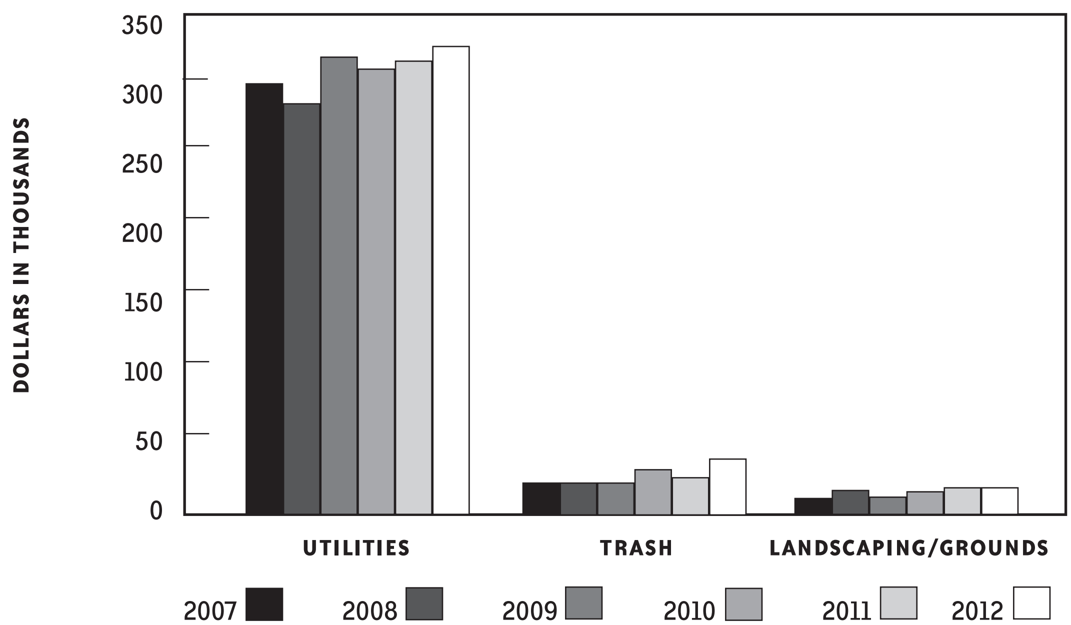
Reliable estimates are important for utility use and costs because even a small difference in estimates can make a large difference in terms of the amount of money involved.

What conclusions can you draw about the estimates for budgeted use and cost for 2011 when you compare them to the actual use and cost?

SAMPLE COMPARISON OF TOTAL CASH, RESERVES FOR REPLACEMENT, AND UTILITY EXPENSES 2003–2011



SAMPLE COMPARISON OF EXPENSES FOR UTILITIES, TRASH, AND LANDSCAPING/GROUNDS 2007–2012



	2007	2008	2009	2010	2011	2012
Utilities	$295,000	$275,000	$310,000	$305,000	$315,566	$325,000
Trash	21,000	22,000	23,000	32,500	30,500	34,000
Landscaping/Grounds	15,500	18,000	15,500	17,500	23,001	23,000

SAMPLE UTILITY ANALYSIS—#72250 Electricity

MONTH	KWH USED 2007	KWH USED 2008	KWH USED 2009	KWH USED 2010	KWH BUDGETED 2011	KWH ACTUAL 20111	# OF DAYS	BUDGETED 2011 (IN DOLLARS)	ACTUAL 2011 (IN DOLLARS)	COST 2011 (IN DOLLARS)	COST 2011 (IN DOLLARS)
JAN	261426	279536	292426	313186	286700	279862	32	$0.062	$0.049	$17,776	$13,581
FEB	283522	274674	278574	261763	274700	263577	29	0.062	0.049	17,032	12,911
MAR	—	221998	268174	261301	246300	258402	30	0.062	0.051	15,270	13,267
APR	467364	277996	266010	289545	266900	265871	31	0.062	0.055	16,548	14,533
MAY	244890	213992	272592	345063	269200	316489	29	0.062	0.056	16,690	17,690
JUNE	538216	464618	417936	397412	454600	667041	31	0.087	0.082	39,550	54,431
6 MONTH TOTALS	1795418	1732814	1795712	1868270	1798400	2051242	182	$0.066	$0.062	$122,866	$126,413
JULY	690192	726024	698236	678616	704900	824233	32	0.087	0.073	61,327	60,396
AUG	1052506	929850	821316	747898	934600	769092	28	0.087	0.081	81,311	62,418
SEPT	773844	801662	569364	633895	715000	727011	30	0.087	0.081	62,205	59,205
OCT	550608	424656	586806	523726	520700	548650	32	0.062	0.092	32,284	50,559
NOV	239370	273508	303876	400265	272300	268742	32	0.062	0.056	16,883	14,992
DEC	279250	261132	287278	266826	275900	278169	31	0.062	0.054	17,106	15,057
TOTALS	5381188	5149646	5062588	5119496	5221800	5467139	367	$0.070	$0.071	$393,982	$389,040

FOCUS QUESTIONS

Use the following questions to help you identify and review the core concepts in this chapter. (*Hint:* Once you look up the answer to a question, you may want to jot down the page number next to the question for future reference.)

1a. What are some sources that typically provide information on the financial duties and responsibilities delegated to a community association manager?
b. What are some examples of financial duties and responsibilities typically expected of a professional manager?

2a. What is the role of a board of directors in the budget process?
b. What is a treasurer's role?
c. What do committees do?
d. What is the role of the owners?
e. What does a manager do?

3a. What is a budget?
b. What is the role of a budget in community management?
c. What are some of the uses of a budget?

4. What are the different sources of budget requirements? Give an example of each for your community association.

5a. What is revenue?
b. Name the different types of revenue for a community association. Give an example of each from your association.

6a. What are expenses?
b. Name the three types of expenses. Give an example of each from your community association.
c. How do the three types of expenses differ from one another?

7. What are the reasons for maintaining a reserve or replacement fund?

8a. What is the typical time period covered by a budget?
b. Why should a budget be passed at least 45 days before the budget year begins?

9a. What are budget line items?
b. What's the difference between mandatory and discretionary line items?
c. What are some characteristics of meaningful budget line items?

10a. Name and define the two basic methods of budget preparation.
b. Why should a combination of both methods be used to prepare an operating budget?

11a. What is the purpose of a reserve study?
b. What do the line items in a replacement fund budget consist of?
c. What three items of information do you need to calculate a replacement fund budget line item?

12. What does it mean to reconcile a community association's revenue and expenses for the coming year?

13. What are some "rules of thumb" to follow in order to make an effective budget presentation?

THOUGHT/DISCUSSION QUESTIONS

Use the following questions to help you apply the information in this chapter to your own situation.

1. What are some financial duties and responsibilities your board expects of you? How do you know?

2. What are the formally required roles in your community association's budget process for the board, the treasurer, committees, owners, and yourself? (*Hint:* See your community's governing documents and your contract.) What are the informally expected roles for each? (*Hint:* What do people ask of one another or act as if they expect?)

3. When you look at this year's budget for your community, what policy decisions do you think it reflects in terms of what your community association will do and will not do this year?

4. What budget requirements are set for your community association by:
   - Applicable federal laws and regulations
   - Applicable state statutes, regulations, and court decisions
   - Applicable local laws and regulations
   - Community association governing documents

5. When you look at the line item expenses in your community's budget, can you tell which are mandatory and which are discretionary?

6. Check your community association's software or records to find its chart of accounts. Are the same account titles and numbers used in the budget and in financial reports?

7. Can you find out what method or methods were used to prepare your community's current budget?

8. What historical information is available to you for preparing the next budget?

9. Does your community association have a replacement fund budget? If not, can you find out why not? How can you help your board and owners see the need for one? If so, how has the replacement fund budget been prepared? Given what you learned in this chapter, are there any changes in line items to propose? Are there any changes in how the budget is prepared to propose?

10. Find out what documents were used to present the current budget to the board before it was adopted. (*Hint:* Check the files.) Were any documents other than the draft budget prepared? If so, what were they used for? If not, what other documents do you think could have been prepared to help explain the proposed budget?

RESOURCES

For further information on budges and reserves, we suggest the following:

A Complete Guide to Reserve Funding & Reserve Investment Strategies (Guide for Association Practitioners Series, Report #24), Fifth Edition, Mitchell H. Frumkin, P.E., P.P., RS, MBA, and Christopher J. Juall, Editors. How to set up and implement reserve funds. Chapters cover investing reserve funds, investment policies and options, and lists the pros and cons of each. Contains a summary of state reserve fund requirements, the complete reserve standards, and the reserve specialist code of ethics. (Community Associations Press, 2001.)

Common Interest Reality Associations Audit and Accounting Guide, by the AICPA. Provides the AICPA recommendations on the application of generally accepted auditing standards plus audits of financial statements of community associations. Also describes and recommends reporting principles and practices. (American Institute of Certified Public Accountants, 2003.)

The Role of the Association Treasurer, (Guide for Association Practitioners Series, Report #22), Second Edition, by Howard A. Goldklang, CPA, MBA. Although written for community association treasurers, this guide provides useful information for everyone on all aspects of association finances—basic financial statements, balance sheets, assets and liabilities, member's equity, cash versus accrual accounting, interpreting accounting information, reserves, investments, audits, and tax filing options. (Community Associations Institute, 1998.)

Note taking

CHAPTER 6

COLLECTING ASSESSMENTS

KEY TERMS

Acceleration, p. 134
Assessment, p. 122
Bad debt write-off, p. 138
Chapter 7 bankruptcy, p. 137
Chapter 11 bankruptcy, p. 138
Chapter 13 bankruptcy, p. 138
Fair Debt Collection Practices Act, p. 122
Foreclosure, p. 135
Lien, p. 135
Personal money judgment, p. 136
Special assessment, p. 122

This chapter provides an overview of assessments—the lifeblood of a community association as its major source of income. If adequate assessments are not collected in a timely manner, the community association will not be able to operate, preserve, maintain, and enhance its common property.

The chapter provides basic information a manager can use to assist and support a board's efforts to fulfill its duty to establish and collect assessments. It explains:

- Owner assessments and special assessments
- Authority to collect assessments
- Establishing annual assessments
- Collection policies and procedures

What You Will Learn

After reading and reviewing this chapter, you should be able to explain and understand:

- Assessments
- Special assessments
- Community association authority to collect assessments
- Process of establishing annual assessments
- Consequences of delinquent payments
- Benefits of an established collection policy
- Characteristics of an effective collection policy
- Collection procedures and remedies
- Lien
- Foreclosure
- Lawsuit for a personal money judgment

- Three types of bankruptcy
- Bad debt write-off
- Solutions for collection shortfalls

Definitions of Assessments

Assessment: As covered in Chapter 5, an **assessment** is the owner's financial obligation to the community association during a given period of time—usually one year. It covers the owner's share of the common expense (known as "common expense liabilities" in some states). An annual assessment may be paid on a monthly, quarterly, or annual basis.

An assessment for an owner's share of the common expenses is a binding legal obligation based on the community association's governing documents. In condominiums and planned communities, assessments are binding obligations that the owner cannot avoid without board consent. In a cooperative, however, the governing documents may allow suspension or reduction of the assessment if a unit is unoccupiable.

Special assessment: A special assessment is—

> A one-time assessment, often voted on by owners, to cover a major expense (e.g. a major repair or replacement or improvement, see page 102) that was *not* included in the annual budget.
>
> To protect your community association's interests, your governing documents should include a broad definition of assessments, if your state law does not. A broad definition includes:
>
> - Monthly (or quarterly or annual) and special charges against all units for *common* expenses, *and*
> - Special charges that may be levied against a *particular* unit, e.g. late fees and interest, collection costs (including attorney's fees), fines, fees, payment for damages to the common property

Authority to Collect Assessments

Authority to collect assessments can come from three sources:

1. **Federal laws and regulations**: The federal **Fair Debt Collection Practices Act** may apply to your community association's collections. The Act requires that the person who owes a debt receive written notice containing:

    - The amount of the debt;

- The name of the creditor to whom the debt is owed (in this case the community association);

- A statement that the debt will be assumed to be valid by the debt collector (in this case the community association), unless the debtor disputes the validity of the debt, or any portion of it, within 30 days after receiving the written notice;

- A statement that the debt collector will mail a copy of verification of the debt or a copy of a judgment against the debtor if he or she notifies the debt collector in writing within the 30-day period that he or she disputes the debt, or any portion of it; and

- If appropriate, a statement that the debt collector will provide the debtor with the name and address of the original creditor, if it is different from the current debt collector, upon the debtor's written request within the 30-day period.

  Notice that the sample collection policy on pages 129-133 fulfills the first four requirements for a debt notice under the Fair Debt Collection Practices Act.

2. **State statutes**: State statutes that enable the establishment of a community association typically state that the association board has the power to collect assessments. These statutes also state what procedures a community association must follow in order to collect delinquent assessments.

3. **Governing documents**: Governing documents typically cover the following items:
   - Mandatory nature of assessments
   - Authority to collect assessments
   - Purpose or use of assessments
   - Basis for calculating assessments
   - Reasons for levying fines, fees, etc.
   - Payment procedures
   - Collection procedures for delinquent payments

On the next two pages is a sample of covenant language on the collection of assessments.

SAMPLE: Covenant Language on the Collection of Assessments

CREATION OF LIEN AND PERSONAL OBLIGATION

The trustee, for each unit ownership hereby covenants, and each owner of a unit ownership by acceptance of a deed therefore, whether or not it shall be so expressed in any such deed or other conveyance, shall be and is deemed to covenant and hereby agrees to pay to the association such assessments or other charges or payments as are levied pursuant to the provisions of this declaration. Such assessments, or other charges or payments, together with interest thereon and costs of collection, if any, as herein provided, shall be a charge on the unit ownership and shall be a continuing lien upon the unit ownership against which such assessment is made. Each such assessment, or other charge or payment, together with such interest and costs, shall be the personal obligation of the owner of such unit ownership at the time when the assessment or other charge of payment is due.

PURPOSE OF ASSESSMENTS

The assessments levied by the association shall be exclusively for the purposes of promoting the recreation, health, safety and welfare of members of the association, to administer the affairs of the association, and to pay the common expenses.

ANNUAL ASSESSMENT

Each year at least sixty (60) days before the end of the association's fiscal year, and at least thirty (30) days before final adoption thereof, the board shall furnish each owner with a proposed budget for the ensuing fiscal year which shall show the following, with reasonable explanations and itemizations:

A. The estimated common expenses with an allocation of portions thereof for the payment of real estate taxes, if any;

B. The estimate amount, if any, to maintain adequate reserves for common expenses;

C. The estimated net available cash receipts from sources other than assessments, including, without limitation, receipts from any leases, licenses or concessions;

D. The amount of the "annual assessment," which is hereby defined as the amount determined in "A" above, plus the amount determined in "B" above, minus the amount determined in "C" above, minus excess funds, if any, from the current year's operation; and

E. That portion of the annual assessment which shall be payable by the owner with respect to his dwelling unit each month until the next annual assessment or revised annual assessment becomes effective, which monthly portion shall be equal to one twelfth (1/12th) of the annual assessment multiplied by the dwelling unit's undivided interest.

PAYMENT OF ASSESSMENT

On or before the first day of the fiscal year, and on or before the first day of each and every month thereafter until the effective date of the next annual assessment, each owner of a dwelling unit shall pay to the association, or as it may direct, that portion of the annual assessment, which is payable by such owner.

NONPAYMENT OF ASSESSMENTS

Any assessments or other charges or payments that an owner is required to make or is liable for hereunder which are not paid when due shall be deemed delinquent. If an assessment or other charge or payment is not paid within thirty (30) days after the due date, it shall bear interest from the due date at the contract rate permitted in _____, but not to exceed eighteen percent (18%) per annum, and the board (i) may bring an action against the owner personally obligated to pay the same, together with interest, costs, and reasonable attorneys' fees of any such action, which shall be added to the amount of such assessment or other charge or payment and shall be included in any judgment rendered in such action and (ii) may enforce and foreclose any lien which it has or which may exist for its benefit, together with interest, costs, and reasonable attorneys' fees of any such action, which shall be added to the amount of foreclosure judgment. In addition, the board may in its discretion charge reasonable late fees for the late payment of assessments or other charges. No owner may waive or otherwise escape liability for the assessments or other charges or payment provided for herein by nonuse, abandonment, or transfer of his dwelling unit.

Establishing Annual Assessments

Annual assessments are based on the community's budget for the fiscal year. The amount of the *total* annual assessment is the amount of income that the board decides to obtain from owner assessments—given the community association's other income sources. (See the discussion of revenue and expenses in Chapter 5.)

Each owner is assigned a share of the community's annual obligation. Frequently, an owner's share is based on the number of owners in the community or on the square footage the owner's unit occupies.

In condominiums, an owner's share is based on his or her percentage interest in the common elements. Here is the formula for calculating assessment fees for condominium owners:

$$\frac{\text{Total Assessments Required in Annual Budget} \times \text{Percentage Interest as Found in the Declaration}}{\text{Number of Installment Payments in a Year}}$$

For example—

1. Assume a total required assessment of $410,000
2. Assume a percentage interest in the common elements of .4682% for a two bedroom unit
3. Assume monthly payments

$$\frac{\$410{,}000 \times .004682}{12} = \$160 \text{ monthly assessment fee}$$

Always obtain percentage of interest as found in the declaration. Do not rely on prior year's percentages as computational errors can occur and be perpetuated.

Note that the above calculations are among the most common methods for determining an owner's share of the total annual assessment. But also be aware that there are others.

INTRODUCTION TO ESTABLISHING A COLLECTION POLICY

A *formal* collection policy is the foundation of a successful program for:

- Maintaining necessary cash flows
- Reducing financial loss from owner defaults on assessment payments

It provides a systematic approach to delinquencies. It can be done without special owner approval—unless it requires amendments to the governing documents.

CHAPTER 7

FINANCIAL STATEMENTS, AUDITS, INCOME TAXES, & INVESTMENTS

KEY TERMS

Accrual basis of accounting, p. 145
Assets, p. 149
Audit, p. 159
Balance sheet, p. 149
Bond, p. 169
Cash basis of accounting, p. 145
Certificate of deposit, p. 169
Commercial reporting method, p. 147
Comparison to budget, p. 148
Compilation, p. 161
CPA, p. 151
Deficit in members' equity, p. 149
Engagement letter, p. 152
Excess of revenues over expense, p. 147
Expense, p. 148
FDIC, p. 167
Fund balance, p. 149
Fund reporting method, p. 147
GAAP, p. 151
GAAS, p. 153
Income, p. 148
Investment liquidity, p. 168
Investments, p. 165
Investment safety, p. 167
Investment yield, p. 169
Liabilities, p. 149
Management letter, p. 160
Members' equity, p. 149
Modified cash basis of accounting, p. 145
Net income, p. 148
Net loss, p. 148
Notes to financial statements, p. 159
Opinion letter, p. 153
Representation letter, p. 152
Revenue, p. 147
Review, p. 161
Statement of cash flows, p. 154
Statement of changes in members' equity (or fund balances), p. 154
Statement of income and expense, p. 147
Statement of revenue and expense, p. 147
Treasury bills, p. 168
Treasury bonds, p. 168
Treasury notes, p. 168

This chapter provides an overview of additional financial operations for community associations.

It explains:

- Financial reports
- Independent certified public accountant services
- Federal income taxes
- Investments

What You Will Learn

After reading and reviewing this chapter, you should be able to explain and understand the:

- Purpose of financial reports
- Sources of variation in reports among community associations
- Accounting methods used for reports
- Warning signs to watch for when reviewing reports
- Commercial and fund reporting methods
- Statement of income and expense
- Comparison to budget
- Balance sheet
- Role of a CPA
- Engagement and representation letters
- CPA's letter or opinion
- Statement of revenue and expense
- Statement of changes in members' equity (or fund balances)
- Statement of cash flows
- Notes to financial statements
- Audits, reviews, and compilations
- Federal income tax filing *responsibilities* for community associations
- Federal income tax filing *options* for community associations
- Investments for community associations
- Investment checks and balances
- Manager's typical investment duties
- Investment policies and procedures for community associations
- Essential investment objectives

This section provides some background information on financial reports in general.

Financial reports have two primary purposes:

1. To provide their internal and external users with the economic information needed to make appropriate decisions on behalf of the community association.

2. To enable the community association board and manager to control the community's financial operations.

Sources of Variation in Reports Among Community Associations

Do not be surprised if the form and content of your community association's financial statements differ from those of other associations. Variation may be due to the:

- Community association's unique informational needs
- Software package used
- Expertise and experience of the internal users—the owners
- Expertise and experience of the preparers
- Reasons for preparing the report

Accounting Methods Used For Reports

A community association's financial reports will reflect one of three possible accounting methods:

1. **Cash basis:** This method records income when it is collected and expenses when they are paid.

2. **Accrual basis:** This method records income when it is earned (or assessed to owners) and expenses when they are incurred or acquired.

3. **Modified cash basis:** This method records income and expenses on a cash basis with selected items recorded on an accrual basis. Modified cash varies in format depending on the number of items accrued. The most common modified cash basis financial statements record income (assessments) on the accrual basis and expenses on the cash basis.

Warning Signs to Watch for When Reviewing Reports

Here are some warning signs about the financial health of a community association to watch for when you review its financial reports:

- A steady decline in the amount of cash on hand

- The inability or failure to set aside planned additions to reserves (no formal reserve study)

- An increase in the amount of owners' assessments owed to the community

- An increase in the amount the community association owes for bills

- The failure to resolve any differences between bank statements and the financial reports in a timely manner

- Significant and/or unexplained differences between actual and budgeted figures for items (See page 148 for an explanation of the difference between actual and budgeted figures.)

- Members' equity (operating fund balance, retained earnings) balance is less than one to three months of operating expenses

- Unpaid amounts showing as due between funds (when fund presentation is used)

Statistical analysis is helpful in this area. A useful indicator is to evaluate assessment delinquencies as a percentage of annual assessments:

Percent Delinquent	Rating
3% or less	Excellent
4% to 5%	Good
6% to 10%	Poor to Average
Greater than 10%	Deteriorating Financial Position

An association's operating fund should be at 10% to 20% of annual assessments.

INTRODUCTION TO INTERIM FINANCIAL REPORTS

Interim financial reports are prepared during the year to provide the board and management with accurate economic information that will allow them to make decisions and take action in a timely manner. Interim financial reports are often presented on a modified cash basis. For example, a modified cash basis report may include an accrual item such as assessments owed but not paid yet (accounts receivable). This gives a more complete financial picture.

At a minimum, interim financial reports should include:

- A statement of income and expense with a comparison to budget
- A balance sheet

Accompanying information to the financial reports should include:

- Bank statements with reconciliations
- Aged receivables report (amount owed by owners)
- Open payables report (amount owed by the association)

Commercial and Fund Reporting Methods

Most community associations use the **commercial reporting method** for their interim financial reports—as do most of the samples in this chapter.

However, there is a growing trend for community association financial reports to be prepared according to the **fund reporting method**—which is based on fund accounting. The fund reporting method consists of preparing separate columns for operating, reserve, and any special funds. This is different from the commercial method which combines operating and reserve activities in the same column.

Where significant reserve expenditures are occurring or a special assessment is in progress, consider using the fund reporting method to issue separate reports on normal operations, reserve transactions, special assessments, and for the receipt and expense of any litigation/insurance proceeds.

The American Institute of Certified Public Accountants recommends the use of fund reporting for community associations—especially for year-end financial reports.

The two reporting methods also use some different terms for key items:

Commercial	Fund
Members' Equity	Fund Balances
Statement of Income and Expense	Statement of Revenue and Expense
Income	Revenue
Net Income (or Loss)	Excess (or Deficiency) of Revenue Over Expense

Statement of Income and Expense

The **statement of income and expense** records the community association's financial transactions *during a given period of time*—generally for a given month plus the fiscal year to date. It is a way to keep track of the community's financial activity.

The sample statement of income and expense on page 150 reports on a community association's financial activity for the month of April in the first column and the year to date in the second.

There are three major components of a statement of income and expense:

1. **Income:** Income represents the earnings of the community association.
   - Income on a *cash basis statement* consists of money received and deposited.
   - Income on an *accrual basis statement* consists of money earned, including amounts assessed to owners in accordance with the budget.
   - Income can either be received or earned on a *modified cash basis statement.* Generally, however, income is on the accrual basis for a modified cash statement.

   What three types of income are recorded on the sample statement on page 150?

2. **Expense:** Expenses are the cost of goods and services used to operate and maintain the community's property.
   - Expense on a *cash basis statement* consists of any amounts paid.
   - Expense on an *accrual basis statement* consists of any amounts owed, whether or not paid.
   - Expense on a *modified cash basis statement* is generally calculated on a cash basis.

   What two broad categories of expenses appear on the sample statement on page 150?

3. **Net income (or loss):** Net income is the amount left after deducting expenses from income. A **net loss** occurs when expenses are greater than income. A loss is indicated on a statement of income and expense by putting the figure in parentheses. The net income or loss can be significantly different depending on whether a cash, accrual, or modified cash basis is used.

   What is the net income for the actual year to date on the sample statement on page 150?

Comparison to Budget

Comparison to budget involves comparing the community's actual income and expenses with its planned or budgeted income and expenses. This is more meaningful when the budgeted amounts are shown in the months the income or expense occur, rather than simply dividing the total expense by 12 and showing 1/12 each month. For example, snow removal would show in winter months, pool lifeguard in summer months, etc.

When you compare actual figures with budgeted figures:

- Identify all significant differences or variances between actual and planned figures
- Determine the reasons for the differences and notify the board
- Advise the board of any necessary corrective action it needs to take as soon as possible
- On accrual basis reports, the budgeted assessment income should equal the actual assessment income

On the sample statement of income and expense on the next page, the second column consists of the actual income and expenses for the year to date. The third column consists of the budgeted figures for the year to date. Often financial reports will have an additional column showing the variance/difference between actual and budget.

Do you see any significant differences between the two sets of figures that the community association should monitor?

Balance Sheet

A **balance sheet** is a summary of a community's financial position at a specific point in time. It tells you how things stand on a certain date.

A balance sheet summarizes:

- What your community association owns
- What your community association owes
- The "net worth" of the association

It is called a balance sheet because what the community association owns and what it owes to others (including the owners) must balance out. A balance sheet typically is prepared on a monthly basis to allow the community association to track its funding for reserves and accounts receivable. (The sample balance sheets on pages 155 and 156 were prepared for the entire fiscal year.)

There are three major components of a balance sheet:

1. **Assets:** Assets include anything owned that has value. Unlike commercial businesses, however, the actual land and buildings of the community association are not generally shown as an asset. For cash basis reports, cash is the only asset.

2. **Liabilities:** Liabilities consist of what is owed to others or collected in advance (e.g. owner assessments received prior to the billed month).

3. **Members' equity:** Members' equity is called the **fund balance** under the fund method of reporting. It equals the difference between the community association's assets and liabilities. Industry standards suggest a minimum balance of 2-5% of gross assessments with 10-15% being very good.

When a community association's liabilities exceed its assets, this condition is known as a **deficit in members' equity**. It occurs when a community association has incurred expenses that it cannot pay until it collects future assessments from owners.

ABC Condominium Association, Inc.
Statement of Income and Expense
for the Month Ending April 30th and 20XX to Date
(Four Months Ended)
With a Comparison to Budget

	April 20XX	Actual Year to Date	Budget Year to Date
INCOME			
Assessments	$ 62,623	$ 250,492	$ 250,490
Interest	3,894	15,577	15,248
Other	2,050	8,198	5,667
Total Income	$ 68,567	$ 274,267	$ 271,405
EXPENSES			
Administrative:			
Management Fee	$ 3,316	$ 13,265	$ 14,465
Legal & Audit	528	2,111	2,363
Insurance	2,182	8,727	8,653
Telephone	416	1,664	2,364
Other	1,553	6,212	6,322
Total Administrative	$ 7,995	$ 31,979	$ 34,167
Operating:			
Payroll & Related Taxes	$ 12,263	$ 49,052	$ 46,726
Professional Fees and Training	287	1,149	2,000
Utilities	23,964	95,857	103,979
Elevator	1,029	4,116	4,637
Security	328	1,313	570
Lawn Maintenance	531	2,127	3,406
Trash Removal	1,610	6,438	7,003
Pool	1,332	5,328	6,229
General Repairs & Maintenance	6,220	24,879	17,811
Depreciation	250	1,000	—
Income Taxes	1,838	3,677	2,821
Total Operating	$ 49,652	$ 194,936	$ 195,182
Total Expenses	$ 57,647	$ 226,915	$ 229,349
Net Income Before Contribution to Reserves	$ 10,920	$ 47,352	$ 42,056
Contribution to Reserves	(10,514)	(42,056)	(42,056)
Net Income	$ 406	$ 5,296	$ —

A community association may have an operating deficit but will reflect replacement reserves. When this occurs the association is in effect borrowing from reserves to fund operations.

Occasional small deficits are common during a normal fiscal year due to such things as seasonal fluctuations in expenses. A continued or increasing deficit, however, is an indication of an inadequate level of assessments or overspending, and a signal for board action.

Can you locate all three components of a balance sheet on the samples on pages 155 and 156? Notice how the three components balance out:

ASSETS = LIABILITIES + MEMBERS' EQUITY

and

ASSETS – LIABILITIES = MEMBERS' EQUITY

INTRODUCTION TO YEAR-END FINANCIAL REPORTS

Accounting standards are called **GAAP**, Generally Accepted Accounting Principles. Their purpose is to provide uniformity among reports from different organizations.

GAAP requires the following set of year-end financial reports for a community association:

- Balance sheet
- Statement of Income and Expense (or Revenue and Expense)
- Statement of Changes in Members' Equity (or Fund Balances)
- Statement of Cash Flows
- Notes to Financial Statements
- Unaudited supplementary information on future major repairs and replacements

GAAP also requires the use of accrual accounting (see page 145) for certified annual reports.

Because many state statutes and community association governing documents specify the role of a CPA in preparing annual reports for associations, we will begin this section with a discussion of that role. Then we will move on to discuss the various types of reports prepared.

Role of a Certified Public Accountant (CPA)

Community association governing documents and state statutes may require that an independent certified public accountant be involved in preparing a community's annual reports (audit, review, or compilation). An **independent certified public accountant (CPA)** is one who is not a community association employee or owner. There are certain circumstances, however, such as in very large community associations, where an owner is considered to be independent.