BUDGETS & REPLACEMENT RESERVES

WHAT IS A BUDGET?

- A budget is an annual financial plan for an organization.
- A budget provides an estimate of a community's revenue and expenses for a specified period of time.

PURPOSE OF A BUDGET

- To plan community activities.
- To determine assessments.
- To measure and control the financial operations.
- To give continuity to services.
- To maintain quality of life.
- To limit surprises.
- To look at the needs and desires of the community.

ROLES & RESPONSIBILITIES

1. **BOARD OF DIRECTORS**
    - Establishing, approving, and monitoring the community's budget.

2. **TREASURER**
    - Ensuring that the draft budget is prepared & approved.

3. **OWNERS**
    - Voting on the budget. It is important to get the owners involved when proposing:
        - An increase in assessments.
        - Special assessments.

- Major Improvements.
- Funding replacement reserves.

4. MANAGER

- Budget responsibilities are more likely to appear in a contract than in the community's bylaws. You may be expected to:
  - Prepare or be involved in the development of a draft budget.
  - Review it with the Treasurer, Finance Committee, and the Board and Membership.
  - Revise it after any changes are made.
  - Mail a summary of the budget to the Owners **after** board approval unless your Governing Documents or State Statute requires otherwise.

5. FINANCE COMMITTEE

- Helping to draft the budget.

BUDGET COMPONENTS

- **Revenue** – The collective items or amounts of income which are appropriated for common expenses.
- **Expenses** – The cost of goods and services used to operate and maintain the association's common elements.
  - **Operating Expenses**: For the normal and usual expense plus repairs for the Association.
  - **Major Improvement Expenses**: Items added to improve the quality of life, appearance of the property, or enhance property values.
  - **Reserve Account**: Used to pay for long-term repair and maintenance issues.

SOURCES FOR BUDGET REQUIREMENTS

- Legal requirements of State Statutes & Governing Documents.
- Owners' needs and desires (balancing mandatory & discretionary items)
- Committee and Owner feedback.
- Reconciliation of Revenue & Expenses.
- Financial forecasting and analysis of past financial activity.

LEGAL REQUIREMENTS

- **Federal**: Income and Payroll Taxes (IRS), Hazardous Waste Disposal (EPA), Mortgage Requirements (FHA, FNMA, VA, FHLMC).

- **State**: Replacement Reserves & Insurance Requirements.

- **Local:** Property Taxes for common areas, Fees for recycling, or Fees for inspections.

- **Governing Documents:** Determines what property is to be maintained by the Association, what services MUST be offered, and what kinds of revenue can be generated.

REVENUE

Revenue consists of the collective items or amounts of income which are appropriated for common expenses. Revenue typically includes owner assessments, interest, and other revenue.

TYPES OF REVENUE

- **Assessment**: 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.

- **Total Annual Assessment**: Amount of income that the Board decides to obtain from Owner Assessments. Each owner is assigned a share of the community's total annual assessment, which may be paid on a monthly, quarterly, or annual basis.

- **Special Assessment:** 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.

CALCULATING ASSESSMENTS

- **Percentage Method**: Uses the assigned percentage to determine each owner's pro-rata share.

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

- **Equal Method Computation**: Assesses each owner equally for each lot or unit.

$$\frac{\text{Total Assessments Required in Annual Budget} \quad / \quad \text{Number of Units}}{\text{Number of Installment Payments in a Year}}$$

OTHER REVENUE SOURCES

- Rent from commercial tenants.
- Rent from lease of units.
- Charges for resale packages.
- Collection on insurance claims or legal settlements.
- Antenna rental.
- Ad space in the community newsletter.
- User fees.

EXPENSES

There are two types of expenditures in a Community Budget:

- **Mandatory Line Items**: Items based on community and owner needs and requirements that the community is obligated to meet. (ie. Income Taxes, Management Fees, Repairs, Utilities, Maint)

- **Discretionary Line Items**: Items based on Owners, Board and Committee desires. They are items people would like to have. They can also be voted out of the budget. (ie. Social & Recreational expenses, etc.)

EXPENSE CALCULATION METHODS

- **Zero-Base Budgeting**: All line items are set to zero and the amount of funds allotted to each must be justified. The zero-base approach keeps you from accepting this year's figures at face value.

- **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.

MAJOR IMPROVEMENT EXPENSES

Major improvements are items that are not necessarily required, but are **added** to improve the quality of life for the residents, appearance of the property, or to enhance the value of the community association as reflected in the resale value of units. They last more than one year and involve a large amount of funding.

They are usually voted on by the members and paid for in one of three ways:

1. Money set aside over time until enough money has been raised.
2. A loan, with the loan payments becoming part of subsequent year's operating expenses.
3. Special assessment, which is generally discouraged as it can be difficult for owners on fixed income to pay special assessments, and it doesn't spread the cost over current and future owners.

THE RESERVE ACCOUNT

A reserve account consists of funds put aside, in reserve, for the **replacement** of major components of a community's common property. (Typically used to replace asphalt paving, concrete sidewalks, roofs, swimming pools, tennis courts, elevators, etc.)

REASONS FOR MAINTAINING A RESERVE ACCOUNT

- Meets legal, fiduciary, and professional requirements.
- Provides for the planned replacement of major items.
- A reserve account equalizes the contributions of old and new owners.
- Minimizes the need for special assessments.
- Enhances resale values.

CONDUCTING A RESERVE STUDY

A reserve study is a budget planning tool with 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 is essential.

The **reserve study** is used for developing a reserve account budget. The study addresses all major common physical components of the property that the association must repair, replace, restore or maintain. **Reserve Specialist (RS)** is a CAI designation awarded to qualified reserve specialists who, through years of specialized experience, can help ensure that community associations prepare their reserve budget and reserve studies as accurately as possible.

THE VALUE OF A RESERVE STUDY

- Fulfills fiduciary responsibility.
- Meets individual state requirements (for regulated states)
- Complies with the American Institute of Certified Public Accountants (AICPA).
- Reduces personal liability from claims of financial mismanagement.
- Saves valuable time with prioritized business plan for capital repairs and replacements.
- Effectively communicates the physical components and priorities to keep owners informed.
- Identifies maintenance issues that haven't been budgeted in ongoing operations.

CONSEQUENCES OF NOT HAVING A RESERVE STUDY

- **Underfunding**: This may result in special assessments, bank loans, deferred maintenance, or a combination of these.

- **Overfunding**: This can result in current owners paying too much (more than owners "fair share"), for the benefit of future owners.

- **Board Member Liability**: This can expose them to claims of fiscal irresponsibility and loss of Directors & Officers insurance coverage.

THE REPLACEMENT RESERVES SCHEDULE

- The replacement reserves schedule is a framework for accumulating and spending the funds for replacing major components of the property.
- The funds are put aside over a period of time to ensure that adequate amounts are available to replace components.
- 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.

BUDGET PRESENTATION

Two questions to help you prepare for your budget presentation:

- 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?

Two common mistakes to avoid when presenting a budget:

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

When preparing to present your budget:

- Identify items your audience is interested in.
- Identify comparisons or trends to help understand estimates.
- Decide what visuals will make it clearer.

COLLECTING ASSESSMENTS

DEFINITION OF AN ASSESSMENT

Assessments (sometimes called maintenance fees) are the owners' financial obligations to a community association during a given period of time. They cover the owners' share of the common expenses.

- An **annual assessment** may be paid on a monthly, quarterly, or annual basis.
- A **special assessment** is a one-time assessment, often voted on by owners, to cover a major expense that was not included in the annual operating budget.

AUTHORITY TO COLLECT ASSESSMENTS

The authority to collect assessments can come from three sources:

- Federal laws and regulations.
- State statutes.
- Governing documents.

CONSEQUENCES OF DELINQUENT PAYMENTS

- Increases assessments to cover the deficit.
- Essential maintenance deferred due to lack of funds.
- Property beginning to appear run-down, which in turn reduces property values.
- Shortfalls added to the next year's operating budget if any monies are outstanding at the end of the year.
- Borrowing from otherwise restricted community association funds.
- Borrowing from a lender.

- Disharmony between paying owners and delinquent ones.
- Inability to obtain mortgages on lots or units in the community.

CHARACTERISTICS OF AN EFFECTIVE COLLECTION POLICY

- Established by a formal resolution of the board.
- Specifies only actions that are within the power of the association and its board.
- Sets a firm due date for assessments.
- Outlines the steps to be taken when a payment is late.
- Allows for discretion in special cases.
- Specifies when a delinquent assessment should be referred to legal counsel.
- Provides for the collection of any costs associated with collecting delinquent assessments.

When a payment is late, your community association's collection policy should tell you:

- When late notices are to be sent and how frequently.
- What late notices should say.
- What late or collection fee to assess the delinquent owner.
- When collection should be turned over to legal counsel.
- When to **accelerate assessment payment** (the collection of all assessments due through the end of the fiscal year).

LEGAL REMEDIES – (EXTRA JUDICIAL REMEDIES)

- Impose late fees.
- Require security deposits.
- Suspending owner's privileges and voting rights.
- Acceleration

LEGAL REMEDIES – (JUDICIAL REMEDIES)

- **Perfecting a lien on the unit.**
  A lien is a legal claim by one party (community association), on the property of another (delinquent owner), to obtain the payment of a debt or the satisfaction of an obligation.

- **Foreclosure of the unit.**
  Foreclosure is a legal proceeding filed in court whereby a party with a claim against an owner can claim ownership of the unit involved in order to recover the money it is owed. If there is little or no equity in the property, the association may not get the money it is owed.

- **Sue the owner for a personal money judgment.**
  A personal money judgment or summary judgment is a decision by the judge to allow the community association to claim the owner's personal property to settle a delinquent account.

BANKRUPTCY

- **Immediately** contact legal counsel when you become aware of a bankruptcy filing by an owner.
- **Immediately** forward any bankruptcy notices to your legal counsel.
- **Immediately** stop all collection efforts.

Prompt filing of a lien **can** make a difference in getting money owed to the community association.

The association still has the right to collect any **new** charges as they are incurred after the owner files bankruptcy, although only an attorney can continue the collection efforts.

TYPES OF BANKRUPTCY

- **CHAPTER 7 –** Straight bankruptcy or liquidation for an individual or corporation.

- **CHAPTER 11 –** Corporation reorganization (allows a corporation to continue to operate).

- **CHAPTER 13 –** Personal reorganization (allows for a payment plan over a period of time to pay debt).

Uncollectible debts should be written off as a bad debt.

SOLUTIONS FOR COLLECTION SHORTFALLS

- Levying a special assessment.
- Raising the regular assessments for the coming year.
- Creating a reserve for bad debts in the budget.
- Cutting this year’s expenses.

FINANCIAL STATEMENTS, AUDITS, INCOME TAXES & INVESTMENTS

ACCOUNTING METHODS USED FOR REPORTS

- **CASH BASIS:** Revenue is recognized when RECEIVED and Expense is recognized when PAID.
- **ACCRUAL BASIS:** Revenue is recognized when EARNED and Expense is recognized when INCURRED.
- **MODIFIED CASH BASIS:** Revenue is recognized when EARNED and Expense is recognized when PAID.

FINANCIAL STATEMENTS

Financial statements have two primary purposes:

1. To provide information for making appropriate decisions about the community association.

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

COMPONENTS OF FINANCIAL STATEMENTS

- Statement of Revenue & Expense.
- Balance Sheet.
- Subsidiary Reports, such as bank statements, aged receivables, and open payables.

STATEMENT OF REVENUE & EXPENSE

There are three major components of a Statement of Revenue & Expense:

1. **Revenue:** Represents the earnings of the community association.

2. **Expenses:** Are the cost of goods and services used to operate and maintain the community's property.

3. **Net Revenue**: Also known as Excess Revenue over Expenses, is the amount left over after deducting expenses from income.

BALANCE SHEET

The balance sheet is a summary, or snapshot, of the financial condition of the association at a specific point in time. It reflects:

- What your association owns. (Assets)
- What your association owes. (Liabilities)
- The "net worth" of the association. (Members' Equity)

Assets = Liability + Member's Equity

Assets – Liabilities = Member's Equity

COMPONENTS OF A BALANCE SHEET

1. **Assets:** Anything owned that has value.

2. **Liabilities:** What is owed to others or collected in advance.

3. **Member's Equity or Fund Balance**: The difference between the community association's assets and liabilities.

If liabilities are greater than assets, there will be a deficit in member's equity.

If liabilities are less than assets, there will be a surplus in member's equity.

VARIATIONS IN APPROACH

Variation between your community association's financial statements and others may be due to:

- 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.
- Formatting.

WARNING SIGNS

- A steady decline in the amount of cash on hand.
- The inability or failure to set aside budgeted additions to replacement reserves (or no formal reserve study has been conducted).
- 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 reconcile bank statements monthly.
- Significant and/or unexplained differences between actual and budgeted figures for items.
- Unpaid amounts showing as due between funds.

STATISTICAL ANALYSIS

Evaluate assessmt delinquencies as a percentage of annual assessmts.

- Excellent = 3% or less.
- Good = 4-5%.
- Poor to Average = 6-10%.
- Deteriorating Financial Position = Greater than 10%.

YEAR-END REPORTS

Accounting standards are called GAAP – Generally Accepted Accounting Principles.

GAAP requires the following set of year-end financial reports for Community Associations:

- Balance Sheet.
- Statement of Revenue & Expense.
- Statement of Changes in Member's Equity (or Fund Balances).
- Statement of Cash Flow.
- Notes to Financial Statements.
- Unaudited supplementary information on future major repairs and replacements.

ROLE OF THE CERTIFIED PUBLIC ACCOUNTANT (CPA)

There are three types of reports that a CPA typically provides:

- **Audit:** An examination of the accounting records and procedures of an organization for the purpose of verifying the accuracy and completeness of financial records.

- **Review:** A less thorough, and therefore less costly, review of a community association's financial activities.

- **Compilation:** A presentation of financial statements by a CPA without the assurance that the information conforms to GAAP.

FEDERAL INCOME TAXES

Community association managers must be familiar with federal income tax requirements and options for two reasons:

1. To determine tax status.
2. To reduce tax obligation.

FEDERAL INCOME TAX FILING RESPONSIBILITIES

- File tax returns annually.
- Pay tax returns by the 15th day of the third month.
- Pay for years that were unpaid.
- Make estimated payments, if necessary.

INVESTMENTS

Investments involve the purchase of anything with money value for the purpose of generating additional money over time (ie. Savings Accounts, etc.)

Typically, a community association manager is expected to:

- Maintain an accurate accounting system.
- Document all transfers of funds.
- Track investments.
- Provide referrals to Professionals (Do not provide specific advice).

INVESTMENT OBJECTIVES

- **Safety:** Protecting the Principle from loss.
  (Principle = the amount of original investment)

- **Liquidity:** The ease with which an investment can be converted into cash or a cash equivalent.

- **Yield:** The amount of return on an investment.

ASSET PROTECTION MEASURES

- Know the association's federal tax identification number (FTI).
- Use a lock box system for deposits.

- Require dual signatures for all withdrawals.
- Segregate and safeguard your association's replacement reserves.
- Require that statements of operating and reserve accounts be sent every month.
- Check invoices against checks paid and the original receipts for credit card accounts, if any.
- Shop around for bank services.
- Know the association's insurance company and consult with the agent.
- Insure the association's money.
- Do not combine funds with other associations.
- Regularly engage an independent CPA to conduct an audit.