

# Ten Things You Can Learn From Your Association's Financial Statements

Presented by  
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## Top Ten .....

1. Auditors' Report
2. Accounts Receivable Balances
3. Interfund Balances
4. Replacement Fund Study
5. Replacement Fund Balance and Activity
6. Working Capital and Operating Fund Balances
7. Deferred Maintenance Fund
8. Sponsor Income
9. Largest Expense Line Item
10. Budget to Actual Variances



1. What does the auditors' report say about the Association's financial statements?
2. How does the accounts receivable balances affect the financial statements and the budget process?
3. What do interfund balances mean and what should you do about them?
4. What is the significance of the replacement fund study?
5. What does the replacement fund tell us about the Association?
6. What does working capital mean? What about the operating fund balances?
7. Are you using a deferred maintenance fund?
8. How does sponsor income effect your budgeting?
9. How can your largest expense line items help in budgeting?
10. How can budget to actual variances help in budgeting for future years and modifying your behavior in the current year?

## Auditors' Report

- The standard report
- A “clean opinion”
- Four standard paragraphs



What is the auditors' report?

This is the independent auditors' report on the Association's financial statements. This is OUR report on YOUR financial statements

The standard report is the most common. The standard report is considered the “clean opinion.”

A clean opinion states that all professional auditing standards are followed and all generally accepted accounting principles are followed.

There are four paragraphs to the standard auditors' report.

## Auditors' Report

### First Paragraph:

We have audited the accompanying balance sheet of Sample Condominium Association, Inc. as of December 31, 2009 and the related statements of revenues and expenses, changes in fund balances, and cash flows for the year then ended. ***These financial statements are the responsibility of the Association's Board of Trustees. Our responsibility is to express an opinion on these financial statements based on our audit.***



This is the first paragraph.

The report is addressed to the board of directors/trustees and lets everyone know what period the financial statements relate to. While we, as the independent auditors, give an opinion on the financial statements, the financial statements, are in fact, the responsibility of the Board.

## Auditors' Report *(cont.)*

- Second paragraph – tells what we did
- Third paragraph – the opinion paragraph



The second paragraph states how we did our audit. It says that we applied generally accepted auditing standards. These same auditing standards apply to each and every audited financial statement in the United States regardless of whether the entity is large, small, public or privately-owned.

The third paragraph is the opinion paragraph. It says that your financial statements are presented in accordance with generally accepted accounting principles and are fairly presented.

## Auditors' Report *(cont.)*

### Fourth paragraph

*“The supplementary information of future Major Repairs and Replacements is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of the board regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.”*



The fourth paragraph is specific to common interest realty associations. It discusses the supplemental information. The American Institute of Certified Public Accountants has required that common interest real estate associations disclose a summary of the replacement study or schedule that was prepared for use in determining the annual funding required for the replacement of common property. A summary of the estimated replacement costs and remaining useful lives (at the time of the study) is disclosed as a separate page in the financial statements. It appears after the Notes to the Financial Statements. We do not audit this information. We don't audit the lives/costs that are included in the study. However, we do apply certain procedures. Additionally, we also look at the age of the study to determine its relevance.

Sometimes we may need to modify this paragraph if we have doubts about the study:

- If the study is old
- If costs are outdated
- If the study doesn't include estimated lives
- If the study doesn't include methods of measurements

## Auditors' Report *(cont.)*

### Alternatives to the standard report:

- Emphasis of matter
- Qualified Opinion
- Disclaimer of Opinion



Sometimes we as the auditors can't give the standard report. Why?

- Sometimes accounting principles are not followed
- Sometimes standard auditing procedures cannot be performed.

There are three alternative to the standard report

1. Emphasis of matter

The emphasis of a matter is added after the opinion paragraph. We will add this, if we, as auditors want to tell the reader even though the financial statements received a "clean opinion" we want to emphasize this other item that needs a extra attention. For example if the Board of Trustees has elected to only partially adopt the funding recommendations of a replacement study

2. Qualified Opinion

For example if accounting principles have not been followed, we would need to issue a qualified opinion. We would add a paragraph explaining the departure from generally accepted accounting principles before the opinion paragraph and then modify the opinion paragraph.

3. Disclaimer of Opinion

We would need to do this if we couldn't perform an audit step that is so material it effects the whole financial statements. For example, the board refuses to sign the client representation letter. We would change the last paragraph to give no opinion on the financial statements.

## Assessments Receivable

- Economic environment
- Allowance for doubtful accounts



Assessments receivable represents the amounts due from unit owners for maintenance fees that have been billed.

### 1. Economic Environment

In today's economic, unit owners may become delinquent on assessments. As unemployment rates rise, there may be a corresponding increase in the delinquency rate.

### 2. Allowance for doubtful Accounts

If Assessments Receivable has increased, then you will probably have to estimate an "allowance for doubtful accounts". This means the board/management has to estimate the amount of receivables that may not be collected.

## Assessments Receivable *(cont.)*

- **Bad debt expense**
  - Less cash collected
  - Budget an expense each year
  - Action items to correct:
    - Aggressive structured collection program
    - Monitor assessments receivable on a regular basis
- **Loss of cash flow**
  - Lack of investment income
  - Can't fund reserves
  - Delinquent payments to vendors



The effect of nonpayment of maintenance fees:

1. You will need to budget for bad debt
  - If unit owners do not pay, then the Association will collect less cash than what was expected.
  - Your budget line item for revenue assumes each unit will pay full fees for the full year. But if some units aren't going to pay, then need to account for that in the budget as an expense using a line item called "bad debt expense". How do we determine what to budget?
    - Look at last year's amount of uncollected assessments and then increase.
    - Budget an amount each year, don't wait until foreclosure.
    - Don't be caught short.
    - Action items to help minimize the problem.
      - Aggressive structured collection program
      - Involve your attorney early in the process
      - Monitor assessments receivable on a regular basis
      - Don't let amounts due grow to such an extent that they become almost impossible for the unit owner to repay.
2. A result of nonpayment of maintenance fees is loss of cash flow. If everyone owes money, then you don't have cash in the bank. If you don't have cash in the bank then:
  - You can't invest and earn investment income, which can effect the budget.
  - You can't fund reserves and may end up with interfund balances.
  - You can't pay vendors on time and may end up with late fees and fines.

## Interfund Balances

### How does this happen?

- One fund paid another fund's expenses  
*or*
- Transfers of cash for monthly budgeted allocations was not done

### Why do we have to eliminate the interfund?

- Need to keep the funds intact
- IRS implications
- Helps to know where you stand



The Association is required to follow fund accounting. They have separate funds and cash accounts for:

- Operating Needs (day to day running of the association)
- Deferred Maintenance Needs
- Replacement Funding

1. How does an interfund balance occur:

- One fund paid another fund's expenses *or*
- Transfers of cash for monthly budgeted allocations was not done.

Why were the transfers not done:

- Cash constraints
- Operating fund deficits

2. Why do we have to eliminate the interfunds?

- You want to keep each fund intact. Each fund is established for certain needs. You want to be sure that there is enough cash in the specific accounts to pay for the needs of the fund.
- There are tax implications if you don't pay back amounts due to the replacement fund. If money is due to the replacement fund then the association is not meeting guidelines set up by the IRS to segregate funds for capital reserves. There is the potential that accumulated replacement funds may be taxable.
- It helps to know where you stand. Do you have available cash?
- Is there an interfund due to a operating fund deficit? Then you may need to reduce the deficit to obtain the money. Budget a line item "deficit reduction" in the next year and subsequent budgets.

## Replacement Fund Study

- What does your study tell you?
- What if your study is old?
  - Current replacement costs higher than in study
- Compensate for outdated costs
  - Fund more than recommended
- Board's fiduciary responsibility



### 1. What does your study tell you?

The study is usually done by an engineer. It tells you how much to put away each year to fund for future replacements of common property. If you put away the correct amount each year, then can avoid large assessment increases or special assessments.

### 2. What if your study is old?

Then actual current replacement costs may be higher than in study. If you are funding on an old study, then it is likely that what you are budgeting for replacement needs is not sufficient. Rising costs in energy and basic resources may mean that replacement costs are probably much higher than what is included in an old study.

### 3. Compensate for outdated costs

If monies put away are not sufficient, then you may need special assessment when it is time to replace the common property. How can that be avoided? Fund more than recommended by the engineer to account for inflation or increased prices.

### 4. Board's fiduciary responsibility

It is the board's fiduciary responsibility to plan and save funds to ensure that adequate funds are available for the repair and replacement of common elements.

## Replacement Fund Study *(cont.)*

- Types of funding
  - Full funding
  - Threshold funding
  - Baseline funding
- Updating study



The replacement fund study not only includes the replacement costs and estimated remaining lives of the common elements. It also gives options on how to fund for these replacements. There are 3 accepted funding methods that can be used to fund for the replacement of common property.

1. Full funding
  - Each item in the study is fully funded based on each items expected life.
  - It's the most conservative approach.
  - The association will have the highest accumulated balance in the replacement fund.
2. Threshold funding
  - Funding is based on a cash flow analysis (usually over 30 years) so that lowest balance in the replacement fund at a point in time would not be lower than a set percentage of estimated replacement costs.
  - It is usually five or 10 percent.
  - There is a lower annual contribution than full funding.
  - There is a lower accumulated balance than full funding.
3. Baseline funding
  - Funding is based on a cash flow analysis (usually over 30 years) so that lowest balance in the replacement fund at a point in time is zero.
  - There is a lower annual contribution than full funding or threshold funding.
  - There is a lower accumulated balance than full funding or threshold funding.

It is important to update study every 3 to 5 years. If using threshold or baseline funding you need to make sure that study is updated frequently (every 3 years) so that you take into account rising costs and expenditures that are made before expected. The study should be updated after major expenditure, since you may have reduced balance below the minimum threshold. Otherwise in times of rising costs and major expenditures, may not have enough funds available as needed and if you don't have enough funds available when needed, may end up with a special assessment.

## Replacement Fund Balance and Activity



- Common Property Replacement
  - Same or better
    - Green product
    - Higher current outlay may reap long term benefits
  - Replace sooner than planned
    - Save on expected rising costs
    - May be able to bundle projects and save money
- Effect on Funding
  - Using funds allocated for other projects
  - Use operating funds

1. The replacement study usually assumes replace common property with like common property. Consider this though:

- Do you want to replace with same or with better?
  - Or do you want to replace with “green product”?
  - A higher current outlay may reap benefits in long term.
    - A longer replacement period
    - Energy savings
    - Possible energy tax credits
- Do you want to replace earlier than planned?
  - You may want to save on expected rising costs.
  - You may want to take advantage of bundling projects to obtain lower prices.

2. What is the effect on funding?

If you are either replacing early or replacing with better, then you are in all likelihood using more funds than had been accumulated/set aside.

- Was it paid for out of replacement fund?
  - Then you probably used funds that were allocated for other common elements and you’re basically borrowing from amounts set aside for other replacements. You’ll need to update study/cash flow to reflect monies spent to include in listing of common property so can start to fund for it.
- Was it paid for out of operating fund?
  - The association can pay for it out of the operating fund if you have a surplus. This does not deplete the funds in the replacement fund.

You need to update study to include in listing of common property so can start to fund for it. Replacing with better effects annual funding and you’ll need to increase funding to meet the higher expected replacement costs.

## Working Capital

- What is working capital?
  - Money accumulated for the peaks and valleys of cash flow/bank balances
  - Allows Association to have funds to pay for unanticipated expenses.
  - May be required by documents
- How is it accumulated?
  - Collected at closings per the documents
    - May have restrictions
  - Accumulated operating surpluses



How is working capital accumulated?

- Many of the associations documents call for working capital to be paid at closing. It may be one or two months of maintenance fees. These funds are not considered revenue.
- It can also be accumulated by having excess revenues over expenses in a given year. This excess becomes the operating surplus and the operating fund balance.

## Working Capital *(cont.)*

- What balance is generally adequate?
  - Generally 1 to 3 months of operating expenses



What balance is generally considered adequate?

- Approximately one to three months of operating expenses.
- Consider the variability of expenses from year to year.
- Don't just look at one year to determine the appropriate balance.
- You need to adjust for unusual ups/downs in that year.
- You need to consider the size of the association.

## Working Capital *(cont.)*

- Working capital/accumulated surplus too low?
  - Will probably have cash flow problems
    - Slow payment to vendors
    - Lack of cash for seasonal expenses
    - No hedge against future deficits
  - Contingency line item in budget
- Accumulated Deficit
  - Budget for deficit reduction in future budgets
  - How did this happen?



1. If the association has a lack of working capital/surplus then it will probably have cash flow problems. Problems the association can experience include:

- Slow payment to vendors
- A lack of cash for seasonal expenses.
  - As an example, perhaps snow clearing costs were high early in budget year, before all the dollars were collected for this type of expense.
- There is no hedge against future deficits.
  - A surplus can help with a deficit in a future year.
  - Without a surplus to help cover the deficit, could cause unnecessary maintenance fee increases.

Have a contingency line item in annual budget to cover unanticipated expenses and unanticipated variances.

2. Accumulated deficits

- Budget a line item in future budgets for deficit reduction. This will be a non-cash expense line item.
- You need to determine why the deficit occurred and then fix the reason. This will be discussed in future detail later in the presentation.

## Working Capital (cont.)

- Accumulated surplus is too high?
  - Maybe collecting money not needed
  - Options:
    - Carry forward to offset future assessments
    - Utilize for special projects
    - Use as additional contribution to replacement fund (in following year)
    - Long-term uses

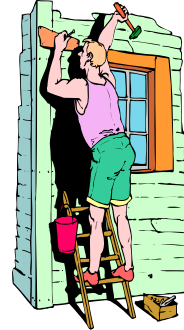


If working capital is too high due to accumulated surplus, then the Association may be collecting money that is not needed. Options for use are:

- Consider it as revenue in the next budget cycle and as an offset of maintenance fees.
  - Be careful though, you don't want to reduce maintenance fees. Rather use the surplus as a hedge against a larger increase.
- Consider it for special projects.
  - Look around and evaluate projects that you didn't think you had the funds for.
  - Think about using it to upgrade common property.
- Use it to increase your replacement fund.
  - Remember though that you need to do that in the next budget cycle as all contributions to the replacement fund must be communicated to the unit owners.
- Think long-term. You may have projects that are a few years off. Consider earmarking the funds for that.

## Deferred Maintenance Fund

- Purpose
  - Accumulate funds for expenses that occur less frequently than annually
- How to fund
  - Budget annually
- Types of expenses
  - Painting
  - Mulching
  - Powerwashing



### 1. What is the purpose?


- A deferred maintenance fund helps to accumulate and pay for those things that occur less frequently than annually.
- If you have a fund, you can save annually for an expense that occurs every two or three years. There is no variation year-to-year for this kind of expense.
- If you don't have one, then you will have a really large expense in the year that the expense is incurred.

### 2. How do you fund it?

- Estimate the total costs of these major expenses that occur less frequently than annually. Determine how frequently this maintenance will be done. Based on these two variables, determine the annual amount that should be saved. Include this annual amount in your budget as a line item for Deferred Maintenance Funding.

# Sponsor Income

- Sponsor Income
  - Payment of unit fees
  - Payment of deficits
  - Payment of benefits derived
- Sponsor provided services



Sponsor income is temporary and will go away as units sell. It is also dependent on Sponsor's financial condition. Consider, once all units are sold, will maintenance fees on these units cover the sponsor income?

1. Sponsor income can be received by various means. Three most common are:
  - Payment of unit fees
    - As these units close, maintenance fees will be paid by new unit owners. This may have no effect.
  - Payment of deficits
    - The sponsor may have agreed to fund the operating deficit. If this is the case, you need to consider if as units close, these maintenance fees on unsold units will equal the subsidy. If not, may be looking at large increase in fees. Consider, have fees been kept artificially low?
  - Payment of benefits derived
    - Is sponsor paying based on a calculation of benefits derived? You need to consider if as units close, these maintenance fees will equal the subsidy. If not, may be looking at large increase in fees.
  
2. Sponsor provided services

Is sponsor providing services such as landscaping and snow clearing? Once sponsor is gone, will the maintenance fees collected cover these additional expenses? Budgets should include the costs of these services so maintenance fees cover them.

## Largest Expense Line Item

If you can reduce the largest line item, you may be able to cut maintenance fees.

- Energy
- Payroll
- Balance cost savings vs. value of services to community

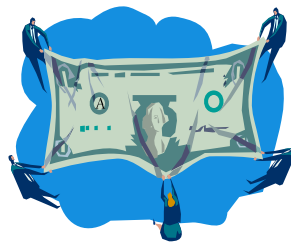


Review the largest line items in your budget.

- Energy
  - Consider locking into a contract to gain savings.
  - Purchase utility in bulk.
  - Purchase energy efficient items.
  - Consider the payback and effect on cash flow. Cash flow may be positive.
  - Solar power is also a consideration.
- Payroll
  - Consider outsourcing various employee roles.
  - Porter/valet services - Are hours of coverage necessary? Or consider hiring services that specialize in this rather than employees
  - Overstaffing/service levels
    - What level of service is necessary?
    - What is expected by the community?
    - Will a decrease in service levels be acceptable?

## Budget to Actual Variances

- Actual expense greater than budgeted?
  - Must monitor monthly financial statements
    - Adjust spending for remainder of year
  - What caused the variance?
    - Understand reasons
  - Effect on future years' fees



Are actual expenses greater than budgeted?

- You need to monitor monthly financial statements on an ongoing basis for these variances. This is very important. These variances will tell you if you need to adjust spending during the remainder of the year. If done on time, you may avoid a deficit.
- What caused the variance?
  - Was it a fluke? If so, keep budget the same.
  - There is an advantage to having working capital surplus to help with these unexpected variances.
  - If it was a really large actual over budget variance, may want to special assess for just that line item.
  - Was it because the budget was unrealistic? If so, you will keep having deficits and you will need to increase the budget in subsequent years and increase fees.
  - You need to be realistic as to actual costs.
- What is the effect on future years' fees?
  - If there are large variances of actual over budget you will need to increase fees.
  - If there are no variances of actual over budget you will want to increase fees minimal amount so that you keep unit owners used to fee increases. This will also help to avoid large increases in other years.

## Questions?

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