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In this issue... Budgeting Matters

WHAT TO DO WITH YOUR ASSOCIATION'S INTEREST INCOME

By Jules C. Frankel, CPA, MBA

It is that time of the year when many Associations are completing the budget process for the upcoming calendar year. One of the common debates is what to do with the interest (and dividend) income that will be generated by the Association's savings and investments. Two basic choices exist. The first is to utilize all of the interest to subsidize operations; the second is to keep the earnings in each respective fund. This article will explore the pros and cons of each approach.

Background

In order to ensure observance of limitations and restrictions placed on the use of resources available to an Association, Associations generally follow the principles of fund accounting. In layman's terms, this allows the Association to separately track financial transactions by major type of activity. For most Associations, this translates into three types of funds:

- **Operating Fund** – which represents funds that are available for the general operations of the Association.
- **Deferred Maintenance Fund** – which represents funds to be utilized for maintenance services which occur less frequently than annually (i.e. painting, staining, power-washing, etc.).
- **Replacement Fund** – which represents funds accumulated over the lives of capital assets so that sufficient amounts are available to pay for their eventual replacement.

At times, other special purpose funds, such as a Capital Improvement Fund or an FRT (Fire Retardant Treated) Plywood Fund may be established. A detailed discussion of these other types of funds is beyond the scope of this article.

Generation of Investment Income

Generally, replacement funds are in the mode of accumulating the largest sums of unspent monies. As a result, this fund would normally generate the most investment income. Since deferred maintenance funds normally accumulate smaller amounts of funds for shorter durations of time, investment income would usually be less than that generated by replacement funds. Since most operating funds are designed to operate at, or close to a break-even situation, investment income generated by the operating fund would usually be even less. (This may not be true if the Association has a large working capital fund or large escrow deposits as part of the operating fund.)

Therefore, most Associations will find that the amount of investment income generated is in the following order: The replacement fund, followed by the deferred maintenance fund, and then followed by the operating fund. How to use the income that is generated, is the key question.

The Key Question

There are two basic choices that an Association can make:

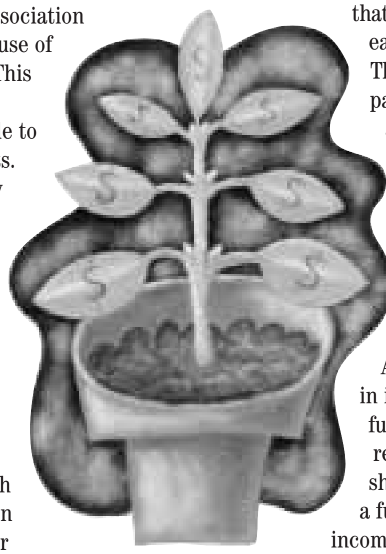
1. Allocate all investment income for use in supporting operations.
2. Let each fund "keep" the interest that it generates.

(Continued on Page 2)

In short, whether or not to allocate all interest for use by the operating fund is the key question. Let's explore the pros and cons of the different choices.

1. Allocate All Investment Income To The Operating Fund

The one overriding benefit of allocating all investment income to the operating fund, is that an Association can "subsidize" its operations through the use of the income generated by the other funds. This might assist an Association in maintaining assessments at a given level or in being able to limit increases in maintenance assessments. This approach also provides an opportunity to use these funds to strengthen the operating fund, if necessary.



This raises a potential issue: When the Association allocates its income in this manner, it means that the Association is not generating sufficient assessment revenue from its members to cover its expenses. In reality, it is subsidizing its operating budget with monies that could perhaps, more appropriately remain in each respective fund. The Association would then need to determine it's preferred method for addressing a potential operating deficit. Let's look at the other option.

2. Investment Income Should Remain In Each Respective Fund

Many engineers perform replacement ("reserve") studies using current replacement dollars. This may create what is known as "inflation risk". That is, as time passes, inflation may cause actual replacement costs to be higher than current replacement costs. Allowing investment income to remain in the replacement fund will partially offset the effect of inflation on future replacement costs, but under this scenario, a supplemental source of funds may be required to offset inflation's impact on the fund.

"Regardless of the approach to allocating investment income, periodic reserve study updates are essential in ensuring that the reserve fund stays on track."

To address this, some engineers factor inflation into their replacement studies. They include assumptions about both inflation and interest rates. Inherent in such studies, is the assumption that the Association will leave investment interest earned by the fund, in the fund.

A similar philosophy could be used for deferred maintenance activities. Prices for items such as painting, staining, power-washing, etc. may increase over time. Leaving investment income in the deferred maintenance fund will partially offset the effects of inflation on such increases.

The primary negative to this approach is that the operating fund would not be subsidized by the investment income generated by an Association's other funds.

My Recommendation

I confess to a personal bias; I tend to be fiscally conservative in these matters. Accordingly, I would prefer that Associations utilize the approach of allowing each fund to keep the interest that it generates. This allows investment income to be used to partially offset the effects of inflation. In addition, it forces an Association to balance current operating expenses with current assessment levels. While I know that some Associations do not agree with this approach, I would hope that an Association Board will consider the philosophical underpinnings of both approaches.

Regardless of which approach the Association utilizes, it should be consistent in implementing the approach across all of it's funds. That is, the integrity of the engineers' reserve fund calculations will be invalidated should the Association elect to subsidize a fund balance by re-allocating the interest income to a different fund.

Having said that, every Association must make a decision most appropriate to their needs and fiscal situation. Regardless of the approach to allocating investment income, periodic reserve study updates are essential in ensuring that the reserve fund stays on track.

A Couple of Final Issues

Regardless of the approach adopted by an Association, Board members should also consider two final issues. They are:

- **Accounting** – reflection in the budget of how investment income will be utilized by the Association.

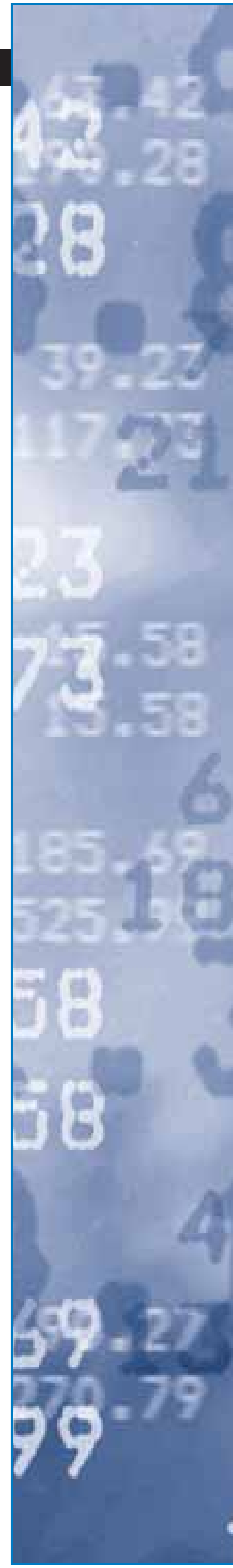
  If it is decided to allocate investment income to each fund which earns it, then this should be clearly reflected by showing gross investment income in the "revenue" section of the budget and by recording estimated investment income as an "expense" underneath the allocation of assessments to each fund.

  If it is decided that the monies will be used to subsidize operations, gross investment income should be reflected as revenue on the budget, with no allocations of such monies to the respective funds.

- **Tax payments** – which fund should pay for the related taxes? Some Associations take the approach that the fund that realizes the benefit of the investment income should be responsible for paying for the income taxes that accompany that benefit. Other Associations assign the responsibility of income tax payments entirely to the operating fund. Boards should consciously decide on the appropriate approach for their Association and reflect this choice clearly in the Association's budget.

Any Questions?

If you have any questions on this topic, or would like any additional input, feel free to call me or to call your Wilkin & Guttenplan, PC advisor.



BUDGETING IN A NEW ECONOMY

By: Gary B. Rosen, CPA, CFE

As the booming growth of the early millennium gives way to the struggling economy of today, Boards of Common Interest Realty Associations are faced with new challenges. Central to this issue: With the likelihood of more limited financial resources available to them, Board members may want to review their financial strategies for maintaining the quality of life to which their Association members have become accustomed.

In order to achieve this goal, the Board and/or the Finance Committee should have an annual budget that realistically reflects the needs of the Community. This budget should contain comprehensive detail of all of the Association's expenditures, as well as, bad debt expense or a provision for doubtful accounts. With the economy considerably weaker than it has been in recent memory, corporate America is under increasing pressure to meet its profit targets and trim expenses to boost its bottom line. Accordingly, many individuals may lose their jobs; this could potentially compromise unit owners' ability to fully fund their obligations to the Association. As such, this potential lost revenue could leave a meaningful void in the Association's finances. To account for this possibility, I recommend that an Association include a line item for those members who may not be able to meet some, or all, of their annual obligations. As a starting point, I would suggest a "look back" at last year's payment history. However, I would recommend that one "err on the side of caution" when calculating this line item.

A second area which could impact the Association's revenues in 2002 is the reduction of non-membership-related sources of income. Federal Reserve Board Chairman Alan Greenspan continues to fight the economic slow down by reducing interest rates to their lowest levels since World War II. Therefore, those Associations who count on this interest income to supplement their operating, or bolster their capital replacement funds, may find themselves with less money available in the coming years. A prudent approach to managing this situation could be to work with a trusted financial advisor and the Association's auditor and/or engineer to determine the Association's future replacement needs. If there are funds which are not needed in the short term, consideration could be given to laddering some certificates of deposits for longer terms or exploring other investment opportunities which do not deplete the principal of the investment.

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Another way to manage the Association's financial resources involves a thorough review of expenses. Associations should review their existing vendor relationships and consider entering into more favorable long-term contracts with them. By obtaining a two or three year contract with a vendor, Associations may not only obtain a favorable price and stability, but may also be able to achieve a continuity in their relationship which could be very helpful when the Association needs to transition leadership to future board members.

Additionally, Associations might consider bundling of various services. Associations should see if their current contractors offer other services. For example, I represent an Association that reduced its cost of sprinkler head repairs by expanding the relationship with it's existing lawn maintenance company to make the sprinkler repairs. This process consolidated the accountability for sprinkler head maintenance, while reducing the Association's out-of-pocket expenses. (In addition to the actual cost savings, these comprehensive service arrangements have the potential to reduce the administration associated with managing relationships with a larger number of vendors).

(Continued on Page 4)

Budgeting in a New Economy

(Continued from Page 3)

One final thought: To help an Association meet its cash flow needs, it may be useful to consider spreading the costs of seasonal contracts over an extended period of time. Currently, the Association budgets its revenues over a twelve-month period. However, many of its expenses are paid over a much shorter period of time. Current vendors should be contacted and new contracts should be written to extend the disbursement time period to more evenly distribute the Association's cash requirements.

By reviewing the Association's budget on an annual basis, thoughtfully analyzing, and where appropriate, negotiating appropriate vendor relationships, as well as, monitoring cash flow on a monthly basis, an Association should be able to continue enjoying the quality of life to which its Board and members have grown accustomed. Please feel free to contact me with any questions or for more detailed information; we would be happy to work with your Association to help achieve these goals.

UPCOMING ISSUES:

- **Data and System Security**
- **How Long Should You Retain Your Financial Records?**
- **Interfund Balances**

NEWS AT THE FIRM

ANNIVERSARIES (October–December)

17 years *Annette Murray*
16 years *Janine Zirrith*
15 years *Margot Julis*
Jeannette Everett
Susan Klimcsak
12 years *Suzanne Hughes*
Marie Mirra
Carol Rosenvinge
9 years *Lorraine Tiberi*
7 years *Sheila Engelman*
3 years *Daniel Manning*

NEW HIRES

Martin DiGiovanni
Patricia Falck
Fatma Fallon
Atara Goldgrab
Kathleen Rose
Elizabeth Simon

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