COMMUNITY PROPERTY ADVISOR

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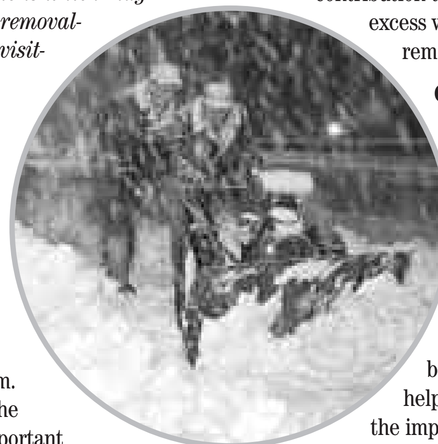
Is Snow Blowing Your Budget?

"Assessing" the Options for Now?

By Jules C. Frankel, CPA, MBA

NOTE: Although variations of this article have appeared in the CPA a number of times during the past several years, we believe that (weather) conditions warrant its repetition. During a number of recent winters, significant snowfall in New Jersey wreaked havoc with Association snow removal budgets. This winter could present a similar situation. Accordingly, to assist Associations which may need to evaluate special snow-removal-related assessments, we are revisiting this important subject—which was first discussed in the CPA in 1994.

For many Communities, resources budgeted for snow removal have been or will be, exceeded as a result of this season's snowfall. Digging out of a financial hole requires more skill than digging out of a snowstorm. What course of action should the Association take? The most important piece of advice to remember is this: The sooner the issue is addressed, the easier the resolution.



Learning From Past Experience

For most Associations, the guide to an appropriate course of action lies in the experience of the winter of 1994. We learned that, as soon as it becomes apparent that snow removal needs will likely exceed budget forecasts, the easier it has been to gain Community acceptance for a special assessment. That is, the special assessment was more "favorably" received by those Communities in which Associations took immediate action, in contrast with those who deferred dealing with the situation until well after the winter. (NOTE: The following suggestions are based on the assumption that the Association is not covered by, or has elected not to purchase, snow removal insurance.)

Therefore, our recommendations are:

1. Assess the status of both actual and anticipated additional (that is-yet to be incurred during this season) costs for snow removal versus the Association's budget.

2. Seek to offset the snow removal budget deficit by determining if there was a surplus from the prior year. This could occur from a number of sources:

A. General Operating Fund

B. Working Capital –there may have been a sufficient contribution to allow for a reallocation of excess working capital to the snow removal budget

C. Deferred Snow Removal Fund (it is rare for an Association to have established this type of fund)

3. Review other expense categories for positive or negative variances relative to actual expenditures. The opportunity to reallocate funds based on these variances may help to soften, (or exacerbate) the impact on the budget of a shortfall in the snow removal category.

4. Once the "variance analysis" is complete, determine if additional funds will likely still be necessary to cover a snow removal budget deficit. If no shortfall exists, or it appears manageable, it may be possible to defer definite action. (NOTE: The Association should set timely follow-up budget review dates to be able to validate, or if necessary, modify its plans.)

5. If the review process provides information indicating that additional monies for snow removal *will* likely be needed, the Association needs to take two actions:

A. Decide between a special assessment and amending the current year's budget

B. Communicate to members regarding both the decision, and the reasons supporting it

C. (NOT RECOMMENDED) Make up the deficit in a future year.

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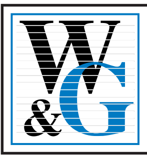

Should You Still Consider Refinancing Your Home?

By H. Edward Wilkin III, CPA

Has the refinancing boom begun to fizzle out? Not yet, as interest rates remain at 40 year lows due to a soft economy and international unrest. Mortgage loan activity still remains high, partially because lenders are cutting their profits and providing strong financial incentives to stimulate mortgage refinance demand. However, should interest rates rise somewhat, it is possible that mortgage refinance activity could slow due to the potential reduced economic appeal to consumers.

Lower interest rates have allowed many consumers to reduce their monthly housing costs. In other cases homeowners used the benefit of lower rates to:

- Consolidate high cost debt into a convenient payment at lower interest rates (and in some cases, obtain a tax advantage by using deductible interest expense from a home loan, in contrast with other non-deductible forms of interest expense)
- Generate cash for home improvements and other purposes.

Clearly, these potential benefits should be considered as primary reasons to refinance if interest rates allow.

So how can a homeowner decide if they would benefit from refinancing a mortgage? Many experts use a standard rule of thumb: A 1-2 percentage point reduction between the homeowner's current interest rate and the proposed refinance rate. However, this guideline should not be uniformly applied because each homeowner's unique situation will dictate the appropriateness of refinancing.

Some recent case studies may provide insight and direction regarding situation-specific opportunities. (NOTE: The interest rates used in these examples are for illustrative purposes and should not be used as a basis for decision making.)

1. Save interest cost by reducing the loan term and interest rate.

John and Samantha Smith purchased their home in early 1997 with a $230,000, 30 year mortgage loan at 7.5%. When they inquired about the appropriateness of refinancing, the Smiths were encouraged to consider a 15-year mortgage at 5.375% for the remaining balance of $215,000. The impact of reducing the rate was to reduce their total interest expense while accelerating their mortgage amortization. The Smiths refinanced using the proposed 15-year mortgage loan, which will save them approximately $150,000 of interest cost and retire their loan 9 years earlier.

2. Consolidate debt and obtain a tax deduction.

John and Nancy Nice bought their home 18 years ago. John is a school teacher and coaches football to supplement his income. Their twin sons are graduating high school and are college-bound. The Nices have accumulated $35,000 in credit card debt and have first and second mortgages totaling $140,000 on their home. Their monthly debt payments total approximately $3,100 and— their credit card interest is not tax deductible. The Nices have sufficient equity in their home to do a cash-out refinance at 6.25%. This means they will be able to use their home equity to generate cash, which provided a number of benefits:

- Reduced their monthly debt payments by approximately $2,000 a month—with a new mortgage loan payment of $1,078
- Retired all of their credit card debt
- Eliminated the second mortgage loan.

With the monthly savings, the Nices have:

- $1,500 a month available to fund college expenses or to use for other discretionary purposes
- The ability to pay an additional $500 on their monthly mortgage payment and thereby accelerate its payoff.

3. Take advantage of property appreciation

Bob and Juliet Young purchased a condominium 3 years ago for $145,000 with a 5% deposit and an interest rate of 7%. The minimal deposit required Private Mortgage Insurance, or PMI. (PMI is required when there is less than 20% equity in the home.) Including the $90 monthly PMI cost, their total monthly mortgage expense was $1,006. The Youngs were advised by a family friend in the mortgage business that they had to reduce their interest rate by at least 2% to justify refinancing. A detailed analysis of their situation demonstrated a different scenario. The Young's condominium had appreciated during the time they owned it, and was now worth $185,000. By refinancing the current mortgage at 6% for 30 years, the Youngs were able to eliminate the PMI and reduce their payment to $797 monthly. This resulted in a monthly savings of over $200.

Although each situation is unique, to the extent the examples cited may be similar to our readers' personal situations, there is still potential opportunity to generate suitable economic benefit through refinancing a mortgage.

NOTE: Wilkin & Guttenplan has established a strategic relationship with a mortgage brokerage company to more broadly serve our clients' financial needs. We can assist with refinancing and other mortgage-related needs in New Jersey, Pennsylvania and New York. For more information about how refinancing a mortgage might enhance your own personal financial situation, feel free to contact me at (732) 846-3000 x122 or ewilkin@wgcpas.com.

Your Budget *(Continued from page 1)*

If point 5 applies, Associations should remember the following:

Special assessments can be paid in one payment or over a period of time. Amending the current year's budget allows the shortfall to be made up with even payments over a definite time period. Additionally, the Community will become accustomed to the new, increased assessment.

Communication is critical. If the snowfall caused the monetary problems, it is effective to ask for additional funds while the snow is still a vivid image in people's minds, in contrast with asking for an assessment while people are relaxing in the warm weather by the swimming pool!

For Association-specific advice and guidance, please feel free to contact me or your Wilkin & Guttenplan advisor.

When is it Appropriate to Use an Association's Capital Replacement Fund

By Gary B. Rosen, CPA, CFE

Several articles in prior *CPA* issues have addressed the topic of fund accounting. This important concept, which segregates money according to different uses (Operating, Capital Replacement, Capital Improvement, etc.) based on the nature of the expense incurred by an Association, is a fundamental principal of an Association's financial practice. Association Boards need to have a working understanding of the purpose, and appropriate use of, the Capital Replacement Fund.

The key Capital Replacement Funding principle is that the money is collected and segregated, over a period of time, to cover the repair or replacement cost of *existing* common elements; that is, capital assets *already in existence in the Association*. (For example, the replacement of an existing swimming pool, tennis court or clubhouse roof.) Capital Replacement Funds are part of a long-term financial plan, which helps:

- Strengthen the Community's fiscal health
- Increase unit's market values
- Boards fulfill their fiduciary responsibilities.

How Should the Board Document its Need for/Use of, the Capital Replacement Fund?

Associations encounter a challenge when they wish to spend money that has accumulated in the Capital Replacement Fund. The Board should document in its minutes, justification of the expenditures, which may include:

- Necessity, and urgency of the need
- Appropriateness as a Capital Replacement (rather than an Operating expense, or Capital Improvement) item
- The Board's vendor selection and proposed project costs
- Any other financial considerations (i.e. special assessments, bank loans, etc.).

What are the Appropriate Uses of Capital Replacement Funds?

To help Board members appropriately discharge their fiduciary responsibilities, we offer the following 10 guidelines for the appropriate use of Capital Replacement Funds:

1. Capital Items Included in the Most Recent Replacement Study—Should be charged to the Capital Replacement Fund. If the item's actual cost is significantly greater, or the useful life is shorter, than estimated, then the engineer should be consulted to update the replacement study as quickly as possible to reflect this transaction's impact. The updated study should be integrated with the coming year's budget.

2. Minor Repairs — Should not be charged to the Capital Replacement Fund. These should be funded via the operating budget. Associations should define thresholds for "minor" and "major" repairs with their managing agent and accountant.

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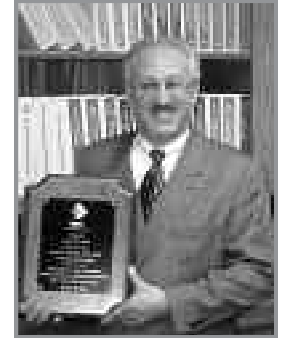
Jules C. Frankel Inducted into CAI-NJ Hall of Fame

At the recent Community Associations Institute of New Jersey (CAI-NJ) Annual Awards Dinner, Jules C. Frankel, CPA, MBA, Shareholder, received a very pleasant surprise: He was inducted into the CAI-NJ's prestigious *Hall of Fame*. Recipients must be chapter members who have served the chapter over an extended period of years, and in many capacities, have consistently been of service and value to the chapter and its leaders.



Jules C. Frankel displays the plaque marking his induction into CAI-NJ's Hall of Fame.

Jules joins fellow Wilkin & Guttenplan Shareholders Gary Rosen and Ed Wilkin in the CAI-NJ *Hall of Fame.* All three served as President of CAI-NJ, in addition to a host of other positions within the organization.

NEWS AT THE FIRM

ANNIVERSARIES (April–June)

Congratulations to the following W&G staffers celebrating anniversaries:

19 years	**Gary Rosen**
16 years	**Sara Gierloff**
	Pamela Wallack

NEW ARRIVALS

Congratulations to:

Vinay & Swati Navani on the birth of their son, Sahil on 1/31/03.

Mohammed & Azmina Salyani on the birth of their twin daughters, Maya & Lyla on 2/12/03.

UPCOMING ISSUES:

- **Using CPAs at Open Meetings**
- **How Association Investments are Insured**
- **Working Capital: How Should it Be Used?**

This publication is prepared quarterly by Wilkin & Guttenplan, P.C. For further information or for complimentary copies or subscriptions, you may contact Jules C. Frankel at:

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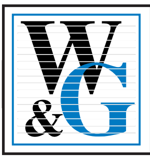

Replacement Fund *(Continued from page 3)*

3. Capital Items Excluded from the Replacement Study – May still be charged to the Capital Replacement Fund. Since Engineering studies *estimate* common elements' replacement costs, certain items may have been missed during the preparation of the Engineer's Report/Study, or item replacement costs/conditions may have changed over time. The Association should recoup both the element's replacement cost *and* the deficit created by the expenditure through an increased replacement contribution level.

4. Deferred Maintenance Fund – Provides for periodic maintenance for items such as painting, caulking, and powerwashing. It would be inappropriate to use the Capital Replacement Fund for these types of maintenance expenditures. Boards should consider establishing a Deferred Maintenance Fund for maintenance on items which do not recur annually.

5. Capital Improvements – *Should not be charged to the Capital Replacement Fund*. Items not currently in existence should be funded via a Capital Improvement Fund, operations, special assessment, loan, excess working capital (if available) or any combination of the above. The items should be included in the next replacement study.

6. Transition-Related Items – May involve the Capital Replacement Fund. During the initial years of an Association's existence there may be situations in which a Sponsor/Developer is responsible for various replacements to the common elements. However, due to transition litigation, the Sponsor/Developer refuses to perform the necessary repairs or replacements. These expenditures can be charged to the fund, and any monies subsequently received should reimburse the replacement fund. If there is no settlement, the Engineer should be consulted to determine the impact on the Association's Capital Replacement Fund, and the Association's future funding policy.

7. Income Taxes – May be charged to the fund. Many Associations choose to allocate any interest or investment income earned by the Capital Replacement Fund back to the fund. Such income may be contributed net of the Federal income taxes, because Associations must pay tax on such income. (Specific details regarding tax treatment of Association revenues are beyond the scope of this article).

8. Capital Replacement Study – Supports contributions to the Capital Replacement Fund. Many Associations utilize an outside professional to prepare a schedule for this purpose. My opinion is that this is an operating expense, and should be charged to the Operating Fund; however many Associations charge the cost of the preparation of this study to the Capital Replacement Fund, which also may be done.

9. Interest Expense – If applicable, may be charged to the fund. Many Associations have authorized major capital replacement projects only to discover that they are unable to fund all of the planned replacements. Absent a special assessment, many Associations seek assistance from lending institutions to close these funding gaps. Proper practice is to include the expenditure, debt service and the future assessments required for debt repayment, in the Capital Replacement Fund budget.

10. Borrowing from the Replacement Fund – *Is strongly discouraged!* Borrowing could create negative tax implications and may ultimately lead the Association down the road of financial ruin. To avoid this, an Association should regularly monitor its operating budget to ensure that each year's deficit, if any, is addressed in the subsequent year. Of course, there are always exceptions to every rule.

Using these general Capital Replacement Fund guidelines, Boards should have a greater understanding of the appropriate use of the Capital Replacement Fund. For more situation-specific guidance, please feel free to contact me, or your Wilkin & Guttenplan advisor.

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