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How Associations Should Invest Their Funds:

RESPONSIBLE ASSET MANAGEMENT... A FIDUCIARY RESPONSIBILITY

By Richard Hausler, Vice President/Senior Financial Consultant, Smith Barney



The past few years have seen Associations' returns on financial assets diminished primarily due to declining interest rates. What should an Association consider in the current environment? While no one has a crystal ball, certain basic investment guidelines can help Board Members feel comfortable that they are properly discharging their fiduciary duty.

Background

Over the past few years, various Board Members have frequently asked me how they can maximize the return on their Association's investment funds. As interest rates have edged lower, the requests are more commonplace and often sprinkled with inquiries about stocks or growth mutual funds. I typically remind Board Members about their primary fiduciary responsibility, which is the preservation of capital. This article is intended to help Board Members and Management by reviewing some basic information that can be helpful to them as they contemplate appropriate investments.

The remainder of this article will discuss:

- ◆ Investment Policy Overview
- ◆ Evaluating the Association's Financial Asset Needs
- ◆ Investment Techniques.

Investment Policy Overview

The initial step for a Community Association exercising responsible asset management is the adoption of an **Investment Policy**. The Investment Policy should explain the Board's financial responsibilities along with specific investment objectives and approved investments of each of the Association's funds (i.e. Operating, Replacement, Deferred Maintenance, etc.). The Investment Policy should stress that the Association's primary investment objective is the preservation of principal, and should be used as a reference while making financial decisions throughout the year. It is also an excellent tool to familiarize new Board Members with their financial

responsibilities. Due to the infrequent nature of investment transactions for these non-operating funds, it is not uncommon for the investment policy to authorize the Association's officers to transact investment business on the Association's behalf.

Evaluating the Association's Financial Asset Needs

Prior to investing, the Board needs to determine upcoming major expenditures from each of its funds. This is critical to the investment process, since it will help to appropriately match portfolio liquidity requirements with anticipated expenses. For example, for the Replacement Fund, an updated **Reserve Study** with cash flow projections should be available for the Board's consideration. For the Deferred Maintenance Fund, anticipated expenses for items such as painting and staining would be useful. These projections can help greatly in preparing for the next step... structuring the investment portfolio.

Investment Techniques

Several investment strategies could be considered appropriate and will be discussed below. Regardless of the Board's, or any professional's, interest rate outlook or the performance of a particular type of investment, these strategies can help Boards meet their specific financial objectives. Additionally, there are investment accounts available to help maximize the return of an Association's "idle cash", while potentially simplifying recordkeeping. With this background, I would like to review:

- ◆ Portfolio "Laddering"
- ◆ Diversification
- ◆ Improving Returns on Cash Assets/Segmenting Funds for Financial Reporting.

Portfolio Laddering

Portfolio laddering involves staggering the maturity of fixed income securities so that a portion of the portfolio matures at regular intervals (often annual-

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ly, or semiannually.) The ladder may be 3-5 years, or even longer, depending on the Association's financial situation. In a simple example of a 5-year ladder, 1/5 of the proceeds are invested to mature each year. When a security matures, it would be reinvested in the 5-year maturity rung. This conservative and widely-used approach helps alleviate the problems associated with trying to forecast the direction of interest rates, while allowing Associations to:

- ◆ Maintain a predictable degree of liquidity and portfolio earnings
- ◆ Minimize reinvestment and interest rate risk as proceeds from maturing securities are reinvested at current interest rates

- ◆ Appropriately balance their objectives of preservation of principal and improving investment returns.

Diversification

There is a cliché about not having “all of your eggs in one basket.” This is just as true in investing as in any other aspect of life. Diversification refers to the idea of distributing investments among different fixed income security types to minimize risk of loss and/or improve returns. Although Association investments may be limited to the fixed-income asset class, there are still a variety of investment alternatives available. What follows is a brief description of some of the most common appropriate fixed income securities Associations might consider.

Security	Minimum Investment	Maturities	Liquidity	Other (insurance, interest payment frequency, etc.)
Money Market Funds	Depends on bank	Intended to be a stable principal/highly liquid “parking place” for cash	Readily available—often can be used as a substitute for a checking account to improve yields	Interest generally credited monthly Insurance limit \$100,000*— FDIC at banks; generally SIPC at brokerage firms. (NOTE: Some brokerage firms may offer FDIC insurance of \$1 million or more of protection for cash in money market accounts.) Check with your financial advisor(s) for specific details
Certificates of Deposit (CDs)	Generally \$1,000; Jumbo CD's—\$100,000	Varies from 1 week-10 years or more (depending on investment amount)	May carry early withdrawal penalties	Interest can be paid at maturity (CDs maturing in less than a year), semi-annually or in some cases, monthly FDIC insurance up to \$100,000* total per financial institution-per tax id#. (Check with issuer/broker for specific coverage before investing)
U.S. Government Securities	<i>Treasury Bills</i> —\$1,000 with \$1,000 increments <i>Treasury Notes</i> —\$1,000 with \$1,000 increments <i>Treasury Bonds</i> —\$1,000 with \$1,000 increments	<i>Treasury Bills</i> —mature in less than 1 year <i>Treasury Notes</i> —mature in 1-10 years <i>Treasury Bonds</i> —mature in 10-30 years	May be sold in the secondary market; principal fluctuates prior to maturity	Backed by the full faith and credit of the US Government Treasury Bills are sold at a discount and pay the full face amount at maturity; others pay interest semi-annually
Zero Coupon Bonds—US Government or US Treasury	Generally \$1,000	Generally 1 year-30 years	May be sold in the secondary market; principal fluctuates prior to maturity	Interest and Principal backed by the US Treasury Issued at a deep discount from face value; full face amount (or other as specified by issuer) payable at maturity
US Government Agency Securities	Generally \$10,000	Generally 1 year-30 years	May be sold in the secondary market; principal fluctuates prior to maturity	Interest and Principal backed by the issuing US Government Agency Examples include: Student Loan Marketing Association (Sallie Mae), Federal National Mortgage Association (Fannie Mae), or the Federal Home Loan Mortgage Corporation (Freddie Mac). Interest typically paid semi-annually
Mortgage-Backed Securities	\$1,000 with \$1,000 increments	Structured maturity generally 5-30 years; check for prepayment conditions	May be sold in the secondary market; principal fluctuates prior to maturity	GNMA is a full faith and credit obligation of the US Government; others backed by the issuing agency Cash flow often monthly

*Includes principal and interest combined

There are also many types of high-grade investments issued by US or foreign corporations, which might be acceptable under the Association's investment policy. A discussion of these securities is beyond the scope of this article, and should be explored with the Association's financial advisor(s). It is worth noting that **some Associations have sought higher returns by investing in the stock market, and often discovered they had lost principal—and thus some portion of their assets were no longer available to them to help fund their obligations.** Therefore, I believe fixed income securities best fulfill the Association's need to preserve principal, while offering some additional opportunities to improve investment returns.

**Improving Returns on Cash Assets/
Segmenting Funds for Financial Reporting**

I suggest Associations use a **cash management account** for managing assets and improving recordkeeping. These accounts, offered by most major securities firms, typically offer:

- ◆ Daily sweep of idle cash into a higher-yielding money market account
- ◆ Extensive (full account value) securities protection
- ◆ 24/7 online access
- ◆ Direct checking.

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The Engagement Letter— A Document of Commitment and Understanding

By Victoria Foody, CPA

When a Community Association enters into a service arrangement with any of its contractors, it is common for the two parties to agree to the terms of the services in writing. The annual audit of the Association's financial statements is no exception. In the accounting profession, this written agreement is referred to as an *Engagement Letter*. As with many previous articles in the CPA, our goal is to help Board Members feel comfortable in fulfilling their fiduciary responsibilities. With this in mind, this article clarifies the Engagement Letter's purpose and contents.



Background

The engagement letter creates an understanding of the nature and scope of services to be provided by the accountant, such as audits, reviews, compilations, financial statement preparation, etc. Further, it delineates the responsibilities of the parties involved, the structure/process of conducting the audit, and specifies the fee arrangements for the services to be provided.

Typically, the letter contains:

- ◆ Accountant's listing of the type and level of the services that will be performed. These services could include, but not be limited to:
 - Audits, Compilations, Reviews and Financial Statement Preparation
 - Management Transitions
 - Transition from Developer to Unit Owner Control
 - Tax Advisory/Compliance
 - Special Projects such as Litigation Support/Expert Witness/Testimony.
- ◆ In the case of an audit (which is the most common situation affecting Community Associations) a statement reflecting the audit's objective—which is to express an opinion whether the Association's financial statements are fairly presented

- ◆ Agreed upon fee for services
- ◆ Accountant's pledge to comply with the professional and ethical standards set forth by the profession
- ◆ Expectation that at the end of the audit, the Board will sign a Representation Letter. (An article on Representation Letters will appear in a forthcoming issue of the CPA.)

Certain limitations are also often detailed. For example, a standard Community Association audit engagement letter states that the auditor's procedures **will not** determine whether the funds designated for future repairs and replacements are adequate to meet such future costs. The engagement letter will also indicate whether the auditor will be meeting with the Board to review the results of the audit. Including such limitations in the engagement letter reduces the possibility of misunderstandings later.

The Board's Responsibilities

The letter is addressed to the Association's Board of Directors and should be signed by a Board Member. Even though an unrelated Managing Agent is usually retained to maintain the Association's financial records, the Board has ultimate responsibility for the Association's financial management. This includes:

- ◆ Establishing and maintaining adequate records, as well as, effective internal controls over financial reporting. (Although the Board often engages a Managing Agent to administer this function, it is ultimately the Board's responsibility to ensure that the Association's records are accurate and complete.)
- ◆ Making the Association's information and complete records available to the auditor
- ◆ (With the assistance of its Managing Agent) accepting responsibility for, and making any necessary adjustments to, the financial statements
- ◆ Providing the auditor with representation in writing that, to the best of its knowledge, it has fulfilled its responsibilities as outlined in the engagement letter, and that the financial statements are complete and free of errors in all material respects.

Bottom Line

The Association's Board should discuss the content of the engagement letter with its CPA and Managing Agent (if any). All parties involved in the annual audit process should understand the services described, and their respective responsibilities. Understanding the objectives and clarifying expectations as part of the formal establishment of the relationship helps to ensure that each engagement progresses smoothly, resulting in its timely completion. As always, should you have any questions, feel free to contact your Wilkin & Guttenplan advisor.



Responsible Asset Management (Continued from pg. 2)

- ◆ A "linking capability" for multiple Association accounts (to simplify recordkeeping and financial statement reporting).

"Linking" allows multiple investments to be consolidated under the "umbrella" of a single account to simplify financial analysis and reporting. For example, additional sub-accounts can be established to allow an Association to segregate funds such as *Reserve, Escrow, Deferred Maintenance* or *Excess Operating*. These accounts can be linked to the cash management account to provide:

- ◆ Ready access to these respective funds, as necessary
- ◆ An efficient mechanism keep all funds earning interest
- ◆ Both sub-account and consolidated statements.

Summary

Establishing an investment policy, creating a solid financial infrastructure, identifying objectives and selecting appropriate securities for investment are important steps in helping Associations meet their financial goals and help Board Members discharge their fiduciary responsibilities. Associations should create policies and procedures that articulate their need to invest their funds prudently, as part of the process of achieving their financial goals. Feel free to contact me, or your Wilkin & Guttenplan advisor for more information, or if you would like to obtain a sample investment policy.

Rich Hausler of Smith Barney in Morganville, NJ, has specialized in Association investment management since 1985. Rich currently serves on the Networking Committee for the NJ Chapter of CAI and has served as both treasurer and president of his own condominium Association. For further specific information, Rich may be contacted at r.hausler@smithbarney.com. (NOTE: This article is not a recommendation of specific investments, strategies, securities or investments, nor is it an endorsement of any firm. It's sole intent is to provide general information regarding investment-related issues to be considered by Associations when investing.)



NEWS AT THE FIRM

APPOINTMENTS, COMMITTEES, PRESENTATIONS, PUBLICATIONS...

Jules C. Frankel, CPA, MBA, was recognized by the *American Institute of Certified Public Accountants* for his contribution to the publication *Common Interest Realty Associations Industry Developments-2003/04 Audit Risk Alerts*.

PROMOTIONS

Melissa Marsicano, Manager **Brian Geissler, Manager**

ANNIVERSARIES (October–December)

Congratulations to the following W&G staffers celebrating anniversaries:

18 years	Sefi Silverstein	7 years	Brian Geissler
17 years	Michael LoVerde		Bill McDevitt
16 years	Kristine Flores	5 years	Amanda Brady
	Rea Hughes		Karen Davis
11 years	Carol Koransky		Leonard Nitti

UPCOMING ISSUES:

- Sales Tax Audits of Large Associations – What to Expect & Who May Be "At Risk"?
- Representation Letters
- Tax Impact of a Superintendent

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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