Understanding Association Financial Matters

eBOOK

A Board Member's Guide

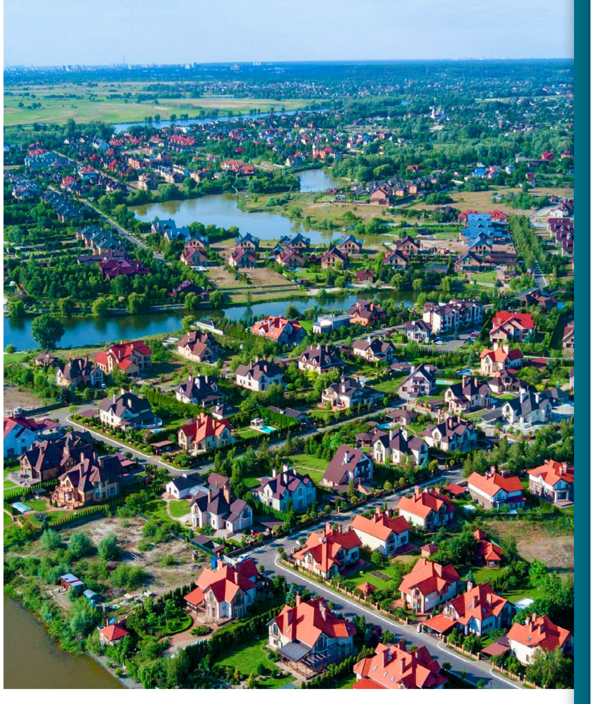
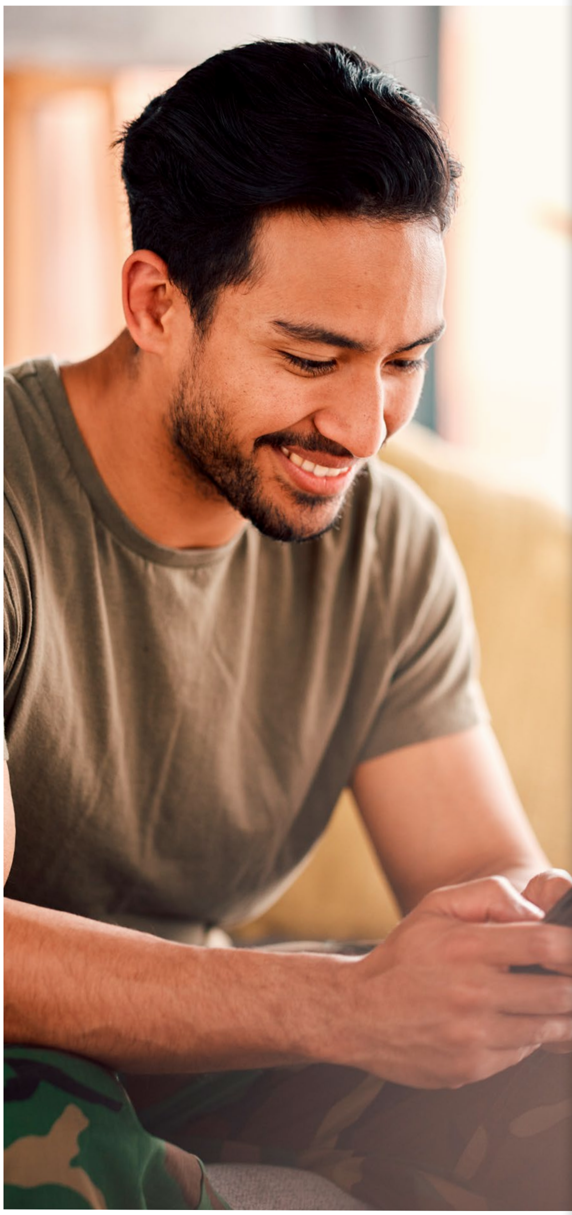


TABLE OF CONTENTS

As a board member of a condominium or homeowners association you have a responsibility to the community. Board members are obligated to make decisions based on the best interest of the association, not for personal gain. One part of a board's responsibility is money matters. Understanding the financial aspects of community association is a key component to running a successful association.

In this eBook, we will start at the basics from understanding different types of financial management available, to understanding your financial reports, creating a budget for your association, long-term planning, reserve studies, coordinating audits and taxes, and planning for capital expenditure projects.



HOA Accounting

Understand Different Methods

There are three main methods of financial management that HOA management companies use. These are generally accepted accounting principles (GAAP), cash-based financial management, and modified financial management. As a board member, it is important to have an understanding of the three methods that are used, their effects on financial reporting and the pros/cons of each method to your association.

GAAP Financial Management

This method of financial management is also referred to as the accrual basis of financial management. In this method, revenues are recorded when earned, and expenses are recorded when incurred (regardless of when the payments are made). The advantage of this financial management method is that it gives an accurate picture of the state of the association and all its transactions at any given time. This is because transactions are recorded at the time they occur and therefore the books are always up to date.

How Transactions are Recorded Under the Accrual Basis

As previously mentioned, the accrual basis operates by the principle of recording revenues when earned and expenses when incurred (not when the cash is actually received). If the association, for example, sells one of its assets today, the transaction is immediately recorded in two accounts; one called the assets account (the assets account is credited because that particular asset has been sold) and the accounts receivables is debited (this is the account that records transactions for which payment is expected at a later date). In most cases, payment is not made immediately as in a regular cash transaction, therefore, the need for recording payments that are owed to the association. Once payment is made for the asset, the accounts receivable is credited (to reduce its balance because the debt has now been cleared) and the cash account is debited (to increase the balance because the cash has been received).

In the case of monthly fees owed by members, the accounts receivable is debited (balance increased) for members that are yet to pay their monthly fees, and it is credited (balance reduced) for members that have paid their dues in advance. The cash account is then debited/credited appropriately as payments are received.

Cash-Based HOA Financial Management

The cash basis of financial management records income and expenses when the cash is received, as opposed to when the transaction is made. The cash basis does not involve the use of accounts receivables. The cash account is simply debited when the cash is received (for example from member dues), and it is credited when cash is reduced (for example when paying expenses).

The disadvantage of this method is that it can be difficult to keep track of all the transactions for which payment is pending to the association or to which the association owes money. It is also not possible to compare the values of these transactions to the final balance sheet prepared at the end of the period in order to verify accuracy.

MODIFIED FINANCIAL MANAGEMENT

The modified financial management basis (also referred to as modified accrual basis) is a combination of the cash and accrual basis of financial management. In this method, revenues are recorded when earned (just like accrual) but expenses are recorded when paid, rather than when incurred (just like cash basis).

This reporting method has the effect of having your accounts receivables accurate and up to date at all times while having your unpaid expenses pending to be recorded (therefore not present on the balance sheet) until the payments are made.

A modified financial management method is deemed appropriate for preparing interim financial reports for the board as you wait to make all payments for expenses that the association has incurred. Many community associations find it easier to record revenues when earned but to wait to record their expenses until they have made the payment.

Financial Reports

Understand Financial Documentation

Association fees help to maintain the property of community residents and to improve the overall quality of the surrounding environment. It is important to understand the financial reports of your community in order for you to keep track of your contributions and the overall use of the association's money.

The following are basic documents that are included in most financial reports for community associations.

Balance Sheet

A balance sheet is a financial document that shows the amount of money that is present in your accounts. It monitors the expenditures and income of your account over a specified period.

Understanding how to read a balance sheet lets you compare the expenditures that your association incurred against the income that it collected.

Income Statement

An income statement is a more focused financial document that specifically tracks all the income that has been received by your community association. Income can come from investments, payments from prior services offered, among others. The primary purpose of the income statement is to show if the association made a profit or loss based on the activities that they carried out.

Account Receivables

Accounts receivables show all the money that is owed to the HOA and has not yet been collected. Accounts receivable include collections, credits from vendors and any other payments for services offered by the association. Understanding the account receivables document can give you a better understanding of the activities that your HOA has been engaging in.

Bank Statements

The bank statement, as you are probably already aware, shows all the transactions that have been carried out in your association's bank account. The association's bank account is probably where the majority of the cash flow is maintained, and therefore it is important to keep track of the bank transactions and overall balance.

Creating Your Budget

Steps to Get You Started

In September 2012, the California Department of Real Estate (DRE) was sufficiently concerned about the number of Homeowner's Associations (HOAs) experiencing financial problems that they decided to issue a special consumer warning:

» "The California Department of Real Estate (DRE) has issued this warning as a result of the growing number of homeowners associations that do not have sufficient funds or reserves to adequately maintain the common areas in the housing developments for which the HOA is responsible."

The CA DRE went on to explain some of the causes of insufficient funds for the state's community associations, including foreclosures, which left an increasing number of homeowners unable to pay their assessment payments, and "inadequate planning" on the part of the board of directors. They also pointed to the several negative effects of insufficient funds, from unexpected expenses for homeowners to a decline in home values due to inadequately maintained common areas.

The Importance of Accurate Budget Preparation

Financial problems experienced by community associations are not limited to California. Similar problems in other states and municipalities have highlighted the importance of adequate budget planning and preparation for every community association. There are seven important factors to consider when creating a realistic budget.

1. CREATE A CAREFUL BUSINESS PLAN

Your condo or association's business plan should include all your goals for the coming year. Best practice is to outline annual goals by month; so that you know what all should be included in the budget. The business plan should ideally be reviewed no later than summer to ensure approval of the plan in a timely manner.

2. SEND REQUESTS FOR PROPOSALS (RFPs)

You do not want to estimate vendor costs in your budget. To ensure accuracy, send out RFPs for all your contracted services, including those for pool management, lawncare and landscaping, snow and trash removal, insurance policies, audits, and tax preparations.

3. ASSESS MAINTENANCE COSTS

The best way to accurately assess the coming year's expenses for maintenance, repair and utilities is to look at what those costs were in the previous year. Add to this any new costs you expect in the coming year, such as anticipated increases in utility costs or new repair items you are likely to incur due to deteriorating conditions.

4. ANALYZE YOUR RESERVE FUND

In general, it's prudent to conduct a thorough reserve fund analysis. Check your specific state's regulations when it comes to the frequency in which reserve studies should be conducted. Regularly updating your reserve fund analysis ensures that members of the community are contributing enough to cover both expected and unanticipated fund expenditures for things like paving, roofs, and playground equipment.

5. PLUG IN YOUR NUMBERS

After you have received RFPs and assessed likely expenses for maintenance, repairs, utilities and reserve fund needs, enter your figures into either an Excel spreadsheet or a budgeting tool. For added clarity, it's a good idea to keep notes on your budget assumptions and calculation methods as line item explanations.

6. CALCULATE ANTICIPATED INCOME

To arrive at your figure for the amount each homeowner must pay in assessment fees, you need to calculate all other sources of income. Since community associations practice zero-based budgeting, you should not include monies left over from previous years. You should, however, include late fee income, as well as any other reliable income source. With figures for expenses and other sources of income in hand, you can calculate the amount of your assessment payments.

7. SHARE YOUR BUDGET

Once the budget is approved, distribute to the homeowners based on your respective state guidelines. Remember that the heart of a thriving community is transparency, cooperation, and collaboration.

Capital Improvement Projects

Key Budgeting Components to Consider

Proactively thinking about and planning your annual capital improvement projects is a key step in your budget preparation process. First, be sure to carefully prioritize next year's projects so that the most critical are guaranteed to get done, while the "nice-to-haves" can get done if time and funds allow. Once you have prioritized your yearly projects, it is time to analyze each of them in terms of scheduling considerations; status as capital improvements or not; contractor payment structure; use of reserve funds versus operating funds; and any need for homeowner approval or special assessments.

Here we take a closer at prioritization and the key project-related considerations that will help you streamline your budgeting process.

Prioritizing Your Projects

If you have doubts about the importance of prioritizing your projects, have a look at your past budgets from the last several years. Was your community association able to complete all of the projects planned in past few years? Were some not completed, but still came close? If not, then you can safely assume that this trend will continue this year, and you want to make sure that the projects that don't make the cut are the nice-to-haves, not the must-haves.

So be sure to set several hours aside with the other directors to deliberately prioritize your planned projects for the year, and don't let your board move to the next stage until they've agreed on their priorities.

Key Considerations

With your prioritized list of projects in hand, it is time to consider each project in terms of the key factors that will impact their cost and timing. If your budget does not reflect your careful consideration of these factors, then it could miss the mark and diverge greatly.

SCHEDULING CONSIDERATIONS

When scheduling your projects, especially the largest ones, timing is everything. All contractors have busy seasons and slow seasons, and the precise time of year often has a strong impact both on their availability for a project and their bid. Some of the most common projects are temperature or weather-dependent. These include roofing, painting, re-siding and laying down sidewalks, among dozens of others. Remember that the best contractors are often booked months in advance. For all these reasons and more, it's important to start planning and scheduling now to get the cost and timing just right for your projects.

STATUS AS CAPITAL IMPROVEMENTS

Generally, capital improvements are changes to your property that do not merely maintain its value, but improve it. However, the term "capital improvements" does not always have the same meaning for all states or individual governing documents. Be sure to check with your state and governing documents, to ensure you have the right definition before determining whether a given project counts as a capital improvement.

CONTRACTOR PAYMENT STRUCTURE

Most contractors will accept progress-based installment payments that track their work through completion. In that case, you need to work out your best estimate of the expected installment-payment schedule for each capital improvement project. However, there are also situations when contractors can reasonably ask your association to pay upfront for at least part of the project. For example, the project may require expensive, non-standard materials that the hired contractor will have to purchase on the association's behalf to complete the project. Either way, work with your contractors to come up with a payment structure and schedule you can count on to give you firm numbers to place in your budget for the year.

RESERVE FUNDS VS. OPERATING FUNDS

If you are in a state requiring a reserve study, then you know that it is an invaluable budgeting tool. Either way, you are probably working with two funds and two budgets: a reserve fund or budget and an operating fund or budget. Knowing which fund will pay for any given capital improvement project will have a significant impact on your approach to planning and budgeting for the year. When in doubt about whether you can use reserve funds to pay for a given capital improvement project or not, consult with your governing documents, your state laws and, if necessary, your association's attorney.

Homeowner Approval

With larger capital improvement projects, you may need to get buy-in from the community as a whole. For example, some governing documents require that the board gets homeowner approval for any capital improvement project expected to consume more than a certain percentage of the projected budget for a given year, such as five or ten percent. If your governing documents or state has such a rule, then you will need to make the rounds with your association and gather votes before you can reliably include a given capital improvement project in your budget.

Special Assessments

If a capital improvement project requires a one-time special assessment this will generally take months to attain. This is yet another reason to start planning your projects right away.

The Virtue of Project-Savvy Budgeting

Your budget preparation process depends in no small part on your project planning for the coming year. So as your first step toward completing your current budget, be sure to prioritize your projects for this year, with a firm dividing line between your must-haves and the nice-to-haves. Once prioritized, it is time to analyze each of your projects for the upcoming year, one-by-one, in terms of scheduling and payment arrangements; status as genuine capital improvements or not; use of reserve funds versus operating funds; and any homeowner approval or special assessments required.

Regression for Long-Term Planning

Determine When and How Much to Raise Assessments

We have all seen it before: the board president stands up at the annual meeting and announces that assessment rates will go up by $10.00. If you have tried to raise assessment rates you know it is rarely met with someone thanking you for your wise fiscal decision. So when is the right time to do it? Some boards say their goal is never to raise their rates and while it is appreciated in their desire to stay fiscally responsible, running a community association is like running any other business. You have to proactively measure cost increases to stay ahead of the power curve, and if you are raising assessments to try to catch up to the higher rates of the previous year, your association will always be behind.

So what can you do to get ahead of your long-term hoa budget planning? You can use correlation and regression to determine when and how much to raise assessments. Take the following data of an Association's Total Expenses:

2018	$115,001
2019	$110,914
2020	$144,871
2021	$152,083
2022	$144,548
2023	$177,778
2024	$205,911

The example shown is from a 500 home community located in Colorado, where seven years of population growth have seen standard year-over-year increases in overall costs. The chart below shows the past seven years of total association expenses, and even a quick glance will tell you that their costs are on average increasing. Using standard spreadsheet programs, you can use these numbers to calculate the correlation of what each year adds in terms of cost. For example, in Excel you can click on "Data Analysis" and then click on "Regression", and it will produce a chart with several numbers. You only need three of those numbers to do a Regression Data Analysis.

Regression Data Analysis

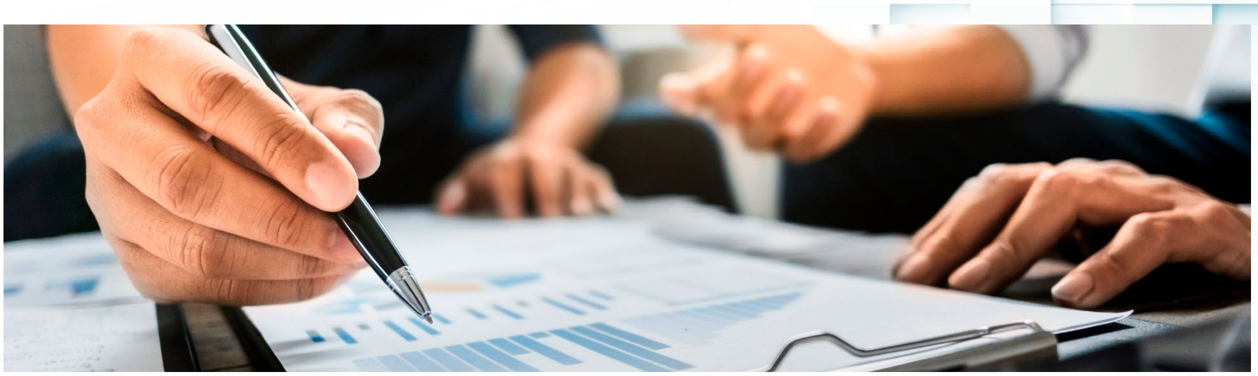
The first number (Multiple R) lets you know how strong the correlation is, and will be between 0 and 1. The closer to 1 that number is, the stronger the correlation and thus the more accurate your regression will be for future predictions. In this case, it is .9333, which is a high correlation. The next two numbers needed (Intercept and X Variable 1) can be used in a simple equation, which is Y=A+BX. Y is the **future budget number we want to solve for**, A is the **intercept**, B is the **year we are looking for**, and X is the **X Variable**. To play this out, let's take a look at what the expected expenses will be for this community in 2026: Y = (-56,619) x 20(15,576), which comes out to $255,000/year (20 represents 2026 in this instance). If I wanted to look to see what estimated expenses are for 2024, the formula is Y = (-56,619) x 18(15,576), or $223,800.

2018	$115,001
2019	$110,914
2020	$144,871
2021	$152,083
2022	$144,548
2023	$177,778
2024	$205,911

Multiple R	0.933294
R Square	0.871037
Adj. R Square	0.845245
Standard Error	14,183.08
Observations	7

	df	SS	MS	F	Significance F
Regression	1	793,347,794	6.79E+09	33.77	0.002129
Residual	5	1,005,798,466	2.01E+08		
Total	6	7,799,146,259			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%
Intercept	(56,619)	5,254.49	1.606	0.1691	(147,244)	4,005
X Variable 1	15,576	2,680.34	5.811	0.0021	5,656	22,466

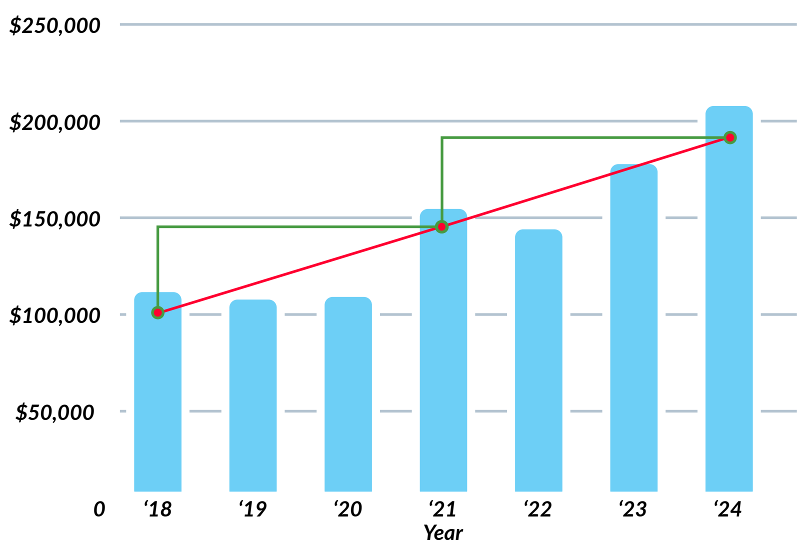


Raising Assessments

The next big question you should ask yourself in this process is "How often should our association raise assessments?" Each association is different, and it might be easier to raise every four years rather than every two years. Shorter iterations can lead to more accuracy, but that can also feel like pulling teeth to tell homeowners that they owe more every year. Longer iterations can lead to less accuracy and payments that are higher than necessary but might be an easier pill to swallow for communities who don't like to raise assessments too often. The chart here shows a three-year cycle for raising assessments. If we want to raise amounts to prepare for 2025, the formula = (-56,619) x 19(15,576), which is 239,325 and a difference of 33,414 from the 2022 total expenses which is around $67 per homeowner per year, or an increase of $5.60 per homeowner per month.

This process not only prepares homeowners for a standardized, predictable assessment rate, but it also generates additional revenue which can be applied to the reserve account to save for a rainy (or snowy) day.

And there you have it! Knowing how to discuss regression statistics is a fantastic tool for being left alone at parties, falling asleep when you have insomnia, and most importantly for regulating your association's budgetary needs! Just review these simple numbers, and I guarantee you will sound like the smartest person in the room at your next association meeting.



Budget Committees

Build a Committee You Can Rely On

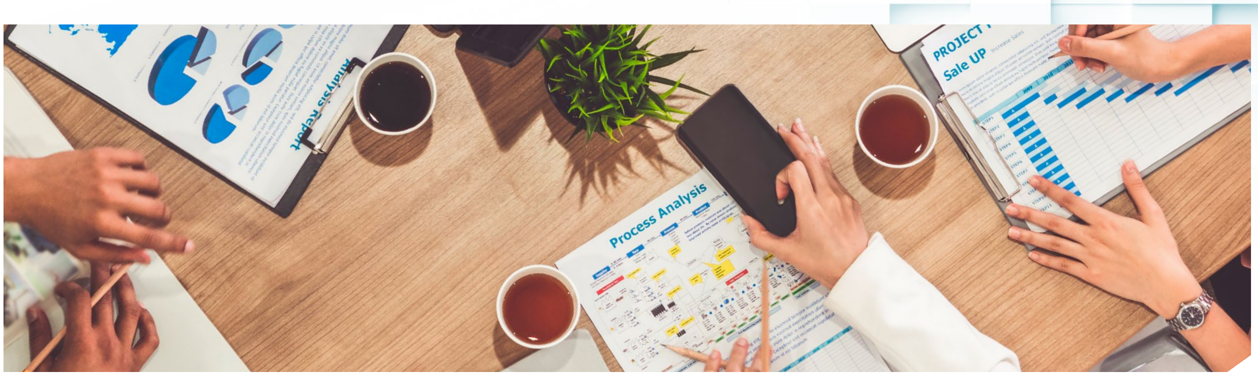
What is a Budget Committee?

The budget committee is responsible for managing the financial aspects of the community association. This includes management of the community, from keeping up with pest control or maintaining the grass and plants in community areas, to ensuring that there is enough money in the reserve pool to cover repairs and other unexpected expenses that may arise as the year progresses. The budget committee is also responsible for assessing the funds needed for improvement projects throughout the community and may need to discuss how to raise additional funds or bring in additional income to complete projects not already covered by the association's assessments.

What Are the Responsibilities of the Budget Committee?

Specific responsibilities of the budget committee will depend on the board of directors and the needs of the homeowners in the community for the upcoming year.

- Evaluating the funds necessary to complete maintenance over the upcoming year.
- Obtaining estimates for regular services to help ensure the association is receiving the best savings.
- Obtaining estimates for projects and services that will need to be completed in the upcoming year, but which are not completed regularly.
- Deciding how to raise funds when the reserve is not adequate to covering the year's needs, including cutting costs in some areas, raising fees, or assessing a one-time fee for homeowners.
- Estimating the reserve that needs to be kept in the budget in case of unexpected expenses, including natural disasters that are common to the area.
- Setting long-term achievable financial goals for the community, which might include setting aside funds each year for long-term projects or for future repairs.
- Monitor adherence to the budget and ensure that the association is sticking to the guidelines created by the budget committee.
- The budget committee may be responsible for assessing the needs and desires of homeowners, i.e. it may be important to know whether or not homeowners want pest control for the entire community, or landscapers who take care of blowing leaves off of communal areas.



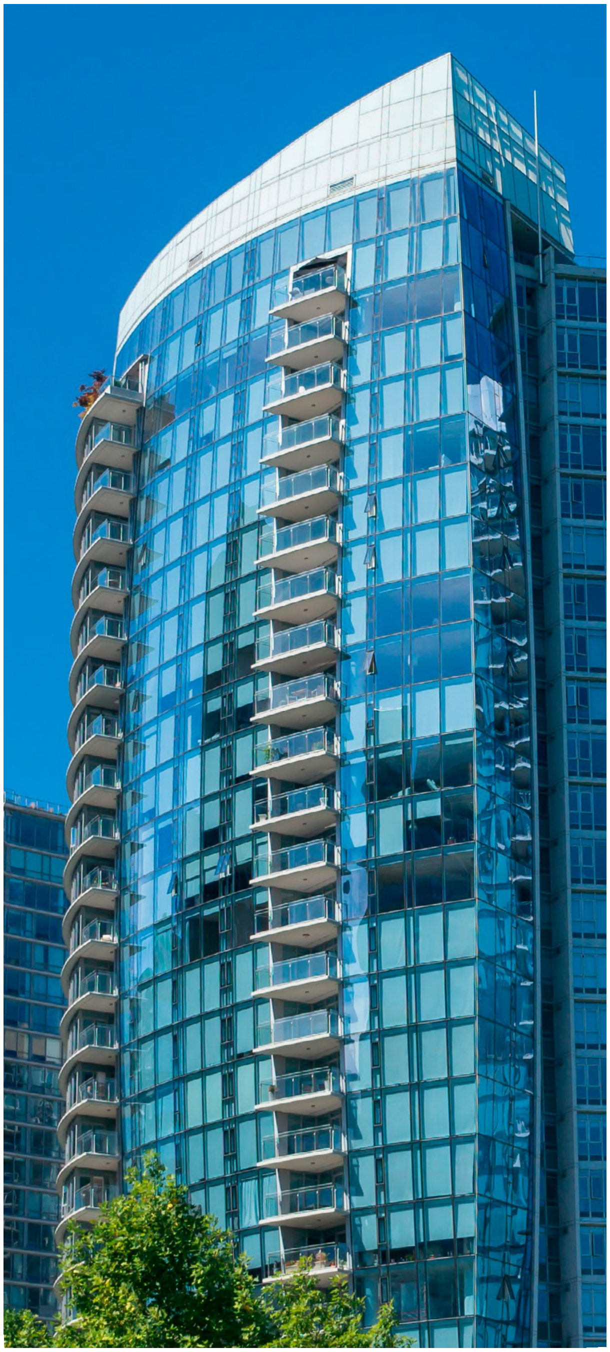
Who Should be on the Committee?

Your budget committee can be made up of members from the board, homeowners, or a combination thereof. Members of the committee should ideally not have a personal interest in how funds are spent. They should, however, be responsible individuals with budget experience to help them make the decisions that guide the association's spending.

What are the Benefits of a Budget Committee?

The treasurer should be on the budget committee and may be the chairman of that committee. Having a specific budget committee allows the board of directors to operate and hold meetings with the answers to many common questions already in hand. The finance committee will know exactly how much money the association has on hand, how much can be spent in repairs or on community projects, and which contractors are able to offer the best benefits for the lowest costs. This also allows the board the freedom to concentrate on other aspects of managing the community.

Having a budget committee is a great way to ensure that your association's funds are being spent in the most responsible way possible. If your board of directors is still forming or you have not had a budget committee in the past, it is time to consider how it could positively impact your community.



Reserve Funds

Stay Prepared for the Future

You might receive your community association's annual budget for review and notice the line item called "reserve fund." You probably wondered: why does the board need to maintain reserve funds? Well, this should answer that question for you.

The HOA Governing Documents

Your governing documents set out the rights and duties of the board. The documents include the articles of incorporation, by-laws, and the covenants, conditions, and restrictions (CCR). The board also generally adopts rules and regulations that reflect their decisions.

The association's governing documents obligate the board to provide maintenance and upkeep for common ground areas of the community, such as landscaping, security lights, play areas, the gym, swimming pools; that is, the amenities that all the owners have the right to use.

To accomplish these tasks, the governing documents give the board the right to impose homeowner assessment fees. Board members owe a duty to residents to keep the association assessment fees within a reasonable range that matches expected expenses each year. So the board develops a budget to reflect these anticipated expenses. Annual expenses include attorneys' fees, management company fees, utilities for common areas, office expenses, etc.

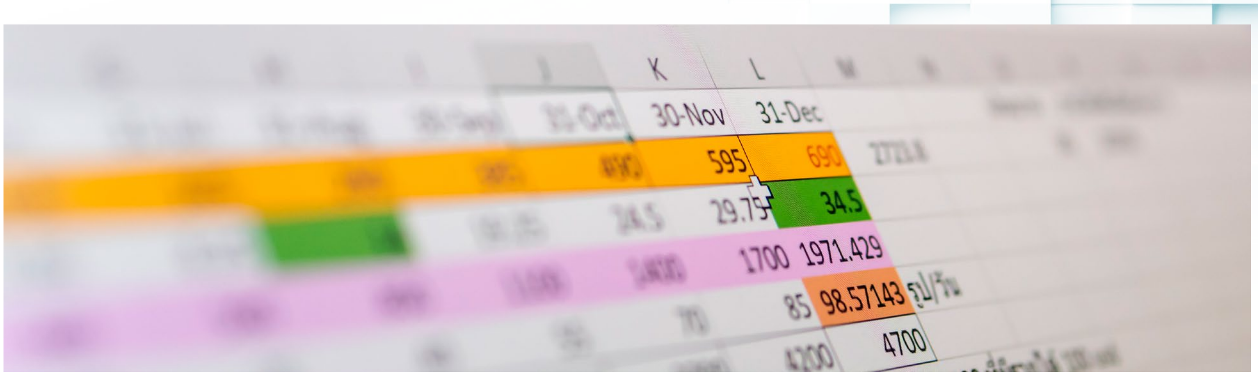
The Reserve Fund

Community associations experience unexpected expenses from time to time just as all homeowners do. To have money on hand for rainy day expenses — such as broken pipes, roof replacement/repair, or replacing the elevator — the board will save some of the assessments in a special fund known as the reserve fund. If the board's reserve fund is not sufficient to cover the unexpected expenses, the Board may also need to impose additional special assessments against the homeowners in order to cover those costs.

DETERMINING THE SIZE OF THE RESERVE FUND

Board members do not just take a wild guess at the amount they should earmark for the reserve fund. A smart board will hire an outside accountant to conduct a reserve study for the reserve fund. The accountant will present a report to the board that sets out the long-term repair/replacement costs that the board can expect given the types of amenities that are part of your community.

The reserve study generally anticipates the costs of repairs/replacements and the time frame during which the board can expect those expenses to occur over the next 20 or 30 years.



For instance, if the accountant estimates that the fitness club will need a new roof in seven years, the reserve report will show:

- The expected cost for the new roof, and
- Recommend that the board set aside a specific amount into the reserve fund from the association fees in each of those seven years to cover the cost of the new roof.

FUNDING THE RESERVE FUND

Some states require funded reserves. For example, in Florida, if the association does not waive the reserve fund, the board must collect dollars from homeowners into the reserve fund for capital expenditures of $10,000 or more. The law does not prescribe the amount of the reserve fund or the amount the board must collect from homeowners annually or how it calculates the amount.

Even if your association is in a state that does not require the board to maintain a reserve fund, or the board waives the reserve fund where permitted to do so, the board still has an overriding fiduciary duty to the homeowners to do what is in the best interest of the community. Funding a reserve fund to anticipate repair/replace expenses certainly fits within that duty. Not properly funding a reserve fund subjects the community to several unpleasant outcomes:

- The board will impose a substantial special assessment against the homeowners to pay for the unfunded repairs;
- The community does not fund the special assessment and falls into disrepair;
- The disrepair — even the unfunding of reserves itself — devalues the community. And that means the homeowners' property is worth less on the open market.

The reserve fund status is something every potential home buyer should inquire about before buying in the community.

Association Reserve Study

Put Your Money Where it Matters Most

We all know we need a community association reserve study – well, we mostly do, right? However, do we utilize these reserve studies in the way that was intended? Are we USING these reserve studies to plan ahead, research and study possible scenarios?

» "A fool and his money are soon parted"
» "It is easy to get money from foolish people"
» "It is difficult or unlikely that foolish people maintain their hold on acquired wealth"

None of us wants to be considered foolish, and often, boards err on the side of micro-managing to avoid looking foolish, even if that isn't the best solution. So, let's delve into the possible scenarios for looking foolish in your reserve spending, avoid the possibility of micro-management and develop a reputation for a community that thinks and plans ahead, and leaves homeowners with a sense of security.

There is a process with reserve spending on large projects, and it involves due diligence on the front end and requires that there is a plan, in advance of large expenditures.

Here is a list of steps an association can take to help avoid many kinds of disaster:

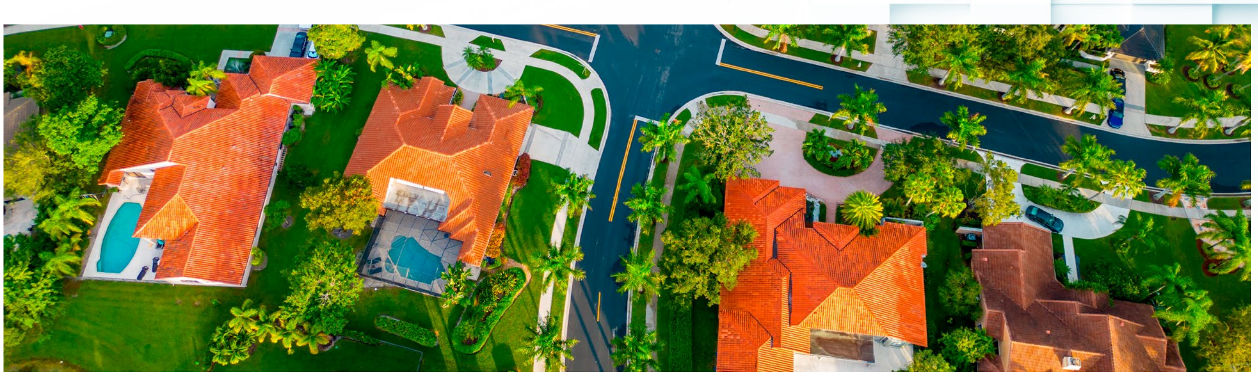
1. Bid With a Professional

Go out to bid with a reserve professional, hire said reserve professional at least six months in advance of the budget season, preferably, and have a final draft of the reserve study ready.

What is so important in that study? Aside from the current and immediate future fiscal year's required spending, it is important to look at the coming five years. What are major expenses happening within the next five years? If it involves anything that has to do with a change in the look of the community (lighting, siding, roofing, painting, shutters, etc.), you have several things to decide, which leads us to our next step.

2. Research

Depending on what the community is in need of, there could be one to two years of research involved with a major capital reserve expenditure. Where to even start? Start by asking questions. Even a survey of the board members, management company, reserve professional and perhaps, the auditor, is a good idea. Gather the answers that each of you thinks is the correct answer, and together you will develop the actual answer.



Below is a list of things you need to start considering. This list is not exhaustive, but it will get you started.

- Does the capital expenditure involve something that could update the look of your community?
- Does the community look need to be updated, to compete in the market?
- Are there other products that may be considered in place of actual replacement with like products?
- Is there a potential for upgrading the replacement of the products, that may offer the homeowners additional comfort in their home or their community?
- Is there the possibility that an upgrade of a particular item may allow for increased security within the community?
- Are there surrounding communities that have caught the participant's eye, and if so, what about that community caught their eye?

3. Project Execution

After asking questions of your professionals and those that live within your community, it is time to consider the process – who is going to be helping, how much will it cost, and what options exist?

- Does the community have a committee that is prepared to offer help with research, specification development, and interviews?

If there is NOT a committee that can assist, is it time to spark some interest with a newsletter article that seeks out individuals that may have a background that includes any of the following – project management, design or decorating, architects, engineers, or anyone in construction? Finding individuals within the community that can assist could help save the community money during the process. If you have residents with the skills it's a great opportunity to use them since both parties are invested in not only the project going well, but the end result.

Even if you do have a committee, do you need an architect or engineer to offer advice, create specifications and drawings, and assist in the bidding process?

4. Whom Do You Need to Hire?

In need of an architect or an engineer? Time to go out to bid at least one to two years in advance of the project, as finding an architectural or engineering firm that suits your needs will take several months. Then there will be a process of creating what you want in the community, which will take a couple of months. It is important to ask less obvious questions, as well, such as – how many communities of this size have you overseen, regarding replacement or redesign? Where are they located? What went well? What didn't? May we call your references?

Do you need a designer? Interview interior designers for the redesign of common area interiors. Find one that you agree that everyone likes, beliefs have the eye that is important, and that everyone will trust in the end. There are at least two things that will make even the calmest professionals act otherwise: towing their car and asking for an opinion on decorating.

5. How Much Money Do You Need to Get Where You Want to Be?

Do you need a loan? Time to talk to local bankers that are happy to tell you about the tons of products they have for community associations.

Do you need a special assessment? All special assessments are not bad. If you are improving something, it involves marketing the solution. Enlist professionals to do that.

Do you need a combination of the above, to achieve the desired result? Your professional team can assist you with this – your accountant, community association manager, banker, your attorney and perhaps your reserve professional.

Do you need to merely increase reserve funding for the next couple of years so that you can achieve the desired results, and perhaps phase in the solution? Consider the other significant reserve expenditures during that period of time. It is important that you have money to handle all of your needs, not only some of your needs.

Keep in mind that all of the above is being done before you have even started interviewing professionals that may end up doing this work. Remember that they may also have suggestions, so finding a trusted partner may bring about additional changes.

Treat your community association as something fluid that can change with the times. If this process is employed correctly, the result will be a well-thought-out, a complete plan that could incorporate changes that will increase property values, including potential safety concerns and incorporate a better way of life for your community members.

Financial Review vs. Audit

Know the Difference

One of the many things homeowners associations and condominium associations need to decide on is whether to do a financial review or an audit. While the two may sound similar, they are two very different tools an association can use to see where their finances are at and what they can do for their community in the coming year.

What is a Financial Review?

For an HOA or a condominium association, a financial review is a review of the association's financial records. This review is done by a certified public accountant (CPA), who analyzes the records using basic financial management principles to determine that the financial records are correct.

What is a Financial Audit?

An audit is a thorough look at the association's financial situation. In addition to reviewing the association's financial records, a CPA will verify the information they have been given by the association. They contact debtors and creditors to confirm the amounts owed to the association and the amounts the association owes. They physically inspect the association's inventories. They also go over meeting minutes as well as contractors to make sure there are no errors or discrepancies between them and what the financial records show.

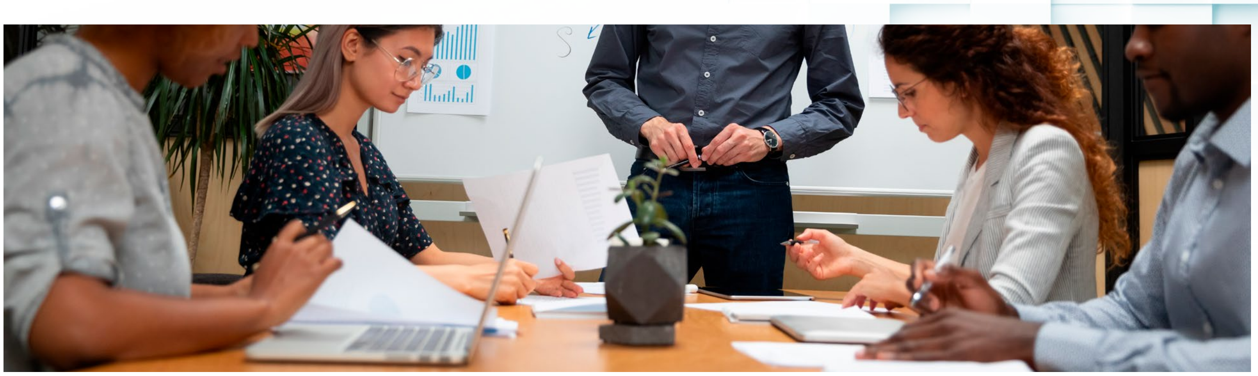
What is the Difference?

The difference between a financial review and a financial audit is that an audit goes more in-depth into the association's financial situation than a review. When a CPA is asked to perform a review, they are looking over financial records with the goal of making sure that whoever is in charge of the finances is managing them correctly. When a CPA performs an audit, however, they are being asked to determine what state the association's finances are in.

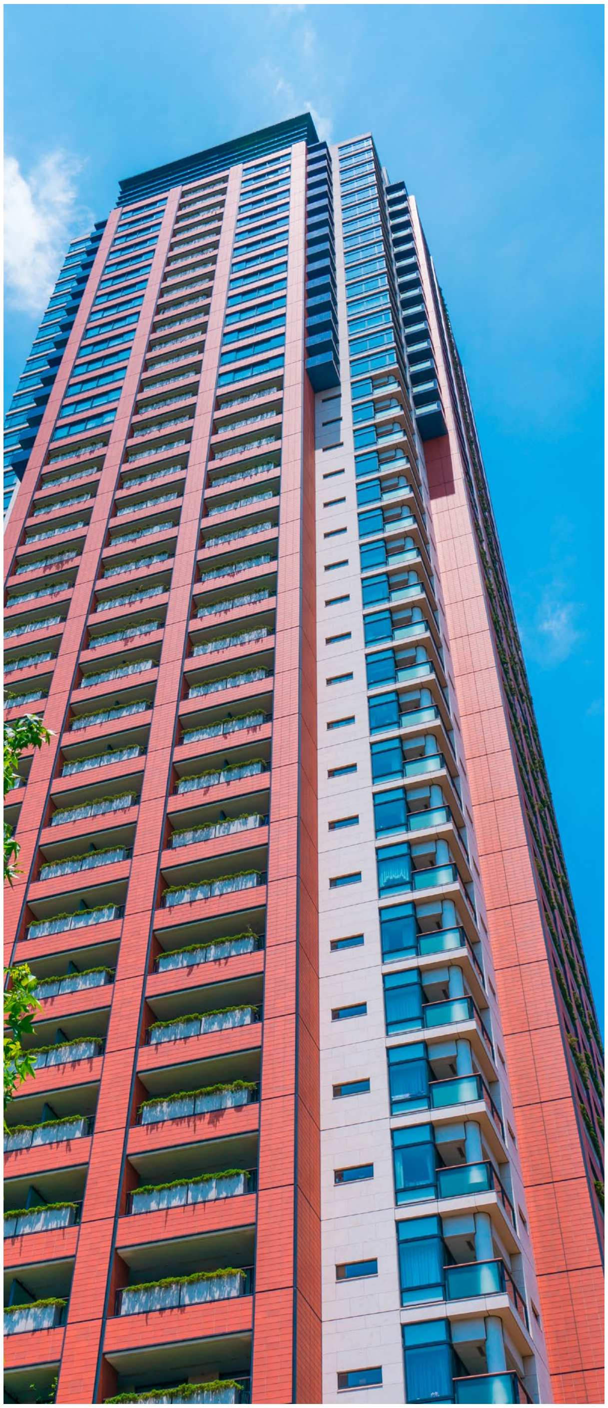
How Does an HOA or a Condominium Association Know Which One Should Be Conducted?

One thing an association needs to do before deciding whether to do an audit or a review is to check their bylaws. Typically, the bylaws will state whether an audit or a review is required, and how often it needs to happen. Most states require associations to, at a minimum, have a review conducted once a year.

Another thing to consider is the size of the association. The smaller the association is, the less assets they have and the less likely it is that an audit will be necessary.



The association should also consider their goals in having an audit. Is it being done to fulfill the requirements laid out in the bylaws? Concerns about how the finances are being handled? A change coming in the association's management, or has there been one recently? The answers to these questions will also help to determine which direction the association should go in.



When is it Appropriate to Have a Review or an Audit?

An association should have one or the other at least as often as its bylaws state (generally, at least once a year). It may also be appropriate if the association's management is changing in order for the new management to determine how the finances are being handled, what assets the association has, and the financial situation the association is in. A third situation in which a review or an audit would be appropriate is if there are concerns about how the association's finances are being handled.

Financial reviews and financial audits are two different, but useful, tools available to homeowners associations and condominium associations in determining the health of their overall finances. Communicating their results with members of the association, especially in a prompt manner, is one of many ways an association's management can use to build trust and a good rapport with its members.

Filing Taxes

Know Which Forms are Required to File

In the United States, there are more than 370,000 (per hoa-usa.com) homeowners associations. They represent about forty million households, which accounts for 53% of the owner-occupied homes in the country. If you own your own home, there's a good chance that you're part of a condominium or homeowners association. Given this fact, it's surprising that most people know very little about how condominium and homeowners associations operate. For example are these associations required to file tax returns? If so, what kind of tax form?

1. Are Any Community Associations Tax-Exempt?

For tax purposes, community associations and condominiums are treated as corporations by the federal government. This is true even if the association was originally created as a nonprofit in its home state. There are exceptions to this rule. An HOA can officially file to be recognized as a nonprofit, tax-exempt organization by the Internal Revenue Service (IRS). Many associations do not file IRS form 1024 (under tax code section501(c)(4)) for this recognition because the process can be expensive and such recognition can be difficult to obtain. It's also important to note that even those associations which achieve tax-exempt recognition are still required to file a tax return.

2. What Tax Form Do Community Associations File?

Community associations must file Form 1120, the U.S. Corporation Income Tax Return. This form is not popular with community associations for several reasons. First, filing the form can be onerous, requiring a great deal of information. Providing this level of detail means communities must be relatively sophisticated in the way they keep their books. Second, this reporting requirement means that any income which isn't spent, but rather held in reserve funds, becomes taxable for that year. Finally, Form 1120 usually means that the treasurer must make estimated tax payments, further complicating his or her work.

3. Do All Community Associations File Form 1120?

Some associations can avoid filing Form 1120 by utilizing section 528 of the tax code. This gives associations the ability to bypass 1120 and instead file the much simpler Form 1120-H. That form is just one page, this compared to the multi-paged 1120, and does not require completing 1120's several schedules. To qualify for Form 1120-H, an association must first satisfy certain requirements. For example, a minimum of 60% of the association's annual income must be so-called "exempt-function income"—this includes income form sources like annual membership dues, assessments, fees and interest on fees. In addition, at least 90% of expenditures must be for maintenance, management and construction of association property.

4. Are There Other Benefits of Qualifying for 1120-H?

A significant advantage of qualifying for Form 1120-H is that it means paying taxes only on "non-exempt income." Examples of non-exempt income are rental income for any property owned by the association, interest and dividends and income from laundry and vending machines. Qualifying associations can deduct any income directly related to the generation of this non-exempt income, but must have records that adequately support those deductions. To calculate the amount of their tax, associations that use 1120-H can deduct $100 from their non-exempt income, with the remainder subject to a flat tax of 30%.

5. Is Qualification for Form 1120-H Permanent?

If an HOA qualifies to file Form 1120-H in one calendar year, it must still qualify again in each subsequent year. To qualify, form 1120-H must be filed on time (defined as the 15th day of the third month after the end of the tax year). Associations that fail to file 1120-H within 12 months of the due date can lose their eligibility to use Form 1120-H for that year.

RealManage's expert financial management services include budget preparation and analysis, transparent financial reporting, and efficient handling of accounts payable and receivable. We work with associations to build strong reserve funds to secure your community's financial future and work with top tax professionals to guarantee compliance and mitigate risks. By choosing us, you're partnering with a team committed to your community's financial growth and sustainability. Discover the RealManage difference today!