Goldklang Group CPAs, P.C.

Budgeting Tips

Healthy finances are critical to the sound operation of a community association. A healthy financial report card is measured by an adequate replacement reserve, control over delinquencies, necessary and adequate excess operating funds and the ability to meet cash flow needs on a monthly basis. The ability to accomplish these goals requires planning, approving and implementing the annual budget.

The Budget Document

The annual budget is probably the single most important recurring document that an association produces. The budget is the basis for determining the assessment fees and serves as an indicator of the board's intentions concerning property and financial matters.

Because the budget is often the only formal communication to association members during the year, it should be informative, clear, and concise. It should contain a narrative supporting the individual line items and a detailed schedule of replacement reserves. Once finished, the budget should be approved and documented in the minutes of the Board of Directors' meeting.

Fee Targeting

The major pitfall that associations must avoid in the development of their operating budgets is the tendency to rationalize expense levels in specific categories to arrive at a predetermined fee increase or no-fee increase. Examples of fee target budgeting are:

- A mild winter or cool summer is predicted; therefore, gas or electricity usage can be reduced.
- The snowfall will be less than in the past; therefore, snow removal costs can be reduced.
- The property is in good condition; therefore, maintenance and repair estimates can be minimal.

These, and other such rationalizations, must be avoided. The budget must be developed in an objective, step-by-step manner based on actual historical data and careful projections. Remember, good budgeting is the key to an association's financial health.

Allowance for Bad Debts

Association budget preparers may overlook the cash flow problems caused by delinquencies and slow payers. In most associations, the budget preparer backs into annual assessments through the determination of expenses. In order to meet cash flow needs, this method assumes all owners will pay promptly each month. This is not always the case.

Consequently, to avoid cash flow problems, an aging of receivables should be obtained and evaluated. A bad debt amount should be determined and established for the annual budget. Costs to collect delinquent amounts should also be budgeted. If an association has a delinquency level greater than 5% of annual assessments, a bad debt amount should be established in the operating budget.

Fidelity Bond Insurance - Crime Coverage

Legislation in Virginia (VA) and Maryland (MD) regarding insurance for associations requires crime coverage. This legislation is detailed below:

VA - The requirements for fidelity bonds were modified in 2008. The new legislation requires that any association collecting assessments for common expenses obtain and maintain a blanket fidelity bond or employee dishonesty insurance policy. This policy must insure the association against losses resulting from theft or dishonesty committed by the officers, directors, or persons employed by the association, or committed by any common interest community manager or employees of the common interest community manager. The insurance policy should provide coverage in an amount equal to the lesser of $1 million or the amount of reserve balances of the association plus one-fourth of the aggregate annual assessment of the association. The minimum coverage amount should be $10,000. The executive common interest community manager may obtain such insurance on behalf of the association.

MD - The MD General Assembly also adopted legislation mandating that all condominiums and homeowners' associations must maintain an insurance policy that covers acts of fraud, dishonesty or criminal acts by any officer, director, managing agent, agent or employee who disburses funds for the community. The coverage must be equal to three months of the association's gross annual assessment income plus all reserve funds held at the time the policy is issued or $3,000,000, whichever is less.

We recommend each association meet with its insurance agent to discuss this change in policy.

Special Projects

Associations may find the need or desire to plan for a special project. The following are examples of special projects that are not part of the replacement reserves:

- Construction of a maintenance building
- Purchase of a truck or bus
- Additional tennis court or swimming pool

Funds should be set aside for such special projects in the same way annual contributions to the replacement reserves are set aside.

Making Up Prior Year Deficits

Most associations have two equity funds - one for future major repairs and replacements called *Replacement Reserves*, and one undesignated operating fund called *Unappropriated Members' Equity*. Unappropriated members' equity is like a retained earnings account in a regular corporation. It is a cumulative account and represents an association's net income or loss since inception.

If an association incurs net losses over a number of years or a significant loss in one year, this can create a deficit in unappropriated members' equity. If a deficit exists in unappropriated members' equity, then the equity designated for replacement reserves is not fully funded. It is important for associations to accumulate excess operating funds to between 10% and 20% of annual assessments to prevent net losses from creating deficits in excess operating funds. Adequate excess operating funds also protect the funds designated for future major repairs and replacements. Many associations incurred significant net losses as a result of the 2009 and 2010 snow removal costs. Due to inadequate levels of excess operating funds, many associations had large deficits in unappropriated members' equity as a result of the snow removal costs.

To eliminate the deficit in unappropriated members' equity, associations must have net income. That means that regular assessments need to increase or a special assessment needs to be passed. If regular assessments are increased, an expense line item titled *Prior Year Deficit Funding* can be added to zero out the budget. Associations should check their legal documents for requirements on making up the deficit because some documents require deficits to be made up in the following year. If the documents do not require the deficit to be made up in a specific period of time, the association should develop a plan on how the deficit will be funded. This may require the association to develop a multi-year budget.

Association Borrowing

Many associations are borrowing from banks to undertake major construction, improvements, or rehabilitation projects. If an association has borrowed funds, it must budget to pay back the loan plus the interest cost of the borrowing.

Income Taxes

Associations should budget for income taxes. Condominiums and homeowner associations have two methods of filing federal income taxes: (1) Section 277 corporation and (2) Section 528 exempt. Cooperatives generally file under Subchapter T.

Taxable income, to most condominiums and homeowners associations, is generally interest income but would include other items like unit rentals, roof space rentals, and easements. Cooperatives are similar but are not taxed on interest income.

Associations can reduce their tax with investments in treasury instruments, as interest from treasury instruments is tax exempt at the state level. They can further reduce their tax burden by identifying direct expenditures related to the taxable income. An association should establish separate expense line items to accumulate these costs during the year and develop rational methods to allocate indirect expenses.

Form 990 - Tax-Exempt Associations

If your Association has obtained tax-exempt status under Section 501(c)(4), then Form 990 or 990-EZ is the tax form to be filed. Form 990 was expanded significantly starting with tax year 2008. We now need to ask associations a longer list of questions in order to prepare it.

Generally, associations filing Form 990 or 990-EZ may budget zero for income taxes. However, it is possible to have *Unrelated Business Income*, which is taxable. The most common example for associations is newsletter income. If your association receives any unusual income, you should consider if it may be taxable as *Unrelated Business Income*. If so, it is reported on Form 990-T, which is filed in addition to Form 990 or 990-EZ.

Insurance - General

Insurance needs should be carefully evaluated and budgeted. An association should budget for the amount of its insurance coverage deductible.

Associations that do not have employees often do not carry workmen's compensation. They should, however, check with their insurance agents to determine if it is wise to obtain coverage to protect the association against injury to a contractor who might not have his/her own coverage.

Other Taxes

There are types of taxes that may be appropriate to a specific association and should be established in the budget. These are as follows:

- **Personal Property Taxes** – If an association is incorporated in Maryland and has related personal property, it might be subject to personal property tax.
- **Real Estate Taxes** – If an association has acquired one of its units, it will have to pay real estate taxes. Homeowner associations that are deeded recreational facilities and common elements may have to pay real estate taxes on these items. Real estate taxes on recreational facilities and common elements should be nominal, if charged at all.
- **Payroll Taxes** – If an association has employees, it will have federal and state unemployment taxes and employer's F.I.C.A.
- **Sales and Use Taxes** – If an association purchases goods across state lines, it may be liable to its own state for use taxes.

Excess Operating Funds (Unappropriated Members' Equity)

Associations need excess operating funds for unplanned contingencies, such as emergencies, new projects, and unexpected utility increases. To meet these contingencies, an association should have between 10% and 20% of its annual assessment in excess operating funds remaining at the end of the year (i.e., the projected year-end unappropriated members' equity).

At the end of the budget preparation, an association should test the effects of its financial plan by projecting the year-end balance sheet. In doing so, an association will be able to determine if it has sufficient excess operating funds.

Another good planning tool is to project the cash flow cycle for the year on a monthly basis to ensure against any shortage during periods of greatest expenditures.

Budget Treatment of Reserve Interest

Interest earned on reserves should remain in reserves to act as a hedge against inflation. In order to clarify its financial procedures, the association should formalize this as a policy.

The operating budget should reflect interest earned on reserves as an operating income item. Correspondingly, a separate offsetting line item in operating expenses should be set up for the amount of the interest earned on reserves, *Contribution to Reserve Interest*.

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Replacement Reserves

We strongly encourage every association to obtain a replacement reserve study. As a general rule, existing studies should be updated every five years.

The recommended annual contributions on an association's new or updated reserve study may be much higher than those originally budgeted. The association should develop a short-term plan to address this shortfall. The plan could be to raise assessments over the next few years, pass a one-time special assessment, or borrow funds. A special assessment or loan provides immediate cash flow for the association. The amounts can fund recommended short term deferred maintenance, as defined by the study. This, in turn, would effectively lower the future recommended or needed annual reserve contribution. The plan should be documented in the association's budget narrative.

If the association does not have a study, the association should document how the annual reserve contribution is being determined. The budget narrative includes what assumptions were made in determining how much to fund annually.

3- or 5-Year Operating Budget

The Budget Committee should consider developing an operating budget that covers periods greater than one year. This helps in the planning and developing of data and avoids surprise increases in association fees and special assessments.

Snow Removal Costs

Snow removal costs should be budgeted on a worst-case scenario rather than an overly optimistic belief that it cannot be that bad again. Any excess in this line item can always be used elsewhere in the budget.

Utilities

Associations should continue to monitor the volatility of utility usage for possible increases in costs that might result. All budget projections in the areas of oil, gas, water and electricity should be considered carefully. Every association that utilizes gas has seen significant increases in the past several years. Precautionary increases in these specific utility areas would seem warranted.

New equipment that is more energy efficient should be considered. Potential rebates from utility companies for installation of energy-saving equipment should be investigated.

Other Income

Be sure to include all income sources in arriving at the budgeted assessment. The following are some of the more common *Other Income* categories:

- Interest
- Laundry
- Late Charges
- Special Fees
    - Move-in Fees
    - Repair Charges
    - Pool Use
- Legal Cost Recovery
- Vending Machines
- Newsletter Advertising

If an association intends for other sources of income to be used for specific purposes, the budget document should detail the board's policy. However, caution must be used and these line items should not be overestimated in an attempt to reduce assessments.