# Commentary

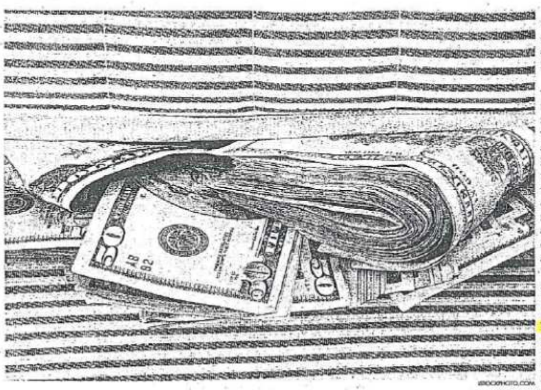
Our firm is very proud of the expansive client service practice that we have serving scores of condominium and homeowners associations. That part of our practice is so substantial that we are highly regarded as experts as relates to this industry sector. As such, we are routinely sought for comment and advice by property managers, but are even more regularly cited and quoted in articles appearing in the prominent publication, *New England Condominium Magazine*. A small sample of those such articles follows below.



## When Good Things Happen

*Dealing with a Budget Surplus*

BY LIZ LENT



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This past year, many condominium associations enjoyed a double dose of good fortune: a milder winter with less snow removal and salting, resulting in a little extra money left in the coffers by spring. The question then becomes: What to do with those funds—what is the best way to ensure they are put to the best use possible?

As anyone with a household budget knows, there are always plenty of needs waiting to be filled by a few extra dollars. For most communities, "there are surpluses in some accounts and deficits in others," says David A. Levy, CPA, based in Brookline, Massachusetts. If there is $10,000 left over from the snow plow contract, that money will not be held back and put into next year's snow plow fund. Instead, it likely will be used to help ease expenses for unit owners in the months and budget year to come.

"Generally speaking, many associations have taken and re-evaluated their budgets to assist owners in keeping fees where they were last year," says Lou Gargiulo, CEO and founder of the New Hampshire-based firm Great North Property Management. "With the economy the way it is and with people hurting, it feels like that's the most important and best thing to do."

He adds, "Other associations have used it for deferred maintenance to keep costs down, while others have deferred doing anything with the surplus until the end of 2012 to wait and see where it will be needed for 2013."

"The operating budget," says Mark Love, CPA, of Love, Jarominski & Raymond, LLP, in Worcester, Massachusetts, "is a management tool." Creating one is both "an art and a science," he says. In 2011, who would have assumed we would have had that much snow and in 2012, that little snow?"

The goal for association budgets is simply to break even. Boards and management "didn't additionally assess unit owners when they got too much snow nor do they return it when there is too little snow," says Love. "Unless it's of some extraordinary nature, the surplus generally gets used to subsidize something over-budget. Or unit owners can vote to transfer the money to the reserve fund. In fact, many financial statements contain standard footnote language that explain that any excess dollars are to be retained for the succeeding year."

Whether the dollars are used to pay for a shortfall in this year's budget or set aside to mitigate costs the following year, the savings come back to the unit owners in the form of fewer assessments or fees that are reduced or held steady for the following year.

For residents, though, examining the financial statements provided by the board and management should be a habit, not a rarity. If residents realize that they are being charged $1,000 a month in fees but the association has an enormous operating surplus each year, "then maybe the association you should only be charging me $500 a month," says Love. Making sure that the numbers are not that far out of line is why creating the budget each year can be and should be—such a time-consuming endeavor.

### Flatten the Spikes

In an association, annual budgets generally include an operating portion and a capital portion, used for major repairs and replacements. According to Levy, some associations this year will turn their surpluses over to an operating reserve account, which provides some cushion for unexpected operating expenses that arise during the year—if fuel costs unexpectedly increase, for example. "Or when insurance prices were so volatile, surpluses were put into reserve with the intent to flatten out spikes," Levy says.

Putting surplus dollars into the capital reserve fund also will ensure that no unexpected assessments will crop up for unit owners, something that benefits not only their pocketbooks in the short term but ensure that capital needs through the association are met in the long term.

With the arrival of fall, boards and managers are moving beyond those surplus dollars to begin planning for 2013. And as good as 2012 may have been for snow removal savings, associations unfortunately cannot count on that good luck repeating itself in the year to come. That is why budget planning can be so difficult and time-consuming. Boards, managers and accountants must look at a broad range of factors and conditions when planning the budget—all with the goal of breaking even.

"There are multiple ways of budgeting," says Levy. There is the method of looking at the previous year's budget and adding or subtracting a certain percentage across the board. Ideally, though, "every year's budget should be based on new information collected, as if starting fresh," Levy says. "You should do your due diligence in getting contracts looked at and reviewed." The problem, he adds, is that a lot of self-managed boards do not have the time to do those kinds of reviews.

Love suggests that budgeters will want to look at their 2012 budget, their 2012 actual and take a quick look at their 2011 budget as well. And you want to look at what some of the predictions are for the coming year. "There could be an extraordinary number of hurricanes predicted or a terrible winter forecast for 2013," he says.

And some things are easier to plan for than others, Love says. "The lights will still be on, the pool will still open at the same time, so some things are more easily budget-able than others."

Gargiulo agrees that a careful examination of past and current budgets as well as contracts is integral to a successful budgeting process. "Don't just say everything is going up five percent," he says. He suggests procuring bids from contractors and then estimating costs before presenting to the board on what the best estimates would be. Capital projects in need of completion that year should also be added to the estimates as well as estimates for what needs to be set aside for the reserve fund.

"We also look at what the current trends will be," Gargiulo adds. "What are we seeing in the insurance field? Increases? When you have a company as large as ours, we're able to say what the trends are in each year of expenses." Right now, for example, he is seeing an insurance market where premiums are increasing. "And we're seeing values in energy conservation," which can help save associations money down the road.

### Look for Savings

Levy agrees that utilities have great potential for budgetary savings. Being

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efficient and having energy audits for the common areas can help associations reduce costs for long-term savings. Other successful associations have looked at ways to change operational procedures, too. "Just because the landscaping budget always has included $1,000 a year for new plantings, do you necessarily need that?"

The associations that are most successful at budgeting "look at each line item on an annual basis," Gargiulo says. "They communicate with various vendors who are a major part of the budget, rebidding on certain critical contracts when necessary. And they look at line items throughout the year."

That constant vigilance is key, Levy says. "The annual budget is the single most important thing the board can approve," he adds. So examining each line each year is always worth it in the long run.

This year, those eagle-eyes are being applied to snow removal as boards and associations plan their 2013 budgets. "We live in New England and no one knows the weather," Levy says. He believes prices will be higher and suggests securing quotes from multiple vendors in order to keep costs down.

As difficult as budgeting can be, Love believes today's boards are up to the challenge. Associations "now function like they're small businesses," says Love. "Boards are well-educated and well-experienced and have gotten stronger in a positive way." That level of experience and expertise can help them work smoothly and cohesively with management and other outside experts to craft polished and professional budgets that benefit the entire community.

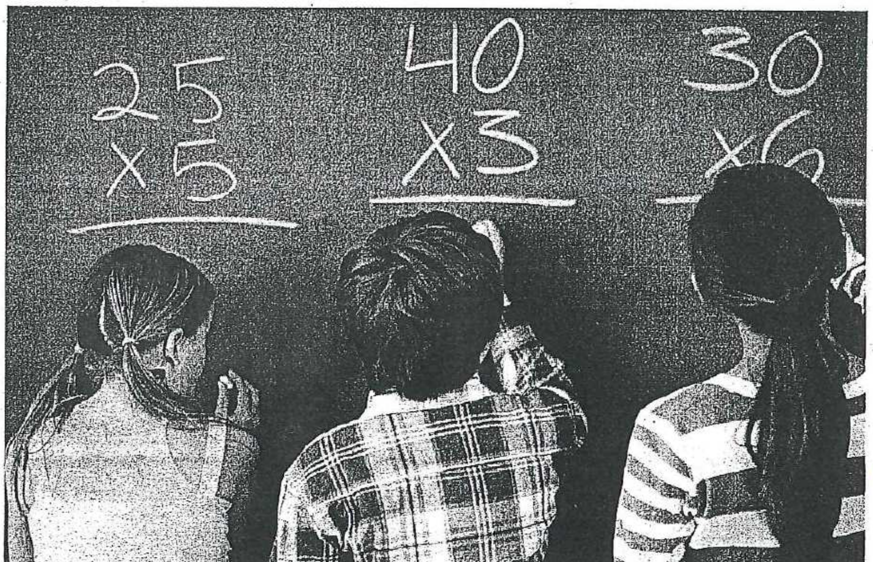
When windfalls happen, it helps to be in a position to take the best advantage of them possible. With proper planning and an understanding of options are out there, budget surpluses can make a difference not only in the current budget year but in the years to come. ■

*Liz Lent is a freelance writer and a frequent contributor to New England Condominium.*

# Understanding Your Association's Finances

## *Reading Between the Line Items*

BY LISA IANNUCCI

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Budgets and financial reports provide a crystal-clear picture of how the association is doing. From an investment perspective, they show how unit owners, managers, tenants, building owners, board of trustees, etc., whether the property is profitable or not. If it is profitable, you can rest assured that everyone is doing a good job. If the property is in the red, it's important to determine why that is, and what needs to be done differently to turn the situation around and restore solvency.

It's important to understand each financial document and its purpose so you can have a better understanding of exactly what's going on in your association. So here's a little Financial Paperwork 101.

"My first suggestions lean on the legal side, because all condo associations are technically trusts, so start by having a trust agreement and a master deed," says Mark L. Love, CPA, a partner at Love, Jarominski & Raymond, LLP, in Worcester, Massachusetts. "A trust speaks to the point of 'how many board members should there be,' 'what's a quorum,' 'what's the year end,' and 'what are the year-end financial requirements?"

A master deed includes all the provisions, rules and regulations that must be followed by the unit owners.

**Financial Statements**

Every month, a financial report should be generated to give an idea of where the association stands. The report compares the actual budget to the projected budget. In addition, it lists the bills that were paid and the monies that were collected. In other words, anything financial that happened that month should be presented in a financial report.

For example, according to the General Laws of Massachusetts, condominiums comprising 50 or more units are required to have an annual review of their financial statements conducted by an independent certified public accountant in accordance with standards promulgated by the American Institute of Certified Public Accountants (AICPA). In certain instances, such a review may be performed less frequently, but in no case less than every two years. In still other instances, a condominium may opt to have that independent CPA firm conduct an audit. "There is considerably more work associated with an audit, hence it costs more," states Love. "As such, most of our association clients opt for us to perform a review. However, a few do choose to have a full audit. They may opt to elect this service for a variety of reasons, particularly when ownership is transferred from the contractor to the association."

"Associations also need an internal set of monthly produced financial statements, such as a profit and loss (a component of the budget variance report) statement and budget variance report," says Kenneth A. Bloom, CPA, partner in Bloom Cohen Hayes in Needham, Massachusetts. "The budget variance report determines how much they'll charge the units. They also need a record system to account for cash receipts and disbursements."

"People want to know how actual expenses are faring relative to the budget," says Bloom. "They are wondering, 'How is it compared to what we expected?' The budget variance report gives you that answer."

For example, Bloom says, a budget might include $20,000 for snow removal, but if it was a winter that didn't see much snow, the actual expense used might only be $2,000. "You'll see that the board is significantly under budget," says Bloom. "However, if oil was budgeted at $250K and the actual is $245K, it might look good that they came in $5K under budget. But if the winter was really cold and oil prices skyrocketed, this number may not be right. Maybe invoices are missing. If I'm doing the audit, I'm going to ask to see the billings for the year and make sure we have 12. This report puts the numbers in context."

**Bank Statements**

Bank statements are needed for each and every cash account the association has, including CD accounts, and a bank reconciliation, which is a process that explains the difference between the balance shown in a statement and the amount shown in the association's own accounting records.

**Tax Returns**

"Even though condos are, for the most part, tax exempt they still need to prepare and file a tax return annually," says Love. "Sometimes the board delegates the responsibility of completing it to the management company and sometimes they want to do it themselves."

**Management Letter**

According to Love, a CPA firm occasionally writes an annual management letter. "It's a letter that comes with suggestions on improving the accounting systems, improving controls, cost savings and other efficiencies. It's not meant to tell how to run the business, it's meant to give ideas to consider for improving your business."

**Reserve Study**

Emergencies are going to happen and every association needs maintenance and repairs. Associations should be prepared with enough financial reserves to cover the costs of these emergencies and repairs. To know what those costs are, associations will typically hire an architect and/or professional engineering company complete a reserve study. A reserve study provides estimations on repairs and replacement costs for the property.

"Reserves studies are not part of the monthly or even annual financial reporting process," explains Jason Powell, CMCA, AMS, of Alpine Property Management in Boston. "Reserve studies should be done every five years or as needed, based on many variables, but the resulting data is supposed to be used by

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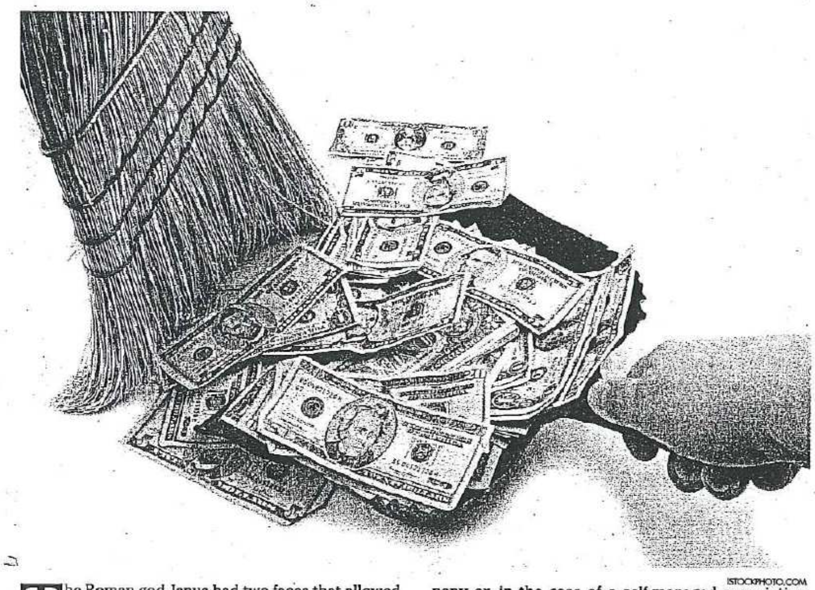
# Look Both Ways

## *Review Last Year's Results Before Creating Next Year's Budget*

BY APRIL AUSTIN



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The Roman god Janus had two faces that allowed him to look backward into the past and forward into the future. When thinking about end-of-the-year association finances, boards would do well to take a lesson from Janus and look back at expenses from 2011 and ahead toward obligations in 2012.

December is the month to take stock of the association's overall financial management, its budgeting and accounting practices, and to prepare for filing federal and state income tax returns.

Even though most homeowners associations don't generate much in the way of net income, they must still file annual income tax returns to the IRS. (States have their own tax forms that must also be filed.) The most common forms are the 1120 and 1120-A. A third form, 1120-H, is more basic and straightforward to fill out, says David A. Levy, CPA, of Brookline, Massachusetts, but the disadvantage is that it taxes at a higher rate. (For more details about tax forms, see the July 2008 New England Condominium issue on Community Budgets & Finance, available online.)

Choosing which IRS form to use can be difficult, because those for HOAs don't look like the forms people are used to. "They're more like mongrels," says Mark Love, CPA, of Love, Jarominski & Raymond LLP in Worcester, Massachusetts. "It's easy to fill out the incorrect form, which can be time consuming and expensive to rectify."

Data for tax returns is drawn from regular financial statements generated by the management company or, in the case of a self-managed association, by the treasurer or CPA. But it is the board's responsibility to monitor these reports. "If you have active, involved board members who take their fiduciary responsibilities seriously, they will examine monthly statements," says Levy. By the time the board arrives at the end-of-year reckoning, its members are in a better position to assess the association's financial health and are less likely to encounter unwelcome surprises.

### Where the CPA Fits In

Certified public accountants offer three basic levels of professional financial services: compilation, review, and audit. A compilation involves drawing together the useful financial information, but does not include analysis or evaluation. In a review, the CPA analyzes the financial statements and provides some assurance that good practices are being followed. An audit takes the oversight to a higher level, in which the CPA investigates the association's actual financial structure and internal controls, as well as evaluating the statements, says Levy.

Association bylaws and state regulations govern how often a review or audit must take place. For smaller associations, a yearly review is likely all that's needed, with an audit on the third cycle, says Levy. Reviews and audits are begun when the books are closed, generally within the first few months of the New Year.

### The Budget

The majority of associations follow the calendar year rather than the fiscal year cycle. In a best practices scenario, the new budget would have been voted on by November 2011 to take effect on January 1, 2012. But the reality is a bit messier. "We see a disproportionate number of budgets done at the last minute," says David J. Levy of Sterling Services, a management company in Holliston, Massachusetts.

Well-run associations draft a budget at least three months in advance of the approval vote. But the work of gathering costs for services should start much earlier. For example, prices for services might be collected in summer, a draft budget produced in September, an open community meeting held in October, and the final budget voted on in November.

The budget process goes more smoothly, Sterling's Levy says, if board members—and owners—understand how critical the budget is to the running of the property and educate themselves about the financial situation. By being familiar with the books, and in particular with the reserve account, board members can speak knowledgeably to owners who might be promoting a pet improvement project. Having hard numbers in hand can counteract the inevitable pressure from owners wanting expensive new amenities to be added to the property.

A "straw man budget" is what Paul Pronsky, treasurer for the 48-unit Quinsigamond Shores Condominium Trust in Shrewsbury, Massachusetts, draws up in late September or early October, before he meets with the board. In it, he tallies the three categories of projects on the table for next year: Those that need to be done, those that are desired, and those that would be nice to do. Usually these projects fall under the heading of maintenance, he says. Then he assigns dollar amounts based on the previous year's spending and any projected increases. By looking at these amounts in the context of capital and reserve funds, the board can set priorities and weigh discretionary spending against monthly fees.

By contrast, if an association is "winging it" because of lack of either board participation or management input, December can devolve into a harried, last-minute race to finalize the budget. If the budget gets pushed over into the New Year, it can create chaos, says Levy of Sterling Services. For example, if board members wanted to raise 2012 condo fees because of increased costs, they would have missed the required 30-day advance notice to owners.

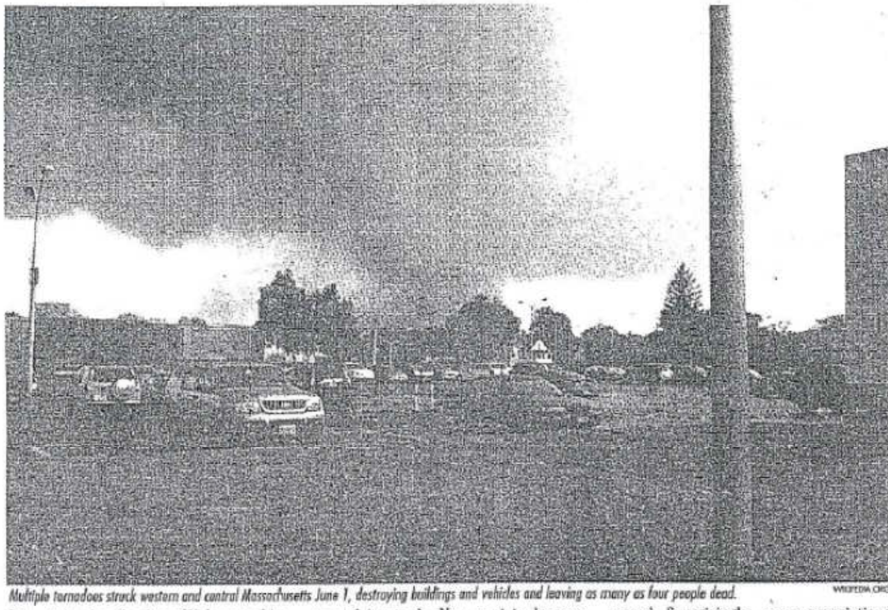
The responsibility for record keeping rests with the management company, if there is one, or with the association treasurer. He or she is also responsible for filing the association's annual federal tax return by March 15, a month earlier than individual taxpayers but the same date as corporations. (The IRS views homeowners' associations as corporations, whether or not they generate much income.)

Rules about the frequency of reviews and audits are spelled out in the association documents. By adhering to the bylaws, boards and managers reassure

# Expecting the Unexpected

## *Planning for Unanticipated Expenses Can Be a Guessing Game*

BY PAT GALE



*Multiple tornadoes struck western and central Massachusetts June 1, destroying buildings and vehicles and leaving as many as four people dead.* WIKIPEDIA.ORG

Massive flooding. Widespread insect infestations. Devastating tornadoes.

It's a good thing those things don't happen in New England.

Condominium trustees and homeowners who thought New England was immune to such catastrophic events have received wake-up calls in recent years. New Hampshire residents haven't yet forgotten the floodwaters that rushed through their neighborhoods a few years ago. Pest control companies have been battling armies of irritating bedbugs. And just weeks ago, a band of tornadoes left large swaths of Massachusetts' communities in ruins.

Add to those woes the destructive ice storm of 2008, unrelenting snowfalls of last winter and spiking oil prices of recent months, and association boards may feel they're rolling the dice when they sit down to develop an annual budget. How can a community prepare for emergencies and the vagaries of nature?

The first step, of course, is to be sure that the property is properly insured. "You have to consider the worst that can happen ... a fire, or a tornado, or those coastal tsunamis. You want to be sure you have it right, to make sure you're adequately insured," says Chris Snow at Bernier & Snow Insurance Agency in Rochester, New Hampshire.

"There's always a push and pull between the board, the manager and the insurance company to figure what's the right number," he says. "We're not prone to wildfires like in the west—one fire and you're gone." In anticipating the result of catastrophes, one consideration may be that many New England condominium complexes are spread out, so if there is a fire, it's not likely that the entire community will be lost. But it's best to be prepared. Surprisingly, some associations look at the short-term cost rather than the potential for disaster. "There was a condo in Florida that elected to drop insurance to save money," he recalls. "And then it burned down, and they had no insurance." Fortunately, he says, most associations will use some common sense when it comes to such perils.

> "Associations are facing a balancing act between preparing for the unexpected and waiting for disaster to strike."

### "Unexpected" Runs the Gamut

Fires, or devastating tornadoes, though, represent just one end of the "unanticipated expenses" spectrum. "Different situations call for different contingency plans," says veteran manager Stephen DiNocco, CMCA, AMS, principal of Affinity Realty & Property Management, LLC in Boston. "With snow removal, for example ... you budget as realistically as possible, and if things go really bad, you can do a supplemental budget at the end of the year."

But, he notes, the wise association will plan ahead and expect that at some point, the unanticipated expense will arise. "I encourage associations to put in a contingency reserve, maybe five percent, and build up reserve money for an operating contingency that you didn't expect. That way, you have some money on hand if it's needed, and it's painful only in the first year."

Associations that have gone that route, he says, "love it. They see that [the contingency fund] is building up and know they have something on hand if it's needed." One attraction of the system, he says, is that there's less likelihood that the board or manager will have to send out notices of a pending special assessment. "Most of my associations have been doing this for quite a while now," DiNocco says. "Some do five percent, some do less, some do more. It depends on what they feel comfortable with."

Of course, everyone would rather keep those dollars in their own wallets, he notes, "but for most people, although they'd like to have that money, I don't think it's enough to break the bank for them." Having that rainy-day fund set aside, he says, lessened the blow for associations that faced excessive snow removal costs last winter as the region got walloped with back-to-back storms.

"Associations are accustomed to having replacement funds for repair and replacement of things like decks and windows," says Mark L. Love, a certified public accountant with the central Massachusetts accounting firm of Love, Jarominski & Raymond, LLP. "They understand about putting money away for things you know are going to happen, like needing new pavement."

But, he says, with the current economy, it can be hard for people to open their wallets to set aside funds for "the unexpected things that might not happen." Associations, therefore, are facing a balancing act between preparing for the unexpected and waiting for disaster to strike. "The final analysis is, having that reserve is nice, but it increases your condo fee. If you don't have it, and a catastrophe occurs, it increases your assessment."

"Associations," Love says, "are pretty much caught in the middle. They all do a very good job caring for at least the replacement portion of the fund, but they're hard-pressed to set up reserves for the unexpected things."

Looking beyond the obvious, Snow says that associations today have a wide range of expenses that could appear at any moment. Suppose, for example, that

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