$how Me the Money

“Why…Why…Why…”
“Do’s and Don’ts…in Sevens”

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Around the Clock
Board of Director Training
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Establishing Good Financial Procedures

<u>Why</u> Do I Care About Financial Procedures???

It's your Job…that's why you get the "big bucks" ☺ (volunteers!)… Your unit owners count on you… Errors can occur…and so can fraud.

<u>Seven Do's and Don'ts of Internal Control for Your Association</u>

1. **<u>Don't</u>** sign blank checks, nor leave blank check stock unsecured.

2. **<u>Don't</u>** accept cash. If absolutely necessary to accept cash, then do so only with 2 witnesses with duplicate receipts.

3. **<u>Do</u>** require invoices, or other type of verification of the expense, on all paid bills.

4. **<u>Do</u>** update signature cards in a timely manner whenever there is a change in board members or change in management personnel. The board may want to consider having a board member deliver/mail the signature cards to the bank. Have a signatory policy for all accounts (e.g. who can sign, how many signers, what dollar amount is required, etc).

5. **<u>Do</u>** require approval of write-offs of A/R balances by a person other than the person making the deposits and reconciling the banks. The board shall approve all write-offs over a certain amount.

6. **<u>Do</u>** review all bank statements and reconciliations at least quarterly for ALL bank accounts - including certificates of deposit.

7. **<u>Do</u>** receive and review financial statements at least quarterly (monthly, is even better). The entire Board has this responsibility not just the Treasurer!

Seven Do's and Don'ts of Fiscal Responsibility

1. **Do** have an investment policy that is in accordance with the Association's governing documents and the long term needs of the Association.

2. **Do** request an annual review of insurance requirements including types of insurance and coverage amounts.

3. **Do** spend time developing an adequate budget annually. That includes an operating budget and a reserve budget. Have a reserve study prepared on a regular basis. Document the Association's funding plan, including any reasons for not funding in accordance with the reserve professional's advice.

4. **Do** have a collection policy that is followed consistently and is in compliance with the laws of the State and the Association's governing documents.

5. **Do** disclose all conflicts of interest.

6. **Do** ensure that the independent contractors have the appropriate licenses, insurances, etc., and that they are truly independent contractors and not employees.

7. **Do** take the time at each board meeting to review the financial statements and ask questions about any financial transactions that are unclear. The board of directors must take ultimate responsibility for the management of the Association. Document financial decisions in the Board meeting minutes.

INTERNAL CONTROLS CHECKLIST

(These are the ***minimum seven*** standards we recommend for associations)

☐ Board meeting minutes approval will consist of:
- ⇒ Opening/closing of bank accounts
- ⇒ All reserve expenditures
- ⇒ Major contracts
- ⇒ Unusual, nonbudgeted items

☐ Board receives financial statements, at least quarterly, consisting of:
- ⇒ Balance sheet
- ⇒ Income statement comparison to budget
- ⇒ Receivable (delinquency and prepaid) reports
- ⇒ Bank statements and bank reconciliations for ALL accounts (including certificates of deposit)

☐ The Board has a signatory policy on cash accounts in compliance with their governing documents and State law. If the Board does not sign checks, other controls are in place to ensure approval and proper payment of expenses.

☐ The Board must approve all bad debt write offs or adjustments to A/R balances over $__________ (depends on Association.)

☐ All related party transactions/conflicts of interest are disclosed to the Board and, where appropriate, to the membership.

☐ The Board has a policy to determine what contracts need to go out for bid.

☐ The Association accepts no cash, or has very specific controls with regards to cash acceptance.

Approved by Board of Directors

____Association

Date ____________________________

By/Title___________________________________

<u>Why</u> Budgets???

<u>Important Time to Evaluate the Association's Obligations, Needs & Expectations</u>

Budget planning is an important time to evaluate the Association's obligations, needs and expectations of its members. It is a time to reflect on exactly where funds are being spent and to project where funds can best be spent in the future. The board has a fiduciary duty to its members to set reasonable assessments, and then spend those assessments in the best interest of the Association. A budget requires the board to evaluate its current policies and procedures. It also gives direction to a new board of directors and supplies an important tool to analyze their spending habits during the upcoming year.

Seven Do's and Don'ts of Budgeting

1. **Don't automatically assume the validity of every expense.** Just because an item was on last year's budget (or always has been on the budget) don't assume that it still needs to be there - or needs to be there at a predetermined amount. Question all line items. Does it really fit into the Association's obligations, needs or expectations? Take some time each budget year to challenge all previously conceived assumptions

2. **DON'T take last year's numbers and increase them** by the cost of living index. For that matter, don't increase them by any set percentage. That may be used as a rule of thumb, but there is no reasonable basis to expect that every item is going to increase at the same percentage.

3. **DO examine each expense item individually** (at least those of a substantial dollar amount). Be sure and understand what your expectations are of that particular expense in the upcoming year...and how that will affect the dollars to be spent.

4. **DON'T start by determining the assessment income**. That is, do not decide first what the assessment amount will be for the next year. Start with expenses first. Go through the expenses line item by line item being realistic as to increases and decreases, changes in services, and additions and deletions of budget items. Then total these amounts to determine what assessment amount is required to meet these expenses. If the assessment amount appears unreasonable, then go back and determine what expenses you are willing to change to adjust the assessment amount. By starting with expenses, it allows the Association to focus on the real priorities and may cause the Association to reevaluate the appropriateness of your assessment amount for the Association style's of living.

5. **DO budget for education & reference materials.** It is very important and very appropriate that the Association pay for the manager and the board members to attend educational functions, such as those put on by CAI, to educate themselves on their responsibilities. Also, the Association may want to consider budgeting an amount to build up their reference library. There are many great publications available which would be nice to have on hand.

6. **<u>Do</u> Budget for Bad Debts.** There is no industry average for this amount. It is a very subjective decision, made on an Association by Association basis. Look at the current outstanding accounts receivable as well as last year's history and come up with a projected amount for next year. One attorney is recommending 50-70% on severely delinquent accounts due to the current economy.

7. **<u>Do</u> Budget for the Unexpected.** What is a recommended amount? Cagianut & Company recommends that an Association have 1-3 month's of operating expenses as an operating fund balance. CAI - National recommends a minimum of 2 - 5% of the annual assessments with 10 - 15% being very good. If the funds are not used in the current year, they can be accumulated in retained earning (excess operating funds/members equity) for future years. There are generally two main ways that Associations budget for the unexpected.

    a. **Set Up a Contingency Account.** The first way is to actually set up a category each year called contingency or some similar term. What the amount of that contingency is may depend on the circumstances of your Association.

    b. **Include Contingencies Within Each Component of the Budget.** The second way to plan for the unexpected is to include contingencies within each component of the budget. For example, if the Association feels that $100,000 is needed in Landscape Expenses for the upcoming year, they may budget $105,000 (or add in a 5% contingency factor). This then is done for most, if not all, of the categories.

Balancing the Budget

There are only two ways to balance a budget – either increase the income or decrease the expenses. The one item that an Association does not want to decrease, without a lot of reasoning behind the decision, is the allocation to the replacement fund. To reduce expenses, go back through the line items and determine if they are an obligation, need or expectation. Obligations should not be changed. If it is a true need, those also would not be changed. But, sometimes those items the Association sees as needs are truly wants or expectations. These are the areas where an Association has more flexibility.

Obligations and needs can be determined from reading the governing documents, reviewing the reserve study and talking with those “in the know” such as professionals, other board members, employees, etc. The expectations are more difficult to ascertain. Consider using surveys. Also, just by talking with the neighbors and reading past board meeting minutes and reviewing the open discussion comments, the board can get a handle on the community’s feelings.

The bottom line is, however, it is up to the board to make the final decisions for the Association. This is a business as well as a community and the board has the fiduciary responsibility to run the Association.

Using the Budget

As you go into the next year, you should get a budget-to-actual income statement. If you spent enough time and effort during the budgeting process, you should have an excellent analytical tool to assist you in keeping the Association on track!

<u>Why</u> Fund Reserves???

<u>Seven Important Reasons (Do's and Don'ts) for Funding Reserves</u>

1. **<u>Do</u> be fair**. The "fairness" policy allows for payment of major repairs and expenses based on the time period that a unit owner has lived in the Association.

2. **<u>Do</u> your duty to all owners** - future, as well as current owners

3. **<u>Don't</u> be swayed** by personalities or "keeping peace"

4. **<u>Do</u> what is right** from a business standpoint

5. **<u>Do</u> maintain the property for resale** values

6. **<u>Do</u> maintain the property for livability** and the enjoyment of the common areas.

7. **<u>Do</u> avoid Special Assessments**

Audits

<u>Why</u> Have an Audit???

"Audits cost a lot of money." "Who can understand financial statements, anyway?" **"Our manager is totally trustworthy."** *"Our homeowners don't look at the audit once it is done."* **"It is just a waste of time and effort."**

Have you heard any of the above statements when it is time for your Association's audit? Or, possibly, is one of these your argument for voting NOT to have an audit? If so, keep reading and, hopefully, by the end of the article you will be re-thinking your decision.

Washington State requires audits for condominium associations when there are more than 50 units and for homeowner associations when there is more than $50,000 in annual assessments. However, the law also allows, in some cases, for the membership to vote not to have the audit. So, the question is – Why have an audit of the association's financial statements?

<u>Seven Do's For Needing an Audit of The Financial Statements</u>

1. **<u>Do</u> Your Duty.** The board has a duty to the Association members. The board is accountable to the membership for the use of the members' assessment monies. Also, the management and care of the assets of the Association, including the buildings, common areas and investments are entrusted to board members. As part of this duty, the Board is charged with making objective decisions. Having impartial advisors, such as CPA, is a good business practice.

2. **<u>Do</u> Run the Association as a Business.** The Association may be a nonprofit organization; however, it is often said that it truly is a "multi-million dollar corporation". There are complex accounting, tax, and finance issues in an Association.

3. **<u>Do</u> Allow for Proper Financial Oversight.** A year end audit supplies independent oversight of the financial transactions that occurred during the prior year. The CPA is independent of all parties and will give an unbiased opinion of the actions of the board and management company.

4. **<u>Do</u> Ask your Auditor about Internal Controls.** An auditor is compelled by generally accepted auditing standards to examine the internal controls of an Association. The auditor should note when internal controls are lacking. Adequate internal controls ensure less chance of error or fraud. Most misstated financial statements are due to human error; however, there is always the chance that fraud can occur. While audits do not guarantee that all mistakes or fraud will be found, procedures are in place to assist in this process.

5. **<u>Do</u> Count on Complete and Accurate Financial Statements.** CPAs are trained to present financial statements in accordance with generally accepted accounting principles (GAAP). This allows consistency when read by others, such as bankers, potential buyers, etc.

6. **<u>Do</u> Provide Adequate Disclosures to Owners and Potential Owners.** Completion of the year end audit with accompanying financial statements and footnotes allows all current, as well as future, or potential, owners a complete, independent summary of the financial status of the Association. If those individuals choose not to read or understand those statements, that is their choice. The information has been made available to them.

7. **<u>Do</u> Ensure Compliance with State, Tax and Accounting Laws and Regulations.** There is a maze of laws and regulations which require compliance by an Association. With regards to financial and tax matters, the auditor can assist and guide the board of directors into compliance.

Here are some other thoughts to replace those at the onset:

"Audits help board members perform their fiduciary duty". "Dollar for dollar, an audit provides a lot of value to the Association". *"Audits are a normal cost of doing business...and the Association is a business".* **"The auditor is an independent voice to the Association".**

So, why would you have an audit?

- ✓ **To assist in your duty**
- ✓ **To ensure the Association is being run as a business**
- ✓ **To allow financial oversight**
- ✓ **To distribute complete and accurate financial statements**
- ✓ **To be accountable to homeowners**
- ✓ **To gain knowledge about improved internal controls**
- ✓ **To achieve compliance with State, tax, and accounting laws and regulations**

<u>When is an Audit Required? Or Recommended?</u>

Washington State Law – Requirements

Old Act Condominiums – Those created before July 1, 1990

64.32.170 (Horizontal Property Regimes Act) – Required an audit once a year by an auditor – all condominiums – however, the new condominium act superseded this law. HOWEVER, if the Old Act Condominium's documents use the Old Act wording, then the governing documents prevail. No mention of GAAP, but our "company policy" is to use GAAP unless otherwise directed, and we strongly recommend GAAP

New Act Condominiums – Those created after July 1, 1990

64.34.372 (Washington Condominium Act)
Condominiums with 50 or more units must be audited annually.
Condominiums with fewer than 50 units – audit is required; however, can be waived by 60% of the owners (other than the declarant/developer)
GAAP required

Homeowners Associations – excludes condominiums, non-residential developments and residential cooperatives

64.38.045 (Homeowners' Associations)
Associations with annual assessments (note: it specifically says assessments, not other income – interesting) of $50,000 or more requires an audit; however, can be waived by 67% of the owners
GAAP not required; however, "keep financial and other records sufficiently detailed to enable the association to fully declare to each owner the true statement of its financial status".

<u>Why</u> Do Associations Pay Taxes???

This is the number one tax question asked by homeowners, board members, managers and even accountants (outside of this industry). Community assocations are nonprofit *mutual benefit type* of corporations. To qualify for Federal tax exemption and pay no income taxes an organization must:

1. ***Serve some type of common good.***
2. Not be a "for-profit" entity.
3. Not have net earnings that benefit the members of the organization.
4. Not exert political influence

Associations are <u>not</u> organized for the common good of society, such as for religious, health and welfare, education or other tax-free type of purposes. A community association is simply a group of taxpayers who have formed an organization to share expenses. Thus, the Association is allowed to exclude from income most monies from the member/taxpayers. However, such items as interest income, which would be taxed at the taxpayer level, are also taxed at the Association level.

There are a very few associations that are considered as "communities" for the public good. They cannot be condominiums, and even very large planned unit developments have difficulty getting exemption. IF exemption is granted by the IRS after applying for it, then all income is tax-free and an entirely different tax form is used each year. The tax form is form 990.

There is even a smaller percentage of CAs which file for exemption, receive exemption on membership income, but pay on interest income. These are "social clubs". They also file form 990.

Seven Do’s of Paying Taxes

1. **Do pay tax on interest income.**

2. **Do pay tax on income from nonmembers.**

3. **Do understand that “per use” fees CAN be taxable.**

4. **Do use a reasonable expense amount to offset income and plan on paying taxes when there is taxable income.**

5. **Do file corporate taxes by March 15th or get an extension** to September 15th (for December 31st year end associations).

6. **Do have a corporate officer sign** the tax return.

7. **Do elect Revenue Ruling 70-604** every year. We strongly recommend that every Association make the 70-604 election on an annual basis. There is absolutely no downside. Even if the election is not used that year, it is available if needed at the time of an IRS audit. It leaves all options open to the Association. Plus, once the membership gets used to making the election, they will continue to do so each year without hesitation. Be sure and document in the annual meeting minutes (if that is when the election is made) and keep a copy of the resolution in the corporation minutes and resolutions book.

For more information about these topics and MORE ~

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