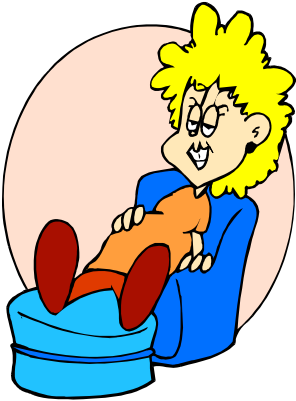
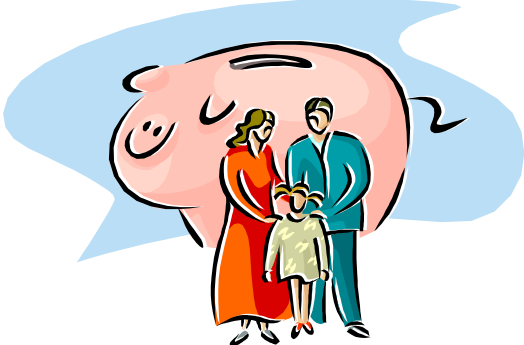


The 3 Stages of an Association's Financial "Life"



BEFORE the year actually starts

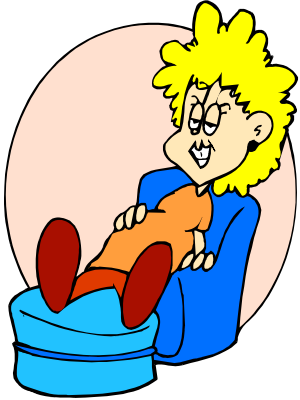


DURING the year



AFTER year end

Presented by
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BEFORE the year actually starts

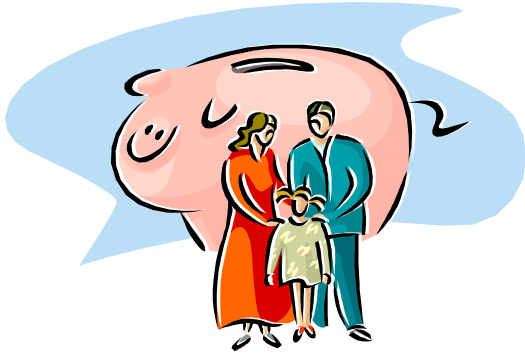
Two parts to a budget – Reserves (Replacement Fund) and Operating Fund

- **Reserves**

- Long-term plans
- Important to get the reserve study done before the operating budget

- **Operating**

- Generally should breakeven each year
- Should build up so that there are 1-3 months of expenses in operating fund



DURING the year

Review Financial Statements

- **Budget to actual comparisons – adjust spending accordingly, but no need to adjust budget**
- **Make sure the Board is aware of WHAT is being spent and out of what fund it is being spent (operating or reserves)**
- **Board should approve unusual, unbudgeted and unexpected expenses
Approval should be documented in the Board meeting minutes**
- **Compare ALL bank statements and reconciliations to balances on financial statements**



AFTER year end

- **Income Taxes**

- Tax return is due **EVERY** year
- Interest income, nonmember income and possibly user fees are **taxable**
- Minimal deductions should be taken against taxable income
- Tax rate – 30% or 15% (but in most cases 30%)

- **Audit, Review or Compilation by CPA**

- **Optional in Idaho** – unless governing documents state otherwise
- **Audit requirement in Washington** for over 50 units in a condominium or over \$50,000 in a homeowners association – unless the membership waives the audit



Appendix

Why Budgets???

Important Time to Evaluate the Association's Obligations, Needs & Expectations

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.

Budget Do's and Don'ts

Don't automatically assume the validity of every expense. Just because an item was on the 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? For example, does the pool really need to be heated all year, does the Association really need to change the color at the front gate every six weeks, or does the Association have the most efficient lighting system in the complex? Take some time each budget year to challenge all previously conceived assumptions

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.

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. For example, should the Association increase or decrease the number of hours the paid security staff will work, will the Association trim more or less trees next year, will the Association have an audit or review of your financial statements, or will the Association keep the pool open more or less, etc?

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. Instead, 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 styles of living.

Options to Resolve Shortages for Major Expenditures

Look to the reserve study. The replacement fund is set up to take care of major repairs and replacements – those that occur over a period of time longer than one or two years. In many cases the reserve study will include an amount for major repairs and replacements. It will also project when that expenditure is to take place. If it isn't currently in the study, possibly it could be added for a future year.

Reduce expectations, thus reducing the expense.

Take the additional amount from reserve contingency – but ensure that the contingency is not needed for other items.

Take a portion out of the operating budget for next year.

Do the project in phases.

Consider a special assessment.

Miscellaneous Budget Items

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.

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.

Budgeting for the Unexpected

There are generally two main ways that Associations budget for the unexpected.

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.

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.

Recommended Amount for Contingencies

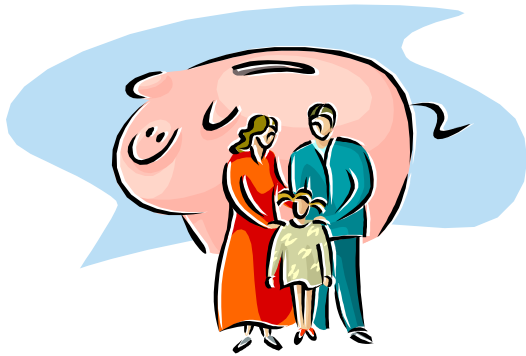
Cagianut & Company recommends that an Association have 1-3 months of operating expenses as an operating fund balance. CAI - National recommends a minimum of 2 - 5% of the annual assessments with 10 - 15% being very good. If the funds are not used in the current year, they can be accumulated in retained earnings (excess operating funds/members equity) for future years.

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.



Appendix

Financial Statements...a Mystery

The plot opens with pages of numbers...the detective begins the work of sifting through the evidence. What exactly are these columns of numbers and what do they mean? Who is the culprit? What caused the Association to not have enough cash to pay the water bill? Has there been foul play? Or, just an error? Or, maybe, a miscalculation? What clues are there, and how should they be interpreted? With some effort, and after being sidetracked and confused over some issues, the plot begins to unravel and the detective starts to make sense of the financial statements...

Are your Association's financial statements a mystery to you? Are you seeing the "clues" that are being presented in your monthly treasurer's report? Are you asking the right questions in order to understand the financial health of your Association? Below are some questions to think about when looking at your balance sheet and income statement each month. Ask the right questions and the financial statements will start being the management tool they were meant to be.

Operating Cash

- Is there sufficient cash to meet your monthly cash requirements? How many months of operating cash does your board feel comfortable with having on hand? (Note: CAI Guidelines recommend 1 – 3 months of operating expenses).
- Is there excess cash sitting in a checking account earning little or no interest? Should you open an operating savings or money market account with the excess?
- Does the board review the bank statements and reconciliations at least quarterly? Are there old outstanding checks which need to be researched? (Uncashed checks can be TROUBLE if they are for such items as insurance and taxes) Are there unusual transfers?

Replacement Fund (Reserve) Cash

- Are funds properly invested in accordance with your Association's investment policy? (*What? You don't have an investment policy? Make this a priority!*)
- Will funds be available for planned replacement fund expenditures?
- Are replacement fund expenditures and transfers properly approved and documented in the board meeting minutes?
- Are two board members signing all reserve checks?

Assessments Receivable

- Does the aging report agree with the financial statements? Is the board taking the proper collection action on delinquent accounts?
- At the end of the year, has the Association determined either which accounts to write off the books or set up with an allowance for bad debts?

Revenues

- Does the assessment income agree with the budget?
- Are all interest, late charges, and violation fees posted in a timely manner in accordance with the Association's collection policy?
- Is miscellaneous income, especially if large enough (e.g. laundry) monitored? (Note: if there is coin or cash involved pay special attention to internal controls)

Expenses

- For items that are significantly over or under budget, are explanations provided?
- Are bills being paid on a timely basis?
- For unusual, non-recurring type of expenses is there a record in the board meeting minutes of approval by the board? For material dollar amount contracts, does the board use a bid process where appropriate?

These are just a few of the questions that can be asked. The numbers in the financial statements should not be a "mystery". They should assist the board members in running their Association, their corporation, in the business-like manner which is required of them. Take time to understand what the numbers are telling you. Important information is available with a little effort and education.

The Ten Commandments of Internal Control for Your Association

1. Thou shalt not sign blank checks, nor leave blank check stock unsecured.
2. Thou shalt deposit all checks in a timely manner (preferably daily). If a deposit is not made daily, then the undeposited funds should be adequately secured.
3. Thou shalt not accept cash. If absolutely necessary to accept cash, then do so only with 2 witnesses, and then generate a receipt for the files.
4. Thou shalt not make checks payable to "Cash".
5. Thou shalt require invoices, or other type of verification of the expense, on all paid bills. That invoice should be "canceled" in some manner after payment to avoid duplicate payment.
6. Thou shall have two board signers on reserve withdrawals. Thou shalt not allow telephone withdrawals of reserve funds.
7. Thou shalt 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.
8. Thou shalt require approval of write-offs of A/R balances by a person other than the person making the deposits and reconciling the bank accounts. The board shall approve all write-offs over a certain amount.
9. Thou shalt review all bank statements and reconciliations at least quarterly for ALL bank accounts - including certificates of deposit.
10. Thou shalt receive financial statements at least quarterly (monthly, is even better).

INTERNAL CONTROLS CHECKLIST

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

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

- Board receives financial statements, at least quarterly, consisting of:
 - ⇒ Balance sheet
 - ⇒ Income statement comparison to budget

- Board reviews **all** bank statements **and** reconciliations at least quarterly (including certificates of deposit):
 - ⇒ Operating accounts
 - ⇒ All reserve accounts

- 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 to bid.

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

Cagianut & Company, CPA

Approved by Board of Directors

_____ Association

Date _____

By _____

Title _____



Appendix

What is an Audit?

An audit is an engagement performed by an **INDEPENDENT** Certified Public Accountant to determine if the financial statements of the Association are **MATERIALLY CORRECT**, if they are presented in accordance with generally accepted accounting principles (**GAAP**), and if they have adequate **DISCLOSURES**.

- ❖ **Independence** – Is a matter of *fact* and *appearance*. The CPA should not, except in very limited circumstances, have ownership within the Association they audit. The CPA should not be paid based on the outcome of the audit or tax returns. The CPA must maintain objectivity in all circumstances and keep an *attitude of skepticism*. The CPA must not be swayed by personalities or the need to “keep the client happy”.
- ❖ **Materially Correct** – The auditor, using *judgment*, determines materiality. The CPA professional guidelines set fairly high materiality standards. This means that the CPA does not look at each and every transaction – a common misconception. The CPA may randomly look at smaller transactions, but it is not a requirement.
- ❖ **GAAP** – Generally accepted accounting principles for Associations requires that the financial statements be presented on the accrual basis of accounting, with full disclosures and supplementary information on the replacement fund. GAAP does not require fund accounting, but recommends it. GAAP suggests that property is not capitalized on the financial statements of Associations, but allows the option (and requires it in some circumstances) to place the common areas on the books of the Association.

❖ **Disclosures** – GAAP requires specific standard disclosures on the type of association, accounting methods, tax choices, and other such items. Other disclosures often missed or not understood include the following:

- FDIC limitation exceeded
- Related party transactions
- Litigation
- Special assessments, and whether the monies have been used as required
- Contingent liabilities, e.g. mold remediation

An audit also examines the **INTERNAL CONTROL POLICIES**, as well as **ACCOUNTING PROCEDURES**. If there are significant deficiencies in internal control policies, a separate letter may need to be sent with the audit. .

Why have an Audit?

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

ASSOCIATION TAXES - THE BASICS

by Gayle L. Cagianut, CPA

Cagianut & Company, CPA ~ Bellevue & Newport, WA

Your association is a non-profit corporation? **TRUE.** Thus, as a non-profit entity, you owe no income taxes? **FALSE!**

This is a common misconception among board members, especially those first time volunteers. If you do not understand your association's taxes, don't feel alone. Community association taxes are very complex. It is quite possible that even your personal tax preparer has little or no knowledge on this subject. That is why it is important the Board chooses an accounting professional who knows this industry and one who will make the best choices for your association.

Unlike individual federal tax returns, which are due three months fifteen days after the year (April 15th), association tax returns are due two months fifteen days after the end of the fiscal year. Thus, for December 31st year end associations, the due date is March 15th. Like individuals, an association can get an extension of up to six months to file its federal taxes. It should be noted that this is an extension to file the tax return – not an extension to pay the taxes! Any taxes due must be paid by the original due date, or the association will have to pay penalties and interest.

So on what income does an association pay tax? This can get very complicated, as will be described in the following paragraphs, but at the very least, the association generally needs to pay tax on its interest earnings. Other items that may or may not be taxable include laundry income, rental income for the clubhouse or other common areas, and sales of goods or services to non-members. Generally membership income is non-taxable.

Associations have a unique tax situation found in no other area of tax law, in that they have the choice of how to file their tax returns and what tax rate to pay – with many rules and regulations surrounding these choices. An association may file as a homeowners' association using Form 1120-H, or may file as a regular corporation using Form 1120. This decision can change annually. The association may file form 1120-H one year, then 1120 the next, then back to 1120-H the third year. Additionally, some larger associations may be exempt from taxation and may file Form 990. This is a permanent decision. The following paragraphs will attempt to quickly explain the differences, but the explanations will touch just the surface issues.

Form 1120-H is the form that was specifically designed for homeowners associations. It is the easiest to prepare. Non-exempt function income is taxed at a rate of 30%. Non-exempt function income includes interest and rental income, net of expenses. A tax savings hint to avoid being taxed on the rental income is to assess the fee on an annual basis or as part of the regular assessment, rather than as a per use fee. It is the per use fee which causes the income to be taxable. Thus, if you have RV parking spaces, you may decide

to assess the fee once a year rather than monthly, or for clubhouse use you may choose to add one dollar to everyone's monthly assessments rather than charge a per use fee.

Form 1120 is the regular corporation tax form. It is much more difficult to prepare, and can cause even membership net income to be taxable. But, it has a much more favorable tax rate – 15% on the first \$50,000 of taxable income. Another advantage is that rental income from members may not be taxable. With proper planning and budgeting, an association may be able to cut its taxes substantially. A common planning tool is to use Revenue Ruling 70-604, which says that the membership may choose to have any net membership income transferred to the next year or returned to the owners. This is an important election that may benefit an association. The drawbacks are, however, that it appears use of this election may not be possible in consecutive years and it may require the election to be made by the owners and not the board. The board also needs to be aware of the inherent risks that may be involved in filing form 1120. Some of the more restrictive accounting procedures – such as segregation of operating and reserve cash, adoption and adherence to a budget that agrees with a reserve study, and adequate accounting for various reserve items by capital and non-capital categories – are issues to consider. Last, it appears that there is additional IRS audit risk when filing form 1120. These matters should be carefully weighed to determine whether the association qualifies to file form 1120 and whether the tax advantages outweigh the audit risk.

Form 990 is for larger associations that are communities among themselves. These associations are exempt from taxation. This designation is difficult to get, but some associations have been successful in obtaining this tax status.

Take time to discuss your Association and its tax matters with your accountant. Ask whether there are any tax saving tools which your association could use. Discuss whether to file 1120 or 1120-H and whether your current accounting procedures allow you to make this choice. Consider whether or not to use Revenue Ruling 70-604. Evaluate the per use fees charged currently. Evaluate IRS audit risk, including any audit activity in your area. Remember, the final tax responsibility rests with you, the board member. It is you who will have to sign the return, and you must ensure that the best interests of the association membership are being met.