Know Your Community's Financial Position

While it is always important to know where your community stands financially, it is especially important to understand the community's financial condition in today's economy. There are several recommendations and standards in place for analyzing a community's financial health, and a few are listed below:

Recommendation A: 2-3 months of expenses in your operating account(s) (liquid funds) at all times.

For example, if your community has a total monthly expense budget averaging $20,000, we would recommend that you have between $40,000 and $60,000 in operating funds. By doing this, the association helps to ensure that they can cover monthly expenses plus some unbudgeted expense that may arise, even factoring in assessments that are delinquent and not received. Boards should keep this in mind when considering additional investments. Only funds in excess of 2-3 months of operating expenses should be considered for investments.

Recommendation B: Investments fully support the reserve funds.

Industry standard (and in some cases state law) encourages communities to segregate operating funds from reserve funds and recommends that a community's investment funds correspond to the penny to the reserve fund balance. It is important that the reserve funds be reconciled regularly with the operating account. When a reserve project is completed, the invoice will likely be paid from the operating (checking) account. The investments and reserve funds will not reflect the reserve expense, but the operating account will now be short that amount, which could affect the association's ability to pay its operating expenses. The association should consider having a reserve money market account that it can use to make the reconciliation (in this case, the reserve money market account would reimburse the operating account for the amount paid for the reserve project.

Recommendation C: Reserves funded in accordance with the reserve study.

Not only is it important to match the full reserve balance with cash, it is also important to review the reserve balance as it compares to the amount recommended by the association's reserve study. Special attention should be paid to this during budget preparation time. Rather than simply plugging in the recommended annual contribution number, an analysis should be done to determine what the projected year-end reserve balance is and whether an adjustment to next year's reserve contribution is warranted. For example, if the reserve study recommends a reserve fund balance at the end of fiscal year 2011 of $400,000, and it is determined that the actual balance at the end of FY 2011 is projected to be $300,000, a multi-year plan needs to be established to increase the reserve contribution to make up the reserve deficit. In some states, an annual review of the reserve study is required and this analysis would be completed during that review. Similarly, if the reserves are funded higher than the reserve study recommends, the reserve contribution could be decreased.

Recommendation D: 10-20 percent of the total annual assessment amount should be included in Prior Year Equity (this is a recommendation that auditors make so that the association has a "cushion" in the event of a major unanticipated event).

Prior Year Equity, which auditors frequently refer to as Unappropriated Members Equity or, simply, Members Equity, is the cumulative operating deficit or surplus from the association's inception. While in the development period, and as long as the declarant is funding the operating deficit, the Prior Year

Equity balance is usually $0. Once the declarant is no longer funding the deficit and the association is self-sustaining, the association should work to achieve the 10-20 percent Prior Year Equity level. For example, if your community has budgeted $300,000 for the total annual assessment income, auditors recommend that the amount recorded in prior year equity be between $30,000 and $60,000. Any amount lower than $30,000 would be noted by auditors as not being sufficient and any amount more than $60,000 would be noted as being excessive. Auditors feel that this gives the association additional funds to cover a major unanticipated event that would lead to a substantial operating deficit, such as having to replace interior pipes because of pinhole leaks, or replacing significant landscaping because of an unusually wet or cold winter. So, what happens if you are not adequately funded in Prior Year Equity? In future years' budgets, the association should consider budgeting for an Operating Contingency (funds not earmarked for any specific expense) or should consider creating a line item specifically to Fund Prior Year Equity in order to bring the balance into the 10-20 percent range.

Recommendation E: Delinquency rate should be between 3-5 percent of the total annual assessment income.

Using the example above with a community that has budgeted $300,000 for the total annual assessment income, the total accounts receivable (delinquent amount) should not exceed $9,000 – $15,000 for the association to be financially healthy. It is important that associations do everything possible to pursue collection of delinquent accounts, in accordance with applicable federal and state law and the association's governing documents and established collection policy. It is also important that the association, in accordance with the collections attorney, periodically review delinquent accounts and make the decision to write off accounts that are not collectible or where further collection effort is not cost-effective. Many boards hesitate to write off uncollectible accounts, but, often, it is the best decision for the board to make.

Recommendation F: Establishment of the Allowance for Doubtful Accounts

The Allowance for Doubtful Accounts line item is what is referred to as a "contra-asset" and appears in the asset section of the balance sheet as a negative number (to counter the accounts receivable asset). The purpose of the Allowance for Doubtful Accounts is to reflect more accurately the association's financial position. Without the Allowance, the association's balance sheet would show the entire delinquent amount as a collectible asset. The Allowance for Doubtful Accounts posts as a negative number to "decrease" the accounts receivable number to reflect more accurately the association's assets. Prior to each fiscal year-end, associations should review their delinquencies and, if an Allowance for Doubtful Accounts has not previously been established, create the line item. There are many different ways to calculate the Allowance for Doubtful Accounts (usually by percentage or specifically identified delinquent owners), so talk with your managing agent and association auditor to determine the right number for your association. If your association has an Allowance for Doubtful Accounts line item, the number should be adjusted each year to reflect any changes in the delinquent amount.