Executive Council of Home Owners (ECHO)

TREASURER'S GUIDE TO COMMUNITY ASSOCIATION FINANCES

A Basic Source on California Community Association Finances

April 2005 Revision

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TREASURER'S GUIDE TO COMMUNITY ASSOCIATION FINANCES

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TREASURER'S GUIDE TO COMMUNITY ASSOCIATION FINANCES

Introduction

The Book

The *Treasurer's Guide to Community Association Finances* is designed to provide California community association treasurers with a starting point for managing, and safeguarding, the organization's financial resources. It was not designed to be a complete authoritative document. Your particular association's circumstances should be adopted after consultation with your CPA, attorney , management and other appropriate personnel. And, as you get into more complex transactions such as borrowing from the bank or from replacement funds, you need to consult with your professionals.

The Authors

Compiled under the auspices of the ECHO Accountants Panel and the ECHO Reserve Analyst Panel, this document is the collective effort of certified public accountants, reserve specialists, bookkeeping professionals, and community association treasurers. Like ECHO itself, it combines the knowledge and experience of a broad spectrum of industry professionals and association members to educate and assist those who volunteer to serve their community association.

Copyright Protection

Treasurer Duties and Responsibilities

A treasurer's duties as a member of the association board are spelled out in the California Civil Code, including Sections 1360, 1365 and 1368, in the association's governing documents and in the concept of fiduciary responsibility.

A treasurer's responsibilities include, but are not limited to, the following activities:

- Working with management or the bookkeeper on **accounting reports.**
- Reviewing **cash disbursements** - looking at invoices and signing checks.
- Reviewing cash receipts - looking at **assessment delinquency reports.**
- Reviewing **bank reconciliations** and supporting bank statements.
- Advising the Board about appropriate **investments.**
- Advising the Board about the potential for a **bank loan,** if needed.
- Advising the Board about the availability of **bank lock box services.**
- Reviewing periodic **financial statements** and comparisons to budget.
- Assisting in preparation of the annual **pro forma operating budget.**
- Assisting in selection of a **reserve study** preparer.
- Assisting in selection of a CPA for **income tax** and/or review/audit services.

The treasurer's role will vary depending on whether the association is professionally managed with full service management, partially managed with financial services provided by management or a bookkeeper, or self-managed with the bookkeeping performed by the treasurer.

While it is true that one need not be a CPA experienced in community association finances to serve as treasurer, the more background one has, the easier it is to serve the Board in this capacity. And even at professionally managed associations, the Board and particularly the treasurer must provide oversight to its professional managers! California Civil Code Section 1365.5 spells out specific oversight tasks that the Board of Directors must make at least quarterly. In financial matters, most boards look to their treasurer to ensure that they remain compliant with the law.

Included under the treasurer's broad responsibility is a myriad of tasks: signing checks and reviewing invoices; confirming that goods or services are received and their costs agree with the contracted amounts; ensuring that the collection policy is promptly and fairly implemented; monitoring expenses and, where they deviate from the budget, determining whether the "reasons" are reasonable. While these tasks keep the association operating properly, they also culminate in the experience and leadership that the treasurer provides the other directors at a board meeting when a critical issue arises and all heads turn to the treasurer.

Reconciling Cash Accounts

California Civil Code Section 1365.5 requires the Board of Directors to review a reconciliation of all association bank accounts at least quarterly. The reconciliation of the association's bank statements uses independent sources of information as a critical audit of the association's cash. It allows the treasurer to see if the association's banker and bookkeeper agree on the amount of cash it has.

A reconciliation should clearly identify starting and ending balances of both the bank and book sources and list major items which reconcile any differences between the two. Note that simply balancing the checkbook is only a part of the reconciliation process. A sample account reconciliation is given below for the fictitious Barcelona View Estates.

Balancing the bank account

Starting with a copy of the current period bank statement, the reconciliation starts with the statement's ***ending*** balance. To it are added any deposits in transit (deposits mailed or delivered to the bank but not yet reflected on the statement). From it are subtracted outstanding checks (checks written in the accounting period which have not yet cleared the account). Any other items (electronic transfers, NSF checks, etc) of which the preparer knows but is not reflected on the bank statement should be added or subtracted accordingly. By this process, a reconciled bank balance is achieved.

Balancing the books

After the bank statement has been reconciled, it remains to do the same to the association's books. This reconciliation begins with the prior period's ending amount. To it are added all the current period's assessment payments that were credited in the association's billing system, miscellaneous deposits (tax refunds, key deposits, etc), bank interest, and other credits. From it are subtracted all the checks written in the accounting period, bank charges, rejected payments, electronic debits, etc. By this process, a reconciled book balance is reached.

The bank balance and the book balance must agree ***not only with each other but also with the cash balance showing in the Assets section of the association's balance sheet***.

What to look for in a reconciliation

The balancing form should clearly display all the items that effect the reconciliation. Unless the treasurer is involved with the association's day-to-day operations, some of the details may fall outside personal review but there are a number of critical components that can and must be ascertained. First, it is critical that a copy of the bank statement be included with the reconciliation form so that the bank balances can be verified. Also, checks that have been outstanding for more than 90 days should be investigated as should all deposits that remain 'in transit' for more than one accounting period. Lastly, it is important the reconciled balances agree and match those on the financial statements.

Protecting the association's cash assets is the treasurer's most important duty and reviewing the account reconciliation is an essential part of that duty.

BARCELONA VIEW ESTATES HOA

BANK STATEMENT RECONCILIATION

HOMEOWNER BANK-OPERATING 123456789 **FOR PERIOD ENDING July 31, 1994**

	BANK STATEMENT BALANCE ON 7/24/94			**14,690.20**
OUTSTANDING CHECKS				
2944	MEL SANTO BACKFLOW SERVICE	7/22/94	(75.00)	
2947	BARCELONA VIEW HOA	7/26/94	(3,184.20)	
2948	ROSA POOL SERVICE	7/28/94	(329.00)	
				(3,588.20)
				============
				(3,588.20)
	RECONCILED BALANCE ON 7/31/94			**11,102.00**

	LEDGER BALANCE ON 6/30/94		**10,445.13**
DEDUCTIONS			
CHECKS WRITTEN		(6,724.13)	
			(6,724.13)
ADDITIONS			
JULY PAYMENTS		7,381.00	
			7,381.00
			============
			656.87
	RECONCILED BALANCE ON 7/31/94		**11,102.00**

Accounting Systems

Methods of recording and reporting financial transactions have developed over time into what is now known as "generally accepted accounting principles". While even a cursory description of these is beyond the scope of this work, a summary will be provided here for board members with little or no exposure to accounting practices.

All the association's financial transactions can be classified into categories called 'accounts' each of which bears a unique number and description. Taken together, these form the association's Chart of Accounts. The accounts themselves are further classified into groupings that, when sorted and summarized, allow the bookkeeper to report thousands of financial transactions in a manner meaningful to the reviewer. These major groupings are Assets, Liabilities & Fund Balances, Income and Expense. The first set, assets and liabilities & fund balances, are balance sheet accounts. The second, income and expense, appear in the income statement. While an association typically has only a few income accounts, it will often have dozens of expense accounts, the latter being the means by which the association's many expenses are classified. In the following section dealing with financial statements, we will show how these account classes are used to describe most effectively the association's financial condition.

Books, ledgers, and journals are terms associated with accounting practices that pre-date computers but they are still used to describe where financial transactions are recorded in each accounting period. For most associations, an accounting period is one month, twelve of which comprise the "fiscal year". For each period, the association's financial transactions are entered into one or more journals. For example, a "cash disbursement" journal will include the payments the association makes to individuals, entities, and service providers. Another may record "accounts payable", the association's unpaid invoices. Most transactions are entered in the general purpose "General Journal". Assessments billed, payments received, interest earned, reserves funded, depreciation of assets, etc. might be found in the general journal.

The transactions in these journals are combined with journals from other accounting periods to comprise the association's "General Ledger" from which everything is sorted and summarized in the financial statements. Few board members need to see financial information at levels lower than the financial statements provide. However, for the treasurer, the devil is often in the details and the detailed, cumulative ledger listing is a valuable reference tool.

Methods of Accounting

Cash

The cash method of accounting recognizes revenues when they are received and expenses when they are paid. This method has the advantage of being simple to implement and understand. One disadvantage, however, is its failing to match revenues and expenses in the time period in which they occur. This means that the associations unpaid assessments, its "accounts receivable", do not appear on its balance sheet. Moreover, monthly financial reports using a cash method may have little in common with the association's annual review because the civil code requires CPAs to employ the accrual method in preparing that document. Since the annual review is the association's 'official' financial document which is distributed to members and shown to prospective buyers, it should bear some reasonable semblance to the financial documents used by the board to manage the association.

Accrual

The accrual method recognizes revenues as they are earned and expenses as they are incurred. This method has the advantage of matching revenues and expenses in the time period in which they occur. It is the method preferred by most corporate entities and is required for financial statements prepared in accordance with generally accepted accounting principles (GAAP). For California community associations, the Civil Code requires that both the annual pro forma operating budget (Section 3.51) and the CPA-prepared reviewed or audited financial statements use the accrual method of accounting.

Modified Accrual

The modified accrual method is a mixture of cash and accrual. For community associations, expenses are commonly recorded on a cash basis (since most operating expenses do not fluctuate significantly from one month to the next) and assessments are recorded on an accrual basis (because keeping track of members who do not pay their assessments is essential). Management companies frequently use this method of accounting in the preparation of monthly or quarterly statements.

HOAs and Fund Accounting

Board members familiar with general accounting reports often find the "Fund" accounts appearing on association balance sheets confusing. Fund accounting involves the division of a not-for-profit's financial organization into a group of separate entities or funds. As not-for-profit corporations, California homeowner associations normally distinguish two funds: the Operating and Reserve Funds. The former embodies those financial transactions necessary for the day-to-day operation of the association. The latter incorporates those transactions relating to the monies reserved for the association's long term capital replacement. Understanding what these funds represent and how the financial statements report them is fundamental to assessing the association's short and long term financial health.

Financial Statements

Many board members look on financial statements as unintelligible puzzles produced under arcane rules by an accounting priesthood and presented to the board principally to meet obscure legal requirements. There is a component of truth in this viewpoint. But for the board member patient enough to untangle the columns and consider the totals, financial reports are powerful tools necessary for the management of the association's finances. Of all the financial reports inflicted on board members, the two most common are also the most important: the balance sheet and the income statement.

Balance Sheet

The balance sheet is the association's financial report. A director can see at a glance a snapshot of the association's fiscal health. Often on no more than a single page, the balance sheet lays out the fundamental accounting equation: ASSETS = LIABILTIES AND WORKING CAPITAL. The first component of the equation, assets, appears at the top of the report. Assets include the association's cash accounts (money in the bank) as well as any money (e.g. accounts receivable) or services (e.g. prepaid insurance) owed ***to*** the association. Below assets are listed the association's liabilities, the monies (e.g. invoices payable, bank loans, etc) and services (e.g. to homeowners for prepaid assessments) owed ***by*** the association.

After what the association owes (its liabilities) is subtracted from what it has (its assets), what is left is its working capital. In the case of an individual's finances, this would be called *equity* but for the homeowner association, it is its fund balances. The balance sheet takes its name from the fact that its first part (assets) must balance its second (liabilities + funds).

The importance of the balance sheet to understanding the association's finances cannot be exaggerated. Summarized in it is information from a host of other reports and source documents, many of which the board member may never see. For example, in the asset section of the balance sheet for the fictitious Barcelona View Estates (see sample Balance Sheet) are listed the cash balances in the various operating and reserve accounts. ***These figures should match exactly the totals of the reconciled bank statements.*** Further down are other assets of which accounts receivable is particularly important. ***This figure should match the total assessments owed by members shown on the association's Accounts Receivable and Prepaid report*** (see sample Aged Delinquency Report). In the "Liabilities" section is the accounts payable amount, a figure that should summarize the totals from association's accounts payable journals (rarely produced or distributed). Similarly, the "prepaid assessments" figure ***should agree with the sum listed in the associations Accounts Receivable and Prepaid report***. (Note: balance sheets using the cash method show neither past-due nor prepaid assessments.)

Finally, there are the fund balances. For each fund, there are two amounts: a prior year and a year-to-date figure. For both operating and reserves, the prior year amount represents total in that fund at the end of the prior fiscal year. The year-to-date figure is the net of income and expenses for the current fiscal year. ***These amounts should exactly match the YTD profit/loss totals shown on the income statement*** (see sample Comparative Income and Expense to Budget Report).

Thus, the balance sheet shows the board member how much cash is available in the association's operating and reserve accounts, how effectively assessments are being collected, how much the association owes other entities, how large its funds were at the start of the current fiscal year and how closely its year-to-date income and expenses have tracked to budget.

Income Statement

The income statement lists, account by account, the association's revenues and expenses. Customarily, these amounts are given both for the current fiscal period (often one month) as well as year-to-date. Also customarily, the budgeted amount for the respective period is provided in an adjacent column for comparative purposes. In some cases, the difference between actual and budgeted amounts will be shown to highlight large variances (**see sample Comparative Income and Expense to Budget Report with**

pages for both the Operating and Reserve Funds). Accounts may be grouped and subtotaled by categories (administration, recreational facilities, building maintenance, utilities, etc) to assist the board and its committees in managing the association's expenses. At the bottom of each fund's section will be a "Net Income/(Loss)" line for the current period and year-to-date. If this amount is negative, then expenses have exceeded income. ***These figures should match the YTD fund balances on the balance sheet.***

California civil code requires board members to compare the association's revenues and expense to its budget ***at least*** on a quarterly basis. Logic would dictate that, if the opportunity presents itself, such a review be done more often. But fear of a lawsuit is not the only or even the best reason for comparing the association's expenses to budget. The figures on the income statement serve as flags that the association's financial matters are on track or warnings that things are not going as the budget committee had planned. These warnings may be dire: persistent cash shortages stemming from widespread expense overruns signal the board that their budget projections were too optimistic and the association may be under funded. Or they might be minor: a spike in the utility bill could signal nothing more that a contractor neglected to turn off the pool heater at the end of the season. Whatever the case, unless it performs a regular review of the association's income statement, the board is managing its finances in the dark.

General Ledger Listing

A YTD general ledger listing contains every single transaction that is summarized in the association's financial report (see sample General Ledger Listing). To help the treasurer, it organizes them by account number and date. This often compendious report is unnecessary for most directors but it is the treasurer's only recourse when asked to account for sums listed in the other reports. So when asked "why are landscaping expenses so over-budget?" or "has the roofing contractor been paid yet?" the treasurer will find in the ledger listing the date, amount and payee of every check written to that expense account.

BARCELONA VIEW ESTATES HOA

Sample Balance Sheet

July 31, 1994

ASSETS

CASH - OPERATING			
103	HOMEOWNER BANK-OPERATING CHECKING	11,102.00	

		11,102.00	
CASH - RESERVES			
109	HOMEOWNER BANK-RESERVE CHECKING	85,512.99	
113	SAVINGS BANK CD 5/1/95 6.75%	36,727.84	
115	NATIONAL FEDERAL CD 7/3/95 5.65%	57,902.68	

		180,143.51	
OTHER ASSETS			
120	ACCOUNTS RECEIVABLE	931.70	
125	WORKERS COMPENSATION DEPOSIT	415.00	
155	PREPAID INCOME TAXES 12/31/93	882.00	

		2,228.70	
	TOTAL ASSETS		193,474.21

LIABILITIES AND EQUITY

CURRENT LIABILITIES			
301	ACCOUNTS PAYABLE	1,322.00	
315	PREPAID ASSESSMENTS	1,452.00	

		2,774.00	
RESERVE FUND			
400	RESERVE FUND-12/31/93	156,378.06	
401	RESERVE FUND-YTD	23,765.45	

		180,143.51	
OPERATING FUND			
410	OPERATING FUND-12/31/93	9,183.09	
411	OPERATING FUND-YTD	1,373.61	

		10,556.70	
	TOTAL LIABILITIES AND EQUITY		193,474.21

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Sample Aged Delinquency Report

AS OF 7/31/94

MEMBER MEMBER NAME	TOTAL BALANCE	CURRENT	30 DAYS	60 DAYS	90 DAY
24 ROACH, JAMES & CHRISTINE	931.70	12.10	133.10	133.10	653.40
TOTAL DELINQUENT	931.70	12.10	133.10	133.10	653.40
PREPAID					
19 GRUBE, THEODORE L	(363.00)	(363.00)	0.00	0.00	0.00
41 NENCINI, JOHN CONSTANTINE	726.00)	(726.00)	0.00	0.00	0.00
46 GABRIANA, DENISE	(242.00)	(242.00)	0.00	0.00	0.00
49 MACKENZIE, NICOLAS	(121.00)	(121.00)	0.00	0.00	0.00
TOTAL PREPAID	(1,452.00)	(1,452.00)	0.00	0.00	0.00
GRAND TOTAL:	(520.30)	(1,439.90)	133.10	133.10	653.40

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Sample *Comparative Income & Expense to Budget*

For the 7 Month Period Ending July 31, 1994

OPERATING FUND

	Curr Month Actual	Curr Month Budget	YTD Actual	YTD Budget	Variance	Annu Budg
INCOME						
OPERATING INCOME						
510 DUES INCOME	7,260	7,260	50,820	50,820	0	87,12
520 LATE CHARGES	12	0	206	0	206	
540 TRANSFER FEES	0	0	100	0	100	
TOTAL OPERATING INCOME	7,272	7,260	51,126	50,820	306	87,12
TOTAL INCOME	7,272	7,260	51,126	50,820	306	87,12
EXPENSES						
OPERATING COSTS						
610 CORPORATE TAXES	433	100	2,139	701	(1,438)	1,20
611 INSURANCE	1	233	940	1,634	694	2,80
612 PG&E	361	383	2,471	2,684	213	4,60
613 CITY WATER & SEWER	598	525	1,666	3,675	2,009	6,30
614 CUSTODIAL	100	100	600	701	101	1,20
615 LANDSCAPE CONTRACT	978	850	6,028	5,951	(77)	10,20
616 LANDSCAPE MAINT & REPAIR	104	1,000	6,812	7,001	189	12,00
617 POOL PERMIT	0	14	179	101	(78)	17
618 POOL CONTRACT	521	148	1,256	1,038	(219)	1,77
619 POOL MAINT & REPAIR	164	100	145	701	556	1,20
621 MISC MAINTENANCE	75	203	2,484	1,420	(1,064)	2,43
631 ANNUAL MEETING	0	8	0	58	58	10
TOTAL OPERATING COSTS	3,335	3,667	24,720	25,666	945	43,99
ADMINISTRATION						
651 ACCOUNTING	0	106	800	744	(56)	1,27
652 OFFICE EXPENSE (SUPPLIES & PHONE)	205	278	1,642	1,945	303	3,33[illegible]
653 LEGAL EXPENSES	0	25	300	176	(124)	30
TOTAL ADMINISTRATION	205	409	2,742	2,865	122	4,91
RESERVE ALLOCATION						
670 TRANSFER TO RESERVES	3,184	3,184	22,289	22,289	0	38,21
TOTAL RESERVE ALLOCATION	3,184	3,184	22,289	22,289	0	38,21
TOTAL EXPENSES	6,724	7,260	49,752	50,820	1,068	87,12
NET INCOME/(LOSS)	548	(0)	1,374	(0)	1,374	0

BARCELONA VIEW ESTATES HOA

SAMPLE COMPARISON OF INCOME AND EXPENSE TO BUDGET

For the 7 Month Period Ending July 31, 1994

RESERVE FUND

	Curr Month Actual	Curr Month Budget	YTD Actual	YTD Budget	Variance	Annual Budget
INCOME						
RESERVE INCOME						
580 ALLOCATION TO RESERVES	3,184	3,184	22,289	22,289	0	38,210
590 INTEREST INCOME	527	0	3,440	0	3,440	0
TOTAL RESERVE INCOME	3,711	3,184	25,729	22,289	3,440	38,210
TOTAL INCOME	3,711	3,184	25,729	22,289	3,440	38,210
EXPENSES						
REPLACEMENT EXPENSES						
802 ROOFING	0	417	0	2,917	2,917	5,000
805 SWIMMING POOL	0	125	1,000	875	(125)	1,500
806 COMMON AREA REPAIRS	0	167	964	1,167	203	2,000
TOTAL REPLACEMENT EXPENSES	0	708	1,964	4,958	2,994	8,500
TOTAL EXPENSES	0	708	1,964	4,958	2,994	8,500
NET INCOME/(LOSS)	3,711	2,476	23,765	17,331	6,434	29,710

BARCELONA VIEW ESTATES HOA

Sample General Ledger Listing

Cumulative to July 31, 1994

	Date	Ck # Source	Item Description	Debit	Credit
Account #:	613-1 CITY WATER & SEWER				
	1/07	2858	CITY OF SANTA ROSA/WATER 11/18-12/21/93	176.18	
	2/01	2872	CITY OF SANTA ROSA/SERVICE 12/21/93-1/20/94	32.33	
	3/01	2879	CITY OF SANTA ROSA/WATER 1/20-2/18/94	30.96	
	4/06	2896	CITY OF SANTA ROSA/WATER 2/18-3/22/94	81.24	
	4/07	2899	CITY OF SANTA ROSA/WATER 2/18-3/26/94	55.21	
	5/05	2912	CITY OF SANTA ROSA/WATER 3/22-4/20/94	307.70	
	6/01	2920	CITY OF SANTA ROSA/WATER 4/20-5/20/94	384.42	
	7/06	2939	CITY OF SANTA ROSA/WATER 5/20-6/21/94	597.56	
			Account Balance	1,665.60	
Account #:	614-1 CUSTODIAL				
	1/28	2868	BOB LAND/JANUARY	75.00	
	2/25	2877	BOB LAND/FEBRUARY	75.00	
	3/28	2889	BOB LAND/MARCH	75.00	
	4/20	2904	BOB LAND/APRIL	75.00	
	5/25	2916	BOB LAND/MAY	100.00	
	6/23	2931	BOB LAND/JUNE	100.00	
	7/26	2945	BOB LAND/JULY	100.00	
			Account Balance	600.00	
Account #:	615-1 LANDSCAPE CONTRACT				
	1/06	2857	PACIFIC LANDSCAPING/DECEMBER	850.00	
	1/27	2864	PACIFIC LANDSCAPING/JANUARY	800.00	
	3/01	2880	PACIFIC LANDSCAPING/FEBRUARY	850.00	
	4/06	2895	PACIFIC LANDSCAPING/MARCH	850.00	
	5/05	2910	PACIFIC LANDSCAPING/APRIL	850.00	
	6/01	2923	PACIFIC LANDSCAPING/MAY	850.00	
	7/06	2936	PACIFIC LANDSCAPING/JUNE	978.00	
			Account Balance	6,028.00	
Account #:	616-1 LANDSCAPE MAINT & REPAIR				
	1/17	2859	PACIFIC LANDSCAPING/REPAIRS	175.43	
	3/15	2884	PACIFIC LANDSCAPING/IRRIGATION	5,940.40	
	4/16	2902	PACIFIC LANDSCAPING/REPAIRS	515.81	
	6/07	2924	PACIFIC LANDSCAPING/SOIL	76.88	
	7/18	2942	PACIFIC LANDSCAPING/PLANTS	103.60	
			Account Balance	6,812.12	
Account #:	617-1 POOL PERMIT				
	5/01	2908	SONOMA COUNTY PUBLIC HEALTH DEPT/POOL PERMIT	179.00	
			Account Balance	179.00	
Account #:	618-1 POOL CONTRACT				
	2/01	2873	ROSA POOL SERVICE/JANUARY	125.00	
	3/15	2883	ROSA POOL SERVICE/FEBRUARY	125.00	
	4/15	2901	ROSA POOL SERVICE/MARCH	125.00	
	5/05	2911	ROSA POOL SERVICE/APRIL	180.00	
	6/01	2922	ROSA POOL SERVICE/MAY	180.00	

Additional Reports Included in the Annual Review

In California, when an association's gross receipts exceed $75,000 in any calendar or fiscal year, an independent review must be done and distributed to the owners within 120 days of yearend, unless the association documents have a more stringent requirement. When a CPA (***see CPA Services below***) is involved in the review preparation, the following statements and reports are required in addition to a balance sheet and income statement.

Statement of Changes In Fund Balances

This report shows the changes in fund balances arising from operating, investing and financing activities. The most common source of a change is the income or loss generated by the association. Commonly this statement is incorporated into the bottom of the income statement to show the balance of the funds at the beginning of the period, the net income that results in the ending balance which in turn agrees to the fund balance on the balance sheet.

Cash Flow Statement

This financial statement shows the sources and uses of cash arising from operating, investing and financing activities. It helps to answer questions like "If my income is positive, why don't I have any cash?" (Perhaps because assessments are not being collected and the receivable is growing.)

Accountants' (or Auditors') Report

This one to two-page document describes the work performed by the association's independent certified public accountant. The three most common services are compilations, reviews and audits. If the CPA was engaged to perform an audit of the financial statements, the auditor expresses an opinion on the fair presentation of the materially correct financial statements after performing an examination of the financial statements. In a review only financial analyses are performed but no examination, and no opinion is expressed.

Notes To Financial Statements

Notes to financial statements reflect mandatory, and optional, disclosures of a financial nature that more fully describe the nature and amount of balances included in the four basic financial statements, balance sheet, income statement, changes in fund balance and cash flow statement. Common notes include a summary of significant accounting policies, assessments receivable, income taxes, future major repairs/replacements, related party transaction, and commitments/contingencies, among others.

Supplemental Information

The American Institute of Certified Public Accountants in their audit and accounting Guide for Common Interest Realty Associations requires additional disclosures for future major repairs and replacements. This typically comes from the reserve study and is an additional financial disclosure required as a part of the financial statements in addition to the disclosures required by CA Civil Code with the annual budget information.

CPA Services: Audit, Review, Compilation

Audit

The "highest" level of service rendered by an independent CPA are audited financial statements. In it, financial records are examined in accordance with generally accepted auditing standards (GAAS). Included are such tests of the accounting records and other auditing procedures as the CPA considers necessary. Because a detailed examination of all transactions is not performed, there is a risk that material errors, irregularities or illegal acts, may exist and not be detected. A CPA who is not independent with respect to the association may NOT prepare audited financial statements.

Review

The next level of service rendered by a CPA is a review. In it, the financial statements are subjected to analytical review and inquiry as a means of insuring compliance with generally accepted accounting principles (GAAP). Community associations increasingly use this service as a cost-effective compromise. A review (as opposed to an audit) is the lowest acceptable level of CPA services to be provided to an association whose gross receipts for the fiscal year exceed $75,000 (Civil Code Section 1365(b)). A CPA MUST be independent with respect to the association in order to review the financial statements.

Review Audit

Although certain Board members and managers have used this term from time to time, **there is no such thing**.

Compilation

The "lowest" level of service_prepared , a compilation gives almost no assurance on the financial statements. Compiled statements are appropriate for those situations in which only conformity with generally accepted accounting principles (GAAP) is desired. This service frequently provides CPA-prepared cash flow forecasts and projections, budgets and interim (monthly or quarterly) financial statements. If a CPA who is NOT independent with respect to the association prepares compiled financial statements, this fact MUST be stated in the accountant's compilation report (e.g. "We are not independent with respect to the ABC Homeowners Association.").

Agreed Upon Procedures

In this type of engagement, the association and the CPA agree on the accounts and/or procedures to be employed, and the CPA's report reflects such agreed-upon scope, and his/her findings. This service may be appropriate when a full audit is not necessary.

Internal Controls

Internal controls are the measures taken by an organization to safeguard its assets, check the accuracy and reliability of accounting data, promote operational efficiency and encourage adherence to policies. Routine review of reconciled bank statements (to confirm cash balances) or accounts receivable (to ensure assessments are being collected in a timely manner) are examples of controls.

The Board of Directors of a CID is responsible for the establishment and maintenance of effective internal controls. The Internal Controls Checklist has been developed by the ECHO Accountants Panel to help your board assess its own procedures. The checklist covers the major items that should be considered for an association's internal controls.

Items on the checklist can safeguard assets only from loss through processing errors or irregularities. They cannot protect assets from improvident management decisions (such as redeeming a certificate of deposit prior to maturity or purchasing material or services that later prove to be unsatisfactory or unnecessary) or from the intent to defraud. However, effective controls and the determination to maintain them create an environment in which financial decisions are more carefully considered and fraudulent activity acquires considerably greater risk.

Cash Controls

1. Dual signatures on checks greater than $-X-. For the sake of expediency, a single signature on checks for relatively small expenses may be allowed but large amounts should have two signatures, at least one of which is a Board member. California Civil Code Section 1365.5 requires that the disbursement of funds from the association's replacement reserve requires two Board signatures, or a board member and an officer. Designated check signers should be readily accessible for that purpose and the bank signature cards are kept up-to-date. Many financial institutions require the submission of a Board resolution as well as appropriate signature cards before changing authorized account signers.

   This control assures that no single individual has sole access to association funds. A check signer should never sign blank checks in advance for this totally defeats the control.

2. Cash disbursements to vendors should be based only on original invoices (NOT monthly statements or "duplicate" invoices). The invoices should be inspected, their amounts checked for accuracy and initial-approved (ideally by both the manager and a Board member). Also, to avoid possible loss of funds resulting from alteration of a signed check, the last check signer or someone other than the check preparer should mail the signed check.

3. Cash receipts should be restrictively endorsed (i.e. stamped "Pay to the Order of ABC Homeowners Association, Account No. xxx ") and deposited promptly. Cash receipts should NOT be commingled (i.e. mixed together in the same bank account) with either (1) funds from other associations, or (2) with operations and replacement (reserve) funds being together in a single account. Bank lockbox systems for collecting assessments achieves both these controls.

4. Account reconciliations should be performed for all bank accounts on a monthly basis, ideally by someone who does not also handle cash receipts or cash disbursements. The preparer should initial the account reconciliation. Bank reconciliations should be reviewed and, ideally, initial-approved, by the Board of Directors at least quarterly. This control assures that cash is really in the bank and that the financial statement cash balances are correctly stated.

5. Bank signature cards should be kept up-to-date whenever Board members change, and such cards should be delivered to the bank independent of the management agent). In addition, authorized check signers should be identified in the Board minutes and, on occasion, independently verified with the bank or financial institution.

6. No more than $100,000 should be kept in any one federally insured financial institution because the federal government will not reimburse for bank failure losses in excess of this amount.

7. If your association uses electronic transfer systems to pay its bills you must make sure that the proper vendors are being paid through the review and approval of invoices and statements. This system circumvents the check signing system and circumvents the intent of the legislature for replacement reserve expenditures.
8. If your association uses electronic transfer systems to receive funds, you must closely examine the bank reconciliation to see that all such receipts are properly recorded.
9. Make sure that all accounts are in the name of the association, not the management company or an individual.
10. Never make checks payable to "cash". Petty cash reimbursements should be made to the custodian of the funds.
11. Carefully control transfers between banks. Checks should be made payable to the association and endorsed as "For deposit only/HOA name/Bank name and account number" before the check is signed and deposited. Be particularly wary of transfers from replacement accounts to the operating account. The state requires two authorized signatures on withdrawals from the replacement funds to keep them from disappearing so easily.
12. Account for any missing checks or gaps in the prenumbered check sequence.

Assessments Receivable

1. Uniform enforcement of the delinquency policy statement California Civil Code Section 1368 requires distribution of this document to all owners during the last 60 days of the association's fiscal year. The delinquency policy statement tells homeowners what actions the Board of Directors will take, and when, in the event that assessments are not paid in a timely manner. Treating all owners fairly and consistently in accordance with a well-written, attorney-reviewed delinquency policy, can help keep overdue assessments to a minimum.
2. Monthly review of the aging of overdue assessments will help insure that owners do not fall seriously behind in the payment of assessments, late charges and interest. California statute allows the imposition of late charges equal to the greater of $10 or 10% of the monthly assessment 15 days after the due date of the assessment. In addition, interest at a rate which does not exceed 12% per annum may be imposed on unpaid account balances beginning 30 days after the assessment due date. In addition, actual costs of collection (lien fees, legal fees, etc.) may be recovered on seriously delinquent accounts.
3. Electronic transfer systems and bank lockbox systems are convenient but also make it easy to misapply a payment and difficult to find it later. Consequently, the review of the assessment aging becomes critical, along with agreeing the total due on the aging to the general ledger to assure that the aging is a complete listing of all that is due to the association.

Property and Equipment

1. Inventory all property in order to establish accountability. Each item should be individually "tagged" (labeled with a prenumbered self-adhesive label or engraved with an electric scribing tool). The property list should include date acquired, description/serial number, cost and physical location. All movable property and equipment should be physically inspected and inventoried at least once a year. Consideration should also be given to photographing such items for insurance purposes.
2. Establish a capitalization policy whereby expenditures over $xxx for personal property items are recorded as assets (rather than expenses) and depreciated (written off) over its estimated useful life. For control purposes, certain smaller expenditures may be recorded as assets (and tagged and inventoried as described above), and depreciated (written off) in one year.

General Controls

1. Review an income and expense statement for the association's operating and reserve accounts on at least a quarterly basis. This control, specially when the financial statements show actual receipts and expenditures compared to budget, gives the Board assurance that money is being spent as planned, or highlights deviations from the budget.

   Budgeting is an extremely important internal control. Any deviations in actual income and expense from the budget will stand out in the Income Statement and be subject to a higher degree of scrutiny.

2. Avoid conflict of interest or even the appearance of conflict of interest. Board members should not receive compensation or payment in any form for either services provided or items sold to the association. If the appearance cannot be avoided, make sure that everyone knows of the potential conflict and what steps are being taken to avoid favoritism and partiality.

   Some examples of conflict of interest or related party dealings, potential self-dealing:

   1. The board is responsible for investing association funds and a board member is an investment broker.
   2. Board members or members of their families should not perform contract work for the association.
   3. The manager's spouse is the painter, gardener, or contractor.

3. Carry proper insurance and review the coverage annually, including fidelity bonds on anyone handling cash and workers compensation insurance even if the association has no employees. This insurance will cover board members if they perform any work around the association and any independent contractors who do not carry their own worker compensation policy and work on the premises. The association should follow a policy of requiring workers compensation coverage from any vendor that performs services on the premises. This includes janitors, swimming pool maintenance companies, handymen, gardeners and landscaping companies, and specially any major repair work such as painting and roofing.

4. Review the internal control structure with the Board on an annual basis so that the entire board is aware of the safeguards that are built into the system. This will also serve as a yearly reminder and a training session on fiduciary responsibility.

Financial and Tax Reporting Deadlines

The following dates are based upon a calendar year-end (for fiscal year-end associations, if different, the month and day of the fiscal year is indicated in bold print- e.g. for a June 30 year end, Form 1120 is due the I 15th day of the 3rd month, or September 15):

Due Date	Reporting Authority and Requirement
January 31	Form 1099 (Federal) to report payments of $600 or more to unincorporated providers of services and all attorney fees paid during the preceding calendar year. One copy goes to the service provider (the person that the association paid) and the other copy goes to the government by February 28 along with Form 1096. **This deadline exists for all associations, even those with non-calendar year-ends**.
February 28	Form 1096 (Federal) to the respective tax authorities along with copies of Forms 1099 (see deadline comments at January 31 above).
March 15	Form 1120 (Federal) and Form 100 (California), corporation income tax returns, unless extension of time to file is requested. Fiscal year associations are due on the 15th day of the 3rd month. To request a federal extension of time to file, Form 7004 must be was mailed by March 15 and all taxes paid. The extension is automatically granted unless terminated by the IRS by mailing a notice of termination at least 10 days prior to the termination date stated in the notice. For a California extension Form 3539, Payment Voucher for Automatic Extension for Corporations and Exempt Organizations must be sent in with any taxes owing. If no payment is due, DO NOT SEND THE PAYMENT VOUCHER. The extension is automatically granted if the tax return is filed by the extended due date
April 15	First quarter estimated income taxes, if any, are due. Federal taxes are paid to a local Federal depository bank along with a pre-printed deposit coupon, Form 8109, which may be obtained from the Internal Revenue Service. Estimated taxes payable to the California Franchise Tax Board may be mailed in along with Form 100-ES (which is generally provided by your CPA). Fiscal year associations are due on the 15th day of the 4th month.
April 30	Year-end audited or reviewed financial statements due to all owners if association gross receipts during the preceding calendar year exceeded $75,000. Generally, these statements must be distributed within 120 days after year-end. Fiscal year associations are due on the last day of the 4th month.
May 15	Form 199 (California) exempt organization annual information return, unless extension requested. Fiscal year associations are due on the 15th day of the 5th month.
June 15	Second quarter estimated income taxes, are due. See filing comments at "first quarter estimated income taxes" by April 15, previously. Fiscal year associations are due on the 1 5th day of the 6th month.
September 15	Third quarter estimated income taxes, are due. See filing comments at "first quarter estimated income taxes" by April 15, previously. Fiscal year associations are due on the 1 5th day of the 9th month.
September 15	Form 1120 (Federal) corporation income tax is due if extended. A copy of the extension request form should be attached to the tax return. Fiscal year associations are due on the 15th day of the 9th month.
October 15	California Form 100 corporation income is due if extended. Fiscal year associations are due on the 15th day of the 10th month.

December 1	Pro forma budget prepared in with California Civil Code Section 1365. This budget must be distributed between 30 and 90 days before fiscal year end - not earlier or later.
December 15	Fourth quarter estimated income taxes are due. See comments at "first quarter estimated income taxes" by April 15, previously. Fiscal year associations are due on the 15th of the l2th month.
December 31	Delinquency policy statement (i.e. statement of collection actions to be taken by the Board of Directors in the event of nonpayment of assessments) due to all owners. This statement must be distributed during the last 60 days of the association's fiscal year. Fiscal year associations are generally due between the 1st day of the 11th month and the last day of the 12th month.

Additional deadlines exist for those associations with payroll tax, real and personal property tax and sales/excise tax filing requirements. Consult your CPA or appropriate taxing authority. The Secretary of State requires the filing of a notice of officers biannually in the month of your incorporation, and failure to file is a common reason for the loss of corporate status.

Within 20 days of making payment(s) to an independent contractor who is an individual, not a corporation or partnership, totaling $600 or entering into a contract for more than $ 600, you must report to the Employment Development Department certain information. This includes their name, address, social security number and contract information. This is reported on the form DE 542. A similar reporting of new employees is required on form DE 34. These are for the enforcement of the child support obligations.

Insurance and alternative dispute resolution (ADR) disclosures must be made annually as well as the delinquency policy statement. You probably also want to remind the members of the Association Rules and Regulations. There are notice requirements spelled out in your documents about the annual members meeting notices as well to be distributed. Do amend and modify this list for your own needs.

HINT: To reduce possible future aggravation and help insure proof of filing, send all income tax returns, estimated tax payments and correspondence (e.g. response to official tax notices) to federal and state authorities either by certified mail, return receipt requested, or (as a less desirable alternative) utilizing the U.S. Post Office's "proof of mailing" service. Each time you respond to an IRS or FTB notice, be sure to include as attachments copies of all prior notices and correspondence.

Also, all payments can be made by electronic funds transfer if you sign up and get setup for it. You receive a confirmation for the funds transfer and its application to the appropriate taxes, and a further confirmation on your bank statement where the transfer was made. The IRS and FTB actually prefer that taxes be paid this way.

Income Taxes

Income Taxes - Overview

Most California community associations are classified as mutual benefit nonprofit organizations. Although such associations are "nonprofit" organizations, with rare exception, most pay tax on net nonmember income (generally interest income, less directly attributable expenses). Income taxes are paid to both the state (the California Franchise Tax Board -FTB) and Federal (the Internal Revenue Service - IRS) governments on an annual basis. Unlike individuals whose taxes are due 3-1/2 months after year end, most community associations are corporations whose taxes are due 2-1/2 months after year end (e.g. March 15 for a calendar year association), unless an extension of time to file (not pay) is requested.

As a California corporation, a community association is subject to a minimum annual corporation tax. Fortunately, a residential association can apply for exemption from the state's (currently) $800 corporation minimum tax by completing FTB Form 3500 (and attaching certain required statements and documents). If granted (and most are), this exemption still requires that tax, at prevailing rates, be paid on net nonmember income, defined above. In addition to the California income tax return, the association must annually file an information return, Form 199 after the exemption is granted. The 199 is due 4-1/2 months after year end.

For Federal tax purposes, a community association may choose to file as a homeowner association under Internal Code Section 528 or as a membership organization under Internal Revenue Code Section 277. Under IRC Section 528 the association pays a 30% tax on net **nonexempt function** - income tax terminology for association income and expenses that are not related to the exempt purposes for which the association was formed (e.g. interest income). Under IRC Section 277 the association pays a graduated income tax, starting at 15%, on net **nonmembership** - income tax terminology for association income and expenses not related to the membership purposes for which the association was formed (e.g. interest income). If this last option is selected, the association's owners must annually approve a tax election resolution. See your CPA for the appropriate resolution wording for your particular association.

Income Taxes - Federal Form 1120 (IRC Section 277)

Title	U.S. Corporation Income Tax Return
When Due	<u>Original due date</u> - 2-1/2 months after fiscal year (e.g. March 15 for a December 31 year-end association) <u>Extended due date</u> - 8-1/2 months after fiscal year e.g. September 15 for a December 31 year-end association)
Where Filed	For most Northern California associations... IRS Service Center, Fresno, California 93888 or IRS Service Center, Ogden, Utah 84201 depending upon which California county the association is located in
Eligibility	All corporations
Advantages	(1) <u>Lower graduated income tax rates</u> beginning at 15% for the first $50,000 of taxable income, rising to a maximum of 39% over $100,000. (2) Excess of membership <u>expenses</u> over membership income may be <u>carried over</u> until the next fiscal year (IRC Section 277) (3) <u>Excess</u> of membership income over membership expenses may be <u>carried over</u> until the next fiscal year (Revenue Ruling 70-604 – see discussion at Section 2.21)
Disadvantages	(1) <u>Possible higher taxes</u> if taxable income exceeds $185,777 (in which case, consideration should be given to filing Form 1120-H) (2) Could be liable for <u>underpayment penalties and</u> <u>interest</u> if Form 1120-H was filed in the previous year and estimated income taxes were not paid for the current year (3) <u>Return is longer and more complex</u> (than Form 1120-H), possibly resulting in higher income tax preparation fees.

Income Taxes - Federal Form 1120-H (IRC Section 528)

Title

U.S. Income Tax Return For Homeowners Associations

When Due

Original due date - 2-1/2 months after fiscal year (e.g. March 15 for a December 31 year-end association)

Extended due date - 8-1/2 months after fiscal year (e.g. September 15 for a December 31 year-end association)

Where Filed

IRS Service Center, Fresno, California 93888 or IRS Service Center, Ogden, Utah 84201 depending upon California county association is located in

Eligibility

(1) Corporations organized to manage/maintain community association common area property

(2) At least 60% of income is exempt function (e.g. related to nonprofit membership activities)

(3) At least 90% of expenditures are exempt function (e.g. related to nonprofit membership activities)

(4) Meets "substantially all residential" test - 85% of project square footage is devoted to residential (versus commercial) usage

(5) No excess eamings of the association inure directly to the benefit of specific owners

(6) Election is made by filing a properly-completed Form 1120-H by the required (or extended) due date

Advantages

(1) Short, simple form to complete

(2) Easy to elect and election may be changed each year

(3) Estimated tax payments are not required

(4) First $100 of taxable income is excluded from the taxable income base

Disadvantages

(1) Relatively high flat tax rate of 30%; taxable income would have to exceed $185,777 before this flat rate tax would exceed the benefit of Form 1120's graduated rates (15% to 39%)

(2) Failure to make required estimated income tax payments in years preceding Form 1120 filing could result in interest and penalties

(3) Once a Form 1120-H has been filed, amendment may be difficult (see your professional tax advisor for exceptions to this general rule)

Income Taxes - California Form 100

Title	California Corporation Franchise Or Income Tax Return
When Due	Original due date - 2-1/2 months after fiscal year (e.g. March 15 for a December 31 year-end association) Extended due date - 9-1/2 months after fiscal year (e.g. October 15 for a December 31 year-end)
Where Filed	Franchise Tax Board, P.O. Box 942857, Sacramento, California 94257-0501 if tax is owing or Franchise Tax Board, P.O. Box 942857, Sacramento, California 94257-0500 if no tax is owed or a refund is due
Eligibility	All corporations

Income Taxes - California Form 199

Title	California Exempt Organization Annual Information Statement or Return
When Due	Original due date - 4-1/2 months after fiscal year (e.g. May 15 for a December 31 year-end association) Extended due date 11-1/2 months after fiscal year (e.g. December 15 for a December 31 year-end association)
Where Filed	Franchise Tax Board, P.O. Box 942857, Sacramento, California 94857-0701 if Payment is owed or Franchise Tax Board, P.O. Box 942857, Sacramento, California 94857-0700 if no payment is owed.
Eligibility	Exempt organizations with gross receipts in excess of $25,000. As stated in the instructions to Form 199, "Homeowners' associations exempt under R&TC Section 23701t include condominium management associations, residential real estate management associations and cooperative housing corporations. Homeowners' associations' gross receipts are defined as gross receipts from all sources before deductions. Homeowners association taxable income is defined as all income received during the taxable year other than amounts received from membership fees, dues or assessments." FTB Form 100 may also have to be filed if gross taxable income exceeds $100. Exempt organizations with gross receipts under $25,000. Technically filing of the 199 is not required, however by not filing the corporate tax return is not filed, the quickest way to lose corporate status. For the $10 fee, we recommend that the return be filed annually for homeowner associations regardless of gross receipts. Note, this form is only required to be filed if exemption is granted under R&TC Section 23701t by applying with form 3500.

Future Major Repairs and Replacements

Future Major Repairs - Overview

On an annual basis California community associations are required to review both their operating and long-term replacement reserve budgets and communicate significant information about these budgets to owners in the **pro forma operating budget.**

In addition, at least once every three years, the association is required to have a more extensive review of their long-term major maintenance program commonly referred to as a **reserve study.** The reserve study consists of two basic parts: a physical visual inspection of the property resulting in current estimates of component useful life, remaining life and current replacement cost known as a **component study**, and the manipulation of this information in the form of a financial spreadsheet to determine long-term funding known as a **funding plan**. While California law does not currently require "full funding" (see discussion of the percentage reserves are funded), industry practice and most community association governing documents require the Board to reasonably plan for the future repair and replacement of common area major components. Generally, a prudent funding plan will accomplish this last purpose without the need to resort to (significant) special assessment(s).

Future Major Repairs - Reserve Component Study

Tranquility Homeowners Association

Reserve Component Study
As of December 31, 1999

ABC Consulting
1234 Main Street, Suite 567
Any town, CA 98765

Independent Consultant's Report

30-Year Component Repair And Replacement Costs
Definitions, Limitations, Assumptions, Qualifications, Etc.

Maintenance Suggestions For Longer Component Life
Component Cost/Life Detail And Photo Documentation

Major component is a common area element such as roofing, painting or paving, which (1) has a useful life in excess of one year but less than the life of the building(s), (2) is greater than some minimum dollar amount in cost, and (3) is the responsibility of the association (as opposed to the individual owners) to maintain, repair or replace. Consideration should be given to having the association's attorney review the governing documents when establishing the major component list.

Useful life is the total number of years that a major component, when new, is expected to serve its intended purpose, given proper original installation and ongoing maintenance.

Remaining life is the presently expected number of years that a major component will continue to serve its intended purpose prior to repair or replacement, based upon its present condition. This estimate should be determined by a detailed, on-site physical inspection of the components.

Current replacement cost is the cost, in today's dollars, to repair or replace a common area major component with one of like kind and quality. If local building codes require a different kind or quality of replacement, this information should be obtained for the long-term funding plan.

Component information may come from the Board of Directors, licensed or unlicensed contractors, architects, engineers and/or independent construction consultants. Most industry professionals do not consider the original developer budget to be a good source of component information because it is often incomplete and/or not adjusted for replacement costs in specific geographic areas. Many component study preparers (also known as "reserve study" preparers) also give associations valuable advice concerning the proper maintenance of common area components, and, in certain instances, may alert the Board of Directors to readily obvious (i.e. "patent") or potential (i.e. "latent") construction defects. The accuracy of the resulting long-term funding plan (see Sections 3.30) and pro forma operating budget (see Section 3.60) are directly related to the accuracy of the component information obtained by the association.

Future Major Repairs - Reserve Funding Plan

Tranquility Homeowners Association

Reserve Funding Plan
Years Ending December 31, 2000 To 2029

Sharp Pencil Accountants, CPAs
5678 Side Street, Suite 123
Any town, CA 98765

Independent Accountant's Compilation Report

Forecasted Statements of Replacement Fund Cash Receipts, Disbursements and Balances

Forecasted Statements of Replacement Fund Major Component Repair and Replacement Costs

Income Tax Computations (may be built into the Funding Model based on Federal 1120 or 1120-H)

Notes and Assumptions to Forecasted Financial Statements

- Compilation of accounting data into the form of forecasted financial statements prepared in accordance with other comprehensive basis of accounting (OCBOA, which is essentially the cash basis of accounting) and California Civil Code Section 1365.
- Compilation of data on major repairs and replacements including, but not limited to, a listing of major components, useful and remaining lives, current replacement costs, 20- to 30-year projection of estimated future replacement costs, significant assumptions concerning interest rates, inflation rates, income tax rates, caution as to achievability, etc.
- Computation of current replacement reserve obligation (liability) in accordance with California Civil Code Section 1365.
- Computation of future (at the end of 20- to 30-year replacement reserve funding plan) replacement reserve obligation (liability) in order to establish the amount of reserve funds needed at this projected future date (thus defining the replacement reserve funding plan goal or objective).
- Computation of 20- to 30-year replacement reserve funding plan which achieves a 100% (or other Board-designated) funded status at the end of this 20- to 30-year (or other Board-designated) projection period.

Future Major Repairs - Annual Provision and Accumulated Reserve

Annual Provision

The annual provision represents the one-year's wear of all major components, expressed in dollars, for a period of one year. The example above depicts the computation for a single component. The provision represents the accrual-basis expense of the replacement fund for a one-year period. California Civil Code Section 1365 requires disclosure of the accrual-basis expense in the association's pro forma operating budget.

Accumulated Reserve

The accumulated liability represents the total wear since last replacement of all major components, expressed in dollars, as of a particular point in time (usually at month end or year end). The example above shows the computation for a single Component at the end of the 10th year of the component's life. California Civil Code Section 1365, effective January 1,1992, requires disclosure of the ratio of actual replacement fund cash reserves to the estimated liability as of the end of the current fiscal year in the association's pro forma operating budget. Based on the following example, if the association's replacement fund cash reserves total $78,000, the percentage funded is 60% ($78,000 cash divided by $130,000 liability).

Examples

Component:	Roofing	Painting	Paving	Total
Useful Life (UL):	18 years	7 years	6 years	Various
Remaining Life (RL):	5 years	3 years	2 years	Various
Current Replacement Cost (CRC):	$180,000	$140,000	$ 60,000	Various
Annual Provision (CRC/UL):	$ 10,000	$ 20,000	$ 10,000	$ 40,000
Accumulated Liability (CRC/UL)*(UL-RL):	$130,000	$ 80,000	$ 40,000	$250,000

Future Major Repairs - Pro Forma Operating Budget

Tranquility Homeowners Association

Pro Forma Operating Budget
Year Ending December 31, 2000

Sharp Pencil Accountants, CPAs
5678 Side Street, Suite 23
Any town, CA 98765

Independent Accountant's Compilation Report

Forecasted Statement of Revenues, Expenses, and Changes in Fund Balances

Notes and Assumptions to Forecasted Financial Statement

Forecasted Schedule of Major Component Replacement Provision for the Year Ending December 31, 2000 and Estimated Liability at December 31, 1999

- Compilation of accounting data into the form of a forecasted financial statement prepared in accordance with generally accepted accounting principles (GAAP, which is essentially the accrual basis of accounting) and California Civil Code Section 1365. This compilation includes both the day-to-day operating budget, and certain replacement reserve information.
- Compilation of data on major repairs and replacements including, but not limited to, a listing of major components, useful and remaining lives, current replacement costs, significant assumptions concerning interest rates, inflation rates, income tax rates, <u>caution as to achievability</u>, etc.
- Computation of current replacement reserve obligation (liability) in accordance with California Civil Code Section 1365.
- Computation of percentage reserves are funded at December 31, 1999, in accordance with California Civil Code Section 1365
- Computation of future (at the end of 20- to 30-year replacement reserve funding plan) replacement reserve obligation (liability) in order to establish the amount of reserve funds needed at this projected future date (thus defining the replacement reserve <u>funding plan goal or objective)</u>.
- Explanation, in words, of 20- to 30-year replacement reserve funding plan which <u>achieves a 100%</u> (or other Board-designated) <u>funded status</u> at the end of this 20- to 30-year (or other Board-designated) projection period.

Future Major Repairs - Civil Code Section 1365 Disclosures

California Civil Code Section 1365 defines certain annual financial reporting requirements by all residential common interest developments in the pro forma operating budget:

1. Listing of common area major components whose estimated remaining life is less than 30 years Generally, this list will contain items which cost more than $___ (you set the limit below which the item, even if a major component, will be expensed as a part of the operating budget) and will, generally, have a useful life of more than one year.
2. Estimated remaining life of each component. Be sure to include those major components whose remaining life has fallen below 30 years!
3. Estimated total useful life of each component.
4. Estimated current replacement cost of each component.
5. The foregoing "component study" information is required to be obtained and/or evaluated not less often than every three years if the estimated current replacement cost of all major components exceeds one half of the association's annual budget.
6. Amount of cash reserves currently set aside.
7. Percent reserves are funded, expressed as a percentage of actual cash reserves to the accumulated wear expressed in dollars (i.e. the reserve liability).
8. Methods of funding the future repair, replacement or additions to major components.
9. Known or anticipated special assessments. No time limit is stated. For example, if the association's long-term reserve funding plan projects a $50,000 ($2,500 per unit) special assessment 9 years in the future, this information should be disclosed.
10. Statement of procedures used for calculating replacement reserve requirements. In addition to disclosing general methodologies used (i.e. straight-line and/or cash-flow for either or both "funding" and "percent funded"), significant assumptions such as replacement cost inflation rate(s), interest earning rate(s) and Federal/California income tax rate(s) should also be disclosed .
11. Accrual-basis revenues and expenses of both the operating and replacement funds. For example, if the annual wearing out (see example at Section 3.40) of major components is $40,000, but only $15,000 reserve cash is projected to be spent in the next year (the budget year), the $40,000 accrual-basis expense (sometimes likened to the concept of depreciation expense) is the amount that should be shown in the annual budget. Additional (though not required) disclosure might be made in the notes to the pro forma budget disclosing the fact that $15,000 in reserve cash is expected to be spent on painting next year.
12. In lieu of distributing a comprehensive pro forma budget which includes all of the foregoing information a summary of the pro forma budget may be distributed if the summary contains, on the front page, in 10-point or larger boldface type, a notice to the owners that, upon request, they may obtain from the association, by first class mail, within 5 days, a complete copy of the pro forma operating budget.
13. Distribution of the budget to all owners within 30 to 90 days BEFORE the start of the next fiscal year. For instance, if the association's year end is December 31, 1999, the year 2000 pro forma operating budget should be distributed between November 1, 1999 and November 15,1999.
14. Penalty for noncompliance, If all of the foregoing provisions are not met, the Board may not be able to increase assessments up to 20% per year, as otherwise permitted by the California Civil Code, without a vote of the membership.

Future Major Repairs - Reserves Percent Funded Computation

The California Civil Code section 1365.2.C requires a comparison, stated as a percentage, of the association's **current reserve cash** with the **estimated reserve cash needed** based upon the accumulated wear of capital reserve components. Commencing in 2005, section 1365.2.5 resolved any controversy about how to estimate the reserve cash needed by laying it out in the "Assessment and Reserve Funding Disclosure Summary", a handy form-imbedded-in-legal-text. In it (section 1365.2.5.b.4) boards are instructed that "the amount of reserves needed to be accumulated for a component at a given time shall be computed as the current cost of replacement or repair multiplied by the number of years the component has been in service divided by the useful life of the component."

The estimated reserve cash needed for all of the individual components, when added together, give the "**Estimated Reserve Cash Needed**." This must be compared to the "**Current Reserve Cash**" on hand in the manner shown below in order to compute the "**Percent Funded**." Thus,

(Current Reserve Cash ÷Estimated Reserve Cash Needed) _ 100 = Percent Funded

Frequently Asked Questions:

1. Can our property manager sign checks on our operation account? our reserve account?

A property manager can be allowed to sign operating checks. This is sometimes done from an operating efficiency viewpoint, because it is sometimes difficult for the property manager to physically get all checks to a Board member for signature. If it is allowed, they the Board should take additional steps to strengthen internal controls, such as reviewing a check register each month and closely reviewing the monthly or quarterly financial statements.

California Civil Code Section 1365.5(b) requires all withdrawals from the association's reserve accounts be signed by either two Board members or one Board member and an officer of the Corporation. The property manager should never be allowed to sign checks or make withdrawals from reserve accounts, even if named as an officer.

2. Do we have to have a separate reserve account? Do reserve transfers have to be made monthly?

The Board of Directors is obligated to account for reserve funds separately from operating funds. Therefore the funds should be physically separated. It is also a preferred practice to make monthly transfers of the budgeted replacement fund assessments from the operating account to the reserve account, but they can be made quarterly, semiannually or on some other scheduled interval.

3. Do we have to fund reserves?

Currently the Civil Code does not required that reserve funds be accumulated. Instead, there is a disclosure requirement. Civil Code Section 1365.5(e)(4) requires that a reserve study includes "An estimate of the total annual contribution necessary to defray the cost to repair, replace, restore or maintain the components ...". Although it is not a prudent policy, the Board could special assess for every reserve fund expenditure. However, the reserve study would still have to disclose the estimated annual special assessments anticipated over the next 30 years as part of their annual budget disclosures (Civil Code Section 1365(a)(2)(C)(3)).

4. Can the Board do the reserve study? Can our CPA?

A reserve study (Civil Code Section 1365.5(e)) requires (1) identification of the major components which the association is obligated to repair, replace or restore; (2) identification of the probably remaining useful life of the components identified based on a physical inspection; and (3) an estimate of the cost of repair, replacement, or restoration. A CPA is not qualified to perform these tasks. Most Boards of Directors also are not qualified. Instead, the Board should engage an outside qualified expert to perform the study. A CPA is qualified to assist in an annual updating of the funding portion of the reserve study.

5. What is "percent funded" and what percentage should we be?

Percent funded is a measurement of how an association's reserve cash compares with an estimation of the cash needed to repair, replace, restore, or maintain its major components. The percentage is determined by dividing the former by the latter. State law requires it to be disclosed to homeowners as part of the annual budget.

Commencing 2005, the California civil code standardized the calculation of this "percent funded" in the manner described in "Future Major Repairs - Reserves Percent Funded Computation" section above.

The legislated method employs simple accrued expense from a single point in time to estimate the cash reserves needed. Easy to compute, it provides a uniform standard for the industry. However, it does not incorporate more complex but important factors like cash flow, inflation, interest, etc. What percent funded is truly sufficient? The answer will vary depending on each association's replacement schedule, actual cash flows and future funding plans. Fortunately, more sophisticated funding projections are often included in the reserves studies supplied by reserve analysts, making the association's reserve study the primary reference for this and related questions.

6. If we are unincorporated, do we still have to file tax returns?

Any association, whether or not incorporated, that has more than $100 in interest or other taxable gross receipts is required to file both Federal and California income tax returns.

7. Can Board members be paid or have their assessments reduced? Can we have a special Board dinner at the end of the year?

Most associations are incorporated as nonprofit, mutual benefit organizations. All associations should carry directors and officers liability insurance. This insurance is predicated on the assumption that Board members serve on a voluntary basis and are not compensated for their services. Reducing Board member assessments or having special functions for Board members only is a form of compensation subject to payroll compensation reporting and therefore can invalidate the directors and officers liability insurance. Having functions where all members of the association are invited such as group pot lucks is quite acceptable.

8. At the end of each year, should the Board transfer any operating surplus to the replacement fund?

Initially the Board needs to accumulate sufficient operating surpluses to use for operations. For example, the accumulated surplus should be large enough to allow for the annual payment of the insurance premium and still allow for a cushion in case operating expenses exceed operating income in a particular year. However, once this surplus is accumulated then it is prudent to transfer any additional excess to the replacement fund or reduce future assessments by using the surplus for operating costs.

9. Do we need to adopt the tax resolution each year if we only file a Form 1120H?

The annual tax resolution is only needed if the association files Form 1120 or 1120A. It is not required if the association files Form 1120H. If the association is not sure which form will be used, there is no harm in passing the resolution and then filing either Form. The resolution should be passed prior to the end of the fiscal year anyway so it is a good idea to pass it as a regular procedure at your annual membership meeting even if it is only a month into your fiscal year.

10. Can we give owners a discount on their assessment payment if they pay in a lump sum at the beginning of the year?

Giving owners a discount for a lump sum payment should be avoided as it can created potential taxable income for the association. For example, if the annual assessments is $1,200

($100/month), and the association allows individual owners to make a lump sum payment of $1,100, then the annual assessments really becomes $1,100. By collecting $1,200 from other owners, the association could be construed as receiving $100 in interest income from each of these owners.

11. Should we keep our books on the cash or accrual basis of accounting?

Either method is acceptable. However, the accrual basis of accounting is more appropriate for larger associations. All associations should at least consider using at least a modified cash basis of accounting where assessments are accounted for on the accrual basis. This method creates control over the collection of assessments.

12. Can our Treasurer or Chief Financial Officer perform the Civil Code Section 1365.5 quarterly review or should the whole Board be involved?

Even though the Treasurer may be the most knowledgeable, the Board as a whole is responsible for the quarterly review and all of the members should participate. We further urge you to document the review when done by either a signoff sheet or a discussion and notation in the minutes.

13. As part of the Section 1365.5 quarterly review, how does the Board review the reserve fund activity since often there is no income statement or detail available? For example, was the pool resurfacing over/under budget per the reserve study?

The Board should ask questions and instruct their financial statement preparer to include this information (detail and budget to actual comparisons). Most bookkeeping systems are not adequate for this item.

14. Can the association use reserve funds to pay for replacing a component that is not listed as a component?

Yes, as long as the item is considered a major component. For example, the association may not have had the tile roofs listed on the component list because the estimated remaining life was over 30 years. However, if an incident happens where major roof repair was necessary. In such an instance, this would be considered a legitimate reserve expenditure.

A couple of cautions are in order. First you may need to update the funding plan to adjust for future assessments. Perhaps a telephone call to the reserve preparer is in order. Second, there can be issues involving capital improvements that are not apparent or even a question as to if the item is truly a major component. If in doubt, contact your professionals—Reserve Study Preparer, CPA or attorney.