SOUTH COAST HOMEOWNERS ASSOCIATION
P. O. BOX 1052, GOLETA, CALIFORNIA 93116
(805) 964-7806
gartzke@silcom.com

Volume 16, Number 5 **September 2003**
Michael J. Gartzke, CPA, Editor

IN THIS ISSUE

NEXT SOUTH COAST MEETING – ASSOCIATION FINANCES DISCLOSE, DISCLOSE, DISCLOSE!

It's been a while since we had one of our meetings devoted to association finances. Discussion topics will include Civil Code requirements for disclosing association finances to the members as well as the board, budget basics, interpreting financial information (how to read financial statements), reserve study questions including calculation methods, percent funded and the integration of reserve information into your annual budget. As always we will set aside time for your questions.

DATE – Tuesday, September 23, 2003
TIME – 7 – 9 PM

PLACE – Holiday Inn, 5650 Calle Real, Goleta

SPEAKERS – Chris Andrews, Stone Mountain Corporation
Michael Gartzke, CPA

COST - None

BOARD BASICS – BUDGET DEVELOPMENT MECHANICS

Developing a sound realistic budget involves **people, planning and research**. Don't wait until 15 days before the budget needs to be mailed to start work on it. Have a plan in place and **implement** it. Here are some guidelines to assist you in developing a budget for your association

People – Who should be involved in developing your budget? The principal players are your board and manager. Some associations will have a finance committee consisting of the treasurer, another board members and some owners who are not on the board. Don't overlook your CPA or financial professionals in this process.

Planning - When do you get started? Budgeting can be a 12-month a year process. Generally, I start working on budget drafts in the eighth or ninth month of the fiscal year. Some associations, especially larger ones may start sooner. Enough time must be allowed to develop the budget draft and have the board approve it prior to mailing to the members. Additional drafts may be needed to complete the process. Budget comparisons should be made monthly with actual income and expense to determine financial performance all during the year – see article following. The budget is due to the members 45 days before the start of the association's next fiscal year. For calendar year associations, that means November 16.

Research – What information do we need? Where can we get it? The answers may or may not be out there but you need to ask the questions. How good can we make the crystal ball?

Have **historical expense** information available. Use complete general ledgers for this year and the prior year to review detailed expense information. Are expenses like water seasonal? Looking at January-July's water expense will not accurately predict common area water use in August – December.

Review **utility** bills for changes in rates. Are they the same as last year? If not, how have they changed? Are you aware of any pending changes?

What have your **insurance** premiums done the past two years? What does your agent/broker think about premiums for the next renewal?

Talk to your **service providers –** If landscaping is a major part of your operating budget, should you find out what the marketplace is? Are landscape companies workers comp premiums doubling? What are contractor rates doing? Is your manager now required to provide more services? What are these costs?

What is the current rate of **inflation**? If I had unlimited time and resources, I'd like to sit down and compute a homeowner association rate of inflation. I am convinced that association costs increase more than the general rate of inflation published by the government. College costs and medical expenses seem to increase more than the CPI. I believe HOA expenses do, too.

Are any **special projects** or new services pending? Are you planning to revise your CC&Rs? Are you planning to change from self-management to professional management? Are you contemplating major maintenance that is not part of your reserve study?

Speaking of the reserve study, what is the **recommended reserve contribution** for the following year? Are **special assessments** needed to meet major maintenance expenses?

Implementation – Once you have pulled together most if not all of the above-referenced information, it's time to start putting together the first draft of the budget. I believe that prior to the finance committee or the board considering the budget, the Treasurer, manager or CPA should put together the initial draft, considering all the information in hand. For me, it's easier to consider changes and discuss it with others if there is a draft available for review. Developing a draft at a committee or board level could be very cumbersome. How do you put together a draft?

I start with a spreadsheet with all the income and expense categories that are to be budgeted listed down the first column. The next column is the actual income and expense for the current year for the number of months completed (e.g. 8 months through August). Column 3 would be a prorata amount of the current annual budget. (e.g. 8/12 of the annual budget through August). Column 4 would be the difference (variance) between the actual income/expense (column 2) and the prorata budget (column 3). The variance would tell us how we are doing so far this year – over or under budget. Column 5 would be the total budget for the current year which would be our reference to column 6 – the proposed budget for next year. You could add additional columns for net change in dollars in this year's vs. the proposed budget and for remarks – why a category is changing.

Having a draft available facilitates discussion. Comments can range from the factual – "The county raised our trash rates 20% last year" to the philosophical – "What would happen if we didn't heat the pool year round? With the proper documentation in place, the board can act and approve the budget.

Other Disclosures – In addition to the budgeted income and expenses for the association for the coming year, the association's operating budget will also contain other disclosures:

- Summary reserve information and percent funded from the reserve study
- Insurance coverages, deductibles and limits
- Assessment collection procedures
- Policies to impose fines for CC&R violations
- Availability of corporate minutes
- Procedures for resolving disputes – Alternate Dispute Resolution
- Notification of assessment change

BEYOND THE BASICS – IS YOUR BUDGET REALISTIC

The association's annual operating budget, when prepared thoroughly, provides significant information to members and third-party users such as lenders, real estate agents and the association's own financial professionals about the association's current and future financial position. While we know that California law requires the distribution of the budget 45 days before the beginning of the association's fiscal year, how useful can this document be? How can the budget be made more "user friendly"? This article will examine a variety of issues with the goal of making your annual budget a most effective financial planning tool for your association.

1) Review your association's income and expenses against the current budget at every board meeting and explain variances.

All financial software programs from Quicken up through specialized HOA programs have the capability of loading your current budget into the program and running actual vs. budget reports for the current month as well as year-to-date. A variance is simply the difference between the actual amount and the budgeted amount. For instance, if you budgeted $5,000 for insurance and the actual was $ 6,000, you would be over budget by $1,000 or have a variance of $1,000 from the budget. Variances may be seasonal such as irrigation water or as a result of expenses such as insurance that may not be paid monthly. Changes in contract costs or unexpected expenses may also explain variances. Reviewing this information on a continual basis keeps the board better informed when making financial or maintenance decisions. Communicating this information to members through the association minutes or newsletter allows members to be aware of the association's current financial status.

2) How do we incorporate the reserve study into the operating budget?

Your reserve study contains disclosures that are required to be included in the budget document. California Civil Code Section 1365 requires a summary of the reserve study be distributed to the members with the budget. These disclosures include:

- Estimated replacement cost, estimated useful life and estimated replacement cost of each major component.
- The current estimate of the amount of cash reserves necessary to repair/replace the major components
- The current amount of accumulated cash reserves
- The "Percent Funded" – actual cash divided by "necessary cash"
- A statement as to whether the board anticipates a special assessment to make major repairs or establish reserves
- A statement regarding the procedures used to establish the component and funding information contained in the reserve study

Most professional reserve studies will have an "Executive Summary" with this information. You can simply copy these few pages from the complete report and include it with your budget document. This summary should also include the recommended annual funding amount for reserves that you can use as the reserve contribution line item in the operating budget.

3) **Is our reserve study adequate? Is it updated?**

Many associations will spend money on "reserve" components that are not included in their reserve study. Examples might include tree trimming, roof repairs or plumbing. These could be considered major components but no funding is being considered in the reserve study. The association should consider operating budget items for these if they occur annually or expanding their reserve study to incorporate these kinds of items if they occur less frequently and provide funding for them.

While California law requires a new reserve study every three years, it also requires the board to review the study annually.and implement adjustments as needed. If there are numerous or substantial adjustments, the board should consider an update to the study. Adjustments could include shortening or lengthening the life of a major component after getting new information from a contractor, changing cost information or adjusting the study when a component is repaired or replaced.

4) Can we use the reserve fund as a contingency fund?

Some boards look to the reserve funds as a funding source for any unanticipated expense whether a reserve expense or not. The California Civil Code restricts the use of reserve funds to “the repair, replacement, restoration, or maintenance of, or litigation involving the repair, restoration, replacement or maintenance of, major components which the association is obligated to repair, restore, replace or maintain and for which the reserve fund was established. “(CC 1365.5(c)(1)). The code allows for some exceptions provided the board meets some very strict disclosure requirements to its members regarding the temporary use of reserve funds and the pay back of these funds over the next 12 months. “The board shall exercise prudent fiscal management in maintaining the integrity of the reserve account…”

5) Can’t we simply not fund all of the budgeted reserves if we run short of operating money?

From your author’s perspective, this appears to be becoming more common and is a recipe for danger.

First, your association distributed a budget where reserve funding is clearly stated. You are actually collecting two assessments, an operating assessment and a reserve assessment, which are combined into a single assessment for administrative convenience. One check can be written by an owner and deposited into one bank account. From there, the assessment can be split and deposited monthly into the reserve account. Members have an expectation that their reserve assessment is funding reserves and not paying for something else, like increased insurance premiums or utilities.

By not funding reserves because of cost overruns in the operating budget, you have used reserve money for operating purposes. California Civil Code Section 1365.5(c)(2) requires that “(t)he board shall exercise prudent fiscal management in maintaining the **integrity** (emphasis added) of the reserve account.” Maintaining the integrity of the reserve account means funding the reserve assessment as budgeted into the reserve account periodically.

Second, California Civil Code Section 1365.5(b) requires “(t)he signatures of at least two persons, who shall be members of the association’s board of directors… shall be required for the withdrawal of moneys from the association reserve accounts.” The manager, bookkeeper, accountant or others cannot sign on the association’s reserve accounts. I have noticed associations not funding reserve assessments but keeping the money in the operating account to pay reserve expenses when they occur. By keeping these reserve funds in the operating account, the intent of the Civil Code is circumvented since nondirectors nor officers of the association need to sign on the operating account under a manager’s or bookkeeper’s control.

Third, not having to fund all of the reserves would allow the association to budget less than necessary to meet its operating obligations. It can be politically expedient not to have to tell the members that assessments need to be increased. Reserves are not a contingency or a slush fund for operating expenses. They are for meeting the major repair and replacement obligations of the association.

6) What are the consequences of not funding reserves?

There are a number of negative consequences when reserves are not funded. Among them are:

a) **Delays in making necessary repairs –** It is much easier to commit resources to make timely repairs when funds are available to the association than when the association has no funds to do the work. If work is delayed, it is inevitably more expensive because additional work may be needed to correct deteriorating conditions.

b) **The need for special assessments –** Special assessments tend to be unpopular, depending upon the reasons for it. See item 7 following.

c) **Marketability of units –** Buyers, lenders and others are looking to budgets and reserve information to determine how financially sound the association is. Association units with stronger reserve positions are more marketable. Poor reserves can make sales and refinances more difficult, especially in a down real estate market.

d) **State law –** While state statutory law does not mandate reserve funding, it does mandate all the disclosures noted earlier. Some California case law (Raven's Cove Townhomes – 1981) involved a board that did not provide for adequate reserves in the association's formation. The court held the directors personally liable for not funding those reserves. This makes the point of funding adequate reserves in light of all the required disclosures mandated by state law.

e) **Unhappy members –** Members who believed that a certain portion of their assessment was going towards reserve funding when it was not can cause the board and the association a great deal of unnecessary grief.

7) Special Assessments – How can they help you or hurt you?

There are times when a special assessment is necessary. As much as you try, there are many variables that boards and their managers cannot control. The association has several forms of special assessments at its disposal. Not all require a membership vote.

a) 5% of the budgeted gross expenses – This assessment is useful for smaller needs and is not subject to a membership vote if used only once during the fiscal year. For example, an association with a $100,000 budget and 50 members could levy a special assessment of up to $100 per member under this provision. ($100,000 x 5% = $5,000 divided by 50 members = $100 per member). This could be useful to meet unanticipated changes in operating expenses such as insurance and utility billings. In some cases, it is impossible to project what certain expenses will be 9-12 months after the budget process. It could also be used to reimburse unexpected legal costs that will not be recovered. It is important to communicate the need to the membership as to why this type of assessment is being imposed and why you could not anticipate its need during the budget process.

b) Extraordinary expense required by a court order – Members don't get to vote on these assessments but these would be rare and generally outside the scope of the association's normal operating or reserve budgets.

c) Extraordinary expense required when a threat to personal safety is discovered – Some years ago, a local association was required to resurface their deteriorated parking area. Their insurance agent felt the existing conditions were hazardous and the association's insurance might be cancelled if the condition wasn't corrected. The board could impose a special assessment to correct this condition without a vote of the membership

d) Extraordinary expense that could have been not reasonably foreseen at the time the budget was drafted – Use caution if considering a special assessment under this section. There could be situations where members would question why you didn't know about the expense at the time the budget was drafted. On the other hand, there can be very valid reasons to use this section for a special assessment. Perhaps there is dryrot or other structural damage that could only be quantified after substantial investigation and testing. It might be best to put this type of assessment to a vote initially to determine the amount of support for the assessment.

e) Assessments not falling under the exceptions listed above – Then a vote of the membership is required either by mail or at a membership meeting with ballots, proxies, etc. where at least 50% of the members participate. In all but the smallest special assessments, the association should consider having a "town hall" type meeting to present the information used to justify the need for the special assessment and allow for member comment and input. Depending upon the amount of the assessment, you may wish to offer the members an opportunity to make installment payments on the assessment to generate more support. Some members will not be able to come up with large sums of money, even with 30-60 days notice so then you can run into collection problems. If the amount of the assessment is large and funds are needed relatively quickly, you may wish to consider a bank loan to fund the work now and pay off the loan with the special assessment proceeds, when received.

Special assessments can have the potential of being politically volatile. Prompt, consistent communication with members through minutes and newsletters can help to diffuse some problems. Special assessments can be a quick way to meet an unexpected need or can cause member unrest if members perceive that the board did not handle the situation correctly.

8) Aren't members supposed to approve the budget at the annual meeting?

In most cases, no. The Civil Code provides that the board of directors approves the budget if the regular assessment increases by 20% or less and it has met its disclosure requirements regarding the preparation and distribution of its operating budget and reserve study disclosures. If the assessment increase is greater than 20% or the association has not made the required disclosures, then the members must approve the change in assessment.

Some CC&Rs, especially ones drafted before 1985, have different requirements for approving the budgets and any resulting change in assessments. The Civil Code **overrides** the governing documents in these situations and is controlling. All associations are governed by these assessment provisions, even if the governing documents are more restrictive.

9) Other Associations pay less than we do. Their assessments are not going up as much as ours. Inflation was only 3% last year. Why are our assessments higher and going up more?

There is peer pressure out there to not change assessments and somehow make it work. There is knowledge that another association of similar size has lower assessments.

There are many factors which go into developing an appropriate assessment:

- Age of the association – newer associations may have lower day-to-day maintenance costs. They may also have fewer maintenance responsibilities than older associations.
- Level of services – some associations will opt for more landscaping services, for example, than its neighbor. Maybe another association carries earthquake insurance and another doesn't. Still others may have more shared utilities than other associations. Within the confines of the governing documents, associations may be able to make some choices regarding how much the association will provide to its members.
- How healthy is the reserve account? Many associations find themselves having to play "catch-up" with their reserve funding because of a lack of appropriate funding in past years. The net result is usually significantly higher assessments in later years
- Economic Conditions – High demand services are not tied to inflationary adjustments but may be increasing more due to demand, government regulations, etc.
- Value of services – perhaps the other association is receiving better value for its assessment dollar than you are. Are you satisfied with the services that you are receiving? These are subjective measures and many times reasonable people will disagree.
- No two associations are exactly alike. Decisions made early on may have an economic impact many years later.

10) If we spend less operating funds than budgeted this year, can we apply the surplus to next year?

Absolutely. The trick here is to determine if you are going to have excess operating funds at the end of the year when you are preparing the budget 3-4 months before the end of the fiscal year. Conversely, you may need to budget additional funds in the subsequent year to meet shortages in the current year. The association should maintain an operating fund of ½ to 1 month's expenses to facilitate cash flow and help meet unexpected costs. (you might need more depending upon the size of your association or the timing of expenditures). Only apply the surplus if you are certain that you will have one to apply to next year.

11) Promote the total economic value of the association and that the assessment is going to maintain and enhance that value (Sell your assessment!) – An association of 100, $500,000 homes has an economic value of $50 million. Sometimes, putting a $10/month increase in the assessment in the context of $50 million seems trivial and indeed, members may be more understanding when the assessment change is seen in that context. The board and its management take the responsibility for maintaining and operating the association seriously.

12) Emphasize the areas where expenses are changing and why the assessment must change to meet these obligations – While the association budget may have 20 or more expense categories, the major changes may usually be distilled into 3-4 areas that cover most if not all of the assessment change. For example, insurance costs have increased dramatically over the past 2 years. Common area electric costs increased 40-50% after deregulation. Some water districts have passed through higher costs to cover state water and other capital projects. After a new reserve study is completed, some associations are boosting their reserve contributions to meet the recommendations of their reserve specialist. By emphasizing these major areas at the beginning of the budget narrative, members will have a quick understanding of the need to change the association assessment.

13) Use charts/graphs to help explain the "numbers", cost history and changes –

Many members can relate better to graphs, charts and other aids rather than just a schedule of numbers. Consider Including these in your budget document or at an annual meeting presentation.

- Pie chart showing allocation of assessment – Most associations can classify their expenses into 5 major categories – utilities, common area maintenance, insurance, general and administrative and reserve funding. A pie chart will show the relative amounts being applied to each of these major categories

- Use of per member per month computations. Members can relate best to the actual amount of the monthly assessment check that they write. For example, a $200 per month assessment might be broken down into $30 utilities, $35 insurance, $75 common area maintenance, $15 general and administrative and $45 reserve funding. You could add a column in the operating budget alongside the budgeted expense amounts to show that information

- Bar graphs can be used to compare relative amounts of the budgeted expenses compared to previous years to show the changes over time and can be enlightening to boards and members about why assessments have to change

14) Involve your professionals – If your CPA, manager or other financial professionals have experience with other associations besides yours, then they have a great deal of information to offer you as you develop your budget and sell it to the membership. We work in this field daily, get calls from concerned board members and owners and have access to many resources to assist in recommending a realistic assessment and help you stay out of trouble.

It can pay dividends to have your financial professionals attend your annual meeting to present the association's current financial condition and budget and help explain the thorny issues. We can bring years of experience to your membership and offer insights and comparisons not otherwise available to your board. I have found members who attend meetings receptive to information provided by the association's professional team and seem pleased that we would take the time to prepare association-specific information and present it during the membership meeting. We're here to help you (and we're not from the government!)

PLEASE FEEL FREE TO MAKE COPIES FOR YOUR BOARD MEMBERS
SHARE THIS NEWSLETTER WITH YOUR ENTIRE BOARD OF DIRECTORS

SOUTH COAST NEWSLETTER SPONSORS

ACCOUNTANTS

Cagianut and Company, CPAs
Gayle Cagianut, CPA
P. O. Box 1047
Oak View, CA 93022
805-649-4630

Michael J. Gartzke, CPA
5669 Calle Real #A
Goleta, CA 93117
805-964-7806

Hayes and Hayes, CPAs ('04**)**
James L. Hayes, CPA
501 S. McClelland St.
Santa Maria, CA 93454

Denise LeBlanc, CPA
P. O. Box 2040
Santa Maria, CA 93457
805-598-6737

FINANCIAL SERVICES

N. Ray Guymon
402 Cameron
Santa Maria, CA 93454
805-937-1552

ATTORNEYS

Karen A. Mehl
Attorney at Law
1110 E. Clark Ave #230
Santa Maria, CA 93454
805-934-9624

James H. Smith
Grokenberger, Smith & Courtney
1004 Santa Barbara St.
Santa Barbara, CA 93101
805-965-7746

David Loewenthal
Schimmel, Hillshafer and Loewenthal
827 State Street #25
Santa Barbara, CA 93101
805-564-2068

ATTORNEYS (Cont)

Allen & Kimbell, LLP
Steven K. McGuire
317 E. Carrillo St.
Santa Barbara, CA 93101
805-963-8611

Beth A. Grimm
www.californiacondoguru.com
3478 Buskirk #1000
Pleasant Hill, CA 94523
925-746-7177

BANKING SERVICES

First Bank & Trust
Diane Doria, CMCA, AMS, CCAM
2797 Agoura Rd.
Westlake Village, CA 91361
888-539-9616

Goleta National Bank
Andy Clark
5827 Hollister Avenue
Goleta, CA 93117
805-683-4944

ASSOCIATION MANAGEMENT

Sandra G. Foehl, CCAM
P. O. Box 8152
Goleta, CA 93116
805-968-3435

Santa Barbara Resources, Inc.
Phyllis Ventura
5813 La Goleta Rd.
Goleta, CA 93117
805-964-1409

Spectrum Property Services
Cheri Conti
1259 Callens Rd #A
Ventura, CA 93003
805-642-6160

ASSOCIATION MANAGEMENT (Cont)

Town'n Country Property Management
Connie Burns
5669 Calle Real
Goleta, CA 93117
805-967-4741

RPL Management
Greg Hohman
P. O. Box 611
Solvang, CA 93464
805-686-9120

RESERVE STUDIES

Stone Mountain Computing
Chris Andrews
P. O. Box 1369
Goleta, CA 93116
805-681-1575

J. D. Brooks Reserve Studies
John Brooks
24 East Cota, Suite 201
Santa Barbara, CA 93101
805-963-1237

INSURANCE

State Farm Insurance
Ed Attlesey
160 N. Fairview #3
Goleta, CA 93117
805-964-9988

State Farm Insurance
Buzz Faull
1236-G Coast Village Circle
Santa Barbara, CA 93108
805-969-5838

Allstate Insurance
Nina Corman, Exclusive Agent
830 E. Ocean Avenue
Lompoc, CA 93436
805-736-8944

LANDSCAPE MANAGEMENT

Kitson Landscape Management, Inc.
Sarah Kitson
5787 Thornwood Drive
Goleta, CA 93117
805-681-7010

PAVING CONTRACTOR

Smith Patterson Paving ('04)
David/Jim Smith
1880 N. Ventura Ave.
Ventura, CA 93001
805-653-1220

ROOFING CONTRACTOR

Derrick's Roofing
718 Cacique St
Santa Barbara, CA 93101
805-957-2065

Thank you to all our professional member advertisers for their support during 2003.

HOMEOWNER ASSOCIATION ORGANIZATIONS

Community Associations Institute –
Channel Islands Chapter
P. O. Box 3575
Ventura, CA 93006
805-658-1438
www.cai-channelislands.org

Executive Council of Homeowners
ECHO
1602 The Alameda #101
San Jose, CA 95126
408-297-3246
www.echo-ca.org

ADVERTISING INFORMATION
805-964-7806