FirstService RESIDENTIAL

Financial Literacy & Association Budget 101

In this guide, we present the basics of financial literacy for new board members and seasoned board members who need a refresher.

Financial Literacy & Association Budget 101

People join their association board to make a difference in their community. But they soon realize there is a lot to learn, especially regarding finances and the association budget. Many new board members do not understand the full scope of the budget process, and it's common for them to have questions. In this guide, we present the basics of financial literacy for new board members and seasoned board members who need a refresher. We break down what items board members should consider (or may overlook) when it comes to finances.

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Financial Terms: The Basics

When faced with the association's finances for the first time, board members might feel overwhelmed by many new financial terms. There is a lot to learn, most of which is brand-new information. Below are some basic terms you will hear during budget conversations. Getting a handle on these terms will help make the process easier to understand.

Accounts Payable: Money that the association owes to vendors and contractors. You can find the AP balance on the balance sheet. If you want a full list of vendors and amounts owed, you can review the AP listing report.

Accounts Receivable: Money owed to the association. You can find the AR balance on the balance sheet. If you want a full list of owners and amounts owed, you can review the accounts receivable and prepaid report.

Annual Meeting: A meeting that takes place once a year to inform homeowners what projects are complete, what to expect for the year and present the new annual budget.

Assessments: Fees homeowners pay to the association to cover operating costs and the reserve fund.

Assets: Resources owned by the association that has economic value (e.g., bank account money). You can find the assets listed on the top portion of the balance sheet.

Bad Debt: Fees owed to the association that you don't expect to collect.

Balance Sheet: A snapshot of the association's financial position. This lists all the of the assets, liabilities and equity for the association.

Bank Reconciliation: A process for comparing bank statements against the association's financial records and determining the cause of discrepancies (e.g., uncashed checks, deposits in transit, etc.).

Bylaws: Include the conduct, elections and responsibilities of members of the board as well as provisions on the board of directors, internal governance and the association's operation.

Capital Improvements: Costs that are for the long-term improvement to the property. The addition or alteration to real property that:

- Substantially adds to the value or prolongs the useful life of the real property.
- Becomes part of or permanently affixed to the real property so that removal would cause material damage to the property or article itself.
- Is intended to become a permanent installation.

Deficit: The amount by which spending exceeds income.

Delinquency Rate: The percentage of homes that are behind on association fees.

Equity: The difference between the association's assets and liabilities.

Liabilities: The association's financial obligations or debts.

Operating Costs: The cost for the day-to-day operation of the association (e.g., maintenance, utilities, landscaping and professional services).

Rent (For Co-op Only): Fees shareholders pay to the corporation to cover operating and capital costs.

Reserve Fund: A property savings account funded by a percentage of your association's monthly fees that serves as a cushion to protect the building's finances from the burden of necessary future expenditures.

Reserve Study: Helps with long-term financial planning by assessing the current reserve fund and determining how much funding will offset ongoing wear and tear and future community enhancements. The reserve study consists of a comprehensive analysis of the community's assets and a detailed financial analysis.

Revenues: Generated income before deducting expenses.

Special Assessment: A one-time fee each homeowner pays the association for a major project, unplanned maintenance or repairs, or an emergency.

Statement of Income & Expense: A summary of the income and expenses in each month, the amount budgeted, the difference between the two and year-to-date amounts.

Variance: The difference between expected and actual expenditures.

Working Capital: The amount of money the association needs to have on hand to cover differences in cash flow.

Budget 101

Creating a new annual budget can be daunting, but it doesn't have to be. By following best practices for budgeting, board members can make the most of their time, resources and the association's finances. Boards should consider the community's operating costs as well as reserve funds. It is important to consider routine expenses around maintenance and care and whether the association's reserve fund is healthy enough to cover unexpected repairs or replace big-ticket items like roofs and new construction.

The following steps can help board members come to the table and produce a sound annual budget.

1. **Begin Early.** The most critical factor in creating a budget is assembling a budget committee and giving them adequate time to plan and make an accurate budget. In most cases, budget planning should begin up to five months before the deadline, which is the first day of the upcoming fiscal year.
2. **Prep Financial Documents.** To work on the annual budget, your committee needs to review the current reserve study, bills, vendor contracts, income statements, previous yearly budgets and monthly financial statements. Having all these ready saves time and allows the committee to gauge the association's financial health, so they know how to adjust the new budget.
3. **Use Your Time Productively.** Budget sessions take time and require board members' undivided attention. Allotting enough time to finalize a budget means scheduling multiple meetings, usually over the summer when vacations can make attending meetings difficult for everyone. Members should create a schedule and agenda for the budget session and stick to it to make the best use of their time.
4. **Plan Well-Ahead.** Consider that a healthy budget accounts for current operating costs and the costs the association may face in the future. Board members need to consider operational and reserve budgets to help the community bear the cost of significant unplanned repairs. An accurate reserve study can help boards shape a better budget and buffer future expenditures. Boards should also budget for inflation, calculating the rising costs of materials and labor.
5. **A Support Team Can Help.** Boards need not go through the budget process alone. An experienced property management team can help organize financial statements and documents, plan and schedule and ensure that project expenditures and vendor contracts are accurate and up to date. FirstService Residential has a team of accounting professionals that administer, monitor and support the community manager with the association's financials. Developing a solid working relationship with property management and your community manager can also align the board with the residents and build trust as a capable manager will have a list of action items for the budget.

Proper Accounting Accounts for A Lot!

To produce a solid annual budget, board members need to understand their community's finances. That means that board members should familiarize themselves with monthly financial reports and be proactive in maintaining the community's financial health. Monitoring these reports depicts what expenditures to cut and what high costs, like insurance, to reevaluate. Boards can also rely on their property management company to help them reassess costs, as large companies can often negotiate better rates with service providers.

Steps to take when getting familiar with your finances:

1. **Keep Financial Records in Order.** An experienced property management company can help with this process by handling accounting, bill payment, banking and deposits, fees and financials. Having professional accountants on hand to ensure that the records and reports are accurate is essential for operational budgeting and forecasting for a new budget.
2. **Review. Monitor. Analyze.** By regularly auditing the financial reports, there are no surprises and discrepancies when creating a new budget. A property management company with accounting resources can help board members access the right experts when needed. Beyond accurate and timely reporting, your board should have access to your financial account status around the clock via a web portal or other tech solutions. Beware management partners that deliver late monthly reports or don't provide financial transparency.
3. **Review Your Policies!** With insurance rates shifting and required coverage changing, some communities may find themselves either over-insured or under-insured, with both situations impacting their financial health. It is essential to review insurance coverage and make changes accordingly, so the community has adequate coverage and is not paying more than it needs to. Having an experienced property management company on hand to help renegotiate contracts, coverage and rates can also help keep the community's financial health in check.

Reserve Funds & Reserve Studies: A Crash Course

It is said that when you fail to prepare, you prepare to fail. The same can be said for reserve funds. Without adequately funded reserves, a community is preparing to fail or, at the very least, create a special assessment. Reserve funds not only help communities prepare for unexpected damages or repairs, but they also help residents avoid the high costs of special assessments or the association having to take out a loan to complete new construction.

But how do you know how much money is needed to maintain adequate reserve funds? The answer lies in conducting a professional reserve study and updating it as the community grows and adds on new assets and improvements.

Reserve Study 101

A reserve study is an in-depth analysis of an association's assets. It identifies the value of each asset, evaluates its condition and projects a timeline and costs for repair or replacement. It provides a financial road map that aims to adequately fund assets identified by the governing documents as the association's responsibility.

There are three different types of reserve studies.

» **Level I:** A full reserve study including a physical and financial analysis.

» **Level II:** This study updates the visual onsite (physical) inspection and financial analysis.

» **Level III:** This study updates the financial analysis only — with no visual inspection — and verifies that the existing funding plan is accurate.

Reserve funds help communities avoid the high costs of special assessments.

Your property manager can help your board hire the right specialist to complete a reserve study report.

Who Conducts a Reserve Study?

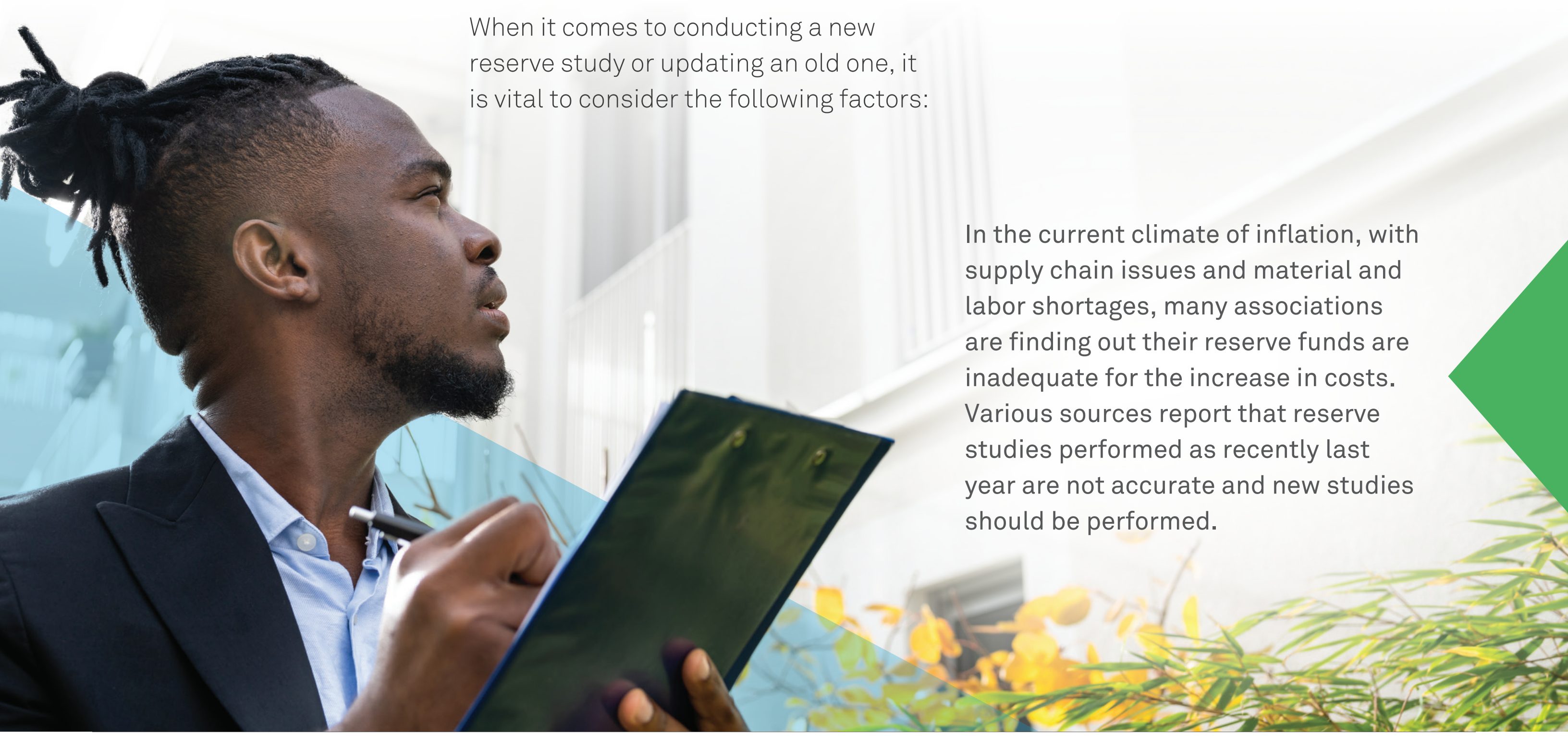
Depending on the complexity of your community and the type of study you need, a certified reserve study specialist can complete the report for your community. Your property manager can help identify candidates and review sample reserve studies from other communities to help your board hire the right specialist.

Every asset in your community has a useful life and will eventually need to be repaired or replaced. A reserve study is essential because it enables proper funding of your reserves to accommodate those repairs and replacements. Without adequate funding, your association could have to charge a special assessment to all owners or access funds through a loan. The alternatives to a properly funded reserve fund will always be more costly in the long run.

How Often are Reserve Studies Conducted?

When it comes to conducting a new reserve study or updating an old one, it is vital to consider the following factors:

1. **Legislation Update:** Some states have laws stipulating when to make updates and what kind of reserve study communities need to have done.
2. **Time-based Update:** It is good practice to update a Level I study at least every other year. If your association has outstanding loans, there may also be lending requirements that stipulate how frequently to update.
3. **Major Repairs Update:** Any time there is a significant repair to an asset or a structure, the reserve study should be updated to reflect it.
4. **New Assets Update:** If your community builds a new playground or adds a pool, the current reserve study needs to be updated to include these assets.
5. **Issue/Event Update:** In case of weather-related or water-related events impact or cause damage to an asset, changing its useful life, you should update your reserve study.



In the current climate of inflation, with supply chain issues and material and labor shortages, many associations are finding out their reserve funds are inadequate for the increase in costs. Various sources report that reserve studies performed as recently last year are not accurate and new studies should be performed.

How Much Do Reserve Studies Cost?

The size of your community and the level of analysis you need can impact the overall cost of a reserve study. However, the price should not be a deterrent to completing a reserve study. A reserve study gives your board an accurate picture of current and future expenses. Failing to have an accurate or updated one will only hurt your board's ability to produce a sound budget and plan for the community's future.

Types of Reserve Funding

Depending on your community's needs and assets, there are three types of reserve funding.

» **Baseline Funding:** Once a reserve study outlines how much the association should spend each year, baseline funding is the amount you request.

» **Fully Funded:** Each year, the total amount to be fully funded is divided by the remaining useful life of the community's assets. For example, if an asset has a lifespan of 20 years, then each year, you should fund 5% (1/20th) of the replacement cost for that asset.

» **Threshold Funding:** This funding identifies a certain amount that ensures that the association always has the money to cover projects, repairs and replacements without keeping any extra money tied up in the account.

FirstService Residential Helps With Finances and Budgeting

Navigating community budgets and finances can be daunting, but FirstService Residential can help. With access to resources, expertise and lending, FirstService Residential can take the heavy lifting out of budget planning.

Contact us today to find out how an experienced property management company can assess your community's financial health and help you create a realistic budget for your association.

About FirstService Residential

FirstService Residential is North America's property management leader, partnering with 8,500 communities across the U.S. and Canada. HOAs, community associations, condos and strata corporations rely on our extensive experience, resources and local expertise to maximize their property values and enhance their residents' lifestyles. Dedicated to making a difference, every day, we go above and beyond to deliver exceptional service. FirstService Residential is a subsidiary of FirstService Corporation, a North American leader in the property services sector. Find out how we can help your community thrive. Visit www.fsresidential.com.

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