

Condo Insights

#46 – Best Financial Practices for Condominium and Community Associations **Part 2**

The second article in this series will discuss financial reporting, annual financial statements, and additional fiscal practices for condominium, community and homeowner's associations.

Sound financial practices, internal controls and a few basic policies can minimize the potential and opportunities for mismanagement. For example, a single board member should never have control over the association's entire financial process without frequent review by the Board and reporting to the association members. Issuance of periodic reports to the Board provides the Board with timely information to ensure the Association is on a stable financial path and to allow the Board to adjust and realign any deviations. When a board understands how much the association is spending and on what, it can make informed decisions, including where spending could be better controlled and when (and how much) fees may need to be increased.

Regular financial reports provide the Board with information about the association's cash position, income and expenses and the best reporting provides reasons why the expenses were incurred. There are several reports that are essential for condominium, community and homeowner's associations.

Two of the most important reports are the income & expense report and the balance sheet. A comparative income & expense report for the period as well as for the fiscal year to date will provide essential information to the Board. A supplement to the income & expense report will include detailed information about the expenses and why they were incurred. A balance sheet is a snapshot report of the association's assets, liabilities and equity at a specific point in time. It is usually prepared on the last day of the fiscal period and includes total of the cash balances in the operating accounts, reserve accounts and any investments, receivables due to the association from members, pre-paid expenses, accounts payable, pre-paid member fees, any loan balances and new equity of the association.

Additional financial reporting should include a delinquency report of members that are not paid current with fees and assessments. A pre-paid report lists members that have pre-paid their fees and assessments. Financial reporting can also include a general ledger of all financial activity during the period. The periodic reporting package should include copies of reconciled bank statements. The more detailed the reports an association can provide, the more transparent it can be.

Best recordkeeping practices also include retaining files with proposals and bids, service contracts, contracts for replacement of association assets, and other significant invoices, payment requisitions, change orders and even documents such as loan paperwork and assessment calculations.

Bookkeeping software programs allow for creating charts of accounts appropriate for specific association needs as well as customizing income & expense reports that classify expenses by operating class, by reserve class or deferred maintenance. Clear and concise expense categorization and classification streamlines essential standard information for association financial recordkeeping.

The Association's annual tax return and annual financial statements should be prepared by an accountant not otherwise involved with the Association as it fulfills the Board's duty to be transparent in its management of fiscal obligations by having an independent outside third party review the Association's fiscal activity.

Associations are corporations and are required by law to file an annual tax return. Most associations file either a form 1120 or a form 1120H. An 1120 is typically used by C-Corporations while the 1120-H is a tax form specifically designed for qualifying associations.

In preparation of annual financial statements, the accountant can perform a compilation, a review or an audit. A **compilation** is a basic summary of the Association's financial records written by a CPA using data provided by the Association without any level of assurance on the accuracy of the financial statements. A **review** provides the basic level of assurance on the accuracy of financial statements. The accountant performs analytical procedures to obtain limited assurance of the accuracy of bookkeeping records and financial statements. The accountant will issue a formal report that includes a conclusion or opinion whether the financial statements are in accordance with the appropriate and applicable financial reporting framework.

An **audit** is the highest level of assurance on the accuracy of financial statements. The accountant performs procedures in order to reach a reasonable assurance that the financial statements are free from material misstatements. The accountant is required to corroborate the amounts and disclosures by obtaining evidence through inquiry, physical inspection and examination, third party confirmations and analytical procedures. The accountant will review meeting minutes, major expenditures and contracts and confirm the operating and reserve fund balances. The accountant will examine the internal control procedures such as the process for approving bills and authorization of expenses for major repair and replacement of association assets. The goal is to make sure that the Association has effective controls and proper procedures in place for accurate reporting of financial information. The accountant issues a formal report and expresses an opinion whether the financial statements are presented fairly in all material aspects and in accordance with the applicable reporting framework.

Some very small associations probably don't need annual financial statements if all owners participate in all financial decisions and regularly receive copies of the association bank statements. But almost all associations should have annual financial statements prepared by a CPA and the annual financial statements should be distributed to all association members once finalized.

Best practices also include instituting an annual workplan that is consistent with the annual operating budget. Previous articles #3 and #36 have discussed the annual workplan and budget preparation.

Communication is also an important part of effective financial practices. Regular open meetings of association members allows for an effective communication exchange including review of the association finances and planning for upcoming projects.

Board members are volunteers managing significant assets for Association members. Implementation of fiscal controls, preparation of periodic interim financial reports and annual audited financial statements are part of best practices for condominium, community and homeowner's associations. Incurring the expense to ensure fiscal controls are in place is a reasonable and responsible action for condominium, community and homeowners associations.

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