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LEGISLATIVE UPDATE

CAROL KORANSKY, CPA
WILKIN & GUTTENPLAN, PC
LEGISLATIVE ACTION COMMITTEE TREASURER

Considering the Uncertainties in a Budget

Preparing an accurate budget can be a daunting task. One that is made harder as there is no definitive legislative guidance or required statutory funding for replacement needs in New Jersey. One thing is certain and that is there can be a great amount of uncertainty in preparing a financial budget for an association. The basic premise in preparing a budget is to evaluate the various outcomes for differing scenarios, chose the most likely based on current knowledge and past experience and then try to have a backstop in place for less likely outcomes.

The first task in putting that safety net in place, is to understand the uncertainties the association faces as best as you can. These areas differ depending on the type of association – homeowners association or condominium association. And if a condominium association, are the buildings one or two levels or is it a high rise building with many mechanical systems. Additionally, the age of the association factors in as well — is the association currently being built, is it a multi stage build out or, is it well established or even an aging community? An older association may have built up an operating reserve and therefore has some leeway within the budget to manage and absorb unexpected expenses, additionally, there is a history to rely on in budgeting and the Board can look to past expenses to predict current expenses. However, an aging association may need increasing repairs and maintenance to keep it in great shape. To help compensate, these budgeted line items could include a buffer for the unexpected additional costs.

For an association currently being built, even those in the process of a multi stage build out, the largest uncertainty the Association faces would be the Sponsor funding of the operating budget and the replacement fund. Under the New Jersey Planned Real Estate Development Full Disclosure Act,

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the Sponsor is responsible for funding the operating budget and replacement fund in accordance with the Sponsor's determination of benefits derived by the Sponsor from line items within the budget. However, there is no legislative guidance as to specific technical implementation. There are various approaches and schools of thought with respect to the concept of benefits derived funding. Therefore, it is important to come to an understanding with the Sponsor as to their interpretation as well as their understanding of their obligation. A young association generally has very little operating surplus to work with, so a clear understanding, prior to the preparation of the budget, of the Sponsor's intended contribution, is very important. Expenditures must be budgeted such that the plan is to stay within the anticipated total amount of the Sponsor's contribution plus unit owners' membership assessments. Actual

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to budget variations should be tracked throughout the year, so that any line item overages can be addressed quickly.

For associations that are no longer under developer control, the largest areas of uncertainty tend to be weather related expenses and replacement/deferred maintenance funding. As we know, weather is completely unpredictable. One year snow fall is at an all-time high and other years it may be minimal. One approach to address uncertainty for this expense is to establish a separate fund for weather dependent costs such as snow clearing. Annual funding can be based on an average of the past several years. For Association that do not have the history to rely on, the information can be obtained from other sources such as the Rutgers University climate website. If costs at the end of the year are under the average, then those extra funds can be carried forward and saved for the next year when costs are over budget. This can help to even out the ups and downs of snow clearing expenses and help to reduce the uncertainty of this line item. Of course, this fund should be reviewed before each budget is prepared to be sure that adequate monies are being accumulated in the fund, but not to an excessive degree.

Funding for the replacement fund based on an independent engineer's recommended funding helps to reduce the uncertainty for what the annual budgeted contribution should be. The engineer's recommendation should be based on a current study, one completed within the last three to five years. Reserve studies often offer various funding methodologie — full funding, threshold funding and baseline funding. Full funding is the most conservative and generally results in the largest contribution of the three methods. Threshold funding, based upon a 30 year cash flow analysis, sets a replacement funding goal of keeping the replacement fund balance above a specified dollar amount at its lowest accumulated amount. Baseline funding sets a replacement funding goal of a zero balance at its lowest accumulated amount. Both full funding and threshold funding allow for some funds to accumulate thereby protecting against the uncertainty of rising costs and expenditures occurring prior to the original estimated time frame. Baseline funding, does not allow for the accumulation of any funds, giving no protection against these uncertainties. Keeping interest income earned on replacement fund assets in the replacement fund is a good hedge against inflation and helps to reduce some of the uncertainty of rising costs. Reducing the uncertainty in replacement funding, helps to reduce the need for an unexpected special assessment. Another critical factor to consider is the age of the association. As an association ages, it is more likely that large projects may be looming, so it is important to note if the accumulated fund balance is also in line with the engineer's projected balance. If the accumulated funds are significantly less than where the engineer has projected, it will be important to institute a catch up plan, so that funds will be in place when needed. An important concept to remember is that reserve studies usually include funding for those common elements within a 30 year life cycle. For each new update, there may be many new common elements whose lives may now be within the 30 year period that require funding. If the study is not updated on a consistent cyclical basis, there may be common elements that should be funded but are not being considered. Taking these factors into account will also reduce the uncertainty of adequate funding.

Lastly, a contingency line item is another way to make sure that the budget compensates for the unexpected. The amount that should be included is really a best guess, but can be based somewhat on past experiences. This line item can be used to fund those unexpected costs that are incurred.

Hopefully, a thorough and thoughtful approach, can help to reduce or even mitigate uncertainties within the budget process. ■