***Expecting the Unexpected***

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What is a Board of Directors to do when an unexpected downturn occurs in the Association’s financial position? This may be from uncollected assessments or write-offs from foreclosures and bankruptcies. It also may be due to poor planning in the past which results in not enough monies being set aside for major repairs and replacements of common area components. Natural disasters, construction defects, increases in operating costs (such as utilities or insurance) and a myriad of other factors may cause the Association to be faced with unplanned expenditures.

When it becomes evident that the Association is going to have a significant unplanned cash flow shortfall the Board needs to review their options. The Board must determine the extent of the shortfall and the timing of the needed funds. All financial options available to the Association should be explored. The Board may want to engage various professionals to assist them in this process – their manager, banker/investment advisor, reserve study preparer, accountant and/or attorney. Determining which financial solutions are best will vary based on each Association’s facts and circumstances. And, often several options may be utilized.

Increase Regular Assessments

Depending on the timing of the upcoming financial obligation the Board may have the ability to raise the needed monies through increasing the regular assessments. The cash requirement may be something that will not begin until the next budget period (e.g. utility rate or insurance premium increase) and that increase can be passed along to the membership in next year’s assessments.

Enacting a Special Assessment

Passing a special assessment is not generally a popular choice. However, it may be the right choice and the Board needs to be prepared to act, if needed. Special assessments may be the answer if the money is needed within a short period of time. It also may be the right choice if there is a one-time event that would not justify the increase in the regular assessment. For example, if there was an ice-storm that caused considerable damage, it may seem fair that the owners that live in the complex at that time pay for the extraordinary expense via a special assessment. Special assessments may also be part of the Association’s plan to obtain a bank loan.

Defer the Expense

There may be the ability to defer the expense to a future year. This also may include a temporary fix of the issue and postponing the larger expenditure to a later date. The Board needs to ensure that they are not jeopardizing the value of the property nor causing damage to the property by choosing this option.

Vendor Financing

For some projects, a vendor may be willing to accept installment payments after the work has been completed. One association did this for a large painting project. While they paid a small premium on the contract amount, they negotiated allowing the painting contractor to do the work during their slow time and, in return, the vendor allowed payments over twelve months.

Borrowing from Reserve Cash

If it is an operating type of expense and the expenditure is eminent, the Board may need to borrow the cash temporarily from reserves. The Board should ensure that they are in compliance with Washington RCW with regards to repayment of those monies. This may be the best option when there is a health, safety or water intrusion issue that cannot wait for increased assessments, special assessments or a loan. The Board may also use reserve monies for unexpected reserve type of expenditures and repayment may not be required under Washington RCW. However, that may leave the rest of the reserve components underfunded so the Board should ensure that they consider the impact on future cash flow requirements by using reserve monies now that were not included in the future projections. That usually entails a new reserve study and a cash flow analysis to determine if increased reserve contributions are necessary to make up for the monies used for unanticipated reserve expenditures.

Loan

It may be possible to borrow money from a bank to fund the expenditure. This process takes some time and not all Associations will qualify for the loan. The loan is often secured by future special assessments and the costs of the loan (e.g. interest and loan fees) are generally passed along to the membership via the special assessment. The loan is in the name of the Association so the individual unit owners are not able to deduct the loan interest. Thus, some unit owners would prefer to obtain their own financing to be able to get the tax write-off. When an Association chooses a bank loan as the financing option for an expected event, future owners pay for a past event. In the case of a common area component, those same owners may pay for the past expenditure as well as for the future replacement of the same component. For example, if a loan is obtained to replace the old roof and the future roof is included in the reserve contribution portion of the monthly assessment, the current owners are paying for the old roof and the new roof. However, if monies have not been adequately set aside in the past for future major repairs and replacements of common areas and if unit owners cannot obtain financing on their own to pay a special assessment, an Association loan may be the best option.

How could have the Association protected themselves a bit better? First, the Board needs to “expect the unexpected”. The Association should consider building up the operating fund for contingencies. Our firm suggests that the Association’s operating fund (retained earnings) has 1-3 months of operating expenses as a balance. This is done by budgeting an excess for contingencies and allowing excess net membership income to accumulate over the years. The members need to understand that it is good business practice to have monies available for contingencies and unexpected cash flow requirements. Next, the replacement (reserve) fund should be funded in an equitable manner. By spreading out funding major repairs and replacements over the life of an asset the owners pay their proportionate share of the use of that asset. The Board should set a goal to have a healthy reserve fund balance to ensure that there are adequate monies set aside for future major repairs and replacement of common area components. By having an operating fund balance of one to three months and having an adequate reserve fund, there is less likelihood of a special assessment or the need to borrow monies from either reserve cash or a lending institution in the event that an unplanned financial downturn happens.

The unexpected will occur. A savvy Board will plan on it and will try and spread the risk out over several years and, hopefully in most cases, will pre-fund for those contingencies. Current and future owners will appreciate the fact that they can budget for their regular assessments with normally expected increases and not worry about either a special assessment or reduced property values or amenities due to the lack of Association funds.