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GETTING THERE – BUDGETING

Building the Association Budget

Fundamentals, Hard Work & Guts

By Thomas L. Willis, PCAM®

BACK TO THE BASICS

The story goes that famed football coach Vince Lombardi, in order to reinforce the importance of fundamentals, opened each Green Bay Packer pre-season camp with the same introductory sentence. Raising the pigskin high enough to be seen by the 50 or so professional players in front of him, he intoned, “Gentlemen, this is a FOOTBALL...”

Budgeting is a fundamental process for community associations. Done properly, an association lays a key foundation block for financial and operational success. Done poorly, serious short and long term difficulties as sure to be created or perpetuated. The budget is the first of the three financial phases – planning, operations, and review. Poor planning leads to poor performance as reflected in the operation of the property and in monthly (or regular) financial statements. Inevitably, this in turn leads to poor results as reported in the annual audit.

So let’s get back to the basics. What is the goal of the budgeting process? Contrary to the belief held by some, it is NOT to keep fees flat, though it is possible that this result is a byproduct of the exercise. Rather, the goal of the budget is to create a plan to finance the operation of a community association in line with its physical realities and in accordance with the vision and values of the community.

THE PAST, THE PRESENT & THE FUTURE

Budget formats can vary fairly significantly, and their contents depend on the complexity of the property. A 300-unit condominium association with a central HVAC plant and staff will clearly have a much more intense budget than a 30 home HOA. However, the best budgets tend to have a few things in common, regardless of their scope and complexity.

There are two basic budget types – “trend” budgets and “zero-based” budgets. Trend budgeting essentially assumes the current year’s budget for each budget line item is the baseline and assumes an incremental increase each year thereafter. If the grounds contract was \$10,000 and the estimated CPI increase is 2%, then it is assumed that the cost the next year will be \$10,200. While there may be variations from line item to line item, hopefully the overall bottom line comes out about right. Zero-based budgeting is commonly utilized when drafting a budget for a community that has not been built yet. All available information about the planned project is utilized, an attempt is made to visualize what it will take to operate the property when built, and every single line item is checked for accuracy against means averages, similar properties and industry knowledge.

The best budgets for existing community associations utilize a combination of the two methods. Every single line item should be scrutinized with a fresh set of eyes each year. At the same time, history inevitably paints part of the picture of the future, like it or not. Uncontrollable trends cannot be ignored.

A benefit to this approach is that members, who are reasonably concerned about how their money is being spend, tend to recognize the scholarship woven into the process and the budget document provides some level of comfort that money is not being spent willy-nilly. This isn’t something conjured up to make the numbers look good, or to achieve some political purpose. The figures represented in each line item mean something – they are grounded in reality and reason.

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HOW DO WE GET THERE FROM HERE?

There are two basic components that can help maintain the discipline necessary to achieve the results and goals noted above. First, a comparative spreadsheet helps to see patterns and context. At a minimum, it is helpful to show columns for next year's proposed budget, the current year's adopted budget, projected current year-end results, and last year's audit results. To gain longer range perspective, prior year budget and audit figures can be added. For smaller communities that may not engage an independent auditor each year, unaudited figures are better than nothing. The goal is to see the reality of past performance in order to help plan for the future.

The next component requires the most work, but will be essential to understanding what's behind the cold, hard numbers in the budget. A detailed narrative, in which each line item and the assumptions behind them are expressed in detail, can make a huge difference. The process of creating, reviewing and editing the narrative is where each line item is challenged. Exactly what is included in "miscellaneous administrative" or "landscaping non-contract?" How was the total annual figure calculated? Memorialize it. If "meeting expense" includes recording secretarial services at \$175 per meeting times 12 meetings plus an allowance for light refreshments at the annual meeting of \$300 and room rental for the annual meeting at \$250, put it in writing. Record contract details. If the terms of a two-year janitorial service contract include a \$2,000 per month fee with an escalation of 1.5% at the May anniversary, show the math: $(\$2,000/\text{mo.} \times 4 \text{ mos.}) + (\$2,000/\text{mo.} \times 8 \text{ mos.} \times 1.015 \text{ increase}) = \$24,240$.

There are many benefits from fully utilizing these components. The discipline to merge wants, needs, and realities with the financial plan is maintained. There will be a clear understanding of the plan for the upcoming year. And the final document helps to ensure continuity from year to year in the event of volunteer or management turnover.

DANGER WILL ROBINSON! – AVOIDING COMMON PITFALLS

1. **Fee Targeting:** If the Board or Management comes into the process predisposed to a meet specific result (such as no or minimal fee increase) results are inevitably skewed. Numbers should not be artificial – they represent real activity
2. **Disconnection From Long Range Planning:** All too often the contribution to reserves is a number picked to help the budget meet a fee target at the end of a budget process. This is a blueprint for major problems. A careful consideration of major projects that may be required in the long run and a realistic funding plan to have the money available when needed are key. Professional reserve analysts can be engaged to perform a reserve study to assist in this process. It can also be helpful to include the planned capital projects in the budget, along with a corresponding transfer from reserves so that these expenses do not impact fees. These steps help establish and maintain a pattern of discipline in long range planning.
3. **Failure to Plan for Contingencies:** Murphy's Law reigns supreme – it pays to plan for the unexpected. This can be accomplished in two primary ways; an operating contingency line item, or an operating reserve contribution line item. The former raises fees to be maintained in the operating account until needed. The latter creates a plan to transfer a specific amount to a reserve fund each month for safe keeping until needed.
4. **Failure to Recognize & Address Realities:** Chronically underfunded associations tend to exhibit the same characteristics – they budget too optimistically without consideration of the actual condition of the property and financial history. This is part of the value of the comparative spreadsheet. The end result is recurring budgeting errors, a vicious cycle of deferred maintenance, operating deficits, and underfunded reserves.
5. **Failure to Recognize FHA Reserve Funding Requirements:** This is a new reality. If your association is FHA-approved or desires to be, be sure that reserves are funded in a way that meets current requirements before the budget is adopted.
6. **Failure to Allow Include all Possible Options in the First Draft:** Rather than force an artificial result by fee targeting on the first draft, it is much better to allow the first draft of the budget to be a "kitchen sink," worst-case scenario version, packed with every contingency and idea that may have come up in the course of the year. This allows honest dialogue geared towards establishing priorities and making value decisions as the budget is pared down in a systematic, logical, and realistic way. In the end, there will be a real plan that just might work.
7. **Failure to Help Owners Understand the Correlation Between the Budget and Their Fees:** Everybody wants something for nothing. Don't assume owners understand that the budget defines the services the Association can afford. A little education can go a long way in building buy-in.
8. **Failure to Separate Emotional Factors from the Business Decision (Making the Numbers Real):** Many owners may intuitively feel they cannot afford a fee increase in any amount. It is sometimes helpful to break down the facts into numbers that are meaningful, such as dollars per month per home. A 5% increase sounds astronomical, but if a condo fee is \$300 per month, that's \$15 per month – roughly the cost of 3 Starbucks lattes. If a 5% increase helps avoid a special assessment in the future, is it worth 3 lattes per month?

9. **Accepting Reserve Study Estimates Without Careful Consideration:** The reserve study referenced above is an essential tool to help the Association plan for capital expenses. However, it is important to remember that reserve analysts are generalists by design. For the most part they will be calculating costs for one-for-one replacements. They are not paid to perform destructive testing, detailed condition analysis and the like. It is advisable to engage specialists to help determine the potential cost of complex projects. Though in some cases this can be pretty expensive, it can save the shock of a very nasty surprise later on. Reserve analysts are generally happy to import data from more detailed studies as necessary, and include special items requested by the Board. Common examples for consideration include:
- Fire protection systems that may need to be brought up to current code when replaced
 - Limited access roofs that present logistical challenges, especially for high rise buildings
 - Elevator modernizations that may need to be brought up to current code when performed
 - Pay special attention to how painting and decorating are handled – different analysts may have different approaches.
 - Wood fencing & trim, especially related to gutters and downspout systems – consider a cost/benefit analysis of replacing wood with lower maintenance materials
 - Any structural rehabilitation projects, such as for underground garages.
 - Any waterproofing membrane replacements under patios, terraces or planters – project details can drive the costs of such projects considerably
 - It is wise to undertake major capital projects with the assistance of a qualified engineer, architect, and/or construction manager to ensure the best quality and value throughout the process. Make sure the reserve study accounts for these costs.

GUTS

A word about leadership and courage here – sometimes the result of due diligence is bad news. As tends to be the case with mature communities that have been chronically underfunded, sooner or later the piper will demand to be paid. Significant fee increases and special assessments are not happy news, and it takes a measure of courage to speak the truth to those who do not want to hear it, especially in difficult economic times. The argument will be made that people can't afford the additional burden, that's it's not fair for current members to pay for the sins of their predecessors, and that resale values will plummet if fees are too high. Leadership and management must be prepared to communicate reality. While fees have an impact of resale values, you can bet that a property in disrepair affects values significantly. Poor curb appeal affects more than just values, it affects salability. At the end of the day, it's the Board fiduciary responsibilities per the association's governing documents to do what it has to do to maintain the property. Biting the bullet at some point is sometimes painful, but necessary. Hopefully the association will learn from history well enough to plan better going forward and avoid repairing the mistakes of the past.

A TIME INVESTMENT

Yes – careful budgeting is a lot of work. But it's well worth it when you consider the benefits. Stick to the fundamentals and follow the disciplines practiced by the best associations. Everyone will win in the end.

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