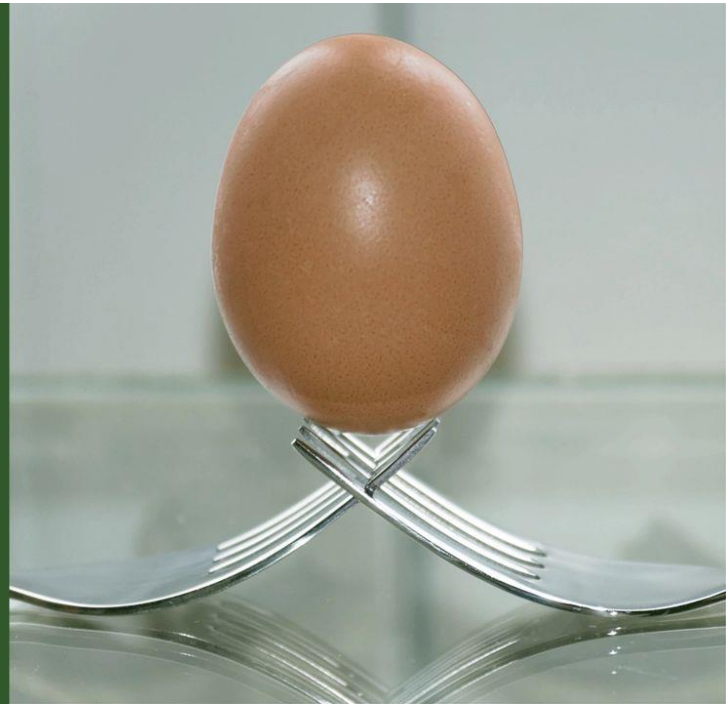


<https://mpsfincial.com/mps-newsletter/f/deconstructing-your-hoa%E2%80%99s-balance-sheet>

Deconstructing Your HOA's Balance Sheet

July 19, 2021 | Monthly Financial Reports

HOW **HEALTHY**
IS YOUR HOA'S
FINANCIAL
POSITION?
ASK YOUR
BALANCE
SHEET



How healthy is your HOA's financial position? Ask your Balance Sheet!

According to California civil code, community associations are required to review a financial reports package on a monthly basis. This package, often referred to as simply your Monthly Financials, provides the board with a detailed understanding of the community's financial position so that they can make informed decisions that are in the community's best interest.

In this series, we are exploring the individual reports that are included in your monthly financial package and deconstructing them so that you can understand how to read them and what to look for to identify problems that may arise...

Often the first report in your monthly financials, the **Balance Sheet** provides a snapshot overview of your community's financial position as of a specific point in time. Think of the balance sheet as your 10,000-foot overview. It shows how much money is in all of your community's accounts, how much is owed, and what you have in equity as of the specific date the report was run.

The Balance Sheet Layout

| | | <u>A S S E T S</u> | |
|-------------------------------------|-------------------|--------------------|-------------------|
| OPERATING ACCOUNTS | | | |
| 1018 OPERATING BANK NAME | 143,931.91 | | #77777777 |
| 1037 OPERATING CD | 50,000.00 | | 08/13/22 0.300% |
| 1060 OPERATING BANK B | 576.12 | | #1111-5555 |
| 1062 OPERATING CD | 100,000.00 | | 01/22/22 0.350% |
| TOTAL OPERATING ACCOUNTS | 294,508.03 | 294,508.03 | |
| RESERVE ACCOUNTS | | | |
| 1021 RESERVE BANK NAME A | 214,787.10 | | #987987987 |
| 1024 RESERVE BANK NAME B | 1,886.25 | | #2222-3333 |
| 1046 RESERVE BANK B-CD | 100,000.00 | | 01/22/23 0.450% |
| 1048 RESERVE BANK B-CD | 100,000.00 | | 05/13/24 0.400% |
| 1049 RESERVE BANK B-CD | 53,000.00 | | 05/06/24 0.400% |
| 1051 RESERVE BANK B-CD | 175,000.00 | | 05/14/14 0.350% |
| 1052 RESERVE BANK B-CD | 10,000.00 | | 09/24/24 0.600% |
| TOTAL RESERVE ACCOUNTS | 654,673.35 | 654,673.35 | |
| OTHER ASSETS | | | |
| 1280 ACCOUNTS RECEIVABLE | 1,860.00 | | |
| TOTAL OTHER ASSETS | 1,860.00 | 1,860.00 | |
| TOTAL ASSETS | | | 951,041.38 |
| <u>L I A B I L I T I E S</u> | | | |
| 2025 PREPAID ASSESSMENTS | 125.00 | | |
| TOTAL LIABILITIES | 125.00 | | 125.00 |
| <u>E Q U I T Y</u> | | | |
| RESERVE FUNDS | 654,673.35 | | |
| EQUITY-BEGIN OF YEAR | 293,244.03 | | |
| CURRENT YR INCREASE/DECREASE | 2,999.00 | | |
| TOTAL EQUITY | 950,916.38 | 950,916.38 | |
| TOTAL LIABILITIES AND EQUITY | | | 951,041.38 |

Sample HOA Balance Sheet

The balance sheet is laid out into three distinct sections:

1. **Assets** - the assets section shows the money your community has available to it. This includes all of your bank accounts, both operating and reserves, as well as other open receivables, such as pending assessments or fees.
2. **Liabilities** - the liabilities section shows money the association owes out, such as prepaid assessments (meaning the owners have paid you for assessments you have yet to bill them for.)
3. **Equity** - the equity section shows the money the association has tied up or earmarked for a certain purpose (in other words, **assets that you cannot spend because they are already spoken for.**) This includes your reserve replacement amounts (from your reserve study), as well as any retained earnings or losses (money leftover or lost from the previous years), and any current year net income or loss.

How to Read your Balance Sheet

For a board member, the balance sheet should be the first indicator of your community's financial health. It's called a balance sheet because the numbers are supposed to balance out. In fact, the balance sheet follows a simple formula, making it one of the easiest reports to recognize quickly if something is off.

Assets = Liability + Equity

So within 2 minutes of looking at your balance sheet, you should be able to identify if there is a red flag very quickly, simply by taking the liability and equity totals, adding them together, and seeing if they match the total assets number. This is why, when reading your monthly financials, you always start with the balance sheet. Because when the numbers don't match, you can go look at the other reports included in the package to see why.

Is Your Association Turning a Profit?

If the formula above does not match up, flip the formula to $\text{equity} = \text{assets} - \text{liabilities}$. If your equity is higher than your assets minus liabilities, that means that your association is garnering a profit. While a small profit is not an issue, as a non-profit organization, this is not the desired result for community associations. Ideally, when the board prepares the budget each year, you should take any leftover profits (called retained earnings) and work those into the budget, either to make up reserve shortfalls or to reduce assessments for owners in the coming year.

Conversely, if your equity is less than your assets, it could mean your association is taking a loss (you are spending more than you are bringing in). This is a red flag that you absolutely need to pay attention to, as it can affect the community's ability to carry out its day-to-day operations.

A Note on Prepaid Assessments

You may find (such as in the sample we have provided above) that prepaid assessments do not match up in the formula. This is because prepaid assessments are an advance payment by your homeowners on future assessments that they will owe. (Often an owner will pay the full amount for the year at the beginning of the year.) Other Things to look for in Your Balance Sheet

Do You Have Enough Operating Funds?

Check your operating accounts against your expenses (in your income/expense statement) to make sure that the community is on track to pay its bills. If you've got the funds to cover it, you should do everything in your power to ensure your bills are paid on time so you don't incur late fees - your budget doesn't cover that! If the amount in the account is not enough, you may need to discuss how the board will address the shortfall.

Can You Meet Upcoming Budget Needs?

You should also compare the amount in your operating accounts to your budget to make sure you have enough to cover items that are coming up in the near future. If you need to plan to cash in a CD or get a loan, you want as much advance notice as possible so you don't have to pay penalties.

Are Your Reserve Contributions on Track?

Check your reserve account balances against your budgeted reserve contributions. Are contributions being properly deposited into reserve accounts? If not, this may be a red flag. If the community is taking a loss, the 'solution' some boards employ is to withhold reserve contributions and reallocate those funds to the operating account. This can have dire consequences in the future when the reserve funds are suddenly needed but are unavailable. Look to your reserve fund allocation report to better understand what is happening with reserve contributions.

Net Income / Net Loss

If the equity section in your balance sheet includes a net income or net loss for the current year, you should have a solid understanding of what that represents. It may impact your ability to carry through with future budgeted actions:

- A net income sounds good, but it may reflect an underlying issue, such as poor budgeting predictions (meaning you could afford to lower assessments slightly), or excessive fines (which could put you at risk from lawsuits).
- A net loss could also reflect underlying issues such as high delinquencies (owners not paying assessments), poor collection practices (an excess of late fees and other penalties), or poor budget planning.

Your First Line of Defense

Your HOA balance sheet is the first line of defense for protecting your community's financial health. As a board member, it is your responsibility to keep a watchful eye and ensure that the community's financial position is safeguarded against all threats.

So the next time you take a look at your monthly financials, start with the balance sheet. Use these tips to be able to confidently know your community's financial health, and ask smart questions that help you get to the bottom of issues before they get out of hand.