SOUTH COAST HOMEOWNERS ASSOCIATION

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Michael J. Gartzke, CPA, Editor

UPCOMING SOUTH COAST MEETINGS

2007 LAW AND LEGISLATIVE UPDATES

James H. Smith – Grokenberger & Smith
David A. Loewenthal – Loewenthal, Hillshafer and Rosen

It's time again for our popular legislative update meetings. This year saw the passage of amended election rules, records disclosure and accounting method legislation (first passed in 2005) along with new reserve fund disclosures. The state HOA agency legislation was vetoed. In addition, we will have a discussion of the earthquake insurance issues and the issue of "loans, litigation and reserves" from the article appearing in this issue. Time permitting, our speakers will take your general legal questions as well.

Note Meeting Locations

Wednesday – January 17 – 7 PM
Encina Royale Clubhouse – 250 Moreton Bay Lane, Goleta (At Encina Lane)

Monday – February 5 – 7 PM
Quail Meadows West HOA Clubhouse – 866 Whippoorwill, Santa Maria

HOMEOWNER ASSOCIATION FINANCIAL ANALYSIS
1-YEAR DATA COMPARISONS

By: Michael J. Gartzke, CPA
Goleta, CA

In the fall of 2005, my "staff" (two teen-aged sons) and I developed a spreadsheet containing financial information from all the homeowner association financial statements that I currently review, now totaling 60 associations. Professional standards for CPAs have been recently amended to emphasize more "analytical review" procedures by the CPA when performing a financial statement review and developing the financial statements that are required annually by California law when associations have more than $75,000 in combined assessment and other revenues. One of the analytical review procedures available is to compare the entity's financial information with comparable information from other entities in the same industry. A lot of that kind of data doesn't exist for homeowners associations. I had several goals in mind when preparing the initial spreadsheet.

- Develop data specifically to our geographic region. 57 of the associations are in South Santa Barbara County. Three are in North Santa Barbara County.

- Establish baseline amounts that could be updated continually as reviews were prepared for 2005 and fiscal 2006. Examine the changes in the amounts over a one-year period and report the findings. (This article!). The analysis is an ongoing project and can be reviewed in the future to determine longer-term trends.

- Develop a range of data (minimum, maximum and median – half above and half-below) to compare a particular association's data set with all the data in the sample.

- Provide a schedule to each association in the sample to compare their own association's data to the total sample data.

The initial schedules to the associations in the sample went out in November 2005. These schedules were sent to my association clients who use the calendar year as their reporting year. An updated schedule is also provided at the conclusion of the review engagement. These schedules have been the source of much discussion between board members, association managers and me. We know that homeowner associations are not a homogeneous group. We have new associations and mature ones. We have condominium townhome style associations where the association has a lot of common area maintenance responsibility. We have planned developments where the association has limited common area. Some associations pay for a lot of the members' utilities. Other associations pay none. Many associations are responsible for building insurance including earthquake and flood. Others are only responsible for limited common area elements and board of directors' insurance coverages.

An unexpected result (at least to me) was that board members and managers have been able to cite data in the reports to back positions for the need to increase assessments and to confront all-too-common peer pressure to not raise monthly assessments. Comments such as "we already have the highest monthly assessment in town" or "if we go over $300 per month, we won't be able to sell our units" (really!) are common. These reports have been used to support facts and debunk myths.

The schedule below compares data from Fall 2005 to Fall 2006. The data is historical. The fall 2006 data includes calendar year 2005 plus some associations whose fiscal years ended during 2006. Commentary follows:

HOMEOWNER ASSOCIATION FINANCIAL COMPARISONS
AND ANALYSIS
FALL 2005 TO FALL 2006

Financial Data Categories (Median) (per member per month)	Fall 2005	Fall 2006	Change	Percent Change
Monthly Assessment	$285.00	$318.45	$33.45	11.74%
Operating Assessment	214.40	234.32	19.92	9.29%
Reserve Assessment	72.22	73.60	1.38	1.91%
Rate of Return – Investments	0.92%	1.75%	0.83%	90.22%
Utilities Expense	$60.75	$64.39	$3.64	5.99%
Common Area Maintenance	90.93	94.61	3.68	4.05%
Insurance	43.62	54.22	10.60	24.30%
Administrative Expense	23.26	26.04	2.78	11.95%
Reserve Expense Paid Out	44.24	57.29	13.05	29.50%
Cash & Investments per member	2663.00	3093.00	430.00	16.15%
Delinquent Assessments per member	16.44	14.11	-2.33	-14.17%
Consumer Price Index	188.50	196.50	8.00	4.24%

Monthly Assessment – The median monthly assessment increased from $285 to $318.45 in the past twelve months, an increase of 11.74%. This increase is substantially higher than the 4.24% inflation rate for Southern California measured by the Bureau of Labor Statistics.

Operating Assessment – The median operating assessment posted a nearly $20 per month increase or 9.3%.

Reserve Assessment and Expenses – The median monthly reserve assessment only increased $1.38 or 1.9%. The total monthly assessment increase of $33.45 exceeds the sum of the operating and reserve increase of $21.30 due to the independent computation of the operating and reserve assessments' median amount. Reserve expenses paid out (median) were $57.29 per member per month - $16 less than the $73.60 collected for reserves.

Rate of Return – During 2004, interest rates hit historic lows. The Federal Reserve Bank's "11th District Cost of Funds" index hit a low of 1.71% in May 2004. Since then, the banks' cost of funds has steadily increased to 4.38% as of September 2006. Those who have adjustable rate mortgages (ARM) are familiar with this index. A borrower who has an ARM at the index plus 2.6% has seen his interest rate increase from 4.3% to 7% during this period. Short-term CD rates which were below 2% three years ago are now up to 5-5.25%.

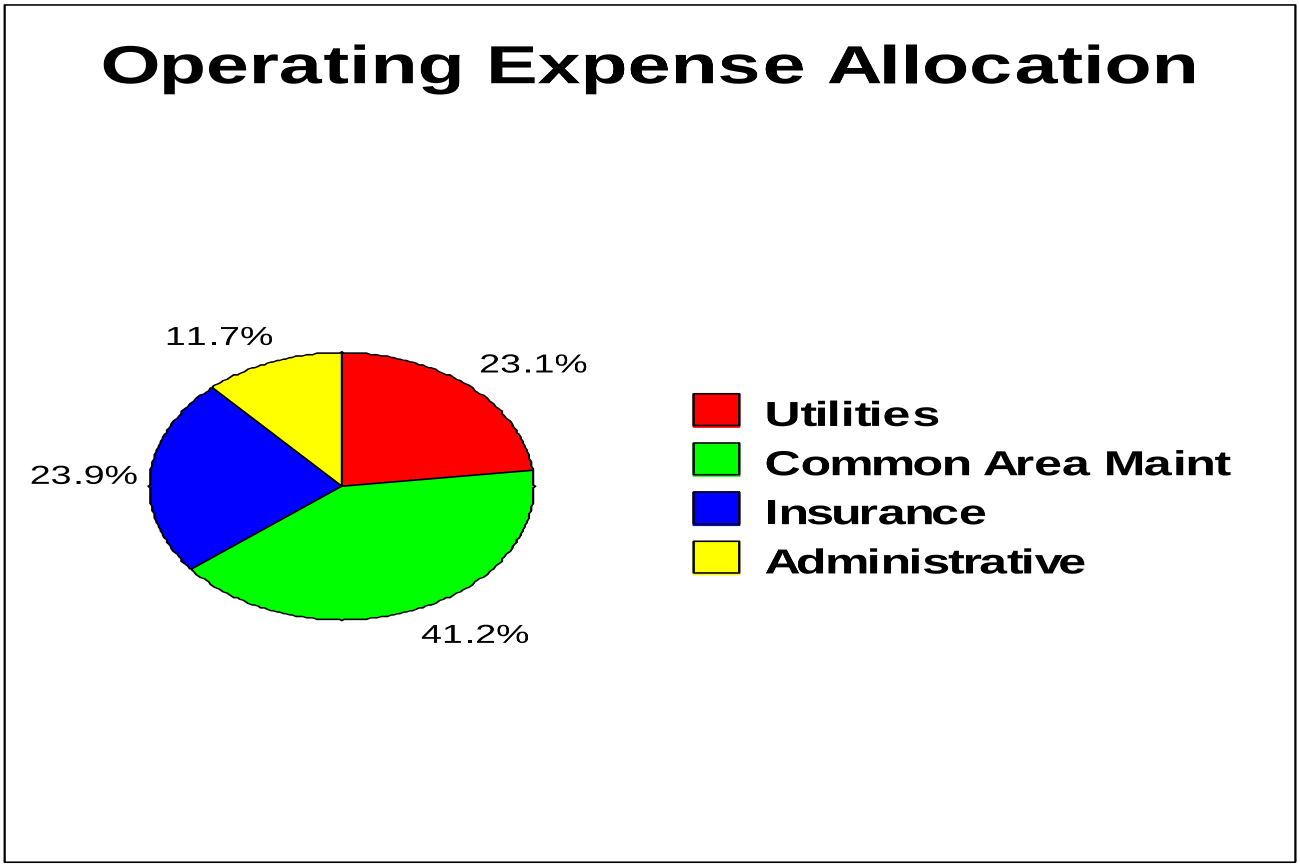
Association return on investments tend to lag these indices. Cash in checking accounts may earn no interest or funds in some savings and money market accounts earn less than 1%. Returns have increased as the Fall 2005 median was 0.92%. It's now 1.75%. CD rates have been in the 5% range for most of 2006 so I would expect that the rate of return amount will continue to increase during 2007.

Utility Expense – The median association utility costs increased $3.64 per month to $64.39 per month, an increase of 6%. For the median association, utilities comprise nearly 24% of the operating assessment. Natural gas prices increased substantially after Katrina (August 2005) while electric costs increased early in 2006. Many water and trash rates increased 4-5% and some, like Carpinteria Water, had double digit rate increases.

Common Area Maintenance – The median association showed a 4% increase in costs from 2005 to 2006. At $94.61 per month, the median association allocates 42.6% of its operating assessment to common area maintenance. Labor costs for landscape and other maintenance services tend to be tied to the Consumer Price Index. Note that the minimum wage will increase 11% on January 1, 2007 from $6.75 per hour to $7.50 per hour and this will indeed have a palpable effect on common area maintenance budgets for 2007 and beyond.

Insurance – Insurance costs increased by over 24% for the median association from 2005 to 2006 or $10.60 per member per month. This increase is computed *before* the latest round of insurance premium increases. The median association was spending $54.22 per month per member on insurance. On a percentage basis, the median association is spending nearly ¼ of its operating assessment on this one item. Board members and managers have been frustrated by the current insurance markets. Late cancellation notices, skyrocketing premiums (double/triple), and the lack of choices in coverage have drained association resources from other obligations. These costs have gotten so high that a bank is offering to make a loan to finance premiums at rates lower than insurance companies.

Administrative Costs – These costs represent about 12% of the median association's operating costs and include expenses such as management, accounting, legal, office supplies, income taxes, etc. The increase for the median association was $2.78 per month. Some of the increase can be attributable to increased income taxes on increased investment income from 2004 to 2005.



The preceding chart shows the relative size of each of the four major components of an association operating budget. This chart only covers operating items, no reserve funding nor reserve expenses. Administrative costs are approximately half of insurance and utility costs while common area maintenance is just over 40% of total operating costs.

Delinquent Assessments – The median amount of delinquent assessments per member actually declined to $14.11 per member per month. An inordinate amount of legislative initiative has been spent on restrictions in collecting assessments. For many, but not all associations, collections are a nonissue. Yet, the increase in mortgage and home equity loan interest rates noted earlier is causing a higher percentage of owners to become delinquent or default on their mortgages. Managers of associations with affordable units are noting an increase in delinquent assessments as a result of the current interest rate environment. It is possible that a highly leveraged unit could be foreclosed upon by the lender resulting in lost assessments to the association because associations are last in line behind loan lenders.

Cash and Investments – In the face of rising costs and pressure to hold the line on assessments, the median association still managed to increase its cash balances by $430 per member during the year to $3,093, a 16% increase. While this may sound like a lot of money to some people, it really isn't when you consider that costs of major repairs have also increased.

There is a substantial range between the minimum and maximum values in each category. For example, a couple of associations have master-metered electricity which means that the association is paying for each unit's electric bill. Insurance costs can fluctuate if the association does not carry earthquake insurance or is not responsible for building insurance at all. Some associations have a lot of landscaping responsibility, others none at all. Some associations operate a full on-site management office and handle vacation and short-term rentals for their members. And finally, some associations are responsible for many common area components, others very little.

This wide range of values is why I have used medians throughout this analysis rather than averages. The "median" of a sample of data is the *midpoint* of the group and is considered to be less susceptible to skewing of the results by unusual data than the "average" of that same group of data. For example, the association in our local sample data that has a monthly assessment of $2,164 – yes, that is not a typo – would increase the average monthly assessment for the total sample of 60 associations by $35 by itself. Using the median treats each association the same. The total number of dwellings in the sample is nearly 4,400 – a significant portion of our region's housing inventory.

The following chart shows five columns of data to show how wide the range of costs can be. The first column is the minimum amount (would be the lowest rank – 60^{th}). The second column is the 25th percentile. One-fourth of the data would be below this number while ¾ would be above it (rank – 45^{th}). The median amount is where half the amounts are above and half are below. The 75 percentile is where three quarters of the data are below the amount while ¼ is above. And finally, the maximum is the highest amount reported – rank equal to 1.

If your association is not in the 60-association database, you can develop your own information from your annual financial statements from your CPA, property manager, bookkeeper or treasurer and make your comparisons. If you publish these comparisons as part of your presentation, please note the source of your information – "Michael J. Gartzke, CPA, South Coast Homeowners Association newsletter – January 2007."

HOMEOWNER ASSOCIATION FINANCIAL COMPARISONS
RANGE OF ASSESSMENTS AND EXPENSES
FALL 2005 TO FALL 2006

Per member per month unless otherwise noted	Minimum	25%-tile	Median	75%-tile	Maximum
Monthly Assessment	$100	$238	$318	$405	$2,164
Operating Assessment	80	177	234	313	2,164
Reserve Assessment	0	50	74	104	226
Rate of Return - Investments	0.00%	1.28%	1.75%	2.32%	5.75%
Utilities Expense	$9	$38	$64	$91	$155
Common Area Maintenance	37	66	95	151	1,367
Insurance	5	39	54	79	434
Administrative Expense	2	20	26	39	188
Reserve Expense Paid Out	0	21	57	139	728
Cash & Investments	555	2,125	3,093	5,291	32,573
Delinquent Assessments	0	0	14	44	544

I will revisit these amounts a year from now and report the changes to you. I welcome your comments and observations.

HOMEOWNER ASSOCIATION FINANCIAL ANALYSIS 10-YEAR DATA COMPARISONS 1995-2005

By: Michael J. Gartzke, CPA
Goleta, CA

I recently analyzed a large amount of association financial data from my HOA clients going back to the early 1990s. For associations that I review financial statements for, I collect a fair amount of historical data on assessments, expense costs by category, cash balances, etc. I was curious as how much assessments have increased during this period, how expenses have changed and whether associations had more or less cash on hand ten years later. I also wanted to contrast the percentage increases with the Consumer Price Index changes published by the Bureau of Labor Statistics. Various professionals in the community association industry have frequently asserted that HOA inflation data far exceeds CPI inflation data but there have been few, if any, quantitative analyses on the subject.

The analysis was conducted on 21 associations containing 1,899 dwelling units. The associations range in size from 28 to 360 units with the median (half larger and half smaller) association having 56 units. Twenty of these associations are in south Santa Barbara County while one is in the north county. All associations were my clients in 1995 and remain so today. Associations that had less than $75,000 in gross revenues are not included in the sample since I don't keep the same detailed information for them (tax return only clients) as I do for my financial statement clients.

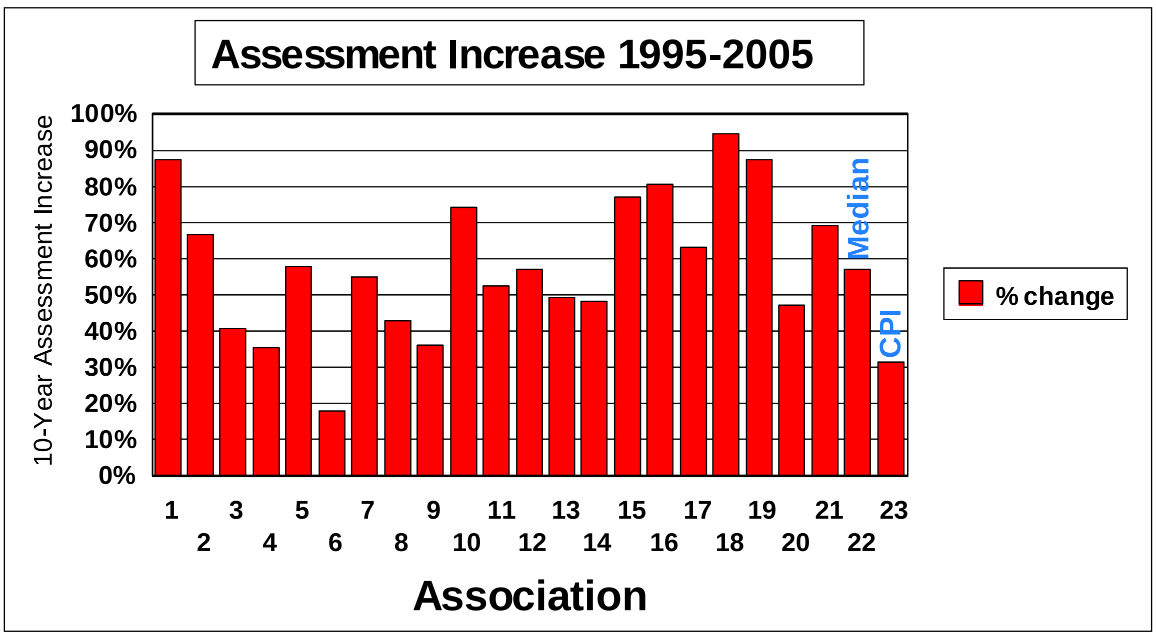
The hypothesis I was looking to examine was whether association assessments mirrored the published inflation rate. With increases in utilities and insurance costs for example, plus the associations are all ten years older than they were, I believed that association costs outpaced standard CPI inflation rates and wanted to develop statistics to support or refute that contention and analyze specific areas of expense and income.

Consumer Price Index – The Bureau of Labor Statistics publishes many different types of indices. The one that I selected for this analysis was the "Urban Wages Earners and Clerical Workers" index for "Los Angeles-Riverside-Orange County, California". The index uses a base year of 1984 = 100. To calculate a rate of inflation, you take the current period factor and divide it by the prior period factor. For example, the factor for December 2005 was 196.5 while for December 2004, the factor was 188.5. The inflation rate for 2005 was 4.24% (196.5 divided by 188.5 = 1.0424)

The factor for December 1995 was 149.4. Making the same computation for the ten-year period from 1995-2005, the rate of inflation was 31.53%. (196.5 divided by 149.4)

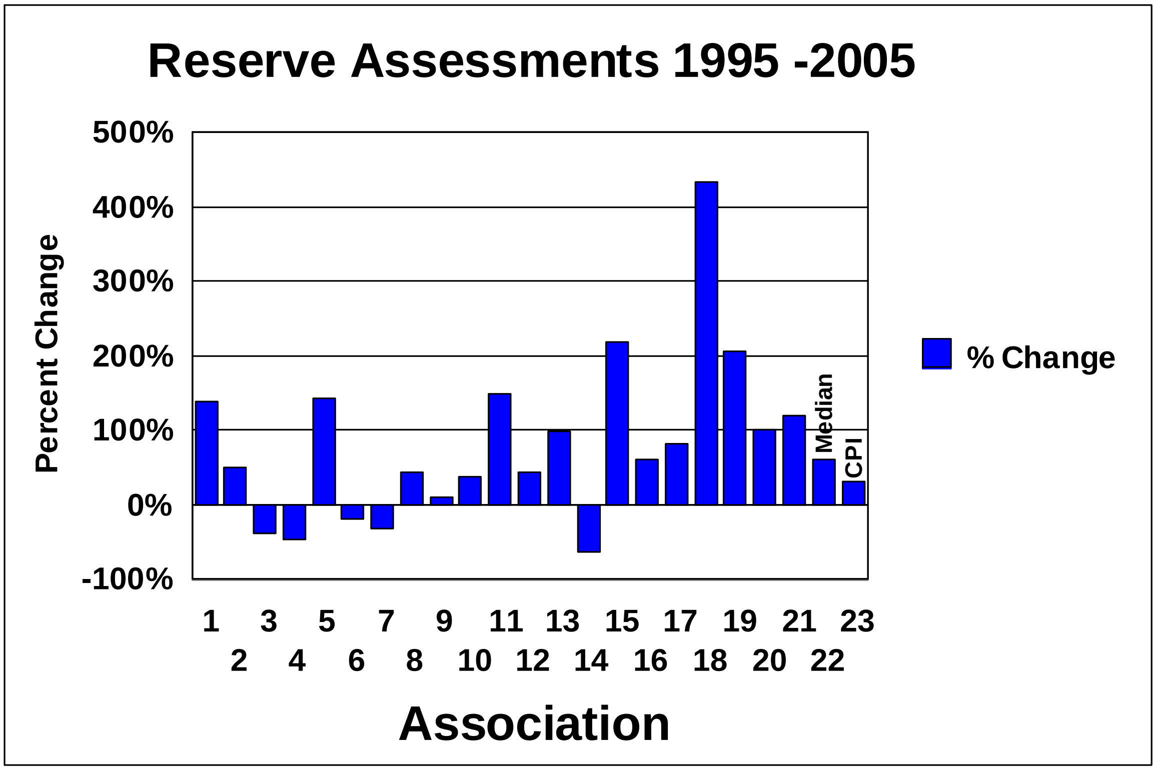
I have analyzed data two ways. On a total basis, I have combined the income and expenses for all the associations into a grand total. Larger associations contribute more to the totals than smaller associations. I have computed averages for the total amounts. To establish median amounts per association, each association has an equal weighting as all other associations. In a sample of 21, the 11th ranked association is the median, since 10 will have higher amounts and 10 will have lower amounts.

Total Assessments – In 1995**,** the average monthly assessment was $192.53. In 2005, the average monthly assessment was $283.03, an increase of $90.50 per month or 47%. These 21 associations collected over $2 million more (from 4.38 to 6.45 million dollars) in monthly assessments in 2005 than in 1995. The median assessment jumped 57% - half the associations had an assessment increase of more than 57% while half had an assessment increase of less than 57% during the 10-year period. Out of the 21 associations in the sample, only one had an assessment increase of the 10-year period of an amount less than the 31.53% increase in the Consumer Price Index. The other 20 had monthly assessment increases greater than the Consumer Price Index. The highest monthly assessment increase was 94.6% from 10 years ago, three times the rate of inflation. (Note: The median change is item 22 and the CPI change is item 23)

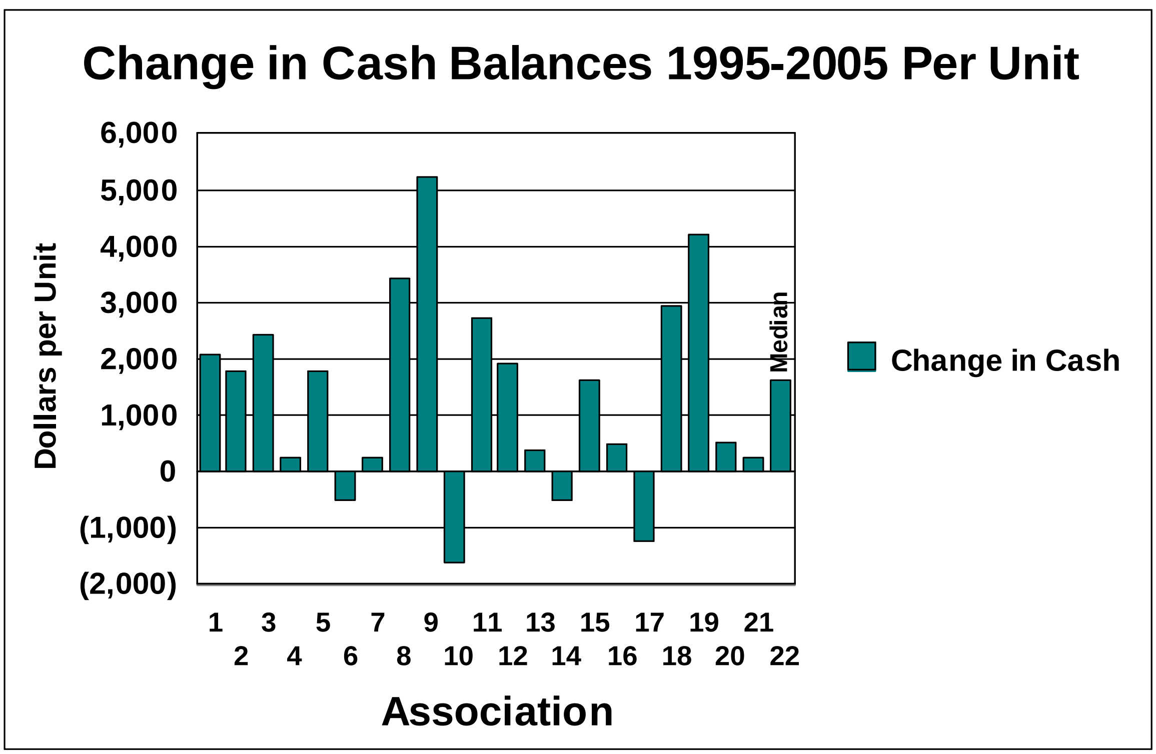


Operating Fund Assessments – Over the 10-year period, the median operating assessment increased by 62.2%, nearly twice the change in the CPI. The overall percentage that the operating assessment compares to the total assessment (operating + reserve) increased from 78.9% to 80.2% during the period.

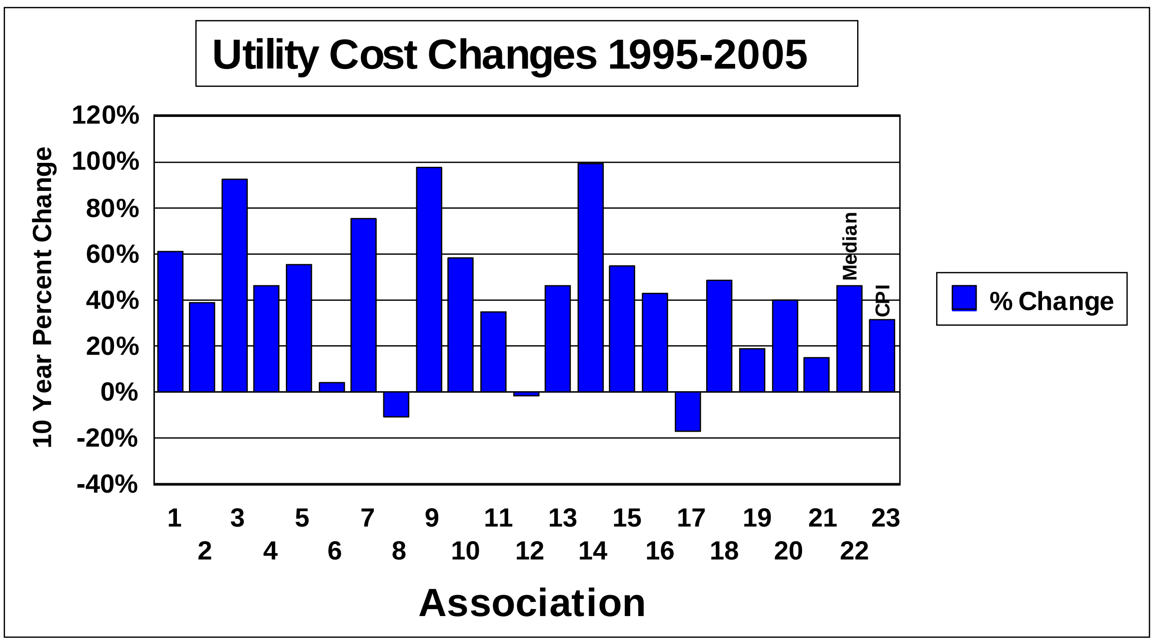
Reserve Fund Assessments – Over the same 10-year period, the median reserve fund assessment increased by 61.4%. Five associations funded less to reserves in 2005 than they did in 1995. Conversely, eight associations had reserve assessments at least double what they funded ten years earlier. One association is funding its reserves at a rate over five times the amount that they funded in 1995. The following graph shows the percent change in the amount of the total assessment dedicated to reserve funding from 1995-2005.



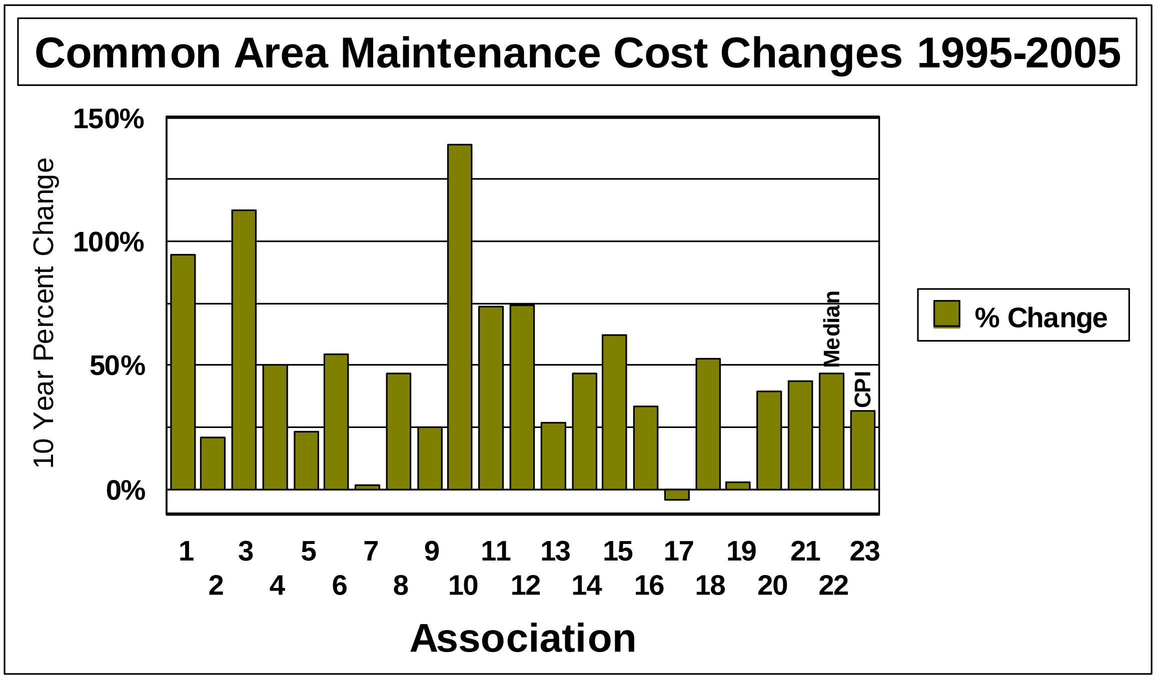
Cash - In 1995, these 21 associations had combined cash and cash investments of $4.06 million. At the end of 2005, these balances had increased to $6.52 million. The median cash balance per member had increased by $1,626 or 46.1% over 10 years. Four of the 21 associations had lower cash and investment balances in 2005 than they did in 1995. Three of those four associations recently completed major maintenance projects such as roofing while the fourth simply reduced its reserve funding.



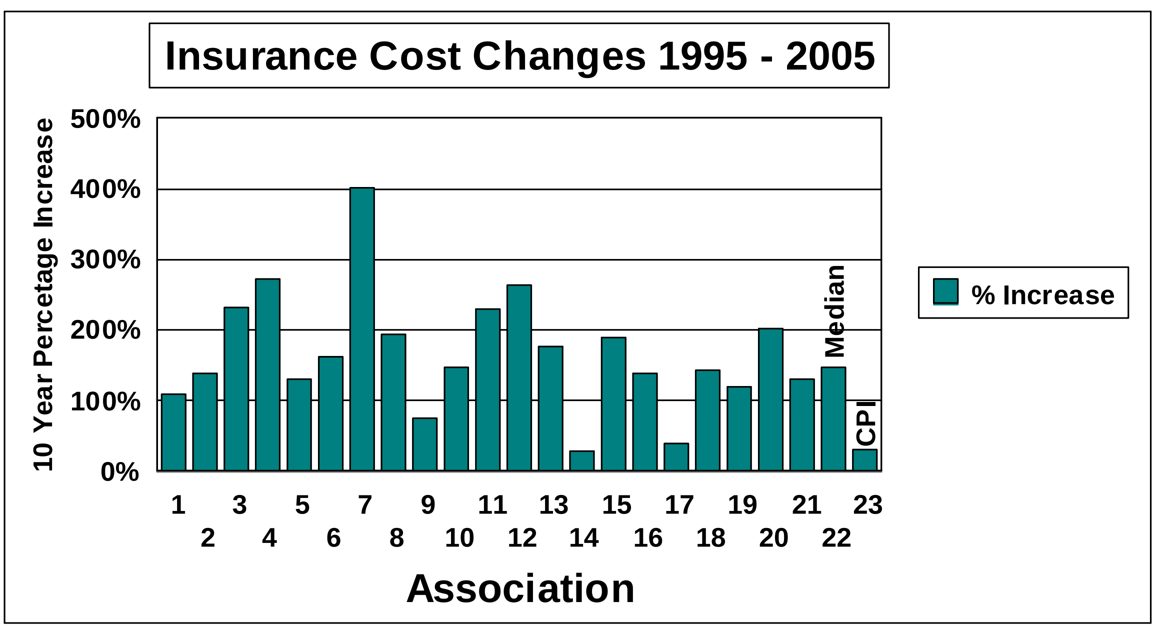
Utility Expense – The median association paid 46.2% more for utilities in 2005 than it did in 1995. Three associations paid less for utilities than they did ten years ago. One of those associations had been paying the sewer charge as part of the assessment. Now, the charge is being handled through the unit owner's property tax bill. The other two associations pay for common water use only and have apparently reduced their usage in the face of rising utility rates. Three associations had utility expense increases between 90-100% from ten years ago. Two of these associations are in Carpinteria where water rates have skyrocketed in the past two years. Overall, utility costs increased $18 per month per member during the ten-year period.



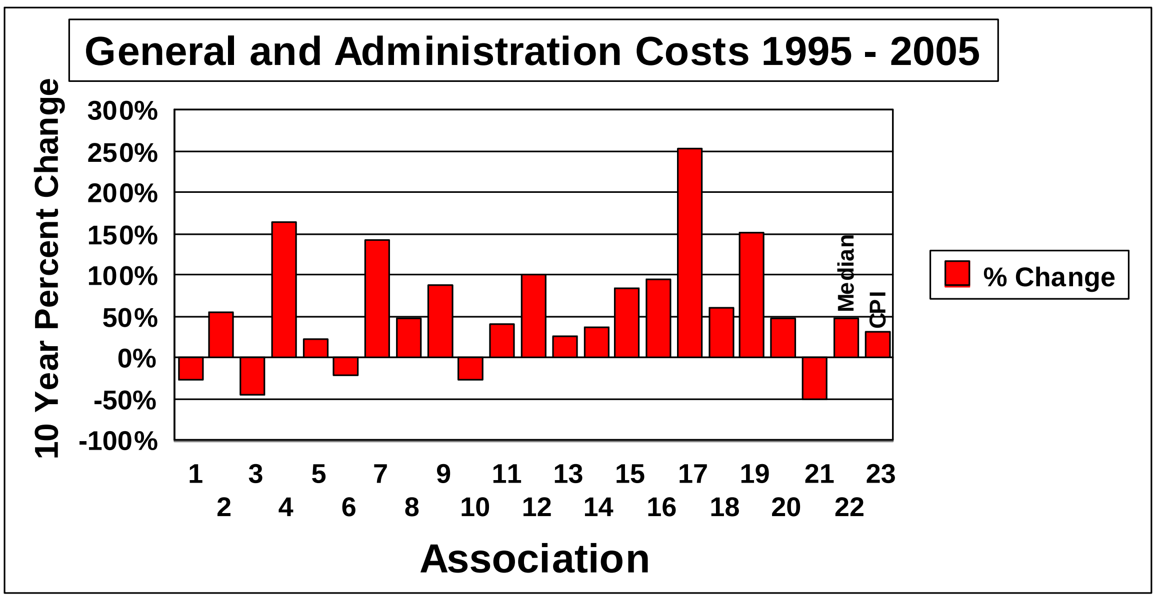
Common Area Maintenance – This category includes gardening, common area repairs not chargeable to the reserve fund, pool maintenance, elevator maintenance, etc. The median association paid 46.4% more for common area maintenance than they did ten years ago. Seven of the 21 associations' common area costs increased by less than the change in the CPI index during the ten year period. Two had increases of over 100%. Overall, these associations paid $869,000 more for common area maintenance and services than they did ten years prior. These cost increases averaged a $38 per month per member.



Insurance Costs – In 1995, these 21 associations collectively paid $435,090 for all their insurance policies. Ten years later, the total premiums were $1,142,274, an increase of 162.5% or $31 per member per month. This increase was 5 times the cost of living increase for the ten year period. Further, this computation does not include the latest round of premium increases that have occurred in 2006. In reviewing the chart below, association number 7 added earthquake coverage after 1995 while association number 14 eliminated the coverage. The median increase in premiums was a little less than the average – 147.5% over 10 years. Indeed, 18 of the 21 associations saw their premiums increase by more than double during the ten year period.

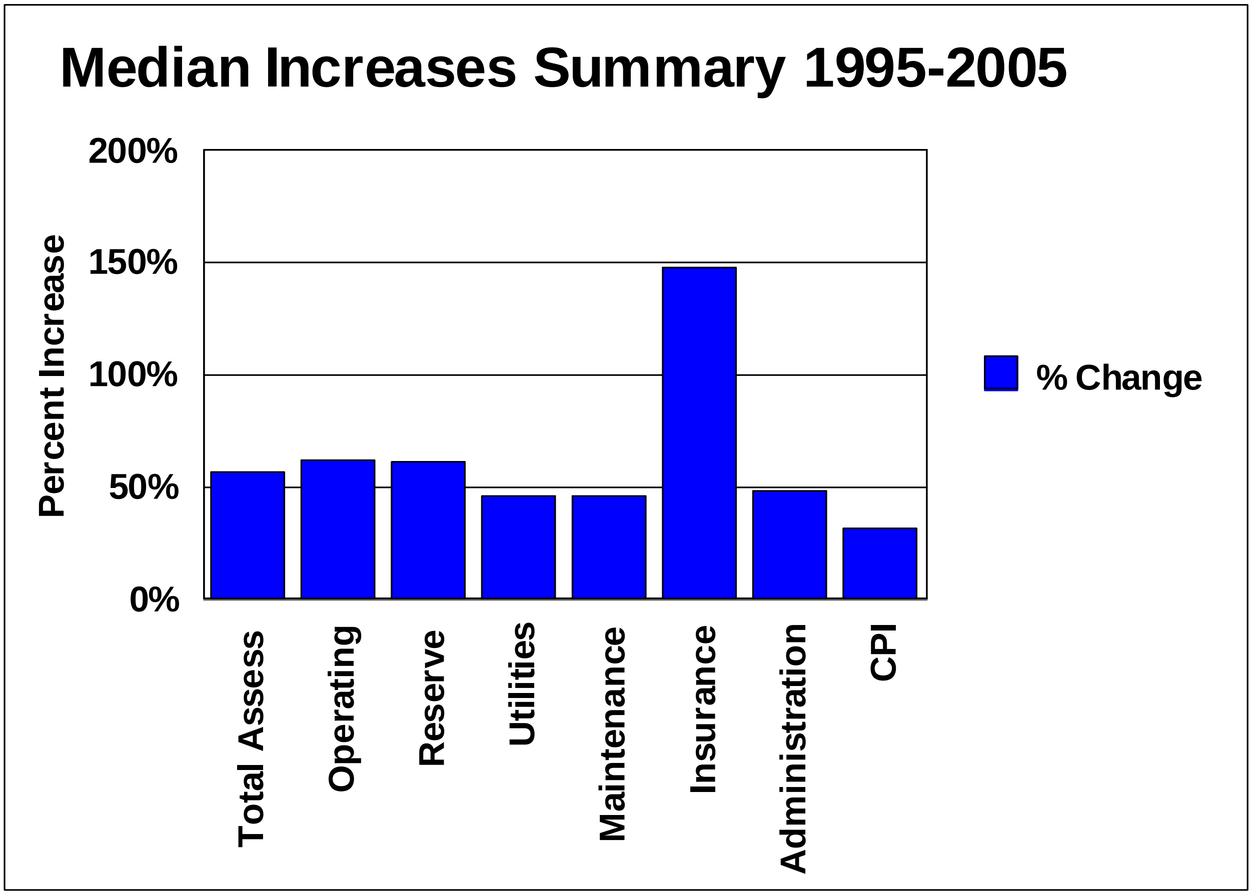


General and Administration Costs – These costs include management, bookkeeping, accounting, legal, other professional services, printing, postage, office supply, filing fees, licenses, income taxes, etc. Some of these expenses, such as legal, are subject to wide variation from one year to the next but a 10-year sampling should effectively smooth out these variations. Some associations added management services during this period. More associations are having a professional reserve study done than in 1995. Certainly, the laws have changed over the past 10 years and thus have increased compliance costs. Five associations had lower administrative costs in 1995 than they did in 2005. The median association had a 48.4% increase in administrative costs but this represented only $6.78 per member per month increase over the 10-year period out of the $90.50 median increase in assessments noted earlier.



Conclusion – It costs money to own property in a homeowners association (or outside a homeowners association for that matter). This analysis confirms that association assessments have indeed increased at a rate greater than the CPI index. All major categories of costs (utilities, common area maintenance, insurance and administration) increased by an amount greater than the CPI. Some expenses, such as utilities are subject to rate-setting by government and the utility provider themselves who need to fund their own capital projects and increased costs. Maintenance costs are heavily influenced by the age of the components. Remember, everything in this sample is 10 years older than it was. Maintenance costs are further influenced by wage increases, vendor costs and overhead, materials costs, etc. Insurance costs are subject to the marketplace. 9/11, Katrina and poor investment results, increased building costs, and few choices for HOAs seeking insurance have contributed to the major increases in premiums.

The final chart summarizes the major assessment and expense categories and compares the median increases for the 10-year period to the CPI change.



As I attend HOA meetings or read minutes as part of my review of the financial statements, you would think that some members believe that associations are looking to cut costs for the first time. My HOA board was looking to cut costs in 1982. In most cases, cost cutting will lead to lower level of services, negatively impacting residents. It can also lead to imprudent delays in maintenance which will only cause increased costs later on. It is difficult to increase assessments to meet these costs. Pressure and negative comments from your members work against meeting these financial requirements head on.

Keep in mind that since 1995, most South Santa Barbara County property values have tripled (gone up 200% or more). Many members have substantial equity in their properties. New owners have a more substantial investment to maintain as well.

Unless the economy enters a deflationary period, it is often pure fantasy to think that association fees can remain the same each year – or be reduced. Costs usually go up every year, so association members should learn to expect annual “Cost-Of-HOA-Living” increases.

As board members, perhaps you can use this information to inform owners of the need to assess adequate assessments. The companion article to this one will compare financial data of 60 associations from 2005-06 and show the changes during that one-year period.

TAX REPORTING AND FILING DEADLINES

The start of the new year is here and that means it's tax time again. Here is a brief summary of the tax reporting and filing requirements for your association. For further information, contact your association's CPA or accounting professional.

1099s: Associations, like all other businesses, are required to file 1099 forms by January 31 for payments made during the previous calendar year. This is true even if the association has a fiscal year end other than December 31. If you pay $600 or more during the calendar year to a "noncorporate service provider", then you are required to issue a 1099-MISC to that service provider. Common service providers to associations include attorneys, managers, accountants, contractors, gardeners, pool service, handymen, etc. Corporate service providers are exempted from receiving 1099s. How can you tell? If the business has the words "inc." or "corp." in its name, then it is a corporation. The word "co" (for company) does not specify a corporation. The 1099 form must show the service provider's name, address, and tax identification number (either social security or employer ID number) along with the amount paid during the calendar year. Copies are submitted to the service provider by January 31 and are due to the IRS by February 28 (the delay is to allow for corrections that may arise).

Independent Contractor Reporting: Six years ago, California law was changed to require businesses that use individual independent contractors to report "within 20 days of the earlier of first making payments that in the aggregate equal or exceed $600 in any year to a service-provider, or entering into a contract or contracts with a service provider providing for payments that in the aggregate equal or exceed $600 in any year" to the California Employment Development Department. (California Unemployment Insurance Code)

This law is intended to locate "deadbeat parents" who are receiving payments other than wages to be able to garnish them quickly to meet child support obligations. You use many of your contractors on a continuous basis so January is a good time to report them to the California EDD. Reporting is done on form DE-542 (available at www.edd.ca.gov) and can be mailed or faxed to the EDD. What is troublesome about this law (yes, there are penalties for failure to file) is that reporting can be required at any time during the year, not just once a year or quarterly. For example, you hire a painter on May 15 and sign a contract for a $5,000 job. Reporting would be required by June 4, even if no payments had yet been made. The reporting deadline is 20 days after signing the contract.

Employment Tax Returns: For those associations that hire employees, Federal form 941 and California form De-6 are due 30 days after the end of each calendar quarter. Tax payments are due semi-weekly, monthly or at the filing date, depending upon the amount owed. Annual tax reports (Federal W2, 940; California DE-7) are due January 31.

Federal Income Tax Returns: All associations, no matter how small, must file a Federal Income Tax Return 2 ½ months after the end of its fiscal year. For calendar year associations, the due date is March 15 although it can be extended for 6 months by filing an extension form. Associations may elect to file Form 1120H or the standard corporate form 1120.

California Income Tax Returns: California Form 100 is also due the same time as the Federal returns. While most associations have "tax-exempt" status with the State of California, nonmembership income such as interest is taxable. If the association has more than $100 in nonmembership income, then a return is required. Failure to file Form 100 when required can result in significant penalties and interest if tax is owed and can also result in the suspension of the corporation by the State.

California Exempt Organization Return: Form 199 is required of all tax-exempt associations that receive $25,000 or more in revenue from any source (assessments, etc.) It is due 4 ½ months after year-end but can also be extended. A $10 filing fee is required annually. Failure to file this form when required can result in an additional $55 in penalties plus interest. Corporate powers can also be suspended for failure to file this form as well.

Estimated Tax Payments: If the association pays income taxes on its nonmember income, then it may be required to pay estimated taxes quarterly to avoid an estimated tax penalty. For Federal, estimated tax payments are required if taxes are $500 or more. The state has no minimum. With increasing interest rates, many associations will be paying more in income taxes than in the last 2-3 years. Federal tax deposits are made to your bank using a Federal Tax Deposit coupon while state taxes are paid by check and mailed using form 100-ES. Payments for calendar year associations are due April 15, June 15, September 15 and December 15.

Secretary of State Biennial Filings: The Nonprofit Corporation Statement of Information (SI-100) and the Statement of Common Interest Development (SI-CID) are required to be filed with the Secretary of State every two years. These are not tax forms, however, failure to file them with the Secretary of State can result in the suspension of corporate status. Filing fees are $20 for the SI-100 and $15 for the SI-CID. Since the forms are required only every two years, the due date is tied to the association's incorporation month, not its fiscal year, and since they are not tax forms, it is common for this filing to be overlooked if the association's mailing address has changed. While seldom done, the state allows for updated forms to be filed without the payment of an additional filing fee. See article following for interim filing of these forms. Fill-in forms are available on line at www.ss.ca.gov.

2007 BLUEBOOKS HAVE ARRIVED

The 2007 *California Condominium Bluebooks* have now arrived and are due to be mailed to all renewed members the week of December 26. We have a few additional copies available at $17/each, postpaid. Send your check to our PO Box address and we will mail the books out to you.

For those that have not renewed for 2007, your book will be held pending receipt of your renewal. On a personal note, I am hoping to have all the renewals wrapped up by January 10 before the start of busy season for CPAs! So far, 87% of you have renewed. Thanks for your continued support.

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