Vistoso
COMMUNITY ASSOCIATION

Board of Directors Meeting
Tuesday, September 7, 2021
Via Zoom – 5:00pm

https://us02web.zoom.us/j/8445866556
Meeting ID: 844 586 6556

I. **Call to Order – Sarah Nelson 5:00pm**

II. **Roll Call and Adopt the Agenda**

III. **Introductions**

IV. **Finance Committee Chair Comments – Matt Wood**

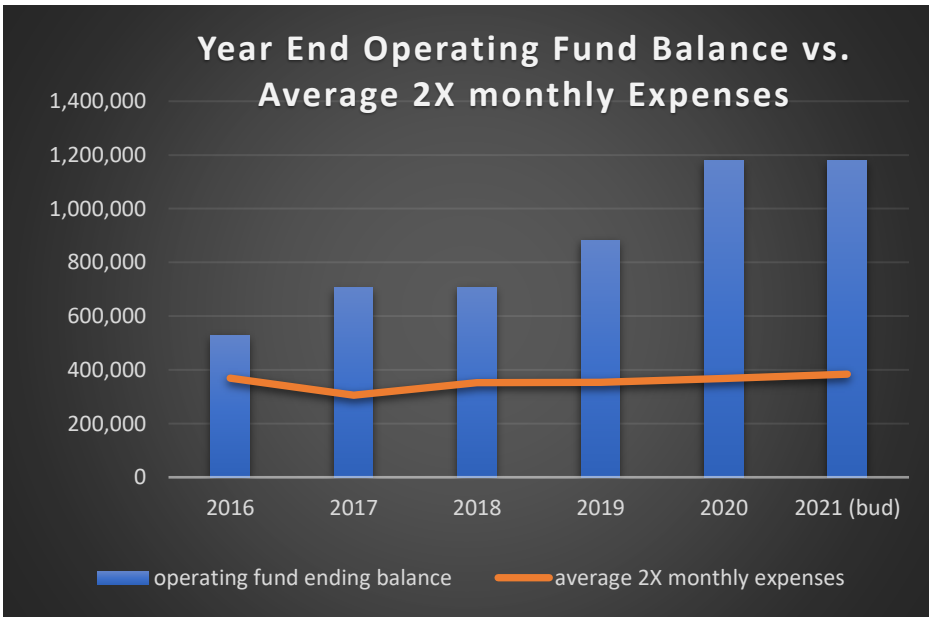
V. **Discussion of Alternate Approach to the Budget – David Light**

VI. **Q & A**

VII. **Adjournment 6:00pm**

Background for Discussion on New Budget Approach

1. **Governing documents.** In any proposal that changes how the Association is governed, it is important to research the governing documents to make sure that there are no conflicts with the proposal. Both the CC&Rs and the Bylaws were researched, and two provisions (one in each document) were found that impact this budget issue.
    a. **Bylaws.** In *Section 6.2 – Budget*, the following passage relates directly to the proposal: "The board shall cause to be prepared an estimated annual budget for each fiscal year of the Association. Such budget shall take into account the estimated cash requirements and income of the Association for the year. The annual budget shall also provide for a reserve for contingencies for the year and an adequate reserve for maintenance, repairs and replacements of those Common Areas that must be replaced on a periodic basis, as determined by the Board. *To the extent that the Assessments and other cash income collected from the Owners during the preceding year shall be more or less than the expenditures for such preceding year, the surplus or deficit as the case may be, shall be taken into account in determining the annual budget.* The estimated annual budget for each fiscal year shall be approved by the Board, and a copy thereof shall be furnished by the Board to each Owner at the annual meeting of the Members, or at any other (meeting), upon the request of any Member." (Emphasis added)
    b. **CC&Rs.** In *Section 10.3 — Association's Rights in Spending Funds From Year to Year,* the following passage has a direct impact on the proposal: "The Association shall not be obligated to spend in any year all Funds received by it in such year, and the Board may carry forward as surplus any balances remaining. The Association shall not be obligated to reduce the amount of the Annual Assessment in the succeeding year if a surplus exists from a prior year."
2. **Historical record of Operating Fund Balances.** The main purpose of this proposal is to use the budget process to help in avoiding an unnecessary inflated operating fund balance. Such balances can easily become inflated by using a zero-based (or balanced budget) approach as a result of conversative budgeting practices. A different approach, by orienting the bottom line according to an agreed-on multiple of average monthly expenses (large associations such as VCA normally use a multiple of 2X or 3X) is becoming more popular. This can result in no increase in assessments but a deficit budget for those operating fund balances that are inflated, or an increased assessment resulting in a positive net income for those operating funds that have year-end balances below the agreed multiple. The multiple that FSR has used in related contexts is 2X to 3X, with an average monthly burn rate of about $186K (according to former FSR Vice President Susan Rodriguez in an email a year ago). The nearby graph shows the six-year history (including the budget for this year) of the association's operating fund balance charted against the annual 2X multiple of its average annual monthly expenses. The graph clearly shows the excess cash being accumulated in the operating fund, and that it is growing, while the average 2X multiple of average monthly expenses is fairly stable at between $300K and $400K. Also, this figure is calculated from the budget. Actual monthly expenses are lower.



3. **The importance of avoiding an inflated operating fund.** This issue has to do with whose money the association is working with. HOA boards are tasked with providing certain services to their members, which are paid for through annual assessments. Not assessing enough increases the risk of a speacial assessment, which reflects poor management and typically results in members' complaints and board member changes. But assessing too much results in HOAs hoarding money that is unproductive, and really belongs to the members. Inflated budgets result from the balanced budget approach because management (and even boards and finance committees) usually like to budget for expenditures conservatively (that is, loosely) so that year-end fiscal performance shows a positive treand. The consequence is that annual net income is increased and accumulates from one year to the next, resulting in larger and larger inflated operating funds as well as budgets. And this issue is made worse by the fact that, in the current low interest rate environment, the annual yield on this excess cash is earning virtually nothing. Currently, VCA's operating fund has cash in the amount of $1,264,522, of which more than half (nearly $660K) is in a checking account that earns no interest, and just under $600K is in a series of savings accounts earning only .4% annually.
4. **How common is this new budgeting approach in the HOA industry?** I first became aware of this idea several years ago as the treasurer for a medium-sized HOA (645 homes) in Oregon. After talking with board members and general managers from other associations that had embraced this approach, I proposed the idea to my fellow board members as we began our annual budget process. It was adopted and has been effective in limiting the growth of our operating fund since then. When I became treasurer three years ago of my HOA at The Estates at High Mesa (an 80-unit sub-association of VCA), I again proposed this new approach to budgeting, and the board accepted it, and have continued to use it successfully. As most of the VCA board members know, the association's former general manager, Colleen Holland, queried FSR accounting experts about this issue when I proposed it last year. Her queries made their way to Tom Reed, who is the Vice President of the West Region Client Accounting. He quickly grasped the purpose of the question, and briefly answered that "…in many cases either excess funds are returned to homeowners or assessment are reduced. This method of budgeting expenses higher than revenue results in a 'book' (budget) deficit on the monthly financials." While returning funds to homeowners or lowering assessments may not be appropriate for VCA (see the CC&Rs provision above), using this approach may be effective in limiting the unnecessary growth of its operating fund by not *increasing* assessments until the operating fund balance begins to level off.
5. **Implementing this approach in the budget.** The process is very similar to the one VCA has used in the past: all expense line items are evaluated and budgeted as in the past, but when determining the level of homeowner assessments, the bottom line (annual net income) is constrained by the 2X multiple of average monthly expenses of the operating fund balance. If the balance is greatly above the 2X multiple, the assessment should not be increased (but it should not be lowered). If the projected balance would be lowered to a level below the 2X multiple by a static assessment, then the assessment should be increased to raise the level of the projected year-end operating fund balance to the 2X multiple of average monthly expenses (or slightly higher).
6. **Other resources.**
    a. First Service Residential has a site (https://www.fsresidential.com/california/news-events/articles/seven-best-practices-for-hoa-budgets/) titled the "Seven Best Practices for HOA Budgets. Number 5 is particularly relevant.
    b. Another FSR resource is a 40-minute webinar titled "Unlock the Secrets to Successful Budget Management", which can be found at https://www.youtube.com/watch?v=ZGMQ74ladUI. It has various comments about the relationship of the operating fund balance and the budgeting process sprinkled throughout it.
    c. A useful primer on HOA accounting principles, titled "Guide to Understanding Community Association Financial Reports", can be found at https://www.hoatalk.com/Portals/0/NTForums_Attach/11027253361571.pdf
    d. Many other resources can also be found online by searching for HOA budgeting and related accounting issues.

David Light

Memorandum to the members of the Finance Committee on a possible new approach to budgeting for VCA's Operating Fund

Most homeowner associations use a zero-based budgeting approach (also called a "balanced budget") when constructing their annual operating fund budgets each year. The process is simple and straightforward. All operating expense line items are reviewed and adjusted for the next year based on expected inflation, new and additional expense needs, and other factors. When all expense items are thus determined, known fixed and variable income items are added to a calculated assessment that produces a number that exactly balances with the total of expenses.

But there is a (potential but frequent) flaw in this approach. HOA managers, boards, and finance committees that are involved in this process are usually (and understandably) inclined to budget their expenses loosely in order to show the association members that they most frequently end the year under-budget. The result is that the operating fund balance grows over time—ultimately, until it is out of proportion to any fiscally responsible safety net for the association.

As a long-time HOA board member and (usually) treasurer tasked with constructing the draft budget that was initially proposed to the board, I had gradually become aware of this issue when, several years ago, I came across a different approach to HOA budgeting, and I now know that it is becoming more commonly used each year. Instead of balancing income and expenses, it strives to produce a budget that will result in a reasonable multiple of the association's average monthly expenses. For very large associations, such as VCA, that multiple is either a 2X or 3X multiple of the average monthly expenses. Smaller associations usually use a multiple of 4X, or rarely, even 5X. The idea is that the association budgets to preserve a reasonable cushion against unexpected financial problems, which could be either unanticipated expenses or a shortfall in revenue. This approach assures the members that their association does not hold a large amount of their money unproductively. As it happens, VCA has an inflated operating fund balance, and to make matters worse, that money has a very low annual yield.

I proposed this idea to the VCA Board last year, but my timing was not good. It was during the budget process (before the Board got the FC's final draft budget, but after the process had begun). The result was that the Board didn't feel like it knew enough about this new approach to embrace it rather suddenly, even though their due diligence did elicit a thoughtful and supportive explanation of the idea from the Vice-President of the West Region Client Accounting (Tom Reed, in FSR's Los Angeles office).

My hope is that the Finance Committee can discuss this idea, asking questions, and looking at what the possible effects might be—both on the budget, to our members, and to the operation of the association. I have more details and data on how this idea would impact VCA.

David Light
July 16, 2021