Aka… looking under the hood.

When you purchase a cooperative or condominium property, you buy a part of an existing company.

BEFORE making the purchase, you should know:

1. What does the company own? (called an ASSET)
2. What does the company owe? (called a LIABILITY).
3. Does the company take in enough INCOME to cover its routine EXPENSES?
4. Was there a financial need that required the company to invoice owners an extra amount (ASSESSMENT)? And what caused that situation?
5. Have all the shareholders (owners) paid the maintenance or common charges, or do they owe money? (ACCOUNTS RECEIVABLE)
6. Has the Cooperative or Condominium paid their vendors? (ACCOUNTS PAYABLE)
7. Does the Cooperative or Condominium have an outstanding bank loan, and what are the terms?
8. Are there any pending significant issues that may result in an upcoming need for a shareholder financial contribution that has yet to appear on the financial statements?

Answers can be found in the financial statements. Potential purchasers should ask for the most recent two years' financial statements. Do not be surprised if the reports are old. It often takes the accounting firms six months from the close of the fiscal year to complete and distribute the financial statements. Thus, if the fiscal year ends on December 31st, it is not uncommon for shareholders to wait until the following summer to receive the reports.

Each Financial Statement will include three accounting reports:

- BALANCE SHEET
- STATEMENT OF OPERATIONS (Revenue, Expenses, Change in Fund Balance)
- CASH FLOW STATEMENT

Unfortunately, most purchasers are not skilled at reading financial reports. They mistakenly believe their attorney will review them, but this is rarely true. Also, it is easy to be overwhelmed by the information on the financial statements. The trick is to know what to focus on and what to ignore. Below are a few essential items to examine.

1. **HOW MUCH CASH (Reserves) DOES THE COOPERATIVE OR CONDOMINIUM HAVE?**
   By what percentage has that amount changed from the prior year?

Cash is listed on the Balance Sheet report under Assets. Often, a building's cash is listed on several lines (e.g., a checking account, savings account, certificate of deposit, and reserve account), so you may need to add the numbers together to get the total cash.

On rare occasions, a building will invest its cash in stocks and bonds, and the funds invested will be called "marketable securities" on the balance sheet. This is not a common practice as marketable securities fluctuate in value and can go down. However, some buildings are willing to take a risk, hoping for a better return.

Having sufficient cash to meet unexpected expenses and capital improvements is very important, and buildings have different attitudes toward how much to keep on hand. Some owners fight against large cash reserves; they say they would rather hold onto their money and pay through an assessment; other owners know that implementing an assessment is painful to shareholders, so they slowly accumulate cash by having the income exceed the expenses and holding onto the surplus.

There is no magic number as to how much cash is enough. Larger buildings need more cash than smaller buildings. Older buildings need more money than newer buildings, as capital improvements and repairs are more likely. Buildings contemplating big capital improvement projects (such as façade repair, roof replacement, etc.) need cash to cover them.

A technique to gauge the building's cash is to divide the Cash balance by the Total Expenses.
For example:

- if the building had $200,000 in cash and $600,000 in total expenses, the ratio = 33%
  33% of 12 months = 4 months
- if the building had $300,000 in cash and $600,000 in total expenses, the ratio = 50%
  50% of 12 months = 6 months

A reserve of four to six months is generally prudent.

2. **DO THE SHAREHOLDERS OWE MAINTENANCE OR COMMON CHARGES? (ACCOUNTS RECEIVABLE)**
   By what percentage has that amount changed from the prior year?

Typically, not all shareholders pay their maintenance or common charges on time, so they owe the Cooperative or Condominium money at the end of the year. The amount shareholders owe to the building is listed on the Balance Sheet under Assets and called Accounts Receivable. It is an Asset to the Cooperative or Condominium because it is money due to the building.

In a perfect situation, the Accounts Receivable would be zero (in which case Accounts Receivable are not listed), but that rarely happens. To gauge if the amount due is problematic:

- Compare the Accounts Receivable to the annual Income. If the Accounts Receivable is more than 5 % of the income, there may be cause for concern.

- Compare the Accounts Receivable at the end of the current year to those of the prior year. If the Accounts Receivable has risen more than 10% over the preceding year, there may be cause for concern.

3. **DOES THE BUILDING OWE MONEY TO VENDORS? (ACCOUNTS PAYABLE)**
   By what percentage has that amount changed from the prior year?

Most invoices received by a building should be paid within 30 days. However, a building may postpone paying vendors if it is short on cash, fighting with a vendor over an invoice, or sloppy with its bookkeeping. Therefore, ensuring that the amount due to vendors is paid on time is essential. The amount due to vendors is listed on the Balance Sheet under Liabilities and called Accounts Payable.

In a perfect situation, the Accounts Payable would be zero (in which case Accounts Payable are not listed), but this rarely happens. To gauge if the Accounts Payable are problematic.

- Compare the Accounts Payable to the Total Expenses. If the Accounts Payable are more than 5 % of the expenses, there may be cause for concern.
- Compare the Accounts Payable at the end of the current year to those payable in the prior year. If the Accounts Payable have risen more than 10% over the preceding year, there may be cause for concern.

4. **DOES THE BUILDING HAVE A LOAN? (LIABILITIES)**
   By what percentage has that amount changed from the prior year? – (a decrease is good)

When buildings need money, they often turn to a bank for a loan. The loan could be a Line of Credit (which may have to be repaid within a short time frame) or a long-term loan secured by the property (e.g., a mortgage). All loans are listed on the Balance Sheet under liabilities.

While there is little you can do regarding the building's loans, it is worthwhile to understand the terms. Hence, valid questions are:

  - When was the loan taken out?
  - What was the loan used for?
  - Over how many years is the loan being repaid (term)?
  - Is the interest rate fixed or variable?
  - What is the interest rate? And if it is variable, what is it based on?
  - Is there a "balloon payment" at the end of a specific period? – a balloon payment is when the loan balance must be repaid.
  - Has the amount due on the loan increased or decreased over the past year?

5. **HOW DOES THE BUILDING EARN ITS REVENUE (income)?** By what percentage has that amount changed from the prior year?

   Revenue/Income can be found in the Statement of Operations.

   In a cooperative or condominium, most of the building's income comes from fees paid by the Owners.

- In a Cooperative, the amount invoiced to shareholders is called "Maintenance."
- In a Condominium, the amount invoiced to owners is called "Common Charges."

It is important to watch the change from year to year.

- If it does not keep up with inflation and the increase in expenses, the building's reserves will likely decrease.
- If they are increasing at a much faster pace than inflation, why?

Some buildings have other sources of income, such as:

- Alteration Fees – charged to shareholders who want to alter their units
- Capital Assessment (see note below)
- Fitness Center Fees (pool usage, gym membership, etc.)
- Flip Taxes
- Late Fees
- Laundry License or Usage Fees
- Move-In and Move-Out Fees
- Parking Fees
- Rent from Tenants (generally ground-floor commercial tenants)
- Sublet Fees
- Storage Fees
- Interest Income on cash funds

If more than 10% of the income comes from other sources, it is important to understand that if those fees evaporate or change, the building owners must make up the difference. During COVID-19, many buildings with commercial tenants who relied on those tenants to pay rent saw that rent stop when tenants vacated. Shareholders had to make up the difference.

6. **HOW MUCH ARE THE ANNUAL BUILDING EXPENSES? – WHAT PROPORTION IS EMPLOYEE RELATED? WERE THERE SIGNIFICANT LEGAL EXPENSES?**

Expenses can be found in the Statement of Operations.

Most buildings have these expenses in these categories:

Administration	Minor expenses to run the office, stamps, postage, co anything not covered by the management company
Insurance	Includes liability (fire, accidents) and an Umbrella policy which covers losses in excess of the basic policy limits
Interest	Specifically, if the property has a loan or mortgage
Management Fees	Property Manager
Payroll, Payroll Taxes, Employee Benefit plans	Can include Health Insurance, 401K Contributions
Professional Fees	Lawyer, accountant, engineers' or other consultants

Real Estate Taxes	In a Cooperative this usually is for the entire building. In a Condominium it is for the common areas.
Repairs and Maintenance	This can also include Service Contracts
Taxes	Income Taxes – although this is usually minimal as buildings rarely have a taxable income
Utilities	Gas, Electric, Water, Sewer – sometimes broken out into sub groups

It is worth calculating the percentage of the overall expenses related to payroll. These expenses usually increase with inflation, and there is little flexibility.

Depreciation Expense is another typical expense. However, unlike the above, depreciation is NOT a cash outlay; it is an accepted accounting entry that reflects that building assets are going down in value and must be replaced. i.e., building boiler, air conditioning system, roof, etc.

When reviewing the financials, it is acceptable to remove the depreciation expense. However, an eye must also be kept on capital improvements that may become necessary in the coming period. A prudent question is: "Does the building expect to purchase any capital items in the coming three years?"

Additionally, if professional fees significantly change, it is worthwhile asking if they are related to a lawsuit. Legal fees may be broken out, but they often are not.

7. **DOES THE BUILDING's INCOME COVER ITS EXPENSES? (NET INCOME)**
The difference between the Revenue and the Expenses is the Net Income, and can be found in the Statement of Operations.

Often, financial reports separate expenses into two groups: "Operating Expenses," which refer to items necessary to run the building and for which payment is due, and "Depreciation Expenses," which refer to the accounting deduction mentioned above.

In that case, the financial reports often report Net Operating Income as a separate line item.

Revenue	$1,000,000
Operating Expenses	$ 950,000
Net Operating Income (Revenue less Operating Expenses)	$ 50,000
Depreciation Expenses	$ 125,000
Net Income (Loss) = Net Operating Income less Depreciation Expenses	($75,000)

The key here is to be sure the Net Operating Income is positive or close to zero. This means the property has enough revenue to cover its ongoing costs.

If the depreciation expense, when deducted, results in a Net Loss, that is not a significant concern.

8. **HAS THE BUILDING HAS ANY ASSESSMENTS?** An Assessment is generally an extra charge to shareholders for a capital improvement (big ticket item) or to cover unanticipated expenses. Assessments are more common in buildings with inadequate cash reserves.

   If there has been a recent Assessment, it will be listed on the Statement of Operations. Purchasers should then ask why the assessment occurred, how much was charged to each unit, and how long the owners had to pay.

9. **WHAT ADDITIONAL INFORMATION DOES THE ACCOUNTING FIRM WANT YOU TO KNOW? (Notes)** The accountant will generally add NOTES at the end of the financial reports. While these may seem like "boilerplate" explanations, the notes are a critical part of the report and should be read. Often, the notes include information on

   - Where and how is the cash held, and is it insured by the Federal Deposit Insurance Corp? (FDIC)
   - The terms of the mortgage, including the interest rate
   - If there is a property management agent agreement
   - If there is an allowance for future significant repairs or replacements
   - Did any events that may affect future building finances occur after the fiscal year closed? This could include new lawsuits.

While the financial statements contain much additional information, answering the above questions will give you a big picture of the building's economic health.