Building's Financial Statements: What To Look Out For And What Banks Are Looking For

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Cooperative and condominium buildings in New York City are run in a similar manner to regular companies. Both are governed by business corporation law, both are controlled by a board of directors and both generate annual financial statements outlining the financial operations and health of the entity. However, reviewing and analyzing financial statements in a co-op/condo building is far different than analyzing them for your typical company.

The main sections in a financial statement are:
1) the Balance Sheet, which outlines the assets and liabilities,

2) Statement of Operations, which demonstrates where the co-op/condo obtains its revenue from, what its expenses are and if it is operating at a surplus or deficit and

3) the Notes section in the financials which explains certain line items in the two aforementioned sections, as well as, describes the details of any commercial leases in the building (for a co-op), the details of any underlying mortgages, if any (for a co-op), any current litigation affecting the building, etc.

When representing buyers purchasing for a primary residence, they often have a fixed carrying cost (debt) to income ratio in mind. When representing foreign and domestic investors, they are making their investment with a target yield/cap rate in mind.

Now if the building is operating at a deficit or its financial status is set to change in the upcoming year, the building may be at a loss of revenue. Any shortfall in revenue is often compensated for through an increase in maintenance/common charges or an assessment. Both items will directly change a buyers carrying cost to income ratio as well as the yield/cap rate on an investment.

Therefore, it is essential for us to review the Statement of Operations to ascertain where the building is deriving its income from, are those sources consistent and stable, what are the buildings expenses, are they subject to a sharp increase and is the building operating at a surplus or deficit.

We also have to review the Balance Sheet to determine how much cash on hand the building has and what the amount of the reserve fund is. Knowing the cash on hand and reserve fund will help us determine if the building can sustain any unexpected costs that it could not normally afford to based on our review of the Statement of Operations.

Banks are now scrutinizing the financial statements of buildings, now more so than ever before. The following are the key points which banks are looking for in the financials:

1) Reserve Fund: banks want to see that buildings have an adequate amount of money in reserves. The interesting thing is that the banks do not have a set percentage of gross revenue that they require buildings to keep in reserves. However, a Fannie Mae/Freddie Mac guideline for condos is that they must have a line item in their *projected* budget for the upcoming year demonstrating that 10% of the gross revenue is being allocated to a reserve fund.
2) Litigation: banks usually view litigation as an automatic red flag in a building, regardless if the building is a plaintiff or defendant. It is our duty to determine the nature of the litigation; is the insurance company covering it in the event of a slip and fall, is the building suing for construction defects in new construction, are there a high volume of common charge/maintenance defaults in the building which are leading to foreclosures?
3) Underlying Mortgage (only in a co-op): an old Fannie Mae/Freddie Mac regulation is that a co-op's underlying mortgage cannot mature in less than two years from the date of closing. The concern behind this is that the co-op will not be able to refinance their mortgage and the shareholders will each owe their proportionate share of the principal balance of the mortgage.
4) Capital Improvements: if the building has recently performed capital improvements or describes any that it plans on performing in the near future, the bank will want to know how they will be paid for (i.e. through an assessment, out of the reserve fund, through financing, etc.) and will this affect the bottom line of the buildings financials.
5) Surplus/Deficit: a common misconception is that if a building is operating at a deficit, it is automatically in financial disarray and not a good investment. The difference between a co-op/condo building and a regular company is that a regular company's main purpose is to produce as much profit as possible, where a co-op/condo building wants to pay for its operating expenses while being conservative and keeping enough funds liquid and available in the event of any unexpected expenses. If a building is operating at a large surplus, then chances are the maintenance/common charges for the building are too high.

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