Sunday, March 7, 1999

The New York Times

Real Estate

Section 11

YOUR HOME

Red Flags In a Co-op's Statement

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THE economics of buying a house are fairly simple: You add up the cost of routine expenses — mortgage, taxes, insurance, utilities and maintenance — and then factor in how much it will cost to replace things like the roof or heating system when necessary. Then you take your checkbook, subtract the down payment, add your income and decide whether what's left over will be enough for food, clothing and other necessities, and perhaps even some non-necessities.

Buying a co-op apartment, on the other hand, is more complicated because in addition to dealing with much of the above, the prospective purchaser must cope with one of the harsher realities of cooperative living — the fact that other people are in charge of the checkbook.

It is thus important to examine the co-op's financial statement carefully to help determine whether a building's books are as well managed as yours.

"The first thing to consider when looking over a financial statement is the availability of the statement itself," said Herb Rose, a Manhattan co-op consultant.

Most co-ops, Mr. Rose explained, operate on a fiscal year that ends on Dec. 31. That means that financial reports for such co-ops should be available in the early part of the following year.

"The financial statement should be available no later than May 7," Mr. Rose said. "Anything later than that is a sign that there's something wrong or that the bookkeeping is in such a mess that they're having trouble reconciling it." (For co-ops on a fiscal year that ends on a different date, Mr. Rose said, financial reports should be available roughly five months after that date.)

Other "red flag" items to look for, he said, are uncollected maintenance charges and unpaid bills.

"Uncollected maintenance is tricky because it's listed on the financial statement as an asset," he said. "But if uncollected maintenance exceeds 5 percent of the total annual maintenance charges for the building, you have a building that's in serious trouble."

Tom Bloom

> A buyer should check delinquent maintenance charges, unpaid bills and number of unsold units.

Excessively high uncollected maintenance charges, he said, is a sign that attention is not being paid to cash flow in the building and that there is no adequate system for collecting receivables.

The flip side of a bad cash-flow equation, he said, is excessive unpaid bills.

"That shouldn't exceed 5 percent of total annual maintenance either," Mr. Rose said. "Because if they're not paying their bills on time, they're probably paying late charges on some things and too much for everything else."

Eric Gonchar, a Manhattan co-op lawyer, said that the total annual maintenance charges could be used as a benchmark for another potential danger sign — insufficient cash reserves.

"A good general rule is that the reserve fund should be approximately one-third of annual maintenance charges," he said. And since reserves can be quickly depleted if major repairs or capital improvements are necessary, he added, there should also be some way of replenishing the fund.

One way that well-run co-ops keep their reserve funds well fed is by balancing income and expenses to generate a surplus at the end of each year. Another is to create revenue generators like flip taxes, whereby a set amount of money — typically a percentage of the sale price — is paid to the co-op when an apartment is sold.

Another thing to determine, Mr. Gonchar said, is whether there are existing property tax abatements on the building and, if so, when such abatements expire.

When such information is included, Mr. Gonchar said, it can usually be found in the "Notes" section of the statement.

"When an abatement expires, the property taxes increase, and that usually means an increase in maintenance charges," he said. Two more bits of important information that might be found in the Notes section of the financial statement, he said, are the number of unsold units in the building and projected major repairs.

"If the number of unsold units in the building exceeds 25 percent, some lenders may be hesitant to lend in the building," he said. "Unsold units" are apartments still owned by the original sponsor, the sponsor's designee or investors.

And if major repairs or improvements are contemplated, he said, the estimated cost of those expenses should be determined as well as whether there is sufficient money in the reserve fund to pay for them.

"If not, that could mean an unexpected assessment for an unwary buyer," he said,

Mr. Gonchar said that a buyer should make every effort to accompany his or her lawyer when the lawyer goes to examine the minutes of a building's board of directors, typically coverng two years. Doing so, Mr. Gonchar said, will enable the buyer or the lawyer to ferret out information that may not be included in the financial statement — information about tax abatements and future repairs, for example — and to get an idea of other issues of importance in the building.

Abe Kleiman, a Manhattan certified public accountant who specializes in co-ops and condominiums, said that somewhere in the financial statement there should be information regarding the co-op's underlying mortgage.

"Look for any changes in mortgage terms that are scheduled to take place," he said, explaining that a scheduled increase in the interest rate or a required payment of principal could result in increased maintenance charges.

It is also important, Mr. Kleiman said, to pay close attention to the date the current mortgage matures because refinancing the mortgage can result in an increase in maintenance charges. Along the same lines, he said, if there are commercial tenants in the building, it is important to determine the terms of their leases.

"An expiring commercial lease may result in either a windfall or a downfall," he said. "But at least you'll know what to expect."

James G. Samson, a Manhattan co-op lawyer, said that another thing prospective apartment buyers might want to look at is the proportional share of underlying debt attributable to individual apartments.

Two other things to look for on a financial statement, Mr. Samson said, are current expenditures for legal services and pending litigation.

"If you see lots of pending litigation or huge amounts of legal fees, you should start asking questions," he said. "Well-run buildings don't have big legal problems and don't have big legal fees."

And where in the report can such information be found?

"You have to look where the lawyers look," he said. "And most lawyers start by reading the footnotes because that's where the problems are usually buried."

In fact, Mr. Samson said, a prudent purchaser will scrutinize every line in the last two or three years' worth of financial reports, and then read between the lines for good measure.

"You have to throw your brain in neutral and look for what's unusual, look for what has changed," he said, adding that such detective work becomes even more important the more "red-hot" the apartment market becomes.

"The market's so good today that people are able to sell their mistakes," he said. "You just don't want to be the person who buys one." ■