What's the Story with Your Financial Statements?

Presented by:
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Your financial statements are trying to tell you a story – how much of it do you understand? Is it a comedy, tragedy or boring research paper? We are going to learn how to grasp the key points in the plot and learn to love the various characters involved. Like any good book there are villains and heroes (often unsung).

How much time does your Board spend on the treasurer's report? Honestly??? In a nationwide poll that I did MANY years ago for a presentation that I gave at a CAI national conference, I found that the overwhelming response to this question was 3-5 minutes. And, there were a lot of 1 minute or less answers and very few 5-10 minute answers!

Let's see…you are running (or managing or living in) a multi-million-dollar corporation (yes, you are a multi-million-dollar corporation if the value of the property was recorded on the books), you are fiduciaries for other people's money (custodians of the assessments monies) or you are assisting the fiduciaries or this is your own investment, and your annual budget is $X (you fill in the blank), and you spend only a couple of minutes on the financial statements at the Board meetings???

Some feel that they have not been trained to read and understand financial statements. Some think because they were terrible in math in school that they cannot learn this accounting-ese. Some feel that it is boring. Others are too intimidated to ask questions. If your association is professionally managed, you may have an accounting department that can assist you in getting the information that you need as you review the financial statements of your associations.

Really, it is not that difficult!

I Love Accounting! ☺ To me reading a financial statement is like reading a book. I know…some of you would prefer a picture book, or a romance novel, but I approach reading a financial statement as reading a mystery (Agatha Christie style). It is my job to determine "who done it" and "why". So, I am going to try and get you just a bit more interested in the why's of financial statements so that you can better do your job!

Let's start….

Financial Statements…a Mystery

The plot opens with pages of numbers…the detective begins the work of sifting through the evidence. What exactly are these columns of numbers and what do they mean? Who is the culprit? What caused the Association to not have enough cash to pay the water bill? Has there been foul play? Or, just an error? Or, maybe, a miscalculation? What clues are there, and how should they be interpreted? With some effort, and after being sidetracked and confused over some issues, the plot begins to unravel and the detective starts to make sense of the financial statements…

Are your Association's financial statements a mystery to you? Are you seeing the "clues" that are being presented in your monthly treasurer's report? Are you asking the right questions in order to understand the financial health of your Association? Below are some questions to think about when looking at your balance sheet and income statement each month. Ask the right questions and the financial statements will start being the management tool they were meant to be.

Operating Cash

- Is there sufficient cash to meet your monthly cash requirements?
- Is there excess cash sitting in a checking account earning little or no interest? Should you open an operating savings or money market account with the excess?
- Does the board review the bank statements and reconciliations at least quarterly?
- Are there old outstanding checks which need to be researched? (Uncashed checks can be TROUBLE if they are for such items as insurance and taxes)Are there unusual transfers?
- Is someone other the person preparing the bank reconciliation seeing the cancelled checks (either online or copies included with the bank reconciliation?

Replacement Fund (Reserve) Cash

- Are funds properly invested in accordance with your Association's investment policy? (*What*? You don't have an investment policy? Make this a priority!) This includes consideration of FDIC or other insured coverage.
- Will funds be available for planned replacement fund expenditures?
- Are replacement fund expenditures and transfers properly approved and documented in the board meeting minutes?
- Are you receiving statements on ALL accounts at least quarterly?
- Are two board members signing all reserve checks?

Assessments Receivable

- Does the aging report agree with the financial statements?
- Is the board taking the proper collection action on delinquent accounts?
    - Collection policy in place?
- At the end of the year, has the Association determined either which accounts to write off the books or set up with an allowance for bad debts?
- Does the Board approve all account adjustments over a certain dollar amount?

Revenues

- Does the assessment income agree with the budget?
- Are all interest, late charges, and violation fees posted in a timely manner in accordance with the Association's collection policy?
- Is miscellaneous income, especially if large enough (e.g. laundry, move in/our fees, rentals, insurance proceeds, settlement monies) monitored? (Note: if there is coin or cash involved pay special attention to internal controls)

Expenses

- For items that are significantly over or under budget, are explanations provided?
- Are bills being paid on a timely basis?
- Is it clear if it is an operating or reserve type of expense?
    - Annual vs. long term? Or extend the life of an asset?
    - Operating budget or included in reserve study?
    - Often Board discretion…but document!
- For unusual, non-recurring type of expenses is there a record in the board meeting minutes of approval by the board?
- For material dollar amount contracts, does the board use a bid process where appropriate?

Fund Balances

- Replacement Fund
    - Look to Reserve Study
        - Percent Funded
        - Funding
- Operating Fund/Members Equity
    - Generally 1-3 months of operating expenses
        - But, know your association!
        - Contingencies and cash flow shortfalls

These are just a few of the questions that can be asked. The numbers in the financial statements should not be a "mystery". They should assist the board members in running their Association, their corporation, in the business-like manner which is required of them. Take time to understand what the numbers are telling you. Important information is available with a little effort and education.

Financial Statements – What are They and What do they Mean?

There are two statements that are issued and it is important that you understand that each of them has a totally different purpose. They are just columns of numbers, but, remember what I said at the onset – they are trying to tell you something!

Balance Sheet

This is the Association's financial position *as of a date in time*. That date is generally the end of a month and/or year. There is a basic "rule" with regards to balance sheets (and, hence, their name):

Assets = Liabilities + Equity
Or
Assets – Liabilities = Equity

Let's define each of these three categories and give examples of the most common accounts within the categories.

Assets
This is what the Association OWNS.

The most common assets are:
Cash & Investments
Assessments Receivable (A/R) – Monies owed to the Association from homeowners.

Question….what asset is NOT on the books???? The buildings and common property! If it was, you would be much more impressed with the size of corporation you were directing or managing!

Liabilities
This is what the Association OWES.

The most common liabilities are:
Prepaid assessments – Monies paid by members before they are due.
Payables – Monies owed for various reasons.
Refundable deposits – Monies being held by the Association to be returned.

Equity
This is the NET WORTH of the Association. It is often called Members' Equity, Operating Fund, or Retained Earnings.

There actually are at least two types of equity/fund balances in an association:
- Operating
- Replacement

There can be other funds such as insurance, special assessment, insurance proceeds, etc.

Cash, Modified Cash and Accrual Methods of Accounting

METHODS OF ACCOUNTING

There are three methods of accounting. They are as follows:

- **Cash**
- **Modified Cash**
- **Accrual**

A method of accounting defines how financial transactions are recorded in the financial statements. It is important that a board of directors understands what method of accounting is being used for their financial statements. Without this knowledge, they cannot accurately use the financial statements as a tool.

CASH

The cash method is the method most easily understood and is simple to maintain. It is simply what it states - cash transactions are recorded when they occur. That is, when cash (or forms of cash such as checks, money orders or charges) are deposited into the bank account the association recognizes *income* When checks are written or cash is taken out of a bank account, the association recognizes *expenses* on its financial statements.

The cash method can be compared to an individual's checkbook. There are transactions recorded when money is put into or paid out of a bank account. A cash balance is kept as a running total. Generally, cash is the only asset on the balance sheet of the financial statement; that is, cash is the only recorded asset of the association.

The weakness of a cash system is that only those transactions that go into or out of the bank are recorded. If the person in charge of financial matters does not make a bank deposit or does not write a check, the board can be misled as to the financial status of the association. They could assume that there is less or more cash, less or more income and expenses, depending on whether all deposits have been made and all checks have been written.

For some very small associations who have very few transactions and make bank deposits and write checks in a timely manner, the cash method of accounting may be appropriate. For most associations, however, most accountants feel that an association needs to use the accrual method or at least the modified cash method of accounting.

ACCRUAL

The accrual method of accounting is considered to be in compliance with "generally accepted accounting principles" (GAAP). It is the most accurate means of assessing the financial status of an association. Under the accrual method, income and expenses are recorded when they are *incurred*, regardless of when they are deposited into the bank or when checks are written. Thus, income is recorded when the unit owners are assessed, not when they make a payment. The amount of unpaid dues is shown on the balance sheet as assessments receivable. An accrual basis financial statement will then, usually, have at least two assets on the balance sheet - cash and assessments receivable. Expenses are recorded when the product or service is provided, not when the check is written. For example, landscape contract for January would show in the January financial statements even though the landscaper was not paid until February. The amounts owed to vendors, but not paid at the end of the month would show as accounts payable in the liability section of the balance sheet. (There could be other assets and liabilities such as prepaid insurance or taxes, taxes payable, etc. but they will not be discussed here.)

A financial statement under the accrual method then states the true picture of the association. The board would know exactly what expenses had been incurred during the month and what income is due the association. Granted, the cash flow of the association may not agree with the net income as either cash has not been received yet or checks have not been written.

The draw backs to the accrual method are that 1) it is more difficult for users to understand, 2) it may require that the books be kept open later so that bills can be received and properly accrued, and 3) it requires a higher level of accounting/bookkeeping knowledge to properly prepare accrual basis financial statements. For that reason many associations prefer to use the modified cash basis during the year and only convert to accrual basis for their year end audit or review.

MODIFIED CASH (ALSO KNOWN AS MODIFIED ACCRUAL)

The modified cash method of accounting is a hybrid between cash and accrual. There is no standard as to what items are modified. It is common for community associations to record income on the accrual method and expenses on the cash method. Thus, there is assessments receivable on the balance sheet but no accounts payable. This method of accounting can be very viable for many associations due to the fact that most expenses are standard. The majority of the expenses occur on a monthly basis and are fairly static. Some examples are utilities, management contract, pool and landscaping. If expenses are paid promptly and if there are any outstanding, unusual type expenses remaining at the end of the month and those are brought to the board's attention, the modified cash method may be considered to be appropriate for many associations.

The Ten Commandments of Internal Control for Your Association

1. Thou shalt not sign blank checks, nor leave blank check stock unsecured.

2. Thou shalt deposit all checks in a timely manner (preferably daily). If a deposit is not made daily, then the undeposited funds should be adequately secured.

3. Thou shalt not accept cash. If absolutely necessary to accept cash, then do so only with 2 witnesses, then generate a receipt for the files.

4. Thou shalt not make checks payable to "Cash".

5. Thou shalt require invoices, or other type of verification of the expense, on all paid bills. That invoice should be "canceled" in some manner after payment to avoid duplicate payment.

6. Thou shall have two board signers on reserve withdrawals. Thou shalt not allow telephone withdrawals of reserve funds.

7. Thou shalt update signature cards in a timely manner whenever there is a change in board members or change in management personnel. The board may want to consider having a board member deliver/mail the signature cards to the bank.

8. Thou shalt require approval of write-offs of A/R balances by a person other than the person making the deposits and reconciling the banks. The board shall approve all write-offs over a certain amount.

9. Thou shalt review all bank statements and reconciliations at least quarterly for ALL bank accounts - including certificates of deposit.

10. Thou shalt receive financial statements at least quarterly (monthly, is even better).

The Ten Commandments of Fiscal Responsibility

1. Thou shalt have an investment policy that is in accordance with the Association’s governing documents and the long term needs of the Association.

2. Thou shalt cause an annual review of insurance requirements including types of insurance and coverage amounts.

3. Thou shalt have a reserve study prepared on a regular basis.

4. Thou shalt have a budget prepared annually. Thou shalt annually prepare tax returns, and determine if a compilation, review or audit by a CPA is needed or wanted.

5. Thou shalt have a collection policy that is followed consistently and is in compliance with the laws of the State.

6. Thou shalt disclose all conflicts of interest.

7. Thou shalt have a signatory policy for all checks.

8. Thou shalt ensure that the independent contractors have the appropriate licenses, insurances, etc., and that they are truly independent contractors and not employees.

9. Thou shalt take the time at each board meeting to review the financial statements and ask questions about any financial transactions that are unclear. The board of directors must take ultimate responsibility for the management of the Association.

An Investment Policy

A Roadmap for Your Association

by Gayle L. Cagianut, CPA

If you were planning a cross-country trip in your car or RV, what would you do? Unless you were really adventuresome and did not care where you go, I think you would map out your trip. You might go online to the Auto Club to get maps and advice on what roads to travel. You would set up your GPS device. You would decide what was your destination and think about how to get there. Some factors may be how many miles you wish to travel in a day, how many days you have to get there, some of your favorite side trips, what time of year it is and the weather in certain areas of the country, how much money you had to spend along the way – to name a few considerations.

Whether it be a cross-country vacation or a weekend excursion, many board members spend more time mapping out their occasional trip than they do in "mapping" out their Association's investment strategy. A decisive road map for investing is vital to the well-being of an Association. Why? For a variety of reasons an investment policy is a MUST. Sometimes well-meaning volunteers will make unsuitable decisions as their personal tolerance for risk or their judgment may not be the same as what is required for Associations. Other, more unscrupulous types may see this as a means to profit from Association funds or a way to "play" with money they never could accumulate. Mostly, however, it is from apathy and lack of effort that association funds are not invested in the best interest of the Association.

The board of directors has a fiduciary duty to properly watch over the investment of Association monies. Due to changes in board members, management companies and other professionals as well as the complexities surrounding legal requirements, it is in the best interest of each and every association to adopt a well thought out investment policy. The revised GAP 24 report published by CAI titled "A Complete Guide to Reserve Funding & Reserve Investment Strategies" gives two sample investment policies. Investment advisors will have other suggestions and samples for boards to consider.

According to GAP 24, the association should address the following topics when formulating an overall investment policy statement:

- General policy
- Goals and objectives
- Investment strategy
- Investment securities' selection criteria
- Review and control procedures

This formal policy statement should be written and adopted for current and futures board's use. Of course, amendments can be made in the future, but only after careful consideration of all ramifications.

Your state may or may not have restrictions on investment of Association cash. Many governing documents do not delineate what investments are suitable for association funds. However, prudence should prevail. The board should consider the association's current and future needs and weigh the risks associated with various investments. The board should carefully review their governing documents, budget, reserve study and most current financial statements. They might discuss their needs with their professionals – manager, insurance agent, reserve study preparer, attorney, investment advisor and accountant.

This article is not written to advise boards as to what investments are proper for their association, but rather to emphasize the importance of committing to writing an investment policy that has been developed with the needs of the Association in mind. Each Association is unique. A written policy is a MUST. It can be a "safety net" for the investment acrobatics of some aggressive board members ("Gee, Sam, we would like to invest in commodity futures but our investment policy does not allow it", or "We would love to have your son control the investment of our funds from his home computer, but…"). It also can be the "spring" to get otherwise reticent board members from taking no action at all ("I know you would like to keep all the funds in 30-day CD's because they are safe, but our investment policy allows investments up to 3 years, including T-bills, when our reserve study shows that funds will not be needed for over 5 years").

Take control of your investments. Map out a strategy, commit it to writing, and move ahead. This, as board members, is your responsibility! Good luck!! You will be happy that you took the time to do so.