NEWMAN
Certified Public Accountant, PC
HOA CPA

Your Association's Financial Statements: Knowing the Basis of Accounting

Homeowners and Boards receive association financial statements at various times during the year. For many, reading and understanding financial reports can be challenging. Understanding the basis of accounting used to prepare financial reports is a vital first step to understanding what you are looking at.

Understanding if revenues are recorded only if earned in the current period, usually a month or a year, or if the revenues include receipts of amounts assessed for a previous or future period; and if expenses presented are for the current period only, or if they are for past or future periods is incredibly important.

What if the financial statements show budgeted assessments of $200,000 for 2020, and actuals for 2020 are $260,000? What does that mean?

What if budgeted expenses for the year total $150,000 but actual is only $100,000? What does that mean?

Understanding your association's basis of accounting is necessary to provide financial statements readers with a foundation of basic and useful knowledge.

You may have heard the term Generally Accepted Accounting Principles (GAAP). The accrual method of accounting is the only GAAP-basis of accounting. The accrual basis is the only basis approved by the accounting standards setters. Other bases of accounting, known as "Other Comprehensive Bases of Accounting", can create more complexity and lack of clarity and useful reporting. So, what are the choices? Some examples:

Pure Cash Basis

Financial statements presented using the pure cash basis only report transactions that affect cash and cash equivalents (money market accounts, certificates of deposit with maturities of 90 days or less). All receipts of cash are presented as increases to cash, and all cash outgoings are presented as cash decreases.

Purchases of certificates of deposits would be recorded as cash disbursements. Acquisitions of property or equipment would be recorded as disbursements when an association pays for the property. The "asset" would not be capitalized to the balance sheet and no depreciation expense would be presented.

If an association has a loan, any proceeds from the loan would be presented as cash receipts. Principal and interest payments should be presented as cash disbursements when they are made.

NEWMAN
Certified Public Accountant, PC
HOA CPA

We recommend that only a statement of cash receipts and disbursements is presented. We do not encourage the use of a balance sheet when reporting using the pure cash basis.

Modified Cash Basis
Use of a modified cash basis is not recommended. There is very little authoritative guidance for the modified cash approach other than requiring that modifications have substantial support.

Modified cash basis financial statements may present balance sheet accounts. Generally, it would be reasonable to record an account if the origination of the balance stemmed from a cash transaction. For example, assessments received in advance could be presented on the balance sheet since cash was actually received.

Modified Accrual Basis
The modified accrual basis is very common for monthly financial statements prepared for common interest realty associations. Assessments and other member charges are recorded when earned/billed which falls under the accrual method. Expenses are typically recorded when disbursements are made (cash basis). Sometimes expenses are also accrued. Modified accrual is a hybrid method requiring the reader to understand what revenue and expense accounts are recorded on the accrual basis and which are recorded on the cash basis.

Full Accrual Basis
The accrual basis of accounting is the most complete and accurate method for recording revenue when earned and expenses when incurred, regardless of when cash is received or paid. Under the accrual basis, associations present a balance sheet that includes accounts receivable (assessments billed but not received) and prepaid assessments (assessments received from owners but not yet billed/earned), loans, deferred revenue, prepaid expenses, accounts payable.

Assessments are recorded when billed to owners, and typically represent budgeted amounts. The aggregate cumulative uncollected balances for all owners are combined and presented on the balance sheet as accounts receivable. As owners' payments are received, accounts receivable balances decrease.

Assessments received from owners before assessments are earned are considered prepaid. Under the accrual method, assessments are recognized as income when earned, typically on the first of each month. If an owner pays their assessments before they are due, the association does not recognize the assessment immediately, thus recording the receipt as prepaid. On the first of the next month, the prepaid assessment would be recognized as income.

NEWMAN
Certified Public Accountant, PC
HOA CPA

Expenses that have been incurred but not paid as of the month or year-end should be accrued. An expense will typically be recorded based on vendor invoices or contracts. On the balance sheet, the aggregate total of all expenses incurred but not paid will be presented as accounts payable or accrued expenses.

When reviewing accrual basis financials, readers should develop an understanding of the relationships between cash balances, accounts receivable and other asset and liability accounts to revenue and expense accounts. If assessments have been billed but owners have not paid, accounts receivable will increase. Depending on the extent of delinquencies, a bad debt provision may be required. Further, the Board of Directors should review the impact of unpaid assessments on cash balances. If delinquencies are significant, Boards may need to review budgeted expenditures and decrease monthly costs in order to retain acceptable cash balances.

Consistency

Which ever basis of accounting is used, accountants, bookkeepers and managers should ensure that the basis is applied consistently.

Initial Questions

Returning to our questions at the beginning of the article, comparing actual results to budgeted amounts is a commonly applied tool to see how an association's operational results compare to plan. Under the cash basis, assessment income might have been originally earned in any accounting period. Maybe the receipt represents a balance an owner owed from two years ago. Should that be presented as current period income? Under the cash basis, it would be. Under the accrual basis it would not.

What if the current financials report expenditures far below budget? That could be caused by various things: under the cash basis invoices may not have been paid or recorded. In the next period, the cumulative unpaid invoices are paid and recorded as an expense, further making comparison to budget challenging.

We encourage Boards, owners and other readers to understand what basis of accounting is used for their association's financials. Without that knowledge it is difficult to fully understand the accuracy and usefulness of the financial statements.

Jeremy Newman, CPA
Owner: Newman Certified Public Accountant PC
www.AOAOCPA.com
www.HOACPA.com
jeremy@hoacpa.com
844-560-7300