Dallas Homeowners League

Brief on Financial Management For Neighborhood Associations

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Financial Management Considerations

Budget Considerations

If you collect dues, spend them productively, you should have a written budget, whether you are strict about observing your budget or regard it only as a guideline or spending plan. In the beginning, you can have the membership vote on all or most expenditures before you adopt a formal budget.

Just because you have a budget doesn't mean you have to have numerous categories. Five or six line items will be enough to reassure any inquiring neighbors about what you're really doing with the money.

Usually when finances become predictable, officers are allowed to make spending decisions for small amounts of money.

A. Bookkeeping

All neighborhood associations encounter a sum of money for one reason or another. A management system needs to be in place for dealing with any funds handled by the association. The best thing to do is to open a bank account for the association.

With so many different types of accounts available, what kind of account should you set up? Research needs to be dedicated to finding out the benefits of certain types of accounts and a decision can be made on an account that will be most beneficial for the group. Check with several banks to get the best deal for the group. Whether you are a corporation or just a designated person, you can open a bank account for the association. If you are a corporation with nonprofit status, you may be eligible to receive a free or reduced fee bank account.

Two things to consider when determining the type of bank account for your neighborhood association are:

- How often will you withdraw money?
- The amount of money your association has to deposit. Do you have enough to keep a minimum balance in your account or pay service fees, if any? Even though many organizations do not have much money, it is important to keep track of whatever money does come into or go out from your organization.

It is a good idea to have an accountant or bookkeeper help you set up a set of books from the start, then the Treasurer or someone who feels comfortable with numbers and figures can take on bookkeeping responsibilities. The sooner the system is set up, the easier it is to keep accurate financial records.

The following are two common systems to help keep your group's records accurate. They provides a record of all money received and where it came from, and all the money paid out and the purpose for which it was utilized.

1) Cash Receipts and Cash Disbursements

Money coming into or out of the organization should be recorded. These transactions are recorded in a format called a journal.

- Cash Receipts Journal
- Record the total amount of money (cash or checks) the day it is received and the source of each amount, i.e., contributions, grants, sale of advertising, etc.
- Cash Disbursement Journal
- Record each disbursement from each bank account. Disbursements made by check should be recorded with the check number, date of check, the payee (who the check is made out to), amount of the check, and the purpose of the disbursement. For savings accounts without preprinted checks, record the date of withdrawal, amount and purpose (use) of the funds. Photocopy the withdrawal slip and file with cash receipts journal to create a record of who withdrew the money.

2) General Ledger

Associations with many different sources of receipts or many different categories for disbursements, particularly those who receive foundation grants that restrict the use of the grant money, may need to set up a General Ledger. The General Ledger is essential for an organization that wants to use the accrual basis of accounting which records amounts owed to the organizations (receivables) and amounts owed by the organization (payables). If you think your association needs a General Ledger or has significant payables or receivables, get help from a trained accountant to set up your system.

Each month, the Treasurer or another designated person should prepare a written financial report. The report should include the results of the month's activities (i.e. from March 1 to March 31). The report should include at least the following information:

- Cash available at the beginning of the month.
- Total receipts during the month (with breakdown by source).
- Total disbursement during the month (with breakdown by type – i.e. postage, supplies, printing).
- Cash available at the end of the month.

Budget Preparation with the Association's Treasurer

Most associations will have their Treasurer or a separate Budget Committee prepare the budget for the board of directors to review and approve prior to it being mailed to all members in accordance with the governing documents or state law. The complexity of the association's budget is generally determined by the size of the association. The larger the association, the more complex the budgeting. When the Treasurer prepares the next fiscal year's budget, the board of directors should consider the following early on:

- Review of all contracts to make sure the association is getting what it wants and is paying the correct price for the services that are being rendered. Boards may want to start the budget process early with regard to contract and pricing review, as the board may consider going out to bid to see what other vendors have to offer. (However, an association should take into consideration all facets when doing this type of bidding, i.e., quality of the workmanship, the established professional relationship, etc.)

- Review of the financial statements (both the income statement as well as the balance sheet) to get a very clear picture of the association's financial position at that moment. This means including a review of the comparative budget for the current fiscal year. Determine where there are excesses and shortages with respect to the current working budget. Adjustments should be made given what is being presented. Also, one must look at the previous year-end to see if the association ended with a positive balance or in a deficit. This, too, should be factored into the figures. If an association is new and does not have a complete year's historic figures to work from, the treasurer and the board should do its best to determine the figures by analyzing the association's known expenses. Having one full year of actual numbers is very valuable since it shows how the association is trending.

- If the association uses utilities, then contact the utilities to see if they can give you an idea of how much their services are anticipated to increase in pricing for the coming year. Calculate this into the working budget.

- Review the most recent reserve study performed. It is important to make sure that an association's reserves are properly funded so that when a reserve component requires the necessary maintenance, there is money on hand to perform the work. Make sure to allocate the monthly reserve expenses as directed by the professional reserve study analyst in its reserve study report. When boards do not fund the reserves in accordance with the reserve study, there is always the strong possibility that members will be specially assessed for a maintenance requirement. A growing number of states now require that associations have on sight reserve study inspections done at regular intervals.

- Upon gathering all the above information, the Treasurer can prepare the budget for the next fiscal year for the board to review. Sometimes, this will mean a raise in the monthly assessments so that the association can operate in a solvent manner. If the board is in agreement, then the board may approve the budget for the next fiscal year and mail it to all the members for their perusal.

Conducting the Budget Meeting

The entire board at a special budget meeting. Note, notice of this meeting must be provided in accordance with any statutory open meeting act and members are typically entitled to attend. If the association is large then a budget committee can be formed to prepare the budget. This committee is approved by the board to provide recommendations to the board. However, if the budget committee consists of a majority of the board, then the same notice requirements are typically necessary as stated in item one above.

Note: The board is the ultimate authority, as the board must approve the budget before it becomes official.

When preparing the association's budget, consider the items discussed above as well as the unique elements of each association. Having current financials, comparative budgets, a current reserve study and a clear understanding of the operations of your association will allow a board to prepare the most accurate budget for the next fiscal year as possible. By reviewing all the above elements, boards will have an understanding of where most of the money is being spent and why.

Budget Preparation Tips

In order to operate a successful neighborhood association there are many important facets of association governance that must be understood and implemented by its board of directors. One of the most important is the budgeting process.

An association's governing documents typically establish the fiscal year-end for the association. Most year-ends occur at the end of a calendar year, but this can vary by association. In associations, a budget is extremely important since it establishes how the association's income will be used to run the association. Note that the only income for associations is from collection of dues which are voluntary.

Budget preparation must be taken very seriously and prepared with a very detailed hand. The following are different variations of budget preparations that an association's board of directors may use when performing this yearly task.

Closing Out Your Year End Financial Statements

The holiday rush is over and the New Year is upon us. It may seem like a good time to settle down and put yourself back into the pace of new activities. While this may be true for most people, accountants and bookkeepers are readying themselves for the final closing of the previous year's financial statements. Their focus is on closing the year end books. What makes this different is that, while individual tax returns are due by April 15, corporation tax returns are due by March 15 (if your fiscal year ends on December 31).

This makes for a very fast paced, hectic 75 days. What is all the fuss about and how much actually takes place in this time-frame? Consider this:

- First, corporations are required shortly after year-end to file 1099's which report specific payments made to specific vendor types (for instance, the association attorney).

- If your association has employees, the year-end means filing quarterly and yearly payroll reports, usually to both federal and state agencies. In addition, association employees receive a W-2 and the association must report employee earnings to the social security administration.

Most neighborhood associations do not have any employees or individuals that require the filing of a 1099.

Once you have prepared the year-end financial statements, the Board and/or accountant should do a final review and analysis of the reports, based on whether the association uses one of these accounting methods:

- **Cash:** has income been recognized when received and expenses recognized when paid?
- **Accrual:** method has income been recognized when earned, and expenses recognized when incurred?
- **Modified accrual:** has income been recognized when earned and expenses recognized when billed?
- When reviewing the financial statements, take into account if the numbers abide by these characteristics:
- **Materiality** means that transactions that have a material affect on the financial position of the association must be reported.
- **Consistency** means that transactions are budgeted and recorded in the same manner from month to month. Proper use of the chart of accounts aids in consistency.
- **Accuracy** means that transactions are computed correctly.
- **Conservatism** means that transactions are neither understated nor overstated.

At a minimum, the association should prepare and the auditors will be looking for these reports:

- Balance sheet
- Statement of revenue and expenses
- Statement of cash flows
- Changes in fund balance

Most association documents require some sort of audit process to be performed at certain specified intervals. The key point for a successful audit is to **BE PREPARED**. Ask the auditors for an initial list of the documents they will want to examine, and ensure that those documents will be readily available. Inform your staff of the audit's purposes and timing, assure them that it's a normal business procedure, and tell them to be relaxed and open with the auditors. Let them know that the auditors are free to interview them and examine documents relevant to the audit purposes. Also advise them that the auditors will minimize use of their time, as much as possible. If the audit is to be done at your premises, as is customary, arrange for an appropriate workspace for the auditors for the estimated audit period.

Audits

Please note that neighborhood associations audits are rare; however, they could happen. The following section provides a brief description of how an association should prepare for an audit.

Audits fall into one of three types:

- **Compilation** does not examine the records or procedures. It merely re-states the information presented by the association into an annual financial report.
- **Review** is an analysis of the association's financial operations. Internal testing is completed that will include policies and procedures that protect and safeguard the association's funds. Comments may include trend analysis, budget variances, and reserve analysis.
- **Audit** is a comprehensive examination of the association's financial operations. There are internal and external tests conducted that provide some assurances of the association's financial operations. An audit will result in a written opinion regarding the association's financial operations.

Your accountant and/or auditor will generally be the one to prepare the association's Federal Income Tax Returns (and state income tax return, if applicable). A few common statements about association income tax returns:

- All organizations are taxable on their income unless specifically exempted.
- All associations must file a Federal tax return every year.
- Federal tax returns are due 75 days after the end of the association's fiscal year (for instance if the association's fiscal year end is June 30, the federal tax returns would be due September 15.

The association can file as a regular corporation IRS Form 1120 or as a homeowners association IRS Form 1120H. Both forms are available online at www.irs.gov.

- Your tax accountant will be able to determine which method is best for the association.
- If your association has significant non-owner income, it may be advantageous to research ways to reduce potential income tax liability.

As you can see, year-end financial statements require a little more work and a short window of time to complete all the activities. Preparation for these steps should begin in late fall by contacting your accountant and working with your accounting staff to be ready.

If You Must Have An Audit

If you have been involved in community association management for any length of time, you have probably encountered a community that needs an audit. Audits can make people nervous. We all fear the dreaded "IRS audit", and no one likes the prospect of someone else looking over their shoulder! Yet audits are beneficial in many ways, and one of the biggest negatives, the expense, can be mitigated with a little planning.

- **Why an audit?** Your association may be required to have an audit, either through the governing documents or by state statute. Even if there is no specific requirement, it is good business practice for most any association to undergo a periodic examination of its financial position and related documentation and procedures - whether annually or every two or three years.

- **What is an audit anyway?** An audit is a verification of the accuracy of an entity's reported financial activity through an examination of its financial records, policies and procedures. An audit is performed by an independent Certified Public Accountant, who, in a clean opinion, will provide assurance that the stated financial position of the entity is free from any material misstatement and that the results of operations are fairly stated.

- **How much does an audit cost?** They're not cheap. A public accounting firm may charge anywhere from one hundred dollars per hour up to three or four hundred dollars per hour, depending on the number and qualifications of the persons involved.. Many factors affect the expense of an audit, and these are but a few of the questions to consider:

- **Are the records organized and easily understandable?** Time is money for an auditor. Extra time spent organizing an association's records into an understandable format will ultimately cost the association more money in audit fees, if not the first year, then certainly in successive years. One of the biggest variables in the cost of an audit is the organization, quality and format of the record-keeping.

- **Has the entity been audited annually every year?** If an auditor is examining an association for the first time, he will have to spend some amount of time gaining an understanding of the association's policies and procedures, its processes for recording and reporting accounting transactions, and its system of internal controls. The auditor will take this fact into account in his proposal for a first year audit. In successive years, the auditor will have many of these facts documented, and can evaluate those facets of the association much more quickly.

- **Has the association's audit committee expressed concern over a specific area?** Emphasis on specific areas that would not ordinarily need additional testing will require more of an auditor's time. Take caution, though, because this is not an area to try to save money. Any concerns by a member of the board or audit committee should be relayed to the auditor at the beginning of his examination. An audit is not designed to definitively assure that an association is free from any fraudulent activity or other malfeasance. Such events do occur, though, and an auditor can best serve an association by having all the information he needs to conduct his evaluation.

- **Does the association have a large number of transactions?** Among many other tests, the auditor will examine the entire billing and collection process on a select number of customer invoices (e.g., assessments, utility billing) and also the vendor payment process. Obviously, larger associations will have more of everything - owners, vendors, and consequently, more transactions. That means more transactions to test and more of the auditor's time. Does the association have several balance sheet accounts that will require testing? In addition to the balance of all outstanding loans to the association, the auditor will confirm through independent sources the balance of all cash and investment accounts. The more accounts there are, the more time an auditor will need.

- **Does the association have any employees, and are they paid through a payroll service?** Many associations do not have employees, but for those that do, auditors are generally familiar with the common payroll services and their reporting formats. Payroll that is processed "in-house" may require more extensive testing.

- **Is there some guideline for how much to pay for an audit?** Because there are so many variables that affect the price of an audit, there is no general rule of thumb on audit pricing. The audit committee should get at least two or three bids, and if they are not all comparable, then each firm should be questioned about how they arrived at their bid. You may also compare your bids to the audit expense for other associations of similar size and composition - but remember that many variables exist even in similar sized associations that can affect the audit price.

Even though audits can be expensive, they are still a valuable tool in the financial management of an association. With a little careful planning though, you can directly impact the cost of that audit. And one final tip: at the conclusion of an audit, be sure to ask the auditor what you could do better to reduce their time next year. They'll be happy to share that information - it makes their job easier!

The Case for Reserves: A Cautionary Tale

How often do you hear the question why do we need reserves? After all, this association is only a few years old?

If the Association is responsible for common areas in the neighborhood, then vandalism, maintenance, etc. may result in unexpected expenses. Having a cash reserve permits the association to fund the repair without depleting yearly revenue.

Understanding Financial Statements

As a board member, you are responsible for reviewing the association financial statements on a regular basis. In addition, you should ask if there are adequate internal control measures in place to assure that you and your fellow board members have sound financial safeguards in place. By definition, internal control is broad in nature.

However, to protect the association, some basic accounting controls need to be implemented so that board and association members can rely on the accuracy of financial records. These control measures are designed to provide a reasonable assurance that financial transactions are executed with management's general authorization.

A. Internal Controls Checklist

This checklist provides simple measures that you as a Board member can take to assure the integrity of the accounting practices and procedures of your homeowner association. The answer to each question should be "Yes."

1) Cash and Bank Accounts

- Are bank reconciliations reviewed by the Board?
- Is the bank statement reviewed with the bank reconciliation?
- Are outstanding checks dated over 90 days reviewed and action taken?
- Are cash deposits in FDIC insured accounts?
- Are the bank account signature cards current?
- Is the total cash balance in any one financial institution over $100,000?
- Are bank accounts (operating and reserve) in the name of the association?
- Is the management company who handles the cash bonded?

2) Cash Disbursements

- Are vendor invoices paid timely to avoid late fees/penalties?
- Do reserve transfers between accounts require two signatures?
- Are checks pre-numbered and accounted for in sequence?
- Are vendor invoices reviewed and approved for payment?
- Are vendor payments posted to the proper general ledger account?
- Are W-9s on file for vendors and independent contractors?
- Are 1099's issued by January 31 each year for applicable vendors who are paid more than $600?

3) Accounts Receivable

- Are bad debt write-offs approved by the board?
- Is there a written, approved collection/delinquency policy in place? If so, is the policy followed?
- Are late charges being levied on past due balances?
- Is the Accounts Receivable aging reviewed each month?

- Are past due balances vigorously pursued by collection agency, attorney, other legal action?
- Are liens and lien releases filed on a timely basis?
- Are cash deposits made on a timely basis and safeguarded until the time of deposit?
- Are adjustments to member accounts made with executive approval?
- Are assessments being properly charged in compliance with the governing documents and budget?

4) Financial Statement

- Do the board members and/or Treasurer review the financial statements each month?
- Are reserve balances compared to reserve study? Is there a supplemental report for reserve contributions and expenditures?
- Is there an income statement to budget comparison report?
- Are variances noted on the financial reports?
- Are the financial statements prepared promptly?
- Is the general ledger chart of accounts adequate for tracking association transactions?

5) Accounting Administration

- Is there an accounting manual that details control measures?
- Is the reserve study updated on a periodic basis?
- Are there accurate minutes of board meetings where financial decisions are approved?
- Is the budget prepared and approved by the board each year?
- Is the budget approval process in compliance with the governing documents?
- Are the records in good order and easy to access?
- Does the records retention follow approved IRS guidelines and practices?
- Does the association contract for an audit on a periodic basis and/or in compliance with the governing documents?

B. Understanding the Balance Sheet

When you receive a set of financial statements, are you able to look at them and gain an understanding of the association's financial position? Or do you, like many people, only look at a few important figures, such as what the association has in cash, investments and replacement reserves, or if the association has net income for the year.

A set of financial statements can provide valuable information if you are knowledgeable about what you are looking for. This will be the first in a series of articles related to financial statements. In the coming months, Association Times will review the income statement, general ledger, and other pertinent reports.

The balance sheet is a picture of the association, reflecting its financial position at a specific point in time. The balance sheet is categorized into three areas: Assets, Liabilities, and Members Equity. The three are always in balance, thus the equation: Assets = Liabilities + Members' Equity (see below).

Assets, such as cash, accounts receivable, property/equipment, and prepaid expenses are items that the association owns.

A **liability** is an amount the association owes to others, such as vendors, or perhaps even a banking institution for a loan. Liabilities usually include association reserves that are supported by a reserve study.

Member's equity is the association's net worth. Basically, it's what the association owns less what it owes. Member equity is usually divided into Prior Year and Current Year.

The balance sheet provides a cumulative, complete picture of the association. The current year's equity reflected on the balance sheet is the net income or loss being added or subtracted for the year's operations.

What is the value of the balance sheet? How can these figures provide meaningful information? Here are some common ratios that can be applied, using the sample balance sheet below.

Current ratio is a measure of the short-term liquidity of the association. It is measured by:

Current ratio = current assets / current liabilities
= $436,500 / $4,000 = 109 times

We can say that this association has current liabilities covered 109 times over. Long Term solvency can be measured with the total debt ratio, which addresses the association's long-run ability to meet is obligations.

Total debt ratio = total assets total equity / total assets
= $456,500 - $59,500 / $456,500 = .87 times

What this means is that for every $1 in assets, the association has $.87 obligated to liabilities, which would be the case since most of the cash is allocated to long-term reserves.

The basic concept to remember about the balance sheet is that it provides the basis for evaluating assets versus liabilities and members' equity - - - much the same way an individual would list their personal assets owned versus the liabilities that are attached to those assets.

Example of a Typical Balance Sheet

Consolidated Balance Sheet December 31, 2002

Assets		
Current Assets	**12/31/02**	**12/31/01**
Cash	$423,000	$398,000
Accts Receivable	$12,500	$15,500
Prepaid exp	$1,000	$500
Total Current Assets	$436,500	$414,000
Long Term Assets		
Prop/Equip	$25,000	$15,000
Accum Depreciation	($5,000	($3,000)
Total Long Term Assets	$20,000	$12,000
Total Assets	$456,500	$426,000
Liabilities		
Current Liabilities		
Accts Payable	$4,000	$6,000
Total Current Liabilities	$4,000	$6,000
Long-Term Liabilities		
Long Term Reserves	$393,000	$354,000
Total Long-Term Liabilities	$393,000	$354,000
Total Liabilities	$397,000	$360,000
Members' Equity		
Prior Yrs Equity	$54,000	$52,500
Current Yr Equity	$5,500	$1,500
Total Member Equity	$59,500	$54,000
Total Liabilities and Members' Equity	$456,500	$414,000