CALIFORNIA ASSOCIATION
OF
HOMEOWNERS ASSOCIATIONS
INCORPORATED

ACCOUNTING

Basic Accounting Concepts for Townhome, Condominium and Other Common Interest Developments

The fair and accurate reporting of the financial status and activities of the Homeowners association is the basis for accounting theory and practice. With the increasing size and complexity of Homeowners Associations in California and the increasing economic role of government, the responsibility placed on the Association's Treasurer and accountants for presenting fairly the results of the association's business operations is greater today than ever before. Therefore, financial statements and other reports prepared by the treasurer or accountants are vital to the successful working of the association.

The basic assumptions which underlie current accounting practice have evolved over the years in response to the needs of various users of the financial reports. Certain organizations, governmental agencies, and legislative acts have been extremely influential in shaping the development of the existing body of accounting theory.

The AICPA., The American Institute of Certified Public Accountants is the professional organization of the practicing Certified Public Accountant (CPA). As a professional organization, the Institute has been vitally concerned with developing standards of practice, both ethical and professional, of its members. The "Journal of Accountancy" has been published monthly since 1905 as a forum for practicing CPA's. Beginning in the early 1930s the Institute, in concert with the newly created Securities and Exchange Commission, began to develop standards of sound financial reporting. During the 20 years from 1939 to 1959 the Institute published 51 *Accounting Research Bulletins* dealing with a wide variety of timely accounting problems.

In 1959 the Institute took the formal step of committing itself to a more comprehensive program of research into the problems of financial reporting. The Accounting Principles Board was formed with the responsibility of formulating and promulgating accounting principles related to financial reporting based on underlying research. The result has been the adoption of accounting procedures which purportedly conform to the basic principles of accounting and which minimize taxable income.

I. RECORDING FINANCIAL TRANSACTIONS

Accounting has frequently been called the "language of business." This designation is applied to accounting because it is the method of communicating business information. Like other languages, it is undergoing continuous change in an attempt to discover better means of communicating.

The AICPA has defined accounting as follows: “the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof..”(AICPA Committee on Terminology, Accounting Terminology Bulletin No. 1, Review and Resume, p. 9).

The three steps of recording, classifying, and summarizing form the basic process by which accounting data are created. These procedures are carried out in accordance with a set of rules and conventions which have been developed over time. A thorough knowledge of the rules and standards is necessary for a complete understanding of the data and the manner in which they are accumulated.

The ultimate objective of accounting is the use of these data, through analysis and interpretation, as a basis for business decisions. Data derived from accounting records serve management in controlling current operations and planning future operations. Published financial statements afford homeowners and outsiders a means of analyzing and interpreting past operations of the association in which they have an interest. Accounting statements are for the most part reports of past events. The past however, is often the key to the future and for this reason accounting information is highly valued by decision makers both inside and outside the association.

Financial reports should be easy to read. They should set forth the financial information in a clear, precise and informative manner. It is not necessary and often confusing to provide the same information in several different formats. Perhaps the financial analysis information would be better understood if limited to a single format selected by the Board. The financial information given to Community Associations should take into consideration that some homeowners or board members may not be familiar with accounting or financial reporting and therefore, some information may be provided in such a manner that it can be easily understood. Simplified reports, however, should not replace formal reports as recommended by the American Institute of Certified Public Accountants.

II. THE ACCOUNTING CYCLE

The accounting cycle is a complete sequence of accounting procedures which are repeated in the same order during each accounting period. The cycle includes:

1. Recording transactions in the books of the association as journal entries
2. Classifying data by posting he Journals to the ledger
3. Summarizing data from the ledger on a trial balance
4. Adjusting and correcting recorded data after due consideration of all pertinent facts
5. Summarizing adjusted data in the form of financial statements
6. Closing the books to summarize the activities of the period
7. Reversing certain adjustments to facilitate the recording process subsequent periods

When these steps are completed, the cycle begins again for the next period.

III. THE ACCOUNTING PERIOD

The normal accounting period for Homeowner Associations is one year, beginning on any given day and ending 12 months later. A calendar year accounting period ends on December 31; all other 12-month accounting periods are known as fiscal years. Associations frequently adopt accounting periods as set by the developer.

IV. DOUBLE-ENTRY SYSTEM

The most common system of accumulating data for an enterprise is the *double-entry* system. As the name implies, the entry made for each transaction is composed of two parts, a **debit and a credit.** The system is based on the theory that the resources used to acquire the assets must be provided by other entities or persons. This situation is usually expressed in terms of the equation, assets equal liabilities plus owners' equity All accounting entries are made within the framework of this equation, and each transaction must, therefore, be analyzed in terms of the elements of this equation.

Double-entry bookkeeping is a universal concept; it takes its name from the fact that equal debit and credit entries are made for every transaction. The terms *debit* and *credit* can be related to the equation $A = L + OE$.

V. CASH BASIS OF ACCOUNTING

Under the cash basis of accounting, revenue is recognized when cash is received; expenses are recorded when they are paid in cash. The determination of income thus rests upon the collection of revenues and the payment of expenses, rather than upon the earning revenues and the incurring of expenses.

A strict cash basis of accounting is seldom found in practice, but a modified cash basis (really a mixed cash-accrual basis) is allowed for income tax purposes. Nearly all individual taxpayers prepare their returns on this modified cash basis. Also many physicians, law firms, other professional firms, and small service-type businesses rely on a modified cash basis of accounting.

VI. ACCRUAL BASIS OF ACCOUNTING

Revenue is recognized when it is realized and expenses are recognized when incurred, without regard to time of receipt or payment. The focus of accrual accounting is on the realization of revenue, the incurrence of costs, and the matching of revenue realized and the cost expired. Adopting the assumption that revenue is recognized when realization occurs and the corollary assumption that costs contributing to the earning of this revenue can be traced through the earning process requires the use of an accrual-deferral system of accounting.

The need for frequent and current appraisals of the past performance of the enterprise as the basis for decisions about the future by management and investors alike has forced the accountant to progress from cash basis to accrual accounting. The financial statements resulting from accrual accounting are less precise than cash flow statements but are at the same time more complex and more useful. The accrual basis of accounting is essentially a process of recording cash inflows and outflows of all four types.

Under the accrual system, the account are adjusted periodically to make the data which have been recorded consistent with the basic assumptions of the system.. The accountant reviews the accounts periodically, usually annually, to ascertain whether all revenue realized has been recognized in the accounts, whether the costs incurred in current and prior periods have been allocated properly, whether any revenue has been recognized that has not met the test of realization, and whether any costs have been incurred but not recorded. In reality, the accountant is adjusting the cash flows for leads and lags which have occurred during the year.

VII. THE INCOME STATEMENT: A REPORT ON OPERATING PERFORMANCE

A good income statement is something more than an itemized list of revenues and expenses. The accountant should give some thought to such issues as the system of classification, the amount of detail that is useful, the order of presentation, the relation between the elements of net income, and the titles used to describe the items appearing on an income statement.

To management a report of net income for the enterprise may not be as significant as statements showing income by products, departments, or divisions of responsibility. Managers are obviously interested in detailed accounting and statistical data that throw light on the contribution of the various elements of a business to its overall efficiency and success. Such information might also be of great interest to outsiders, but because management is unwilling to reveal operating details to competitors, the information appearing in published income statements is usually highly condensed.

VIII. CLASSIFICATION OF REVENUES

For most Homeowners Associations the major source revenue is association dues. Examples of secondary sources of revenue are laundry equipment, use of clubhouse, golf course etc. One objective in reporting revenues on an income statement is to disclose the major sources of revenue and to separate primary from ancillary sources.

Revenue offsets should be clearly distinguished from expenses and deducted from gross revenues in the revenue section of the income statement . Such items as late fee or fine reductions do not represent expenses but rather revenues that are never in fact realized.

IX. CLASSIFICATION OF EXPENSES

Expenses are classified in income statements to help the reader grasp important operating cost relationships. Classification may be according to the nature of the expense elements, business functions, areas of responsibility, or any other useful basis.

X. THE BALANCE SHEET: A REPORT ON FINANCIAL POSITION

The Balance Sheet reports the financial position of the association by disclosing the amount of cash the association has in the bank, cash in savings or other investments, the amount of dues uncollected and other receivables. The Balance Sheet reports the association's liabilities or other financial obligations and sets forth the association's allocation of reserves.

XI. DISCLOSURE

The accounting assumption of disclosure has been described as follows, "Accounting reports" should disclose that which is necessary to make them not misleading. (Maurice Moonitz, "The Basic Postulates of Accounting," Accounting *Research Study No. 1,* AICPA (New York: 1961) This statement is deliberately broad, but it points squarely to the objective of adequate disclosure of all material known facts which will aid an informed reader of financial statements in interpreting accounting results. Published accounting reports include not only the financial statements (Balance sheet and Income statement) but should include all the necessary supporting information to convince the reader of it's accuracy. Accounting reports should include a schedule of all checks issued during the month, a schedule of all monies received and the source form which received. A list of all homeowners and the amount each paid during the month including check number date of check and amount. The financial report should include a schedule or list of all homeowners that are not current in the payment of their dues and the total amount of each delinquent homeowner. The report should include supporting reconciled bank statements and balances of accounts in each bank. And finally the report should include a list of all journal entries made during the month. Indeed at the end of a fiscal period, a homeowner should be able to take all twelve reports and set them side by side and track the finances of the association for the entire year.

XII. PLANNING CASH ACTIVITIES

The administration of cash is of major importance in any business because cash is the means of commanding goods and services. In addition, careful scrutiny of cash transactions is required because this asset may be readily misappropriated.

The administration of cash generally is centered around two areas: cash budgeting and accounting control. The responsibility of the Treasurer and management with respect to cash is (1) to ensure that there is sufficient cash to carry on the daily operations, (2) to invest any idle cash which is not needed for current operations, and (3) to prevent loss of cash due to theft or misappropriation. Cash budgeting is necessary for the proper planning of future operations and to assure that cash is available at the right times but that cash balances are not excessive. Accounting safeguards are necessary to provide a basis for the planning function, and in addition to assure that the cash is used for proper business purposes and not wasted, misused, or stolen. The Treasurer is responsible for controlling and protecting all assets of a the association. He faces special problems in controlling cash, however, because money is universally attractive and can be easily misappropriated.

XIII. THE CASH BUDGET

The cash budget is a forecast of cash transactions for a stated time period It is a statement of estimated cash receipts and disbursements. The cash budget is neither a pro forma operating statement nor a forecast of financial results. Rather it is a prediction of the cash flow through the association based on analysis of past operations and study of future requirements of the association. This prediction is necessary to enable the Board of directors and management to plan the financial affairs of the association, an area of decision making equally as important as the planning of maintenance and repairs.

The time covered by a cash budget is largely determined by the pattern of operations. An association which demonstrates an erratic management pattern presents special problems for the forecaster, and a very short range forecast may be all that is feasible and useful. On the other hand, a useful cash forecast can be made for several months in the future for an association which demonstrates a regular pattern of activity. Normally cash budgets are prepared for each month of the budget period; however, if large inflows or outflows of cash occur at particular times during a month, the interval may be changed to reflect these special situations. The manager needs information about the extremes of the cash position; these extreme points do not always occur at the end of the month.

There are two types of cash budgets: (1) the short-term or operating budget, which usually encompasses a year or a shorter time period, an (2) the long-term or policy budget, which usually covers several years. The short-term budget is used in planning daily operations and serves as the guide for daily operations.

XIV. CONTROLLING CASH TRANSACTIONS

1. Internal Control

The purpose of a system of internal control is to assure that assets which belong to the association are received when tendered, are protected while in the custody of the business, and are used only for business purposes. The system of internal control consists of all measures employed by a business for purposes of (1) safeguarding its resources against waste, fraud, and inefficiency; (2) promoting accuracy and reliability in records kept; (3) encouraging and measuring compliance with association policy; and (4) judging the efficiency of operations. Internal controls are not designed primarily to detect errors but rather to reduce the opportunity for errors or dishonesty to occur. **(This definition of internal control was adapted from Walter B. Meigs, Principles of Auditing, 3rd ed., Richard D. Irwin, Inc. (Homewood, Ill.: 1964), p. 77.)**

Implicit in all control systems of internal control is the concept that no one person should handle all phases of a given transaction from beginning to end. For example, if one person were permitted to order supplies or enter into contracts, receive the supplies or monitor the performance of the contract, write a check in payment of the goods and services and record the transaction in the official records of the association, there would be no protection against either fraud or accidental errors. In all Homeowner Associations separate and independent persons or agencies should be established for such functions as purchasing, receiving, finance, and accounting, which assures that no one person handles all phases of a transaction.

In many associations the system of internal control is improved by physical safeguards. Computers and other business machines help to improve the efficiency and accuracy of the record keeping function. Purchase orders approved by the Board and signed by the Treasure pre-numbered checks and other business forms are also very helpful in safeguarding the asset and establishing responsibility for it. The system, regardless of the plan, must be supervised with care if it is to function effectively.

2. Controlling Cash Receipts and Disbursements

The objective sought in the control of cash receipts is to ensure that all cash due to the association is collected and recorded without loss or diminution. The system of controlling cash disbursements should be designed to ensure that no unauthorized payments are made. Control is accomplished by division of responsibility so as to achieve independent verification of the cash transactions without duplication of effort. Cash is safeguarded by depositing it in banks and through the use of petty cash funds, which locate responsibility for relatively small sums of cash in a single person.

3. Imprest cash funds (petty cash)

The term imprest cash refers to a fund of fixed amount used for making small expenditures that are most conveniently paid in cash. The imprest fund is restored to its original amount at frequent intervals by writing a check on the general bank account payable to Petty Cash. The replenishment check is equal in amount to the expenditures made from the fund. Imprest cash funds placed in the custody of the treasurer or other responsible homeowners thus serve to maintain control over cash without burdening the Board with involved procedures for small disbursements.

The size of the fund should be sufficient to meet the normal need for small cash payments for a period of two or three weeks. As each cash payment is made, a voucher or receipt is placed in the fund in lieu of the cash removed. These vouchers are reviewed and canceled when the fund is replenished.

4. Reconciliation of Bank Balances

The cash balance as indicated on the associations balance sheet and the balance shown on the bank statement will seldom agree. Because of financial transactions that have not been received by the bank such as checks issued or deposits not yet recorded by the bank (in Transit) the bank will show a different balance than the association. For this reason it is essential for the association to reconcile their bank statements each month.

5. Reconciliation of Receipts and Disbursements

Cash balances per bank statements and the company’s ledger are reconciled in order to establish the accuracy of the records. In some cases accountants find reconciliations of cash receipts and disbursements (the bases of the balances) to be useful in establishing the accuracy of the balances.

6. Collection of Accounts Previously Written off

When the decision is made to charge off an uncollectible account, the charge against the Allowance account and credit to Accounts Receivable has no effect on either the book value of accounts receivable or on the net income of the period in which the write-off occurs. If an account that has been written off is late collected, a common procedure is to debit Accounts Receivable and credit Allowance for Uncollectible Accounts. This reverses the entry, erroneously made, and the collection is then recorded in the usual manner.

There is no objection to this procedure if the only error was in writing off an account prematurely or if the amounts are small. The collection of a large amount previously considered uncollectible, however, may indicate a need to review receivable more closely before they are written off.