

# **The Keys to Unlocking the Mysteries of Your Monthly Financial Statements**



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**Presented by:**

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How much time do you spend on the treasurer's report? Honestly??? In a nationwide poll that I did several 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 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) and your annual budget is \$X (you fill in the blank), and you spend only a couple of minutes on the financial statements???

As volunteers, many of you 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.

Really, it is not that difficult! Tonight we are going to go slowly through the financial statements. We will use a couple of sets of reports that were actually issued by Morris Management. We only have a couple of rules:

- Do not be afraid to ask any question.
- Do not let me proceed if you do not understand what I just said.

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 fiduciary duty!

Let's start....

# *Cash, Modified Cash and Accrual Methods of Accounting*

I'm sorry, but before we begin, we have to come to an understanding about a few accounting terms. They aren't as difficult as they seem at first glance!

## **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**

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.

## **MORRIS’ FINANCIAL STATEMENTS**

Morris’ financial statements are prepared on the modified cash basis of accounting. In the financial statements that we will be using tonight, income is on the accrual basis and expenses are on the cash basis (generally).

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

There are two statements that are issued on a monthly basis by your management company, 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):

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Or

$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

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 two types of equity/fund balances in an association:

- Operating
- Replacement

Okay...now you know the terminology, it is time to put your knowledge to the test. We will look at some actual financial statements.

## 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? How many months of operating cash does your board feel comfortable with having on hand? (Note: CAI Guidelines recommend ½ to 2 months of operating expenses. We recommend 1-3 months).
- 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?

#### ***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!)
- 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 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?
- 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?

#### ***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) 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?
- 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?

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.