

Maintaining Association Accounts

Healthy finances are critical to the sound operation of a community association. And the association treasurer is responsible for maintaining the finances and ensuring financial growth.

Association documents establish the treasurer's authority in maintaining these accounts and bylaws outline the treasurer's responsibilities. Following is an example of bylaws that discuss what the treasurer is required to do:

The treasurer shall have the responsibility for association funds and shall be responsible for keeping and maintaining a complete set of financial and accounting records. He or she shall be responsible for the deposit of all monies in the name of the association in such depositories as designated by the board of directors, and he or she shall, in general, perform all the duties incident to the office of treasurer of a condominium organized under the laws of the state of _____ . He or she shall cause an annual audit of the association's books to be made by a certified public accountant at the completion of each fiscal year, and the treasurer shall prepare an annual budget. He or she shall receive no compensation for his or her duties as treasurer.

In addition to the responsibilities outlined above, the association's documents and bylaws specify a number of other financial requirements that the treasurer must oversee, including:

- Insurance
- Financial record keeping
- Investment of funds
- Assessment collection and collection of delinquent accounts
- Replacement reserve program
- Timely filing of all income tax returns

Understanding the Basic Financial Statements

The treasurer is responsible for maintaining the association's financial records. Therefore, the treasurer must understand the basic components of the financial statements.

The Balance Sheet

The balance sheet reflects the association's financial position at a point in time. The balance sheet is divided into three major categories: assets, liabilities, and members' equity. It is called a balance sheet because it is based on a balancing equation: assets equal liabilities plus members' equity. For example:

$$\text{assets} = \text{liabilities} + \text{members' equity}$$

Assets

Assets represent what the association owns. Common asset categories include: cash (operating and savings) investments, assessments receivable (unit owner delinquent balances), prepaid insurance, and fixed assets (property and equipment less accumulated depreciation). Other assets—such as utility company deposits, other types of accounts receivable, and other prepaid expenses—appear occasionally.

Liabilities

Liabilities represent what the association owes to others. Common liability categories include: accounts payable (unpaid balances to vendors), mortgage payable (mortgage on a common interest realty association (CIRA) owned unit), note payable (borrowing from a bank to finance a major repair project), and prepaid assessments (unit owner balances paid in advance).

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Members' Equity

Members' equity represents the association's net worth at a point in time: assets (what the association owns) minus liabilities (what the association owes to others) equal members' equity (its net worth). Members' equity is generally divided into two categories:

1. **Replacement reserves** represent what the association has set aside as a fund for the periodic replacement of major assets of the property.
2. **Operating fund balance** represents the operating funds that the association has accumulated over its lifetime.

While replacement reserves and the operating fund are two major components of members' equity, the association might periodically use other categories. They are as follows:

■ **Initial working capital** represents funds collected at settlement from first buyers into a community. Usually the equivalent of two months assessments is collected, although one or three months assessments or a set amount are collected occasionally. Working capital funds provide operating capital during the association's initial stages. The fund is generally used for unusual, one-time expenditures. What remains in the fund after the initial stage is

eventually transferred to the association's replacement reserve fund.

■ **Special project funds** pay for projects that are not accounted for in the replacement reserves. A special project may be a construction project, such as a shed or a recreation facility (tennis court or swimming pool), a landscaping program, or a lobby redecoration.

■ **Income statement** reflects the actual financial activity of the association during the year. The income statement summarizes income and expense categories and shows profit and loss for the year.

■ **Statement of members' equity** reflects the changes during the year in the association's equity accounts.

■ **Statement of cash flows** reflects where the association raises its cash funds. For the most part, cash is derived from members' assessments. However, if cash is derived from a bank loan or a sale of an asset, it is reflected in this statement.

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Cash Versus Accrual Accounting

Cash-basis accounting is the recognition of accounting transactions when cash is either received or paid out. Cash basis is most appropriate for small, stable associations with relatively few transactions. The drawbacks to cash accounting include the following:

- Limited accounting information
- A shortened and limited-use balance sheet
- An inability to highlight a weakened financial position

Accrual accounting is the recognition of accounting transactions when they actually take place. Revenue is recognized when earned and expenses are recognized when incurred, not necessarily when cash is received or when cash is paid out. Where cash accounting is weak, accrual accounting is strong. Accrual accounting provides:

- More detailed and in-depth accounting information
- A detailed balance sheet
- The ability to highlight a weakened financial position

The following is a list of major accrual accounts:

- Assessments receivable
- Other accounts receivable
- Prepaid insurance
- Mortgages and notes payable
- Accounts payable
- Accrued expenses
- Prepaid assessments

Community associations rarely use a full accrual system. Modified-accrual systems are implemented more frequently. Only the major balance sheet accounts, such as assessments receivable and accounts payable, are established under the modified-accrual system. Expenses such as prepaid insurance and all minor payables and accrued expenses are not set up. A modified-accrual system generally provides reasonable financial information to the treasurer and the board without the major cost and time commitment

associated with full accrual accounting. The treasurer must ensure that the association's accounting system is set up accurately and is followed consistently, no matter which method is used.

Interpreting Accounting Information Provided by the Management Company

The professional management company should give the treasurer a package of financial material for analysis at least one week before the monthly board meeting. The financial package should include the following items:

- Balance sheet
- Statement of income
- Cash receipts and cash disbursements activity
- Unit owner balances (delinquents and unpaids)
- General ledger activity and journal entries
- Schedule of accounts payable
- Bank statements and bank reconciliations

The Treasurer as an Accountant to the Community

In smaller, self-managed communities, the treasurer's function generally is broadened to include bookkeeping. The treasurer should provide a financial statement to the board a few days before the monthly meeting and should give a presentation of the association's financial status at the meeting. The treasurer summarizes basic financial information for the board. It might be helpful to use ratios, pie charts, and other statistics to highlight important financial matters. (See Appendix 2, page 24.) Five-year trends for cash, delinquencies, payables, and reserves are always helpful. Two commonly used ratios are cash to liabilities and cash and delinquencies to liabilities.

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The Treasurer as an Internal Auditor to the Community

The treasurer's responsibilities include making sure that association assets are secure. To ensure that appropriate internal controls are in effect, the treasurer should evaluate certain questions. (See Figure 1, page 7.)

Misappropriation of funds or embezzlement is the misuse or diversion of association assets from their intended use or purpose. Segregation of duties and responsibilities, inventories and tagging of equipment, and requiring dual signatures on checks are some important internal control procedures that help prevent the misuse of association funds. Following are some examples of misappropriations that could take place at an association or its management company:

- **Cash taken directly out of the association bank account.** After collecting a large assessment for a special project, the association finds that the project is delayed. The management company writes checks to itself out of the special project fund. The differences are carried as deposits in transit on the bank reconciliation.

FIGURE 1: Sample Checklist

Ensure the Security of Association Assets

Ask the following questions to ascertain the security of association assets.

- Are the general ledger and subsidiary ledgers balanced and posted monthly?
- Does the management company maintain adequate bonding on employees?
- Does the association maintain its own fidelity bond covering the board, employees and the management agent, including principals.
- Are essential accounting records adequately safe-guarded from destruction or loss by fire?
- Are all checks numbered and accounted for?
- Are all checks manually signed?
- Are invoices and supporting documentation examined by the check signer prior to signature?
- Are checks mailed by someone other than the preparer?
- Is supporting documentation defaced to prevent reuse?
- Are voided checks retained and defaced?
- Do bank reconciliation procedures include the following:
 - Inspection of checks for signatures?
 - Inspection of checks for endorsements?
 - Examination of checks for number, payee, date, and amount?
- Are bank reconciliations prepared promptly at the end of each month?
- If there is a payroll, is a separate payroll bank account used and is it maintained on an imprest basis?
- Are each day's receipts deposited intact and without delay?
- Are banks notified immediately when an authorized check signer leaves the association or resigns from the board?
- Are all investments registered in the association's name?
- Are assessment revenues adequately controlled so that their non-receipt would be noted and investigated?
- Is the practice of drawing checks to cash prohibited?
- Is the practice of using cashiers prohibited or limited?
- Are petty cash funds:
 - Kept in a safe place?
 - Reasonable in amount?
 - Controlled by one person?
 - Maintained on an imprest basis?
 - Counted periodically by someone other than the person who controls the fund?
- Are the investments maintained in a safe place?
- Are owner balances aged?
- Are write-offs of owner balances approved by the board of directors?
- Is an inventory of property assets maintained and are the assets identified by a metal tag?
- Are vendor invoices checked regarding quantities, prices, clerical accuracy, and duplication?
- Is a purchase order system used?
- Are major contracts obtained through a bidding process using a prequalified list of contractors?
- Does the board of directors authorize all replacement reserve transactions?
- Are appropriate payroll records maintained that include:
 - Detailed individual employee records?
 - Adequate time records?
 - Proper approval of pay rates and pay rate changes?
 - Proper authorization for payroll deductions?
- Is insurance coverage reviewed annually to ensure that there is appropriate coverage?

Solution: The association should insist on reasonable explanations in writing about the reasons for a delay. All bank reconciliations should be sent to the treasurer for review each month. The treasurer should ensure that deposits in transit are not carried forward each month.

■ **Association cash pledged as collateral on management company loans.** An association seeking to cash in one of its certificates of deposit cannot do so because it has been used as collateral for a management company loan.

Solution: Any financial activity involving association cash funds should require the signature of two individuals, one of whom must be a current member of the association's board of directors.

■ **Nonexistent employees on the association payroll.** An association manager set up dummy employees on the association payroll to divert association funds for personal use.

Solution: The treasurer should make sure that he or she has personal knowledge of each employee. If there is a large payroll with changing employees, the treasurer should be present periodically when the payroll is distributed and personally meet each employee.

■ **Nonexistent vendors.** To divert funds, an association manager set up a dummy company and created false invoices for goods from that company.

Solution: The treasurer should familiarize himself or herself with all vendors and the goods and services that they provide. The treasurer should make sure that he or she examines all invoices and immediately investigates all unfamiliar vendors.

■ **Employee increases own pay.** An employee turns in false time sheets to increase personal pay.

Solution: The treasurer should review and approve employee time sheets.

■ **Unit-owner assessments are diverted.** A manager diverts payments of unit-owner assessments for personal use.

Solution: The treasurer should review delinquent balances each month and periodically confirm those balances with the unit owners.

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■ **Property manager taking kickbacks.** A property manager, through a relationship with a grounds contractor, was receiving kickbacks to ensure continuation of the contract.

Solution: The treasurer should determine the appropriateness of the manager's method of selecting contracts, review the bidding process, and determine why the manager did not accept the most qualified bid. The treasurer should evaluate the specifications and re-bid the contract.

Replacement Reserves

A key aspect of an association's financial health is the development of an adequate long-term replacement reserve program. Such a program is a primary responsibility of the treasurer and the board of directors. To fulfill this responsibility, the treasurer and the board of directors must develop a clear understanding of the purpose of replacement reserves. This understanding of purpose should be formalized in the association's resolutions.

TABLE 1: Sample Schedule

Replacement Reserve Schedule					
Components	Estimated Remaining Useful Life (Years)	Estimated Current Replacement Cost	Replacement Fund Balance at Beginning of Year	Estimated Required Annual Contribution	Replacement Fund Balance at End of Year
Asphalt	15	177,377	16,698	10,712	27,410
Concrete	Varies*	412,780	63,138	18,402	81,540
Roofing	20	303,620	61,005	20,218	81,223
Exterior building	10	216,670	68,674	16,443	85,117
Plumbing	30	Varies*	5,163	5,000	10,163
Electrical system	30	Varies*	4,495	3,300	7,795
Doors and windows	30	Varies*	4,010	1,000	5,010
Fans and vents	12	23,200	5,932	1,439	7,371
Tennis courts	20	Varies*	6,683	2,000	8,683
Signs	17	5,000	983	300	1,283
Retaining wall	25	240,000	22,746	8,691	31,437
TOTALS			\$259,527	\$87,505	\$347,032

**Represents more than one time frame or amount in this category.*

The treasurer must clearly understand that replacement reserves are for future major capital expenditures. They are not another form of operating funds. They should not be used for contingencies, nor should they be considered excess cash available for emergencies or unusual expenditures. It is imperative that the treasurer conveys this understanding to the other directors and to the general community.

Once the concept of replacement reserves has been defined, the treasurer must take steps to implement the program. First, the treasurer should establish a special committee to develop the program. The committee should inventory the association's major capital assets, establish remaining useful service lives, and determine individual asset replacement cost. Management, contractors, and association professionals should help the committee conduct the study. The committee should consider engaging a consulting engineer or architect who is a certified Reserve Specialist® to guide the study.

Once the study is in place, it should be funded annually and updated periodically for changes in replacement costs, for new information on remaining useful services lives, and for any technological development in program components. The treasurer and the board of directors should adhere to the study and ensure the annual assessments are set aside so that adequate cash is available when needed. Table 1, above, contains information that would be included in a typical replacement reserve schedule.

The association must survey its property to make sure all major components are included. Many times, important components are overlooked when a reserve schedule is being developed. Some examples of less than ordinary components are: fountains, fences, retaining walls, balconies, ponds, bridges, and wharfs.

Another important aspect of the reserve schedule is the funding time frame. Most associations fund on a straight-line basis over the projected useful life of the asset. However, the time frame for the funding is generally limited to those assets with remaining useful lives, from 20 to 30 years. The association should also limit inclusion in the reserve schedule to those major components that have a financial impact on the association. The association's formal policy regarding the replacement reserve should include a dollar amount limitation for included components. The dollar amount limitation varies based on the size of the association's budget. Associations often assign a limit that is within the range of \$5,000 to \$20,000.

The association should update its reserve schedule every three to five years for changes in replacement cost and remaining useful lives. By updating for replacement cost periodically, contributions can be changed annually, thus taking into consideration inflationary factors. Some associations transfer interest earned to reserves as a hedge against inflation, while others try to build an inflationary factor into their annual contribution. While most associations generally fund on a straight-line basis over the useful lives of the assets, some associations fund with a cash flow model. The cash flow objective aims to maintain appropriate levels of cash for major reserve expenditures as they come due. With this method, the reserve fund is not allowed to fall below a predetermined cash level.

Special Projects

Special projects represent first-time major expenditures or major projects that were left out of the replacement reserve study. They should not be confused with the replacement reserve. Examples of special projects include a new recreational facility (swimming pool or tennis court), a maintenance shed,

and a fence or wall. Funds are collected and set aside for the project. When the project is built, the expenditures reduce the fund to zero.

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Operating Reserve

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reserve or excess operating fund may be established to meet these contingencies, should they arise. Generally, to limit the number of equity accounts, the unappropriated members' equity account should serve as the excess operating fund because it has the same meaning. The association should plan to have between 10 percent and 20 percent of its annual assessment in excess operating funds.

Association Investments

Every association needs to develop an investment policy that is formalized as a financial record of the association. This formalized investment policy is important because it will guide future boards, treasurers, and finance committees. The investment policy should be structured around three elements. The three elements are, in order of importance: safety, liquidity, and yield.

Because safety and liquidity are of prime importance to the association, investments should be limited to:

1. Instrumentalities of the federal government, which are backed by their full faith and credit (e.g., treasury bills or treasury notes).
2. Money market accounts and certificates of deposit at federally insured institutions (limited to \$100,000 per institution).

Treasury bills and notes are safe investments because they are backed directly by the federal government. And treasury bills and notes are not limited to a ceiling amount, as are banks, with their \$100,000 Federal Deposit Insurance Corporation (FDIC) limitation. Treasury instruments are also exempt from state income tax and they pay interest immediately. If the association prefers a financial institution certificate of deposit or money market account, it should evaluate the financial stability of each bank before it makes an investment. The amount in any one institution should always be limited to \$100,000. Associations should purchase long-term certificates of deposit that are under \$100,000 so that the FDIC protects the principal plus accrued interest on maturity.

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The treasurer should maintain contact with the auditor throughout the year and make sure that the auditor is kept up-to-date on important financial developments.
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Once an association's investment policy has been established, it should be reviewed by an attorney to ensure it is in accordance with association documents and all appropriate state laws.

The majority of association-invested funds result from the need to fund the replacement reserve schedule. A carefully planned and developed replacement reserve schedule allows the association to match investments with scheduled reserve expenditures. Long-term investments generally result in higher yields.

Selecting the Association's Certified Public Accountant

Finding a qualified certified public accountant (CPA) may be the treasurer's most important role. The treasurer should not hire his or her personal CPA or hire a CPA who is a personal acquaintance of the treasurer or of another board member. An association should not consider a CPA merely because he or she is a member of the community. Only knowledgeable CPAs with a proven background in association work should be considered.

Start by obtaining a preliminary list of qualified CPAs:

1. Obtain a list of CPAs from the local CAI chapter.
2. Survey other local associations on their experience with CPAs.
3. Obtain a list of knowledgeable CPAs from the local chapter of the state CPA society.

After developing a list of qualified CPAs, request proposals outlining their qualifications, scope of work, time frame for completion, background and experience of staff, hourly rates of professional staff, and projected cost range. Select three CPAs for interviews. It is preferable to interview them at their offices and to give them plenty of time to present their qualifications.

Following are some sample questions to ask during the interview:

1. Are you a member of the American Institute of Certified Public Accountants (AICPA) and your state society?