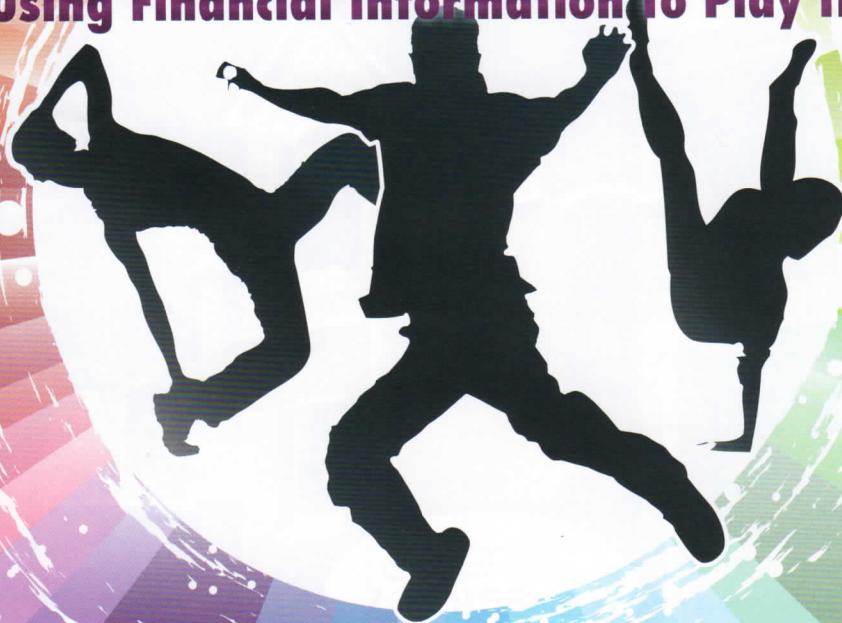


THE SAFETY DANCE:

Using Financial Information to Play it Safe



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“There’s safety in numbers.” You may have heard this phrase before; it refers to the idea that if one is part of a large group, they will be less likely to suffer a mishap or bad event. While this may be true in some instances, it may also be proposed that there is “safety in numbers,” referring to an association’s financial statements. To clarify, there is “safety” – or at least, less of a chance of financial mishaps occurring – when a board of directors and management are involved in the financial process of an association. This includes reviewing and understanding the financial statements, adopting fiscally prudent budgets and involving outside accounting professionals.

First, an association’s board of directors has the foremost responsibility for the association’s financial statements and financial aspects. One could argue that an association’s management is responsible for preparing the financial statements, budgets, and other financial reports. However, the board hired management, and has a duty to the association to oversee and direct management’s actions.

Learning to Dance: The Basics of Financial Statements

Financial statements are various schedules or reports that present the association’s financial position and the results of its activities. Boards utilize financial statements and other financial data when making important decisions. It is essential that financial statements are reliable, consistent, and issued in a timely fashion.

It is also necessary that boards comprehend the financial statements that they are receiving every month. If a board does not know how to read the financial statements, or if

the financial statements contain inaccurate or misleading information, it can have disastrous results when major decisions are made based on erroneous or misunderstood data. If a board is having trouble understanding the association’s financial statements, they should seek assistance from their management company and/or outside accountant. Never be afraid to ask questions from these professionals; it is part of their job to help boards run their associations.

Regular monthly financial statements should include, at a minimum, the following:

- **Balance sheet** – a list of all of the association’s assets, liabilities, and the net equity.
- **Income statement** (also called a profit-and-loss statement) – a report that shows all of the Association’s income and expenses for the given period.
- **Delinquent receivable report** – a list of all owners who have a receivable balance, showing the amount each owner owes to the association for unpaid assessments and any other charges.
- **Check register or cash disbursements report** – reporting all amounts paid during the period.
- **Detailed general ledger report** – a report that shows activity in all of the accounts in the association’s financial statements.
- **Bank reconciliations for all cash accounts** – reconciling the bank account balance to the balance of the cash account in the financial statements
- Any other report(s) the association deems important.

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The Budget Dance

A budget is another financial schedule or report that can be incorporated into the association's financial statements. The budget is the association's guideline for spending and should be compared to actual results on a regular basis. Creating a budget for a given year is how the association should determine the level of assessments. Budgets should list all planned income items and all expense items, as well as the amount the association plans to contribute to its reserve fund. The net result or bottom line of the budget should be zero.

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There is often a dangerous "dance" involved with the budget process. Too often, a board decides to keep assessments the same as last year, and then is faced with the pressure of squeezing all of the expenses to fit a known total dollar amount. The problem is that though the income stays stagnant, costs seem to rise every year. Similar to allowing a clumsy dance partner to lead, the risk with this "budget dance" is that in order to have sufficient money budgeted for rising costs, boards and managers reduce or eliminate reserve funding, which can be detrimental to the association in the long run. This can result in insufficient reserves for necessary projects, a fate far worse than stepped-on toes.

In order to avoid this fiscal foxtrot, an association should lay out all of their anticipated expenses – including estimated or actual price increases – as well as an amount budgeted to transfer to reserves. If the association has a current reserve study that includes projected annual amounts to be funded to the reserves for future years, refer to the study for the recommended levels of reserve contributions. Incorporating the study's recommended funding figures into the annual budget will result in a healthier reserve fund.

Once an association's expenses and reserve funding are laid out for the upcoming year, the total budgeted amount of income for the year should equal the grand total of the expenses and reserve funding. If an association has significant income generated from other sources such as clubhouse rentals, laundry machines, recreational activities, rental of roof space, etc., this may reduce the burden of funding the expenditures through assessments.

Accounting Professionals Can Be Great Dance Instructors!

There are various levels of service that accounting professionals can provide to associations to lead them in the financial dance. These include income tax preparation, compilations, reviews, audits, agreed-upon procedures, and other attestation services. All residential associations are required to file income tax returns, even though they are "not-for-profit" corporations. An accounting professional can evaluate each association's tax and financial position to determine the best type of tax return to file for the association.

From time to time, it may be necessary for an association to have its financial statements prepared or audited by an independent accountant. Perform research and select a public accounting firm that is experienced in the association industry. They have the knowledge and understanding of all of the unique traits of associations, and are skilled at issuing financial statements and reports tailored to associations.

An annual audit of an association's financial statements is the highest level of service that an accountant can provide. An audit requires additional procedures that are not mandated in the performance of a review or compilation. An audit involves testing of transactions and balances, communication with third-parties, an understanding of internal controls, and other procedures. The conclusion and objective of an audit is to issue an opinion as to whether the association's financial statements are free from material misstatement.

Annual reviews and compilations are the middle and lowest level of accounting services, respectively. At the conclusion of a review, the accountants state whether the financial statements are in need of significant adjustments in order to be in conformity with accounting principles generally accepted in the United States of America. No opinion is expressed on the financial statements as a whole. A compilation involves very limited procedures, and simply presents the association's financial statements, without the expression of any opinions or assurance on the financial statements. Reviews and compilations are less costly alternatives to annual audits.

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When determining what type of year-end accounting services an association should have performed by a public accountant, the following should be considered:

- **Declaration and By-Laws** – Associations need to review their governing documents to see if an annual audit is required.
- **Bank loan** – Some banks demand an annual audit every year as part of the loan requirements. If an Association has a bank loan, it should check with the bank or the loan documents to determine if a specific report or level of accounting is required.
- **Management transition** – If an association changed management companies during the year, it may decide to obtain a higher level of accounting service to ensure that all bank accounts were transferred over and that owner and other account balances were properly recorded.
- **Developer turnover** – When an association is turned over from the developer to a board of homeowners, it is good financial practice to have an audit done from the period from inception (date of the first closing of a unit or home) through turnover date. A turnover audit will focus on initial capital contributions, assessment calculation, and any developer responsibilities. Obtaining an audit from day one helps an association lead off on the right financial foot.

In the current economic times, it never hurts to play it safe in financial matters. Just as a formal dance requires two partners, the best safeguard regarding financial statements is to have more than one set of eyes looking at everything. Remember, an association's financial decisions don't just affect one person, but a whole building or community. If an association has sound financial practices and proper financial statements, it can answer Men Without Hats' famous inquiry: "Is it safe to dance?" with a resounding "Yes!"



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