2021
TREASURER'S ACCOUNTING HANDBOOK
&
PROCEDURES MANUAL

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SCHWINDT & CO.
CERTIFIED PUBLIC ACCOUNTANTS

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INTRODUCTION

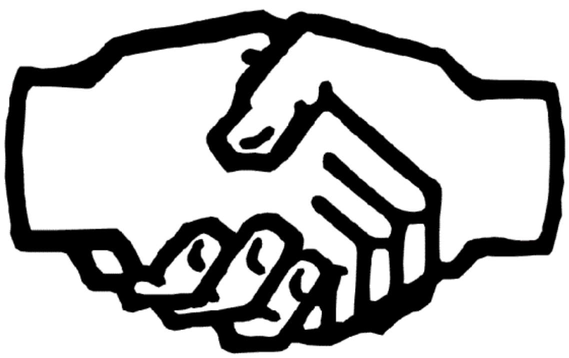
Congratulations! By electing you Treasurer of your Association, the membership has demonstrated its confidence in your abilities to lead the Association towards fiscal responsibility and financial stability. Whether you are a seasoned Chief Financial Officer or a layperson that generally has trouble balancing your own checkbook, this manual is designed to give you the tools necessary to do a great job.

This handbook is intended to provide board members with a quick, handy reference to many financial issues facing homeowner's associations. The handbook is organized in accordance with the accounting cycle, which consists of approving a budget, billing regular assessments, collecting regular assessments, paying vendor bills, and periodic financial reporting.

Many sections of this handbook include easy-to-follow procedures that can be implemented by virtually any association in carrying out its daily operations. There are also other issues discussed such as accounting for special assessments, borrowing funds from the replacement reserve account, and considering working capital in preparing an annual budget.

Schwindt & Co. would be pleased to personalize this handbook to include specific needs, procedures and accounting treatment for your Association. Please feel free to contact us to discuss this engagement.

This handbook assumes the use of QuickBooks Pro accounting software. However, the procedures provided can be adapted to any accounting software package.



SECTION 1: DUTIES AND ROLE OF THE ASSOCIATION TREASURER

Most bylaws outline the duties of the Treasurer. Please refer to your bylaws and familiarize yourself with the duties of your Association. These duties generally include but are not limited to:

- Keeping and maintaining a complete set of financial records.
- Depositing funds in the name of the Association in Board approved depositories.
- Overseeing payment of all bills, including proper expense classification.
- Taking responsibility for the identification, implementation, and on-going monitoring of internal controls.
- Preparing an annual budget.
- Overseeing insurance coverage.
- Overseeing investment of funds.
- Billing assessments and collecting on delinquent accounts.
- Overseeing the replacement reserve program.
- Filing all federal, state, and local tax returns in a timely manner.
- Reviewing monthly financial statements.
- Reviewing monthly bank reconciliations.
- Interviewing major contractors.
- Communicating financial information to the Board and, if appropriate, the membership.
- Implementing and monitoring safeguards to protect the Association's assets.
- Preparing and implementing the operation and reserve budgets.
- Monitoring the annual preparation of financial statements by an independent CPA as well as preparation of year-end tax returns, including other appropriate tax and corporate filings.
- Overseeing an annual compilation, review or audit by a CPA.
- Working with an outside CPA to evaluate the system of internal controls.

UNDERSTANDING FINANCIAL STATEMENTS

The Treasurer is responsible for maintaining the Association's financial records. Therefore, the Treasurer should 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. In essence, it tells the membership what assets they have title to and who owns the assets. The balance sheet is divided into three major categories, assets, liabilities, and members' equity (fund balances), which are segregated into two categories – operating fund and replacement fund. It is called a balance sheet because it is based on a balancing equation: assets equal liabilities plus members' equity. For example:

Assets = liabilities + members' equity
OR
Total assets = what others own + what members own

Assets

Assets represent what the Association owns. Common asset categories generally include cash (operating and savings), investments, assessments receivable, prepaid insurance, and fixed assets (property and equipment less accumulated depreciation).

Liabilities

Liabilities represent what the Association owes to others. Common liability categories include accounts payable (unpaid balances owed to vendors), notes payable, assessments paid in advance, and contract liabilities.

Members' Equity

Members' equity (fund balance) represents the Association's net worth at a point in time. Assets (what the Association owns) less liabilities (what the Association owes to others) equal members' equity (fund balances).

- **Working capital** represents funds collected at settlement from buyers into a community. Usually the equivalent of two months' assessments is collected. The Association should refer to their CC&Rs to determine if these amounts can be used solely for operating, unbudgeted or unusual expenses and/or if they can be eventually transferred to reserves. In addition, the Association's governing documents may provide that working capital contributions be made at the subsequent sale of each unit or that the working capital fund remain at or above a given threshold.
- **Statement of Revenues and Expenses**. The statement of revenues and expenses summarizes income and expense categories and shows revenues over (under) expenses for the year.
- **Statement of Members' Equity (Fund Balance)** reflects the changes during the year in the Association's equity accounts (generally affected by net revenues over [under] expenses and contributed working capital).

Reports typically provided to the Board

Typical reports provided for the Board's review on a monthly basis include:

- Balance sheet
- Statement of revenues and expenses by class (operating and reserve)
- Cash receipts and cash disbursements
- Assessments receivable aging report
- General ledger detail
- Accounts payable aging report
- Bank statements and bank reconciliations
- Budget-to-actual comparison of revenues and expenses by class

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 financial reports to the Board a few days before the monthly meeting and should give a presentation of the Association's financial status at the meeting. See Sections 8 to 14 for a discussion of accounting procedures.

PITFALLS TO AVOID AS TREASURER

Do not bring your own agenda to the job of Treasurer. Some common personal agenda items include:

- Keeping dues at a predetermined level.
- Hiring personal friends to perform accounting functions.
- Catering to a rival faction.

Do not try to keep operating and reserve assessments at a predetermined level. As mentioned in other sections of this manual, the operating and reserve budget process should be conducted without regard to its eventual financial outcome. The numbers are the numbers. Think of yourself as merely a messenger of amounts that are realistic and meet the objectives of sound financial management.

Keep an open set of books and records. Most associations allow members to inspect financial records. Communicate as often and in a manner as detailed as you can to the membership regarding budgets, variances, cash shortfalls, et cetera. Do not hide any financial affairs of the Association.

The Treasurer and Board should be a part of the following financial decisions:

- Selection of an accounting method (cash or accrual).
- Selection of your CPA.
- Determination of whether to perform a compilation, review, or audit.
- Determination of which tax form to file: 1120 or 1120-H.
- Selection of a reserve study provider.
- Selection of banker.

Do not use financial service providers unless they are experts at providing services to community associations and members of appropriate trade organizations (such as Community Associations Institute) and have a proven track record of providing excellent services to associations. Do not select service providers based on cost alone. You should consider interviewing potential service providers to ensure that they meet the qualifications set by the Board.

Although board members are not required to be experts in various aspects of homeowner associations, Directors are expected to make sound business decisions by hiring experienced professionals. They should also work with professionals that can explain complex issues in terms that can be understood by laypersons.

SECTION 2: INTERNAL CONTROL CONSIDERATIONS

GENERAL INFORMATION

The Board of Directors is responsible for safeguarding the Association's assets. As such, the Association should implement and monitor internal control policies and procedures that help protect the Association's assets. Internal controls are procedures implemented by management which ensures the proper recording, summarization and reporting of financial information, and the safeguarding of the Association's assets. The following information outlines recommended internal control practices for homeowner associations.

SEGREGATION OF DUTIES

The segregation of duties is one of the most effective internal controls in combating fraud and embezzlement. The Association's system of checks and balances should include the segregation of the duties in each of the Association's accounting processes, including cash receipts, accounts receivable, cash disbursements, payroll, inventory, fixed assets, investments, loans, and the financial statement closing process.

Ideally, no individual person should handle more than one of the following duties in a single process: custody of assets, record keeping, authorization, and reconciliation. The Association should separate these functions amongst employee/management personnel. Often, smaller, self-managed associations do not have enough employees/management personnel to segregate all duties. In this case, compensating controls should be put into place. An independent management-level person, who does not have custody, record keeping, authorization, or reconciliation responsibilities, should regularly review reports, analyze the reports, and investigate any discrepancies found between reported activity and expectations.

If the Association uses a community management company, the Board is responsible for understanding and ensuring that the management company's internal controls are adequate and are being followed by the management company.

CASH

Bank Reconciliations

The Association should perform reconciliations on all the bank accounts at least monthly to compare bank account activity per the bank statement to bank account activity per the Association's records. Timely bank reconciliations allow for discrepancies to be cleared up promptly and with relative ease. All monthly bank reconciliations should be examined and approved by a designated board member. **If the Association currently uses or is considering using online banking, please read about online banking, cyber-theft, and internal controls in appendix G**. Consider applying the following procedures in maintaining control over cash.

One of the easiest and most cost-effective safeguards against fraud and embezzlement for homeowner associations is board of director review of bank reconciliations.

1. Each month, the Board of Directors or, at a minimum, the Treasurer of the Board of Directors should review the bank reconciliations for all accounts in conjunction with the financial statement review.

2. Each bank reconciliation should include the following information:

    a) The ending balance from the prior month's bank statement.
    b) All transactions that cleared the bank during the month reconciling to the ending balance on the current month's bank statement.
    c) All outstanding items (transactions that have occurred but have not yet cleared the bank) reconciling the ending balance on the bank statement to the ending balance on the financial statements.
    d) The bank statement should be attached to the reconciliation.

3. Verify that all checks are accounted for on the reconciliation (no check numbers missing), including voided checks. The list should include the date, check number, payee, and amount of the check. This list should be reviewed for reasonableness and examined for duplicate payments and old outstanding checks.

4. Verify that all deposits are included on the reconciliation. Examine the outstanding items for old outstanding deposits.

5. Make sure that all transfers between accounts are reflected on both account reconciliations in the same period. All transfers listed should indicate which account received the transfer and the purpose of the transfer.

6. Ask for more information if any item comes to your attention that seems to be out of the ordinary.

7. Review and approval of the bank reconciliations should be documented in the Board of Directors' meeting minutes.

Dual Signatures

The Association should institute a dual-signature policy that requires two authorized signatures on all cash disbursements over a certain prescribed dollar amount ($1,000 recommended). Banks do not usually verify there are two signatures before releasing funds. A dual-signature policy is recommended as a way to document at least 2 board members approved payment of expenditures over the prescribed dollar amount, and someone other than the 2 signers can make sure this was done before the check is mailed.

Maintaining/Updating Authorized Check Signers

As board terms are generally limited, so too is authorized check signing authority. Authorizing signature cards should be updated and/or reviewed on an annual basis to remove signers that are no longer authorized. Obtain the authorizing signature cards from the Association's financial institution. Most financial institutions can assist with completing the necessary paperwork.

Cash Receipts

All incoming checks should be restrictively endorsed "For Deposit Only" by the individual opening the mail or receiving the check. Cash and check receipts should be stored in a safe or locked cabinet until the time of bank deposit. Deposits should be made daily.

Voided Checks

Voided checks should be properly disposed of with the signature section removed. All voided checks should be entered into QuickBooks Pro to maintain a complete numerical sequence of checks.

Establishing a Petty Cash Fund

If the Association finds it beneficial to maintain a petty cash fund, it should be established by a board resolution. The resolution should include the level of cash and provide the name and position of the custodian of the fund. A check should be written to the petty-cash custodian who will cash the check, place the cash in a locked and secured container, and enter the opening balance of petty cash in a petty cash register.

Petty Cash Custodial Changes

In the event of a change in the custodian of the petty cash fund, the name and position of the new custodian should be included in the meeting minutes and attached to the board resolution that established the petty cash fund.

Funding Petty Cash

After the initial creation of the petty cash fund, cash is added to replace the amount of any cash disbursed from the fund. Funding procedures include summarizing all disbursements and issuing cash back to the fund for that amount.

1. A reconciliation form is completed which lists the remaining cash on hand, the vouchers issued for each disbursement, and any variance (overage or underage) between the cash balance in the register and the actual cash on hand. A second accounting staff person reviews and approves the form and a copy of the form is sent to the accounts payable staff along with all vouchers referenced on the form. A copy of the form is retained by the petty-cash custodian.

2. The accounts payable staff creates a check made out to the custodian in the amount needed to fund petty cash to its established limit. The accounts payable staff forwards the petty cash reconciliation form to the general ledger accountant.

3. The custodian cashes the check and replenishes the cash in the petty cash container. The custodian enters the amount of cash received in the petty cash book or register and updates the running total of cash on hand.

4. The general ledger accountant records the voucher amounts listed in the petty cash reconciliation form as expenses in the general ledger and then files the form and attached vouchers.

Disbursing Petty Cash

Each expenditure and the disbursement of funds should be sufficiently documented.

1. Funds should only be disbursed for minor expenses.

2. If a petty cash disbursement request meets the disbursement requirements, the petty cash container can be unlocked. The container should remain locked when it is not being used.

3. The person requesting a reimbursement completes a reimbursement voucher. Vouchers should contain a description of the expense, date of expense, the name of the person requesting reimbursement, and the date reimbursement was made. If a receipt is submitted, it should be attached to the voucher. Finally, the voucher should be signed by the person requesting reimbursement.

4. The cash being disbursed should be counted by the custodian as well as the person requesting reimbursement. The voucher should be signed by the recipient indicating the cash was received.

5. The petty cash book or register should be updated with the date, the voucher number, the amount disbursed, and the running total of cash on hand.

Investment Policy

The Association should develop and implement an investment policy that addresses uninsured deposits. The Federal Deposit Insurance Corporation (FDIC) insurance limit is $250,000 per financial institution. If the Association has uninsured deposits, the Association could consider moving some funds to the Certificate of Deposit Account Registry Service (CDARS). CDARS offers a convenient way to obtain full FDIC coverage on deposit amounts larger than $250,000 by breaking large deposits into smaller amounts and placing them with other banks that are members of its special network. If the Association has certificates of deposit (CDs) with another financial institution (for example, with a brokerage company), care needs to be taken that they are adequately insured as they may not be covered by the FDIC.

Competitive Bidding Policy

The Association should consider establishing a formal competitive bidding policy, whereby a certain number of bids and other parameters are established for the solicitation of bids for major projects. Lack of competitive bidding may result in overpayment of time and materials.

Other

1. Avoid signing blank checks.
2. Store blank checks in a locked cabinet.
3. Pay vendor bills only from an original invoice, never from a duplicate.

ASSESSMENTS RECEIVABLE

Periodic Examination of Past-Due Assessments

The Board of Directors should be provided with a monthly delinquency report for examination and approval. Additional information should be requested for anything that appears out of the ordinary. In addition, collection efforts should be examined for each delinquency. Potentially uncollectible amounts should be considered as potential bad debt (or decrease in assessments if the uncollectible amounts were billed in the current year) with a corresponding allowance for doubtful accounts.

Late Fee/Collection Policy

The Association should consider establishing a formal late fee/collection policy that provides for the treatment of late assessments – including interest on late payments, number of days until account is liened and/or turned over for collections, et cetera. This policy should be adopted via a Board Resolution.

Bad Debts

Delinquent assessments receivable should be analyzed to determine collectability. Liens should be placed on all accounts that are more than 90 days past due.

If the books and records are on the accrual method of accounting, the Board should consider recording a bad debt (or decrease in assessments if the uncollectible amounts were billed in the current year) and a corresponding allowance for doubtful accounts for assessments that are in danger of not being collected. Care should be taken to not completely write off receivables by taking the amounts off the accounting records, even if foreclosure occurs and the homeowner is no longer a member of the Association. It is possible to eventually receive payment if the former member wishes to clear his/her credit history by paying on past-due amounts. The Treasurer should consult with appropriate experts, such as CPAs and collection attorneys, for guidance.

FIXED ASSETS

General Information

Capitalized assets are depreciated over their estimated useful lives in accordance with the Association's formally adopted fixed-asset capitalization policy (see below for guidelines on the elements of a good capitalization policy).

Capitalization Policy for Association-Purchased Assets

Capitalization is the recognition on the balance sheet of the Association's property and equipment. The capitalization policy sets guidelines regarding what assets are appropriate for capitalization and at what dollar amount the assets should be capitalized. The elements of a good capitalization policy are as follows:

1. There is a clear understanding of what is appropriate for capitalization.

    a) For condominium associations, real property and common areas acquired from the developer and related improvements to such property are not capitalized because those properties generally are owned by the individual unit owners in common and not by the Association.

b) For planned unit developments, real property and common areas acquired by the original homeowners from the developer are generally not capitalized on the Association's financial statements. This real property and common areas are defined as common areas in the association's governing documents. Real property taxes are paid by the Association Members on a pro-rata basis on this type of real property. Although these properties are owned by the Association, the assets are not normally recognized under generally accepted accounting principles since the Association will not, in the ordinary course of business, dispose of the property to generate significant cash flows.

2. An association may hold title to common personal property. Generally accepted accounting principles require associations to capitalize common personal property, such as furnishings, recreational and maintenance equipment, and work vehicles. Associations hold title to personal property and the Association's Board of Directors can sell personal property at its discretion with the Association retaining the proceeds. Thus, the property qualifies for asset recognition.

3. An association may hold title to real property that is not included as common areas in the governing documents. Property taxes are paid by the Association on this type of real property. The Association's Board of Directors could sell this property with the Association retaining the proceeds. Thus, the property qualifies for asset recognition.

4. Property that should be considered for capitalization are those assets having the following criteria:

    a) The Association has clear title or other evidence of ownership.

    b) The Association can dispose of the property for cash.

    c) The property is used by the Association to generate cash from nonmember sources.

    d) The Association has title to real property that can be sold.

5. A dollar limitation based on the asset's cost basis should be imposed on depreciable capitalized items. The amount of limitation would depend on the size of the Association. Reasonable levels might range between $1,000 and $5,000. Items below this dollar limitation would then be expensed and not capitalized.

6. Property that is capitalized should be presented in the operating fund (or in a separate fund established for that purpose) and depreciated over the estimated useful life of the asset on a straight-line basis.

7. See Appendix F for example resolution.

SECTION 3: ACCOUNTING SOFTWARE

Selecting the right accounting software can seem overwhelming, as there are many accounting software programs available for purchase. However, selecting an accounting software package can be simplified greatly if you know what features to look for. In selecting accounting software for common interest realty associations, the software should contain the following modules:

- Banking
- Invoicing
- Bill paying
- Budgeting
- Payroll processing

Additionally, the accounting software should serve as a management tool by providing reports such as budget-to-actual comparisons, aging reports, and other financial reports. The software should be user friendly and easy to learn.

QuickBooks Pro accounting software is a purchased accounting software package published by Intuit that is user friendly and mass distributed. It is not necessary to update the QuickBooks Pro software product every year.

Useful Hints:

- **Intuit only supports the most recent three versions of QuickBooks. For example, once QuickBooks Pro 2019 has been provided to the market, the only versions supported are 2019, 2018, and 2017. For the safekeeping and integrity of Association records, it is very important to use a supported version of bookkeeping software.**
- Verify the date for each transaction.
- Verify that the appropriate bank account is used for each transaction. It is very easy to post transactions to the incorrect bank account in QuickBooks Pro.
- Verify that the appropriate class is used for each transaction (Operating or Reserve). It is very easy to post transactions to the incorrect class in QuickBooks Pro.
- The “Audit Trail” included in Company “Preferences” should always be activated to provide session reports.

SECTION 4: ACCOUNTING USERS AND PASSWORDS

To ensure the integrity of the Association's financial records, authorized users of the Association's bookkeeping software should be minimized. Each user should always log in under a unique username and password, and passwords should be created when there is a turnover in personnel.

The following may need to be authorized users in the Association's accounting software with access limited to specified areas to assure segregation of duties:

- Administrator – IT
- Manager
- Accountant

SECTION 5: CHART OF ACCOUNTS

The chart of accounts is a listing of all accounts in an association's general ledger. Below is a listing of the most frequently used accounts in an association's chart of accounts and includes a description of each account. It is recommended that a designated board member approve all future changes to the chart of accounts. An example chart of accounts can be found in Appendix E.

ASSETS

Checking/Savings

- **Operating bank accounts**: These accounts contain the funds designated for paying operating expenses. All assessments collected from the homeowners, including both operating and reserve assessments, are deposited into the operating checking account.

- **Payroll account**: This account contains the funds designated for payroll expenses, including wages and applicable payroll taxes. Funds are transferred to this account monthly from the operating bank account.

- **Replacement reserve bank accounts**: These accounts contain the funds designated to pay replacement fund expenses. Every month, the Association transfers the monthly reserve assessments from the operating fund to the reserve fund.

- **Special assessment bank accounts**: These accounts contain the funds designated for special assessment projects. When a special assessment is collected from a homeowner, it is typically deposited directly into these accounts. However, a homeowner may write one check that includes the regular operating assessments and the special assessment. When this occurs, the check is deposited into the operating fund, and the Treasurer then transfers the special assessment portion to the appropriate bank account.

Other Assets

- **Interfund balance**: These accounts are used to track the amounts borrowed and payable among the operating, reserve, and other fund accounts. An interfund balance arises when one fund pays amounts that are proper expenses of another fund. An interfund balance may also arise when a budgeted transfer has not been made, including the transfer of the monthly reserve assessments from the operating fund. Ideally, the balance in these accounts should be zero at the end of each month after the Treasurer has made the appropriate transfers for the month.

- **Assessments receivable** (accrual basis): These accounts contain amounts billed to the owners for all assessments. More than one assessment receivable account may be used if owners are billed separately for reserve assessments and/or special assessments.

- **Prepaid expenses** (accrual basis): These accounts contain amounts paid for expenses pertaining to a future reporting period, such as an insurance payment made for the entire year.

- **Fixed assets** (accrual basis): These accounts contain the cost basis amount for capitalized assets.

- **Accumulated depreciation** (accrual basis): This account contains the total depreciation on fixed assets currently on the Association's balance sheet.

LIABILITIES

- **Accounts payable** (accrual basis): This account contains amounts owed by the Association for expenses accrued during the current period.

- **Prepaid assessments** (accrual basis): This account contains the amount of assessments paid by owners that is not due until a subsequent reporting period.

- **Note payable:** This account contains the principal balance on a note/loan payable by the Association.

- **Contract Liabilities** (accrual basis): This account contains the amount of reserve assessments and other assessments that were due and paid, which have not been spent on the obligation for which they were assessed. See Appendix I for more information.

MEMBERS' EQUITY (FUND BALANCE)

- **Members' equity – operating (Operating fund balance)**: This account contains the accumulated earnings of the operating fund to date. The current year's accumulated income/loss may be a separate line item that when added to the prior year accumulated earnings, equals total members' equity – operating fund.

- **Members' equity – replacement (Replacement fund balance)**: This account contains the accumulated non-contract earnings or deficit of the replacement fund to date. As major repairs and replacement expenses are incurred, non-contract income is first used to pay these expenses and then contract income is used. Unspent contract income is reported in the liability account, Contract Liabilities, until it is used to pay for major repairs and replacements. The current year's accumulated income/loss may be a separate line item which when added to the prior year accumulated earnings equals total members' equity – replacement fund.

- **Members' equity – working capital (Working capital fund balance)**: Certain association's governing documents require that a separate fund for working capital be maintained. This account contains the accumulated non-contract earnings of the working capital fund to date. As working capital expenses are incurred, non-contract income is first used to pay these expenses and then contract income is used. Unspent contract income is reported in the liability account, Contract Liabilities, until it is used to pay for working capital expenses. The current year's accumulated income/loss may be a separate line item that when added to the prior year accumulated earnings equals total members' equity – working capital fund.

- **Working capital contributions**: This account contains the amount of working capital contributed to the working capital fund which is based on requirements in the Association's governing documents. Working capital contributions are reported as contract liabilities until they are used to pay for working capital expenses.

REVENUE

- **Assessments – operating:** On the accrual basis, this account details the amount of assessments billed, which is based on budgeted assessments. On the cash basis, this account reports the amount of assessments actually collected.

- **Contra Revenue:** On the accrual basis, this account is used to adjust the value of operating assessments revenue. The account is based on the amount of budgeted assessments in the current year that are considered uncollectible.

- **Assessments – replacement:** On the accrual basis, this account reports the amount of contract revenue used to pay for major repairs and replacements. Associations will often report two accounts for replacement fund assessments, one to show the amount billed during the year and the second to show the amount not spent, but rather moved to the contract liabilities account to be recognized at a future date. On the cash basis, this account reports the amount of assessments allocated to the replacement fund. See Appendix I for more information.

- **Interest – operating:** This account details the amount of interest earned or collected on interest-bearing operating bank accounts.

- **Interest – replacement:** This account details the amount of interest earned on interest-bearing replacement bank accounts.

- **Interest – working capital:** This account details the amount of interest earned on interest-bearing working capital bank accounts.

- **Other revenue accounts:** Accounts should be created according to the Association's needs. Each budget item should have a separate revenue account to assist the Board in analyzing budget to actual comparisons and in developing the subsequent year's budget.

EXPENSES

- **Operating expense accounts:** Accounts should be created according to the Association's needs. Each budget line item should have a separate expense account to assist the Board in analyzing budget to actual comparisons and in developing the subsequent year's budget.

- **Replacement expense accounts:** These accounts contain the details of major repairs and replacement expenses. The reserve study, and thus the replacement fund budget should be used as guidance in determining the expenses that should be coded to these accounts. The Association may want to use only one expense account, or it may want to keep one expense account for each component depending on the number of expenses.

OTHER REVENUE AND EXPENSES

- At times, the Association may levy special assessments to pay for a designated expenditure, or it may receive proceeds from a legal settlement. Activity related to special assessments or litigation proceeds that are designated for a specific expenditure should be tracked in separate revenue and expense accounts, and depending on the nature of the activity, the Association may want to track this in funds other than operating or replacement reserves. Separate general ledger accounts should be created for the revenue and expenses related to each fund.

SECTION 6: ANNUAL BUDGET

General Information

Annually, the Association should prepare and adopt an operating and reserve budget for the ensuing fiscal year. This annual budget is the basis for establishing annual regular member assessments to cover operating expenses and contributions to the replacement reserve fund. The annual budget is a financial action plan, and it should be realistic.

To prepare an operating and reserve budget each year:

- **Operating budget:** The operating budget is based on estimated expenses required for the ongoing upkeep and maintenance of the Association such as utilities, payroll, general maintenance, etc. It is also prudent to factor in a contingency or emergency budget line item of around 5% to 10% of all other operating expenses for unexpected operating costs. The operating budget should also include a line item for bad debts. (see Section 7 for a discussion of bad debts) Each operating budget line item should be supported by a written narrative explaining in detail how the amount was computed.

- **Reserve budget:** The Association's reserve budget should be based on its reserve study. The reserve study should be updated each year. Most Associations are required by statute to prepare and annually update a reserve study (See Section 8).

The total assessment includes the operating budget plus the required contribution to reserves.

Operating Budget Disclosures

The following are provisions from the Washington State statutes relating to operating budget adoption and disclosures**.**

RCW 64.34.308 and (64.38.025)
Board of Directors and Officers

(3) Within thirty days after adoption of any proposed budget for the condominium, the board of directors shall provide a summary of the budget to all the unit owners and shall set a date for a meeting of the unit owners to consider ratification of the budget not less than fourteen nor more than sixty days after mailing of the summary. Unless at that meeting the owners of units to which a majority of the votes in the association are allocated or any larger percentage specified in the declaration reject the budget, the budget is ratified, whether or not a quorum is present. In the event the proposed budget is rejected or the required notice is not given, the periodic budget last ratified by the unit owners shall be continued until such time as the unit owners ratify a subsequent budget proposed by the board of directors.
(4) As part of the summary of the budget provided to all unit owners, the board of directors shall disclose to the unit owners:
(a) The current amount of regular assessments budgeted for contribution to the reserve account, the recommended contribution rate from the reserve study, and the funding plan upon which the recommended contribution rate is based;
(b) If additional regular or special assessments are scheduled to be imposed, the date the assessments are due, the amount of the assessments per each unit per month or year, and the purpose of the assessments;
(c) Based upon the most recent reserve study and other information, whether currently projected reserve account balances will be sufficient at the end of each year to meet the association's obligation for major maintenance, repair, or replacement of reserve components during the next thirty years;
(d) If reserve account balances are not projected to be sufficient, what additional assessments may be necessary to ensure that sufficient reserve account funds will be available each year during the next thirty years, the approximate dates assessments may be due, and the amount of the assessments per unit per month or year;
(e) The estimated amount recommended in the reserve account at the end of the current fiscal year based on the most recent reserve study, the projected reserve account cash balance at the end of the current fiscal year, and the percent funded at the date of the latest reserve study;

(f) The estimated amount recommended in the reserve account based upon the most recent reserve study at the end of each of the next five budget years, the projected reserve account cash balance in each of those years, and the projected percent funded for each of those years; and
(g) If the funding plan approved by the association is implemented, the projected reserve account cash balance in each of the next five budget years and the percent funded for each of those years.

RCW 64.90.525
Budgets – Assessments – Special assessments

(1)(a) Within thirty days after adoption of any proposed budget for the common interest community, the board must provide a copy of the budget to all the unit owners and set a date for a meeting of the unit owners to consider ratification of the budget not less than fourteen nor more than fifty days after providing the budget. Unless at that meeting the unit owners of units to which a majority of the votes in the association are allocated or any larger percentage specified in the declaration reject the budget, the budget and the assessments against the units included in the budget are ratified, whether or not a quorum is present.
(b) If the proposed budget is rejected or the required notice is not given, the periodic budget last ratified by the unit owners continues until the unit owners ratify a subsequent budget proposed by the board.
(2) The budget must include:
(a) The projected income to the association by category;
(b) The projected common expenses and those specially allocated expenses that are subject to being budgeted, both by category;
(c) The amount of the assessments per unit and the date the assessments are due;
(d) The current amount of regular assessments budgeted for contribution to the reserve account;
(e) A statement of whether the association has a reserve study that meets the requirements of RCW 64.90.550 and, if so, the extent to which the budget meets or deviates from the recommendations of that reserve study; and
(f) The current deficiency or surplus in reserve funding expressed on a per unit basis.
(3) The board, at any time, may propose a special assessment. The assessment is effective only if the board follows the procedures for ratification of a budget described in subsection (1) of this section and the unit owners do not reject the proposed assessment. The board may provide that the special assessment may be due and payable in installments over any period it determines and may provide a discount for early payment.

QuickBooks Pro Accounting Procedures

The annual approved operating and reserve fund budgets should be entered into QuickBooks Pro using the budget feature. If the Association uses the class-tracking feature in QuickBooks Pro, each budget line item must be classified as either OPERATING FUND or RESERVE FUND. If the budget items are not classified in this manner, the Association's budget-actual comparison reports (variance reports) will not be accurate. See the Association's accounting software handbook for instructions on entering a budget.

SECTION 7: ACCOUNTING FOR BAD DEBTS

Collection of assessments is a major problem for many associations. This issue affects the ability to qualify for loans, to satisfy HUD requirements to become approved for FHA loans, and to fund ongoing cash flow needs. This section offers ways to assist associations in the collection process and discusses the appropriate accounting treatment of allowing for and writing off uncollectible assessments.

Associations should receive and review a listing of past-due assessments monthly, which identifies the members or units, and details the amounts due and the past-due period generally segregated by 30, 60, 90, and 120 days or more past due. If the unit is voluntarily sold, the full amount of the lien must be paid unless the Association agrees to a lesser amount. If title passes and the lien is not paid in full, the lien passes to the new owner. If the unit is involuntarily sold through foreclosure, there is a danger the lien will not be paid if there are insufficient funds to pay the underlying mortgage. If there are not sufficient funds to pay the mortgage, the Association will not recover assessments. Because of this, a lien is also filed (recorded) with the County. This lien is generally filed by the Association's Attorney or the firm engaged to provide collection services. This lien will appear on the title report. It is also possible to obtain a judgment personally against the debtor and perform additional collection techniques such as garnishing wages. Once a judgment is obtained, the lien will appear on the member's credit report.

One series of events that may lead a debt to eventual non-collection is as follows:

- The member fails to pay assessments for an extended period. A lien is filed against the member.
- The member also does not pay the mortgage on the unit and the financial institution begins foreclosure proceedings.
- The financial institution forecloses on the unit, and there are insufficient funds to pay the mortgage. In this instance, other liened debts of lesser priority such as unpaid assessments are extinguished.
- The member files Chapter 7 personal bankruptcy extinguishing all personal debts including the past due assessment. (In some cases, Chapter 13 will extinguish the debt.)

Until the debtor files Chapter 7 or 13 personal bankruptcy, there is a possibility of collection, and collection efforts may recover all or a part of the outstanding debt.

Accounting Treatment

Cash basis financial statements merely recognize revenue when dues are received regardless of whether the dues are current or delinquent. Because accrual basis financial statements record assessment income when the assessments are due rather than when the dues are received, this requires the Association to record assessments receivable. If the Association believes an assessment is in danger of not eventually being collected, it is appropriate to reduce the receivable balance via an account labeled "allowance for doubtful accounts" and record either a bad debt expense (for assessments billed in previous years) or a contra revenue account (for assessments billed in the current year.). This, in effect, decreases net revenue over (under) expenses in the period the Association believes the debt becomes in danger of non-collection. It should be noted that this accounting treatment does not take the member's balance off the listing of assessments receivable. It merely reduces the total balance of all receivables by the amount in danger of non-collection. We generally believe a debt is in danger of non-collection when foreclosure proceedings have begun. Until this happens, appropriate collection efforts are deemed to render the debt reasonably collectible unless there is other evidence to suggest the debt is in danger of non-collection.

When there is no chance of collection, the debt is permanently deleted from the listing of assessments receivable. Deleting the account is called "writing off" the receivable. The distinction between recording an allowance account and writing off the account is important. By recording the allowance, the Association is preserving information relating to the past-due account on Association records including the listing of assessments receivable. If the debtor sometime in the future wishes to extinguish the debt and thereby remove the debt from his/her credit report, it may be necessary to verify the debt. If the debt is written off, the Association may not have the necessary information to satisfy reporting agencies. **Therefore, we recommend that past-due assessments are never written off until the Association becomes aware the debtor has gone through personal bankruptcy thus extinguishing all debts, including amounts owed to the**

Association. This information is generally communicated to the Association by the Attorney in charge of collections indicating the matter is closed and collection activities have ceased.

Please also be aware that being aware of uncollectible accounts and planning accordingly will aid in proper budgeting. Properly prepared budgets should recognize that not all members will pay assessments on time. Therefore, including a contra revenue line item in the budget will allow the Association to increase required assessments to compensate for uncollectible assessments.

By systematically budgeting, accounting, reviewing, placing liens, and employing aggressive assessment collection efforts, associations can help minimize the impact of uncollectible assessments.

SECTION 8: PREPARING A RESERVE STUDY

General Information

Educated buyers are looking closer at an association's reserve funds (or lack thereof) as a basis for determining the purchase price or buying a comparable unit/house with a sound reserve game plan in place. The state of Washington recommends reserve funding including the preparation of a reserve study for most associations.

Reasons to prepare and update a reserve study and follow the funding requirements are as follows:

- Meets the fiduciary responsibility of the Board.
- Meets statutory requirements.
- Meets legal requirements dictated by the CC&Rs.
- Provides for planned funding of major expenditures.
- Distributes the cost of future expenditures to old and new owners. Matches the enjoyment and use of facilities to the ratable value.
- Minimizes the need for a special assessment. Some owners are on fixed incomes and are not able to pay large special assessments.
- Enhances resale values.
- Is recommended by accounting standards as are funding reserves, segregating capital vs. non-capital assets and segregating funds and may help reduce income taxes for individual owners when a unit is sold.
- Meets HUD and Fannie Mae requirements.

The Association should seek consultation on its financial needs with its property manager, accountant, engineer, et cetera before proceeding with the study.

Reserve studies generally should be updated annually. Washington state statutes require an annual reserve study or reserve study update and a maintenance plan for most associations. Changes in the estimated current cost to repair; inflation, interest earned on accumulated reserve deposits, and expected life of each item all effect the amount which should be contributed to reserves each year in order to meet the funding needs of the Association. If these elements are not considered annually, the Association may need to suddenly increase assessments in order to "catch up" to the necessary funding level. Gradual increases in budgeted reserve assessments are generally preferred over unexpected spikes. The Association should consult with the state statutes and the Association's governing documents to determine legal requirements.

Treasurers should be aware of various methods used by reserve study professionals to compute the required contribution. Terms such as *full funding, percent funded, threshold method*, and *baseline method* can be confusing.

All reserve studies should include a cash flow schedule detailing the beginning balance, plus required reserve contributions, plus interest earned minus expenditures (adjusted for inflation) and ending balance each year. This schedule should show this activity for a 30-year period. The ending cash balance for each year should never drop below zero. If the ending balance drops below zero, the Association will most likely need to levy special assessments.

The lowest year-end ending balance in the 30-year schedule is the threshold balance. If the ending balance never drops below $50,000 over the 30-year period, theoretically, the Association will always have at least $50,000 to pay for contingencies. This amount of overfunding leads to much discussion in the reserve study industry. The Treasurer should consult with the reserve study provider and/or CPA to determine the appropriate threshold amount.

Additional information on reserve funding and a risk mitigation matrix can be found in Appendix H.

The following are provisions from the Washington State statutes relating to reserve studies:

RCW 64.90.545
Reserve Study

(1) Unless exempt under subsection (2) of this section, an association must prepare and update a reserve study in accordance with this chapter. An initial reserve study must be prepared by a reserve study professional and based upon either a reserve study professional's visual site inspection of completed improvements or a review of plans and specifications of or for unbuilt improvements, or both when construction of some but not all of the improvements is complete. An updated reserve study must be prepared annually. An updated reserve study must be prepared at least every third year by a reserve study professional and based upon a visual site inspection conducted by the reserve study professional.
(2) Unless the governing documents require otherwise, subsection (1) of this section does not apply (a) to common interest communities containing units that are restricted in the declaration to nonresidential use, (b) to common interest communities that have only nominal reserve costs, or (c) when the cost of the reserve study or update exceeds ten percent of the association's annual budget.
(3) The governing documents may impose greater requirements on the board.

RCW 64.90.535
Reserve Accounts

An association required to obtain a reserve study pursuant to RCW 64.90.545 must establish one or more accounts for the deposit of funds, if any, for the replacement costs of reserve components. Any reserve account must be an income-earning account maintained under the direct control of the board, and the board is responsible for administering the reserve account.

RCW 64.90.550
Reserve Study—Contents

(1) Any reserve study is supplemental to the association's operating and maintenance budget.
(2) A reserve study must include:
(a) A reserve component list, including any reserve component, the replacement cost of which exceeds one percent of the annual budget of the association, excluding contributions to the reserves for that reserve component. If one of these reserve components is not included in the reserve study, the study must explain the basis for its exclusion. The study must also include quantities and estimates for the useful life of each reserve component, the remaining useful life of each reserve component, and current major replacement costs for each reserve component;
(b) The date of the study and a disclosure as to whether the study meets the requirements of this section;
(c) The following level of reserve study performed:
(i) Level I: Full reserve study funding analysis and plan;
(ii) Level II: Update with visual site inspection; or
(iii) Level III: Update with no visual site inspection;
(d) The association's reserve account balance;
(e) The percentage of the fully funded balance to which the reserve account is funded;
(f) Special assessments already implemented or planned;
(g) Interest and inflation assumptions;
(h) Current reserve account contribution rates for a full funding plan and a baseline funding plan;
(i) A recommended reserve account contribution rate for a full funding plan to achieve one hundred percent fully funded reserves by the end of the thirty-year study period, a recommended reserve account contribution rate for a baseline funding plan to maintain the reserve account balance above zero throughout the thirty-year study period without special assessments, and a reserve account contribution rate recommended by the reserve study professional;
(j) A projected reserve account balance for thirty years based on each funding plan presented in the reserve study;
(k) A disclosure on whether the reserve study was prepared with the assistance of a reserve study professional, and whether the reserve study professional was independent; and

(l) A statement of the amount of any current deficit or surplus in reserve funding expressed on a dollars per unit basis. The amount is calculated by subtracting the association's reserve account balance as of the date of the study from the fully funded balance, and then multiplying the result by the fraction or percentage of the common expenses of the association allocable to each unit; except that if the fraction or percentage of the common expenses of the association allocable vary by unit, the association must calculate any current deficit or surplus in a manner that reflects the variation.
(3) A reserve study must also include the following disclosure:
"This reserve study should be reviewed carefully. It may not include all common and limited common element components that will require major maintenance, repair, or replacement in future years, and may not include regular contributions to a reserve account for the cost of such maintenance, repair, or replacement. The failure to include a component in a reserve study, or to provide contributions to a reserve account for a component, may, under some circumstances, require the association to (1) defer major maintenance, repair, or replacement, (2) increase future reserve contributions, (3) borrow funds to pay for major maintenance, repair, or replacement, or (4) impose special assessments for the cost of major maintenance, repair, or replacement."

RCW 64.90.555
Reserve study—Demand—Enforcement

(1) When more than three years have passed since the date of the last reserve study prepared by a reserve study professional, unit owners of units to which at least twenty percent of the votes in the association are allocated may demand in a record delivered to the board that the cost of a reserve study be included in the next annual budget and that the study be prepared by the end of that budget year. The demand must refer to this section. The board must, upon receipt of the demand, include the cost of a reserve study in the next budget and, if that budget is not rejected by the unit owners pursuant to RCW 64.90.525, arrange for the preparation of a reserve study.
(2) One or more unit owners may bring an action to enforce the requirements of this section and RCW64.90.545 and 64.90.550. In such an action, a court may order specific performance and may award reasonable attorneys' fees and costs to the prevailing party.
(3) A unit owner's duty to pay assessments is not excused because of the association's failure to comply with this section and RCW 64.90.545 and 64.90.550. A budget ratified by the unit owners pursuant to RCW64.90.525 is not invalidated because of the association's failure to comply with this section and RCW 64.90.545and 64.90.550.

The state law may contain other nuances. See Section 64.34 for condominiums and Section 64.38 for homeowner associations for a full list of items.

SECTION 9: DAILY AND MONTHLY ACCOUNTING/BOOKKEEPING TASKS

DAILY BOOKKEEPING TASKS

Entering Transactions into QuickBooks Pro

All financial transactions should be entered into the accounting system on a **daily basis** (or as frequently as possible, at least every 3 days) from the original source document (e.g., vendor bill for check payment, online transfer, owner payments, et al.). This will enable the Association to generate accurate bank account balances for all bank accounts at any point in time.

Duplicate Transactions

Only the designated bookkeeper should make entries into the accounting system to avoid duplicate transactions in the financial reports. We recommend that the Association develop a simple transfer form that provides documentation for all bank account transfers.

Memos

Every transaction entered into the accounting system should include a memo (on the memo line) that describes the purpose of each transaction. This provides a quick reference in the general ledger.

Coding Expenses

All revenues and expenses should be given a classification, such as HOA Operating, HOA Reserves, Working Capital, or Special Assessments. This allows for segregated reporting for Operating, Reserves and Special Assessment activity. On a monthly basis, prior to the monthly accounting analysis, the manager should generate a Profit and Loss by Class report and classify any “unclassified” revenue and expenses.

The manager should write the general ledger accounting coding and classification (Operating, Reserve, Working Capital, or Special Assessment) directly on each paid bill. The check-signer should review the general ledger coding and classification for appropriateness. If the coding is incorrect, the manager should be notified immediately. In addition, the designated board member should be provided with a monthly general ledger printout for review and approval of the account coding and classification of all transactions entered into QuickBooks Pro.

Additional Notes:

- No general ledger postings should be made to the accounts “Uncategorized Income,” “Uncategorized Expense” or “Opening Balance Equity.” These are special accounts automatically set up in QuickBooks Pro for purposes of storing damaged or unknown data.

- If there are ever any cash receipts (checks, cash, bankcard payments) or cash disbursements that are unclear with respect to which general ledger account to post or its classification, these must immediately be resolved by contacting the appropriate individual, company, board member, etc. These add up quickly and can become overwhelming. A quick response is necessary for effective financial reporting.

MONTHLY BOOKKEEPING TASKS

Replacement Reserve Expenditures

If possible, the Association should pay its replacement reserve expenditures from the reserve bank account. However, if the operating bank account pays replacement reserve expenditures, the operating bank account should be reimbursed as soon as possible. It should be noted, however, that due to withdrawal restrictions on many money market and investment brokerage accounts, and for practicality reasons, it might be necessary to pay replacement fund expenditures through the operating fund checking account. A detailed record should be kept of each payment made by the operating fund on behalf of the replacement fund and a repayment transfer should be made at least once a month. See the description of interfund balances in Section 5.

Bank Transfers

The Association should consider authorizing the manager to make certain preauthorized banking transfers to free up board members. We recommend developing a form/template that includes a line for the date, affected bank accounts, transfer amount, purpose and authorized signatures. The form/transfers should be approved by the Board at a regularly scheduled meeting and given to the manager to make the transfers. The following routine bank transfers should be made on a monthly basis.

1. **Reserve Contribution (Operating to Reserve):** The approved budget should be followed in determining the amount to transfer.
2. **Reimburse Operating for Reserve Expenditures:** When the operating account pays for reserve expenditures as a matter of convenience, the replacement fund owes the operating fund for these amounts, and these must be reimbursed in a timely manner.

Reconciling Interfund Balances

Interfund balances may occur for several reasons. The Association should reconcile its interfund balances on a monthly basis, including determining outstanding interfund balances among the funds for unreimbursed expenses and transfers. Interfund balances may occur when one fund pays the expenses for a second fund without being reimbursed. For example, the Association's operating account might pay the replacement reserve expenditures and later be reimbursed by the reserve account. Between the date the operating account pays the reserve expenditures and the date the replacement account reimburses the operating account, there is an interfund balance. Other causes of interfund balances include the following:

- Budgeted reserve assessments were reported in the reserve fund, but cash was not transferred from the operating cash account to the reserve cash account.
- The operating fund borrowed from reserves to pay for unanticipated expenses.
- Expenses for one fund were incorrectly coded to another fund
- Operating cash was transferred to reserve cash accounts to earn higher interest.

Bank Reconciliations

The Treasurer or Manager should reconcile all bank accounts or review bank reconciliations on a monthly basis. The Treasurer should focus on the items listed in Section 2 on internal control considerations, when performing the monthly bank account reconciliations.

Statements to Delinquent Owners

Monthly statements should be mailed to delinquent owners to serve as reminders. Note: If the delinquent account has been turned over to collections, the attorney will require that no further contact be made between the Association and the delinquent owner concerning the debt, as part of the federal Fair Debt Collection Practices Act. The A/R Aging Summary report in QuickBooks Pro can provide a list of delinquent unit owners.

Monthly Replacement Reserve Fund Contributions

The reserve contributions are reported separate from operating assessments in the statement of revenues and expenses. Reserve assessments not used to pay for major repairs and replacements are reclassified to the contract liabilities account.

SECTION 10: BILLING AND CASH RECEIPTS

ASSESSMENTS

General Information

As stated in Section 6 of this handbook, the annual budget is the basis for establishing annual regular member assessments to cover operating expenses and the contribution to the replacement reserve fund. Budgeted regular assessments should be allocated to each member in accordance with the Association's legal documents.

First some tips on setting up owner accounts

1. The lot or unit number and the Owner's name should be used as the Owner (Customer) name. It may also be helpful to use leading zeros. For example, if there are more than 100 units, use 045 rather than 45. This will be useful when generating reports so that units will be listed in numerical order.

2. If ownership changes or a new account has to be created for an Owner, the old account should be renamed in some consistent way to designate that the account has changed. Examples: Accounts for old Owners might have an additional digit at the end of the unit number (045 vs. 0459). Prebankruptcy balances might have an additional 2 digits at the end of the unit number (045 vs. 04599).

3. After changing the name of the old account, the new Owner's account can be created with the unit number and name of the new Owner.

4. On the date the customer information is entered into the bookkeeping system, it is important that the Owner's balance to date is entered. Assessments receivable pertaining to prior year's assessments should be entered using the prior years' billing dates. Assessments receivable pertaining to the current year, should be entered using the current year's billing date. This tip applies to existing Associations changing bookkeeping software or entering information into a system for the first time.

5. It is also important to update Owners' names on a regular basis in order to keep activity for each Owner (account) separate.

Accounting Procedures

The following accounting procedures can be used in member billing and cash receipts:

Billing: Once the annual budget is approved, members should be billed accordingly. A charge should be established in QuickBooks Pro based on the Association's billing frequency, which is usually found in the Association's legal documents.

The following accounting procedures should be used in accounting for billing regular member assessments:

1. A regular assessment charge should be posted to each member's assessments receivable account. If the Association uses class tracking in QuickBooks Pro, each charge for regular member assessments should be classified to the "operating fund."

2. If requested, an invoice should be generated for delivery to each member.

3. Late charges should be assessed in accordance with the Association's late fee policy.

Cash receipts: The following accounting procedures should be used related to cash receipts on a daily basis.

1. Restrictively endorse checks immediately. A restrictive endorsement stamp can be ordered through your financial institution.

2. Prepare a deposit slip that lists all cash, coins, and checks received.

3. Copy the deposit slip and all checks received.

3. Post cash receipts to the respective member assessments receivable account using the “receive payment” function of QuickBooks Pro.

4. Deliver the deposit to the bank on a daily basis.

4. Attach the validated deposit slip received from the bank to the cash receipt copies prepared in step 3 and file temporarily in a daily deposit folder until the bank reconciliation is completed for the month.

SECTION 11: CASH DISBURSEMENTS

General Information

The Association's approved annual budget should indicate what types of operating expenses the Association expects to incur during the year. Whether an expense is classified as an operating fund expense or replacement fund expenditure is governed by the adoption of the Association's annual budget. If the Association incurs expenses that have not been budgeted, they should be reported in the fund that most closely relates to the nature of the expense and documented by a formal Board Resolution.

Accounting Procedures

If the Association uses the QuickBooks Pro class tracking feature, it is very important to classify each vendor bill as either "operating fund" or "reserve fund" (see QuickBook Pro's help menu on how to use the class-tracking feature in QuickBooks Pro). A knowledgeable individual familiar with the Association's operations and budget should code the vendor bills prior to posting them to the general ledger.

The following accounting procedures can be used for cash disbursements:

1. On a periodic basis (weekly, biweekly, etc.), all vendor bills received should be forwarded to a designated board member for general ledger account coding, proper classification (operating or reserve fund), and approval for payment. The designated signer should initial the approved invoice, indicating that the bill should be paid, along with proper coding.

2. The bills should then be posted, and a vendor payment check should be prepared. It is important to note from what bank account bills are being paid. If the operating fund pays a reserve fund expenditure, this creates an amount due from the reserve fund to the operating fund. An entry to record the amount due to operating from replacement should be made in the interfund balance accounts.

3. The payment check, along with the original vendor bill, should be forwarded to the authorized check-signer.

4. The authorized check-signer or a designated individual other than the person preparing the payment check, should mail the vendor payments.

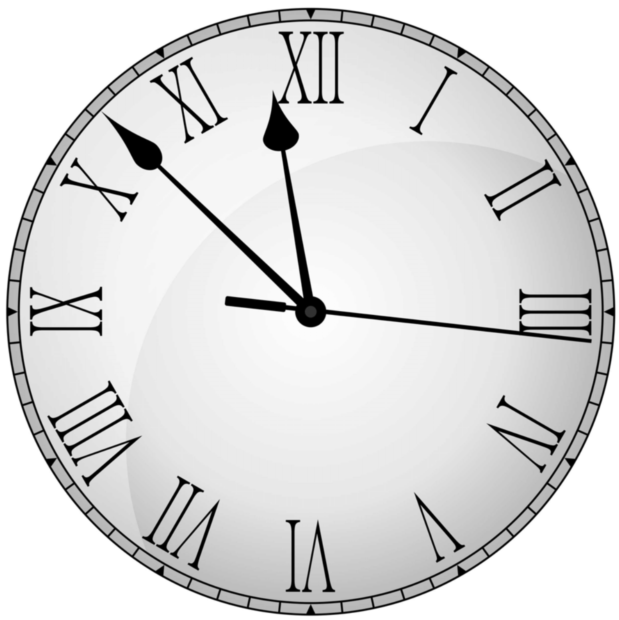
5. Attach a copy of the check voucher to the paid vendor bill and file. If voucher checks are not used, a "PAID" stamp should be used, and the date, check number, and initials should be placed directly on the paid vendor bill.

SECTION 12: PAYROLL TRANSACTIONS

If the Association has employees, appropriate forms, payments, and other documentation should be completed on a timely basis. See Section 20 for information regarding association employees.

The Association may choose to hire an outside firm to prepare its payroll reports, schedule tax payments, and send paychecks and tax payments on its behalf. A payroll service will prepare monthly journal entries which should be posted to the Association's books.

Payroll expenses, including payroll taxes, may be paid from a payroll bank account, which should be replenished monthly from the operating bank account.



SECTION 13: RESERVE CONTRIBUTIONS

General Information

As part of the Association's operating and reserve budget, a portion of regular assessments may be used to fund reserves for major repairs and replacements. On the cash basis, budgeted reserve assessments should be reported separately from assessments for operations in the period assessed. On the accrual basis, regular reserve assessments are reported separately from assessments for operations as either revenue or an increase in contract liabilities (deferred revenue). On the accrual basis, reserve assessments are recognized as revenue when expenses for major repairs and replacements are incurred. Prior to changes to generally accepted account principles effective for years ending after December 15, 2019, on the accrual basis, reserve assessments were recognized when billed.

Accounting Procedures

The following accounting procedures should be used in making periodic reserve contributions:

1. On the first day of each month, the Association should transfer cash from the operating bank account to the reserve bank account for the budgeted monthly reserve contribution.

2. On the cash basis, a general journal entry should be made each month to reclassify the reserve contribution from operating assessments to reserve assessments.

3. On the accrual basis, a general journal entry should be made each month to reclassify reserve assessments from operating assessments to the contract liabilities account.

4. On the accrual basis, a general journal entry should be made each month to reclassify reserve assessments from the contract liabilities account in the amount necessary to cover that month's reserve expenditures.

Other Useful Information

A memorized transaction and a reminder can be easily set up in QuickBooks Pro to assist in making the monthly reserve contributions. However, upon the annual update to the reserve study, the monthly reserve contribution may change; therefore, the memorized transaction amount should be replaced.

SECTION 14: RESERVE FUND BORROWING AND WORKING CAPITAL

Borrowing from the Reserve Fund

In Washington, an association may withdraw funds from its reserve account to pay for unforeseen or unbudgeted costs. The Board of Directors shall record any such withdrawal in the minute books of the Association, cause notice of any such withdrawal to be hand delivered or sent prepaid by first-class United States mail to the mailing address of each unit or to any other mailing address designated in writing by the unit owner, and adopt a repayment schedule not to exceed twenty-four months unless it determines that repayment within twenty-four months would impose an unreasonable burden on the unit owners.

It should be noted, that due to withdrawal restrictions on many money market and investment brokerage accounts, and for practicality reasons, it might be necessary to pay replacement fund expenditures through the operating fund checking account. A detailed record should be kept of each payment made by the operating fund on behalf of the replacement reserve fund and a repayment transfer should be made at least once a month. See Section 5 for a definition of interfund balance accounts.

Working Capital Considerations

Some associations prefer to keep a certain amount of cash in the operating cash account to absorb seasonal cash flow needs as well as to pay for unforeseen operating expenses. In addition, the Association's governing documents may require working capital contributions at the initial sale or at each sale of a unit. This surplus cash is sometimes computed at 2 to 6 times the monthly operating budget. If this average cash surplus drops below the desired amount, the budget may be adjusted to help build up this cash surplus to a comfortable level.

If there are many unanticipated expenses occurring, the Association may wish to consider adding an amount to the operating and replacement fund budgets for contingency expenses. This is an account that can be used when unbudgeted events occur and for which the Association should provide a definition.

SECTION 15: SPECIAL ASSESSMENTS

General Information

Associations generally have the authority to levy special assessments. The Association should take care in levying special assessments in accordance with their governing documents. Special assessments are sometimes levied to fund future major repairs and replacement deficiencies, to offset operating deficits, to provide for unanticipated expenses (such as litigation costs), or to provide for a contingency or emergency fund for other unanticipated expenses.

A Board Resolution should include the following elements: dollar amount, proposed use of funds, method of allocation among the affected members, member payment terms, and late fee policy. The proposed use of funds should specify deposit into either the operating fund, the replacement fund, or a special assessment fund, and should specify the use as either for general expenses or for a designated expense. This will determine into which bank account the special assessments collected should be deposited. If a special assessment is approved for a designated purpose, the accounting of revenue and related expenses will be easier if a separate special assessment fund is used.

The Board Resolution should be provided to the accounting department and/or accountant.

On the cash basis, special assessments should be recognized as revenue when they are received. Recognition of special assessments on the accrual basis will depend on the purpose of the special assessment.

Accounting Procedures

The following accounting procedures can be used in accounting for special assessments:

1. A charge should be assessed to each member's assessment receivable account in accordance with the Board Resolution. It is important to classify these charges as either "special assessment fund", "operating fund", or "reserve fund." This information should be stated in the Board Resolution. If it is not, a board member should be consulted.

2. If requested, generate an invoice for delivery to each member. The invoice should explain the purpose for the special assessment, the late fee policy, payment terms, et cetera.

3. Special assessment cash collections should be deposited into the designated bank account. If it is necessary to deposit the special assessment cash receipts into a bank account other than that designated, a detailed record should be maintained. The special assessment cash should be transferred to the designated bank account as soon as possible.

4. Late charges should be applied in accordance with the Board Resolution.

5. The special assessment resolution may give owners the option to pay the assessment over a period of months or years. These types of payment plans are a financing arrangement between the member and the Association. If the special assessment resolution specifies an interest rate, the Association will be required to record interest income on monthly payments. If the resolution does not indicate an interest rate, the Association may be required to impute interest and prepare appropriate amortization schedules. It is recommended to seek the assistance of the Association's CPA for this accounting treatment.

6. If the special assessment resolution is for serial special assessments, owners will be assessed multiple special assessments (periodic) on a regular basis over a period of months or years. The owners may have the option to prepay the serial assessments in full, with or without a discount. If the resolution allows pre-payment with a discount, the Association will need to prepare a payment schedule.

7. On the accrual basis, special assessments should be recognized as revenue when the obligation for which they were assessed is performed. Unless the special assessment is levied to pay a current expense, they should initially be recorded as contract liabilities.

8. On the accrual basis, a general journal entry should be made each month to reclassify special assessments from the contract liabilities account in the amount necessary to cover that month's expenditures, either operating expense, major repairs and replacements, loan servicing, or other obligations as designated by the special assessment resolution.

See the following Section 16 for a discussion of assessment revenue recognition for regular assessments, special assessments, and serial assessments.

SECTION 16: ASSESSMENT REVENUE RECOGNITION

Assessments are based on contracts between the Association and its members. The contract between an association and its members defines what the Association is obligated to provide its members based on its governing documents. Operating budgets, provisions in governing documents to assess initial working capital and budget for major repairs and replacements, and special assessment resolutions are contracts with association members.

When revenue is reported on the statement of revenues and expenses, it has been recognized. On the accrual basis of accounting, assessments are recognized when the obligation for which they are assessed is performed (defined by contract). On the cash basis of accounting, assessments are recognized when payment is received. Homeowner Associations generally can have three types of assessments:

#1 Regular Assessments
Regular assessments include operating and reserve assessments. Regular assessments are sometimes referred to as periodic assessments. Legally, operating and similar assessments are defined as separate assessments levied in defined intervals. For many associations, the defined interval is monthly. The authority and practice of assessing regular assessments come from the legal documents (CC&Rs) and GAAP, including industry accounting practice. Every year, as dictated by the CC&Rs, Associations prepare a budget of expected expenses for the coming year. This budget will generally include not only operating expenses but will also include the contribution to the reserve fund for major repairs and replacements. The contribution to the reserve fund is most often derived from a reserve study budget that details expected expenditures for repairs, major maintenance and replacements over a thirty-year period, which includes the recommended contribution to reserves for the budget year and each of the following 29 years. Based upon the legal authority of the Board, the budget is either approved and adopted by the Board or by the membership. If the CC&Rs call for monthly assessments, the Association will assess 1/12th of the total budget pro rata to each member.

The operating budget is a contract that gives an estimated cost of goods and services the Association plans to provide its members during the budget period (usually one year) and the amount of assessments the members will be billed for their right to the goods and services during the budget period. On the accrual basis, operating assessments are recognized in the period they are budgeted.

The reserve study is a contract that gives the estimated costs of repairs and maintenance an association plans to provide to its members, but not necessarily in the same period as members are assessed. Members are also generally billed monthly for estimated future reserve expenditures. On the accrual basis, reserve revenue is only recognized when the contract obligation (major repairs and replacements defined in the reserve study) are incurred. Reserve assessments are reported as an increase in contract liabilities (deferred revenue) until they are recognized as revenue.

#2 Special Assessments
Special assessments are generally levied for expenditures not contemplated in the ordinary course of business or dictated by the reserve study. Special assessments are also governed by the CC&RS which give the Association guidance on the authority and other required procedures of special assessing. An example of a typical special assessment would be the discovery of dry rot in a portion of the siding which needs immediate attention, when the repair or replacement of siding is not included as a planned expenditure of the reserve study. A typical special assessment may include the option of paying the full special assessment on a specified date or paying over a specific time period. In this instance, if funds are needed immediately, and funds are available, the Board could borrow from the reserve fund to effect repairs and use the special assessment proceeds to pay back the borrowing from reserves. Since the assessment is a sum certain with a specific due date, the entire special assessment would be recorded as receivable from members when levied. It would make no difference that certain members were paying the assessments over the specified period. You can think of a special assessment just the same as assessing the monthly regular assessment; once the assessment is due, a receivable is recorded from the members.

The special assessment resolution is a contract that gives the estimated costs of dry rot repairs and the amount of special assessments that will be levied to members. On the accrual basis, special assessment revenue is recognized when the contract obligation (dry rot repairs) is performed. Special assessments are reported as an increase in contract liabilities (deferred revenue) until they are recognized as revenue.

#3 Serial Assessments
For purposes of this discussion, we will assume serial assessments are for remediation. Associations considering a serial assessment will generally need a large amount of cash to pay for a major remediation project such as replacing windows, decks and/or siding. The Association often will work with a bank to finance the project. Repairs are then financed through the bank via a construction loan that will convert to a term loan once the borrowing amount is set. Terms can be anywhere from 5 to 20 years. It should be noted that the remediation project expenses and bank borrowing represent activity separate from the serial assessment. The Association will record the remediation expenditures and the amounts owed to the bank that financed the project. This entry utilizes the GAAP matching principle which matches the remediation expenditures with the funding sources, the owner/members that elect option 1 discussed below and the bank loan. The Association will use funds from the owner/members that choose to pay their serial assessments in a lump sum and bank loan proceeds to pay for the project. At the end of the project, the bank will determine the monthly loan payment required by the Association. The loan payments become an obligation of the Association along with all other obligations as detailed in the budgeting process for regular assessment.

The authority of levying the serial assessment comes from the legal documents (CC&Rs) and from the serial assessment resolution. Serial assessment resolutions generally give the members two options:

Option 1 – Elect to pay the serial assessments in full on a specific date with no payment terms, referred to as a lump-sum payment. Lump-sum payments are generally discounted. The accounting treatment for option 1 is similar to the special assessment as described in #2 above. Members that elect this option owe and pay their special assessments in full on a specified date. If the member chooses option 1, the Association will assess the member accordingly. The Association will record the receivable for amounts owed for option 1 and reduce the receivable when paid. Remember that the event that requires the Association to record a receivable is the levying of the assessment. Owner/Members that pay in accordance with option 1 will not have the future serial assessments levied to them. The lump-sum payments will be recorded as contract liabilities (deferred revenue) and recognized as remediation expenses are incurred.

Option 2 – Elect to be assessed via a serial assessment. The accounting treatment for the serial assessment mirrors the accounting treatment for regular assessments except for the term of the budget. The serial assessment resolution ratifies the budget to repay the loan. Instead of a one-year budget, the serial assessment will detail a multi-year budget over the same time period as the loan repayment. This treatment follows the GAAP matching principle. The budget with a serial assessment includes one corresponding line item – loan payment. Every month, the Association levies that month’s serial assessment just like regular assessments and matches the monthly serial assessment with the payment of that month’s loan payment.

Option 2 may include an option to pay the remaining sum of serial assessments at a discount, at which case the payoff amount is recognized as revenue in the period it is assessed and paid, and the amount received is used to pay down the loan.

For all types of assessments, the event that requires the Association to record a receivable is the levying of assessments. On the accrual basis, the event that requires the Association to recognize revenue is performance of the contract obligation. On the cash basis, assessments are recognized as revenue when payment is received.

SECTION 17: FINANCIAL REPORTING TO THE BOARD

PERIODIC IN-HOUSE FINANCIAL REPORTING

General Information

It is important that the Board of Directors examine the Association's financial statements on a periodic basis. A monthly examination is recommended. The Board is responsible for the protection of the Association's assets. As such, the periodic examination of financial information allows for the timely identification and investigation of potential errors and irregularities that may exist in the Association's financial records. In addition, examination of periodic financial information allows the Board to compare actual operating results to those budgeted and to investigate and control ensuing budget variances.

Basis of Accounting

Financial reports are generally prepared on the cash or accrual method or using a combination of the two methods. Generally accepted accounting principles require the accrual method of accounting. The accrual and cash methods are discussed in more detail below. **See excerpt from Washington state statutes in this section 16 regarding requirements on basis of accounting.**

- **Accrual method:** The accrual method of accounting reports revenue in the period in which the related contract obligation is performed and expenses in the period incurred. Thus, assessment revenue is reported on the basis of the contract rather than when the payment is actually received by the Association. The accrual basis of accounting matches the revenue with related expenses. The accrual method of accounting is generally preferred because it facilitates a better comparison of actual operating results to the annual budget. Additionally, the accrual method of accounting reflects a more accurate depiction of the Association's financial position than that of the cash method.

- **Cash-basis method:** The cash-basis method of accounting reports revenues and expenses based on the physical cash inflows and outflows of the Association. It is important to note that cash-basis financial reports do not include delinquent assessments or unpaid vendor bills. It is recommended that the following additional reports be used in conjunction with cash basis reports: assessments receivable aging report to identify amounts due to the Association, accounts payable report to identify amounts due to vendors for services rendered.

- **Modified cash-basis method:** This method may add certain components of the accrual method such as receivables and prepaid assessments but leave out other accrual method accounts such as accounts payable.

Reporting and Board-Review Procedures

On a monthly basis, the Board of Directors is generally given the following financial reports for review:

1. Balance sheet
2. Statement of revenues and expenses by class (operating and reserve)
3. Budget-to-actual comparison of revenues and expenses by class (operating and reserve*)
4. Bank reconciliation reports and copies of bank statements for the month
5. Accounts receivable aging report
6. Accounts payable aging report
7. General ledger detail report for the month
8. A list of all checks written, sorted by check number (out-of-sequence checks should be investigated).

*It is extremely important that the Profit and Loss by Class be reviewed for unclassified items. Unclassified items result in incomplete financial reports.

The Board of Director may want to use a checklist, such as the following, as they read through the monthly financial information:

- Were all bank accounts reconciled? Do the account balances on the reconciliation report agree to the bank statement and to the balance on the balance sheet? Has the treasurer followed up on old uncleared items or discrepancies on the reconciliation? Has the Board noted these actions in the meeting minutes?
- Is the cash or investment balance in any one financial institution less than $250,000 to insure all deposits are federally insured? Are deposits earning interest or just sitting in checking accounts?
- Does the accounts receivable aging report balance agree to the balance on the balance sheet? If the aging report shows significantly past due balances, has the Board followed the Association's collection policy to collect on past due accounts – notices, liens, collection attorney, etc.? Are any accounts foreclosed or bankrupt? Has the Board noted these actions in the meeting minutes?
- Does the accounts payable aging report agree to the balance on the balance sheet? Does it include all unpaid bills? Does the balance sheet include a liability for expenses for which a bill or invoice has not been received? Has the Board reviewed and approved the payment of all invoices listed in the accounts payable aging report? Has the Board noted these actions in the meeting minutes?
- Does the monthly loan statement balance agree to the balance on the balance sheet? If not, has the treasurer followed up on this discrepancy? Has the Board noted these actions in the meeting minutes?
- Were all reserve expenses approved by the board? Do reserve expenses, including change orders, agree with the amount approved by the board? Were approvals noted in the meeting minutes?
- In a comparison of revenue account balances and the approved operating budget, are assessments or other sources of revenue more than or less than budget? On the accrual basis, assessment revenue should agree with the budget. Has the treasurer followed up on any discrepancy? Has the Board noted these actions in the meeting minutes?
- In a comparison of expense account balances and the approved operating budget, are expenses more than or less than budget? Were expenses greater than budget approved by the board and noted in the meeting minutes? If expenses are less than budget, has the Board determined the reason? Has the Board noted these actions in the meeting minutes?
- Are there any accounts on the financial statements that have vague descriptions and significant balances? The Board should consider reclassifying this activity to other appropriate accounts.

ANNUAL FINANCIAL REPORTING

General Information

Many associations are subject to annual financial reporting requirements, either by governing documents or by state statute. Accountants are generally engaged to compile, review, or audit and report on the Association's annual financial statements. **Please read section below on Washington State Statues regarding Audited financial statements.**

Financial Statements

There are three types of assurances CPAs place on financial statements. These assurances in order of reliance are as follows:

- **Compilation:** When a CPA compiles financial statements for a client, the CPA presents information obtained from the client in the form of financial statements in accordance with generally accepted accounting principles. The CPA does not audit or review the information and thus places no assurance on the statements. However, if during the course of the compilation engagement, the CPA notices anything peculiar about the financial information, the CPA is required to investigate to satisfy the CPA that the information would not be misleading to a user.

- **Review:** A review consists of applying analytical review procedures to the information to provide limited assurance that nothing came to the attention of the CPA that would lead the CPA to believe the statements were not fairly presented. This analysis would include, but not be limited to, vouching balance sheet amounts to supporting documentation and comparing current year revenue and expense amounts to prior year and budgeted amounts. This type of assurance is far less than an audit in accordance with generally accepted auditing standards. If the CPA becomes aware of a peculiarity as a result of this review, it is incumbent upon the CPA to perform additional procedures.

- **Audit:** Audited financial statements require the CPA to perform such auditing procedures as promulgated by generally accepted auditing standards to enable the CPA to express an opinion as to the fairness of the financial information. This basically means the CPA's report will say if the CPA believes the amounts reported in the financial statements are materially correct. An audit also requires the CPA to document and analyze the system of internal controls inherent in the accounting system. Any weaknesses in internal controls and other operational efficiency comments are normally communicated via a management letter to the Board of Directors. See Appendix D for further discussion on financial audits.

Which Type of Assurance Service Should the Association Obtain?

Associations should require at least a yearly compilation. Most large associations require either a review or an audit at year end. Factors in requiring a review or audit are frequently a:

1. Requirement in state statutes.

2. Requirement in the Association's governing documents.

3. Time period elapsed from the last audited report.

4. Familiarity with the Association's management company and ongoing financial information.

5. Change in management companies.

6. Turnover from the Declarant to the Member Board of Directors.

7. Subsequent change in the Board of Directors.

Washington Statutes on Annual Audit of Financial Statements

See Appendix C for information on accessing Washington State Statutes governing condominiums and homeowner associations.

Condominiums – RCW Chapter 64.34.372 (1)

- Annual audit required for associations with 50 or more units.
- No opt-out for associations with 50 or more units.
- Annual audit is required for associations with fewer than 50 units unless annually waived by 60% vote of the unit owners.
- The statute appears to require GAAP basis financial statements (accrual basis).
- No due date noted in the statute.

Homeowners Associations – RCW Chapter 64.38.045 (3)

- Annual audit required for HOAs with annual assessments of $50,000 or more.
- Opt-out provision: Audit may be waived with an annual vote of 67% of the owners at a meeting where a quorum is present.
- No due date noted in the statute.

RCW 64.34.372
Association records — Funds

(1) The Association shall keep financial records sufficiently detailed to enable the Association to comply with RCW 64.34.425. All financial and other records of the Association, including but not limited to checks, bank records, and invoices, are the property of the Association, but shall be made reasonably available for examination and copying by the manager of the Association, any unit owner, or the owner's authorized agents. At least annually, the Association shall prepare, or cause to be prepared, a financial statement of the Association in accordance with **generally accepted accounting principles**. The financial statements of condominiums consisting of fifty or more units shall be audited at least annually by a certified public accountant. In the case of a condominium consisting of fewer than fifty units, an annual audit is also required but may be waived annually by unit owners other than the declarant of units to which sixty percent of the votes are allocated, excluding the votes allocated to units owned by the declarant.

(2) The funds of an Association shall be kept in accounts in the name of the Association and shall not be commingled with the funds of any other association, nor with the funds of any manager of the Association or any other person responsible for the custody of such funds. Any reserve funds of an association shall be kept in a segregated account and any transaction affecting such funds, including the issuance of checks, shall require the signature of at least two persons who are officers or directors of the Association.

RCW 64.38.045
Financial and other records — Property of association — Copies — Examination — Annual financial statement — Accounts.

(1) The Association or its managing agent shall keep financial and other records sufficiently detailed to enable the Association to fully declare to each owner the true statement of its financial status. All financial and other records of the association, including but not limited to checks, bank records, and invoices, in whatever form they are kept, are the property of the Association. Each association managing agent shall turn over all original books and records to the Association immediately upon termination of the management relationship with the Association, or upon such other demand as is made by the Board of Directors. An association managing agent is entitled to keep copies of association records. All records which the managing agent has turned over to the Association shall be made reasonably available for the examination and copying by the managing agent.

(2) All records of the Association, including the names and addresses of owners and other occupants of the lots, shall be available for examination by all owners, holders of mortgages on the lots, and their respective authorized agents on reasonable advance notice during normal working hours at the offices of the Association or its managing agent. The Association shall not release the unlisted telephone number of any owner. The Association may impose and collect a reasonable charge for copies and any reasonable costs incurred by the Association in providing access to records.

(3) At least annually, the Association shall prepare, or cause to be prepared, a financial statement of the Association. The financial statements of associations with annual assessments of fifty thousand dollars or more shall be audited at least annually by an independent certified public accountant, but the audit may be waived if sixty-seven percent of the votes cast by owners, in person or by proxy, at a meeting of the Association at which a quorum is present, vote each year to waive the audit.

(4) The funds of the Association shall be kept in accounts in the name of the Association and shall not be commingled with the funds of any other association, nor with the funds of any manager of the Association or any other person responsible for the custody of such funds.

Preparing for Audit, Review, or Compilation

- Fund balances (retained earnings or members' equity), at the beginning of the year, should agree with the fund balances as of the end of the prior year. Any adjustments entered in these accounts should be reconciled and an explanation provided to the CPA.
- Accounts payable should have a positive (credit) balance unless payments were made before the end of the year and bills were entered after the end of the year. In that case, the CPA will need this

information when performing the audit, review, or compilation and may propose an adjustment to reclassify any prepaid expenses to a separate account.

- Accounts payable aging report balance should agree with the ending general ledger (GL) balance.
- Undeposited cash should only include the balance of cash on hand that has not yet been deposited in the bank by the year end date. Payments received on assessments should be applied to Owner balances when they are entered into the accounting software so the balance will not cause Undeposited Cash to be misstated.
- Accounts receivable should have a positive (debit) balance unless prepaid assessments were entered in owner's receivable accounts. In that case, separate reports should be generated to show total of accounts greater than zero (accounts receivable) and total of accounts less than zero (prepaid assessments). Prior to printing these reports, payments received from owners should be credited to the Owners unpaid balances. If accounts receivable and prepaid assessments are combined in one account, the CPA may propose an adjustment to reclassify prepaid assessments to a separate account.
- Accounts receivable aging report balance should agree with the ending GL balance.
- Interest on certificates of deposit, other investments, and other deposit accounts should be posted prior to sending the GL and financial statements to the CPA. The board should always be able to get reports on year-end balances from their financial institutions upon request.
- The GL (register) balance reported on bank reconciliations should agree with the ending GL balance.
- Financial statements and the GL provided for the financial engagement should be printed directly from the accounting software and should all be printed on the same basis of accounting, either accrual basis or cash basis.

Steps in the Audit Process

An understanding of services to be provided is established with an engagement letter between the Association and its CPA. The Association's main point of contact and the person designated to oversee preparation of the financial statements (if applicable) should be indicated. The Association's desired due date should be communicated.

Information will be requested and should be provided to the CPA in a timely manner for the audit process to be completed in time to meet the Association's desired due date.

Fieldwork date(s) will be scheduled for evaluating the design and implementation of the entity's internal control system and for obtaining adequate information to form an opinion on the financial statements as a whole. This will include interviewing staff, tracing source documents to accounting records, verifying balances, vouching accounting records to source documents, and comparing accounting records to expectations established during audit planning.

The CPA will evaluate the audit findings and evidence and may request additional information.

Finally, the CPA will prepare required reports and communications to management and issue an audit draft. The Association's management, including the President and Treasurer of the Board of Directors and the Association's Managing Agent, if applicable, will sign a representation letter stating that the financial statements are the responsibility of management and that management's statements to the auditor during the audit process are true. If applicable, the CPA may also present proposed adjusting journal entries that are a part of the draft. The proposed adjusting journal entries should be reviewed and approved by management.

Although the steps above may appear to be sequential, the audit is a continuous process of collecting and analyzing the financial information presented and disclosed in the Association's financial statements. Therefore, the audit process may involve repeating steps already taken or asking additional questions after initial answers are received.

Signed Documents Required by CPA

Upon the completion of a financial statement review or audit, the Board of Director's President/Chair and Treasurer and the Association's managing agent (if applicable) will be required to sign a client representation letter and to review and approve any proposed adjusting journal entries prepared by the CPA.

The client representation letter from the Association’s management states that all questions and information provided for the review/audit have been answered fully and truthfully and acknowledges that management is responsible for, agrees with, and understands the listed items in the letter.

It is the Treasurer’s responsibility to ask enough questions relating to the information surrounding the proposed adjustments and to perform sufficient due diligence to ascertain the correctness and accuracy of the entries. The Treasurer assumes the responsibility of deciding which adjustments to post to the Association’s books and records. By signing the proposed adjusting journal entries, the Treasurer acknowledges that the adjustments are now a part of the Association’s books and records and that they will also be incorporated in the reviewed/audited financial statements.

SECTION 18: INCORPORATION

Washington State Statutes require that condominium associations maintain corporate status.

Although Washington State Statutes do not require incorporation for homeowner owner associations, we recommend that all associations be incorporated with the state and maintain this corporate status to allow the Association certain advantages, including protecting the members' individual interests from third party claims.

The Association's Board should also review its governing documents for corporate requirements.

To retain the Association's corporate status, a report should be filed with the state annually. The Association should also record changes to the Association's registered agent, changes to the registered address, and changes in the Board's President and Secretary.

SECTION 19: INCOME TAX MATTERS

Your Association has two options when it comes time to file your federal income tax return:

- File as a Homeowners Association with Form **1120-H.**
- File as a Nonexempt Membership Organization with Form **1120.**

Below are some guidelines for selecting which form is right for your Association in a given year.

Advantages of Filing Form 1120-H	Disadvantages of Filing Form 1120-H
1. Form 1120-H is a simple form to complete.	1. Net nonexempt function income taxed at a flat federal rate of 30 percent.
2. There is less risk of audit.	2. There is no net operating loss deduction allowed.
3. Association is only taxed on net nonexempt function income.	3. Associations cannot write off organizational costs.

Exempt function income: Associations filing a Form 1120-H have the advantage of not being taxed on certain income. This income mainly includes member dues, late fees charged to members, interest on late member dues.

Nonexempt function income: Nonexempt function income is defined as coming from three main sources: (a) revenue from non-association property, (b) revenue from nonmembers for the use of Association property, and (c) amounts charged to Association members for specific services that are not charged ratably to all members. The first income is from interest income and other commercial ventures that an association operates. The second income is any income that an association receives from non-members. The third income includes charges to members for per-use fees such as for use of a clubhouse or pool.

Expenses allowed: Nonexempt function income can be offset by expenses that are directly related to that source of nonexempt function income. Other common expenses allowed are accounting fees, management fees, reserve study fees, state income taxes, and bank service charges.

Advantages of Filing Form 1120	Disadvantages of Filing Form 1120
1. Taxable income is taxed at a flat federal rate of 21%.	1. There are more rules that need to be followed, which can be time consuming.
2. Certain tax-planning opportunities may be created by electing Form 1120, including to defer revenue for one year using Revenue Ruling 70-604.	2. Form 1120 is more detailed, more complex, and costs more to prepare than Form 1120-H.
3. Net operating losses are allowed.	3. Associations can be taxed on excess member and nonmember income.

Member vs. nonmember income: Associations that file Form 1120 are required to break their income into categories of member and nonmember. Member income is defined as gross income from members that is used to carry on member functions. Nonmember income is defined as anything that cannot be described as member income. Nonmember income typically comes from interest on investments and any services provided to nonmembers. Unlike for those that file Form 1120-H, associations that file Form 1120 can be taxed on excess member income, which mainly consists of member dues. Form 1120-H treats member dues as exempt, and the dues are not taxed. Associations that file Form 1120 can use Revenue Ruling 70-604 to defer excess membership income to the next year.

Expenses allowed: Nonmember expenses are similar to nonexempt function expenses for associations filing Form 1120-H. The main difference with Form 1120 is that an association also breaks down its expenses between member and nonmember, with adjustments for capital expenditures.

Associations under IRS attack: On October 2, 1995, the IRS published a “deletion’s copy” of Tax Advice Memorandum (TAM) No. 9539001 requested by the Jacksonville, Florida district IRS office relating to the audit of a timeshare association. Even though several years have passed since issuance, this TAM still has authoritative significance and gives added insight into the IRS’s position on certain issues relating to filing Form 1120. Does a timeshare audit affect condominium and homeowner associations? The answer appears to be yes. In the eyes of the IRS, all residential associations are the same. When a residential homeowners association files tax Form 1120-H, the IRS considers it a homeowner association. When that same residential association files Form 1120, the IRS considers it a nonexempt membership organization which is identical to a timeshare association. Associations benefit from filing Form 1120 rather than Form 1120-H because the tax rate for Form 1120 is a flat federal rate of 21% of taxable income, compared to a flat rate of 30 percent for Form 1120-H. Associations may elect on an annual basis to file either Form 1120-H or Form 1120. However, filing Form 1120 puts associations at risk if they do not comply with all IRS procedures. The above-mentioned memorandum details numerous failings of the time-share association, which filed Form 1120, to adhere to IRS procedures.

The following list, borrowed from the winter edition of *The Ledger Quarterly*, addresses the IRS’s rulings, and describes steps to be taken by associations in order to safely file Form 1120:

- Maintain three separate categories of bank accounts: Operating accounts, Capital reserve accounts, and Noncapital reserve accounts such as painting and contingency reserves.

- Conduct a reserve study that supports the specific capital use for the reserves.

- Prepare a budget that agrees with the reserve study.

- Separately account for operating and reserve transactions in the Association’s financial statements and general ledger.

- Have the members annually approve the Association’s election under Revenue Ruling 70-604. The Board of Directors may not approve this on behalf of the membership. (See Appendix A.)

- The Association may not conduct any interfund borrowing among the operating bank accounts and the capital reserve bank accounts.

- If operating and reserve assessments are collected together, deposit them first into the operating account. The reserve dues should than be transferred to the appropriate reserve bank accounts within two weeks.

- Take reserve expenditures directly from the reserve bank accounts. If reserve expenditures are paid from the operating account, that account should be reimbursed in the exact amount of the reserve expenditure at least monthly.

The above list describes the Association’s responsibilities. Tax return preparers should also be aware of additional tax return issues and supporting schedules addressed by this TAM.

Deadlines: All homeowners associations are treated as corporations and have the same deadline of filing three and a half months after their year-end. An association may request a 6-month extension of the time to file its return. However, this extension is not an extension to pay their tax liability. If an association has tax owing, it is required to make its payment before the 3 ½ month deadline after their year-end. The IRS will assess penalties and interest on any association that fails to make timely payment of its tax liability. Associations filing Form 1120 are required to pay federal and state estimated taxes quarterly to avoid underpayment interest if their tax liability equals or exceeds $500. Estimated tax payments are required to be paid electronically and the Association may be penalized if payments are not made timely or electronically.

Penalties: Associations that do not timely file their tax return may be penalized 5 percent of the unpaid tax for each month or part of a month the return is late. The maximum penalty that may be assessed for late filing is 25 percent of the unpaid tax. Associations are also penalized on late payment of their tax liability. The penalty for late payment is .5 percent of the unpaid tax for each month or part of a month that the tax remains unpaid. The maximum penalty that may be assessed for late payment is 25 percent of the unpaid tax. The minimum penalty for a return that is over sixty days late is the smaller of the tax due or $330.

Other Taxes: Associations may be subject to other taxes such as sales taxes, lodging taxes, property taxes, or other county or city taxes. The Association's tax accountant should be consulted on these matters.

SECTION 20: INSURANCE MATTERS

Most associations are familiar with insurance products that insure the association from loss due to fire, water damage and personal liability including directors and officers (D&O) coverage. Insurance that is sometimes overlooked by associations involves fidelity insurance which insures the association against loss from dishonesty, embezzlement and theft by officers, directors and association employees. This coverage should also include loss from other parties including contracted community association managers, bookkeepers and other persons authorized by the association to handle money owned by the association. This coverage is important because many associations have large sums of money in operating and reserve accounts that are potential targets by unscrupulous individuals.

Computer fraud insurance is important if the association uses electronic banking to pay bills or transfer funds. This coverage is different from Fidelity insurance. Many banks require that loss from theft due to electronic transactions be reported to the bank within 48 hours. If the bank is not notified, the bank is held harmless and will not reimburse the association for losses. Most associations do not have systems in place that alert the board or managing agent in a timely fashion and thus will not be reimbursed by the bank. Computer fraud insurance covers the association in the event of theft due to electronic transactions. The parties covered by this insurance should include officers, directors, association employees, contracted community association managers, bookkeepers and other person authorized by the association to handle money owned by the association.

Some Fidelity insurance policies include computer fraud insurance. Care should be taken to ensure that the fidelity policy has a Computer Fraud rider that covers electronic transactions.

Policy Coverage on both Fidelity and Computer Fraud insurance should be equal to all reserve account balances plus three months of operating assessments as well as money in other types of funds including remediation funds and contingency funds.

Board members should be familiar with all insurance policies of the association. If Board members are unsure of specific provisions of the policies, they should consult with their insurance agent.

The Association's Treasurer and Board of Directors should meet annually with the insurance agent. The agent should discuss in layman's terms the insurance coverage including replacement costs, directors' and officers' liability coverage, and property and liability coverage. The Board should question any potential gaps in coverage, as well as how claims are coordinated between the Association's policy and individual homeowners' policies. Insurance deductibles should also be reviewed.

Please note that certain financing agencies, such as HUD, require associations to budget for deductibles. We recommend including deductibles as a component in the reserve study.

SECTION 21: FORM 1099-INFORMATION RETURNS

Form 1099 Information Returns

Forms 1099 are information returns required to be filed annually when certain conditions are met. Although there are sixteen different 1099 forms, the most commonly used by HOAs are Forms 1099-MISC, 1099-DIV, and 1099-INT. In general, payments for non-employee compensation, rents, interest or prizes, royalties and awards made in the course of a trade or business transaction aggregating $600 or more are reported on a Form 1099-MISC. Payments aggregating $10 or more for interest, dividends, or pension distributions, and interest also require issuance of a Form 1099-D**IV,** a 1099-INT, or a 1099-R.

When filing paper copies of Forms 1099-MISC, the recipient and IRS copies are required to be mailed by January 31 if you are reporting non-employee compensation in box 7. If you are reporting amounts on Form 1099-MISC other than in box 7, mail recipient copies by January 31 and paper copies to the IRS by the end of February. Those filing Forms 1099 electronically have until the end of March to submit the information to the IRS for Forms 1099-MISC reporting amounts other than in box 7, non-employee compensation.

Corporate recipients are generally exempt from receipt of Forms 1099 unless the corporate recipient is an attorney or law firm. Most limited liability companies (LLC's) are not exempt and do need to receive a Form 1099 if they meet the dollar threshold. The IRS applies penalties ranging from $50 to $540 per statement to those failing to file timely or correct returns, and the state may disallow the entire related deduction, or issue separate penalties. Some states require electronic submission of certain 1099.

Form W-9 Request for Taxpayer Identification Number and Certification

Form W-9 is commonly used to request the legal name, type of entity and identification number of a vendor and is recommended to be completed prior to payment. This form is used for purposes of verifying whether a Form 1099 is required based upon the payee's federal tax classification and provides much of the needed information when preparing Forms 1099 at year-end.

SECTION 22: EMPLOYEE VS. INDEPENDENT CONTRACTOR

General Information

The proper classification of workers as employees or independent contractors is crucial. A worker classified as an employee requires income tax withholdings; payroll tax payments (such as FICA, Medicare, and unemployment insurance); preparation and filing of various federal and state payroll returns; and, if eligible, employee benefits, such as health insurance and retirement plans. Employers are also required to carry workers compensation insurance on employees. If a worker is classified as an independent contractor, there is no requirement for payroll tax payments and payroll returns or other employee-type benefits. Generally, the only required filing is an annual Form 1099 with the Internal Revenue Service (See Section 21).

The primary factor in classifying a worker as an employee or independent contractor depends on the extent in which the individual receiving the services has the right to direct and control the actions of the worker with respect to what is done and how it is done.

To determine whether a worker is an independent contractor or an employee, you must examine the relationship between the worker and the business. All evidence of control and independence in this relationship should be considered. The facts that provide this evidence fall into three categories – Behavioral Control, Financial Control, and the Type of Relationship itself (Adapted from topic 762 from the Internal Revenue Service website).

Behavioral Control covers facts that show if the business has a right to direct and control how the work is done, through instructions, training, or other means.

Financial Control covers facts that show whether the employer or business has a right to control the business aspects of the worker's job. This includes:

- The extent to which the worker has unreimbursed business expenses
- The extent of the worker's investment in the business
- The extent to which the worker makes services available to the relevant market
- How the business pays the worker
- The extent to which the worker can realize a profit or incur a loss

Type of Relationship covers the following facts:

- Written contracts describing the relationship the parties intended to create
- The extent to which the worker is available to perform services for other, similar businesses
- If the business provides the worker with employee–type benefits, such as insurance, a pension plan, vacation pay, or sick pay
- The permanency of the relationship

If it is determined that an employee has been misclassified as an independent contractor, penalties, interest, and payment of withholding taxes on behalf of the employee may result. The extent of penalties and interest depends on whether the misclassification is deemed to be intentional or unintentional.

SECTION 23: OTHER ACCOUNTING PROCEDURES/POLICIES TO CONSIDER

Periodic Backup of Financial Data

On at least a weekly basis (daily, if possible) the Association should prepare a backup of its accounting data files. These backup files should be stored in a location separate from the data source. Having a recent backup of your accounting data allows for the convenient restoration in the event of lost data.

Record Retention Policy

It is recommended that the Association establish a record retention policy. An example record retention policy is included in Appendix B of this manual. All financial and other records should be stored onsite to avoid the possibility of fragmented records.

Collecting Assessments via a Bank Lockbox

A lockbox is a service offered by many banks that allows owners to mail their payments, along with an encoded payment coupon, directly to the bank. The bank deposits each check directly to the Association's bank account (per encoded payment coupon). The bank generates a daily deposit record organized by individual unit and generally transmits this information to the Association electronically. Essentially, a lockbox greatly improves the efficiency and accuracy of assessment collections and daily postings. Associations of all sizes can utilize a lockbox.

SECTION 24: FHA CERTIFICATION AND FANNIE MAE UNDERWRITING REQUIREMENTS

Sellers and purchasers of condominiums are becoming aware of the advantages of HUD certification. If an association is approved by HUD for government insured loans such as FHA loans, the potential purchaser and borrower of a condominium unit has an advantage of using these loans which may offer easier qualifying ratios and down payment requirements.

To become approved by HUD, associations will need to apply and become re-certified periodically. Associations should work with professionals who specialize in assisting associations with the approval process. It is not recommended that associations apply for approval without consulting with such professionals.

APPENDIX A1: REVENUE RULING 70-604 ELECTION

By: David T. Schwindt, CPA

What is the 70-604 election?
The Revenue Ruling 70-604 election is a tax election that documents the intention of the Association to consider utilizing the provisions of Revenue Ruling 70-604 when filing Form 1120. This election, if used when filing Form 1120, may reduce potential risks of filing Form 1120. Associations filing Form 1120H do not qualify to use the provisions of Revenue Ruling 70-604.

How is the election made?
Revenue Ruling 70-604 election is made by voting on the election at a duly organized annual meeting of the membership of the Association. A duly organized annual membership meeting is by definition a meeting that conforms to the annual meeting criteria as set forth by the Association's governing documents. After the duly organized meeting is called to order, the election can be submitted to a vote of those in attendance at the annual meeting. If more than 50% of the members in attendance at the meeting vote in favor of the election, it passes.

After passing the election by vote, the election form should be signed by an officer of the Association signifying the action taken. The form should be forwarded to the Association's tax preparer.

Should an Association pass the 70-604 election if the Association generally files Form 1120H which does not use Revenue Ruling 70-604?
Yes, the election should also be made by Associations that file Form 1120H. There is always a chance the Association may want to file Form 1120 in any given year due to unexpected potentially taxable income such as a lump sum utility easement payment or other unexpected taxable income. In this case, it is advisable to make the election just in case the Association may want to take advantage of Revenue Ruling 70-604 when filing Form 1120.

Is there any potential liability to the Association in making the 70-604 election and voting on the election at the annual meeting?
No, there is no tax liability to the Association for making the election.

Questions regarding this article may be directed to David T. Schwindt, CPA at Schwindt & Co. (503) 227-1165.

APPENDIX A2: 70-604 ELECTION LETTER RECOMMENDED FORMAT

ASSOCIATION RESOLUTION FOR REVENUE RULING 70-604 ELECTION –
EXCESS INCOME APPLIED TO THE FOLLOWING YEAR'S ASSESSMENTS

RESOLUTION MUST BE VOTED ON BY THE MEMBERSHIP
AT THE ANNUAL MEETING

ANNUAL RESOLUTION OF THE ________________(NAME)________________________

RE: EXCESS INCOME APPLIED TO THE FOLLOWING YEAR'S ASSESSMENTS REVENUE RULING 70-604

WHEREAS, the ___________________(NAME)_____________ is a Washington corporation duly organized and existing under the laws of the State of Washington;

and

WHEREAS, the members desire that the corporation shall act in full accordance with the rulings and regulations of the Internal Revenue Service;

NOW, THEREFORE, the members hereby adopt the following resolution by and on behalf of the _______(NAME)_______:

RESOLVED, that any excess of membership income over membership expenses for the year ended _______(DATE)_______ shall be applied against the subsequent tax year member assessments as provided by IRS Revenue Ruling 70-604.

This resolution was voted on and made a part of the minutes of the annual meeting of _____(DATE)___ .

BY: ___________________________________
President

ATTESTED: ____________________________
Secretary

Treasurers' Note: This election should be voted on at the annual meeting. The vote does not require a quorum. This election does not bind the Association in filing a particular tax form. It does, however, make it safer to file Form 1120 if the Association so desires.

Note: This resolution is for discussion purposes only. All legal resolutions should be approved by Association's legal counsel.

APPENDIX B: RECORD RETENTION POLICY

HOA Record Retention Policy Guidelines
Prepared by: Schwindt & Co.

The following is a listing of common records for Associations along with recommended retention times from the AICPA. You should check with your attorney or review state statutes to determine if the length of time may be longer.

RECORD	RETENTION GUIDELINE (Paper/Electronic)
Accounting Records:	
Chart of accounts	Permanent
Budgets	Permanent
Invoices/Owner billings	7 years
Vendor bills/expense records	7 years
Accounts payable ledgers	7 years
Accounts receivable ledgers	7 years
Bank statements, cancelled items and reconciliation reports	7 years
Cancelled checks, important (tax payments, property purchases)	Permanent
Duplicate deposit slips	3 years
Petty-cash records	7 years
Certificate of deposits, matured	7 years
Investments (stocks/bonds), sales and purchases	Permanent
Balance sheet and profit/loss statement, internal, year-end reports	Permanent
Trial balance, year-end	Permanent
Balance sheet, profit/loss statement, internal, monthly reports	1 year
General ledger report, annual	Permanent
Check register, annual	Permanent
Journal entries	Permanent
Subsidiary ledgers	7 years
Property/Fixed asset purchases	Permanent
Real estate purchases	Permanent
Depreciation schedules	Permanent
Inventory records	7 years
Purchase orders	7 years
Lease payment records	4 years (after term)
Audited/Reviewed/Compiled year-end financial reports	Permanent
Tax returns and IRS documents	Permanent
Tax documents/elections	Permanent

Employee Records:

Benefit plans, including pension and profit-sharing plans	Permanent
Employee files, ex-employees	3 years
Payroll checks and register, including time records	7 years
Employment tax returns	Permanent
W-2 forms	Permanent
Employment applications	3 years

Association Documents:

Ownership/Membership records	Permanent
Deeds, Plats, Maps	Permanent
Governing Documents:	Permanent
Declaration, Covenants, Conditions, and Restrictions, including all amendments	Permanent
Articles of Incorporation, including all amendments	Permanent
Bylaws, including all amendments	Permanent
Board policies and resolutions	Permanent
Restrictions and rules	Permanent
Architectural guidelines	Permanent
Architectural approvals and disapprovals	Permanent
Election records	Permanent
Meeting Minutes, Annual Meetings	Permanent
Meeting Minutes, Board of Director	Permanent
Meeting Minutes, Committees	Permanent

Other Documents:

Insurance policies	4 years (after term)
Insurance claims	Permanent
Contracts, vendor, minor	4 years (after term)
Contracts, vendor, major	Permanent
Contracts, employee	Permanent
Contracts, management	Permanent
Bids/Proposals	3 years
Correspondence, general	3 years
Correspondence, legal matters	Permanent
Leases	4 years (after term)
Mortgages	Permanent
Note payable documentation	4 years (after term)

Note: Check with your attorney prior to discarding records that may be related to pending litigation.

APPENDIX C: STATE STATUTES GOVERNING

PLANNED UNIT DEVELOPMENTS AND CONDOMINIUMS

Washington State Statutes

Chapter 64.32 – Horizontal Property Regimes Act (Condominiums)
http://apps.leg.wa.gov/RCW/default.aspx?cite=64.32

Chapter 64.34 – Condominium Act http://apps.leg.wa.gov/rcw/default.aspx?cite=64.34

Chapter 64.35 – Condominiums – Qualified Warranties
http://apps.leg.wa.gov/RCW/default.aspx?cite=64.35

Chapter 64.36 – Time Share Regulation http://apps.leg.wa.gov/RCW/default.aspx?cite=64.36

Chapter 64.38 – Homeowners' Associations
http://apps.leg.wa.gov/RCW/default.aspx?cite=64.38&full=true

Chapter 64.90 RCW – Washington Uniform Common Interest Ownership Act
http://app.leg.wa.gov/RCW/default.aspx?cite=64.90

APPENDIX D: FINANCIAL AUDITS –

NECESSARY EVIL OR SOURCE OF VALUABLE INFORMATION?

By
David T. Schwindt, CPA, RS, PRA

Washington State Statute **RCW 64.34.372** requires all **Condominium Associations** annually to engage a CPA to audit the financial statements. In the case of a condominium consisting of fewer than fifty units, the requirement for an annual audit may be waived annually by a vote of 60% of the unit owners excluding votes allocated to units owned by the declarant. If a condominium association consisting of fewer than 50 units elects to waive the audit requirement, the Association is still obligated to annually prepare, or cause to be prepared, a financial statement of the Association in accordance with generally accepted accounting principles (GAAP). Condominium Associations subject to pre-July 1, 1990 statutes are required annually to conduct an audit regardless of size. The auditor must not be a member of the Association and there are no provisions to waive the requirement.

Washington State Statute **RCW 64.38.045** requires all **Homeowner Associations** with annual assessments of $50,000 or more to be audited at least annually by an independent Certified Public Accountant. (The $50,000 requirement appears to include only assessments, not other types of income such as interest income.) This requirement may be waived annually if 67% of the votes cast by owners in person or by proxy at a meeting of the Association at which a quorum is present, vote in favor of the waiver. If assessments are less than $50,000, the Association is still obligated to keep financial and other records sufficiently detailed to enable the Association to fully declare to each owner the true statement of its financial status. (In my opinion, the “true statement of financial status” would require GAAP basis financial statements.)

Washington State Statute **RCW 64.34.425(1) (i)** pertaining to **resale certificates** does not require an audited financial statement. However, the statute states that the resale certificate shall contain a balance sheet and a revenue and expense statement of the Association prepared on an accrual basis, which shall be current to within 120 days. To be in compliance, associations would be required to prepare accrual basis monthly financial statements.

The above statutes either imply or directly state that financial information must adhere to generally accepted accounting principles. These principles are the official guidance to CPAs on how to account for various transactions. The rules and procedures for reporting under GAAP are complex and have developed over a long period of time. These rules also encompass industry specific procedures. Application of these rules in financial statement preparation ensures that financial statements are prepared in a manner that users have all of the information needed to make informed decisions with respect to the financial condition of the Association. Accrual basis is an example of GAAP. Under the accrual basis accounting, revenue is recorded when earned and expenses are recorded when incurred. Under the cash basis of accounting (non-GAAP), revenue is recognized when received and expenses are recognized when paid.

Audits provide the highest level of assurance obtainable from a CPA and require the auditor to test the books and records to ascertain the correctness of financial information contained in the statements and notes to the financial statements. One of the major benefits of performing an audit relates to the auditor’s requirement to consider the organization’s system of internal controls in determining the timing, extent and nature of tests of transactions. The system of internal controls includes all policies and procedures employed by the Board of Directors, accounting personnel and community manager that help protect Association assets and help insure that no one person is in the position of defrauding the Association without management detecting the fraud within a reasonable length of time. No system of internal controls is flawless, and collusion among personnel can make it more difficult to detect fraudulent activities. The CPA is required to communicate weaknesses in the system of internal controls to the Board. This is commonly performed in writing via a “communication with those charged with governance” (formerly called the Management Letter). This form of communication is also used to communicate suggestions to improve the financial health of the Association, operational efficiencies, and non-compliance with State and Federal statutes and regulations.

When analyzing the system of internal controls, auditors commonly look for incompatible duties of accounting personnel and board members. An example of an incompatible set of duties would be a bookkeeper who manages all aspects of the accounting process including billings, deposits, signing checks, preparing bank reconciliations, and preparing financial statements with little oversight by the manager or Board. This person could have the opportunity to take funds from the Association and conceal the theft by manipulating the financial records. Strong internal controls generally include segregating the duties of performing and reviewing financial transactions among Association personnel, community manager, and board members to establish a system of checks and balances to help prevent defalcations. Changes in board members, community managers, and accounting personnel require associations to constantly monitor the effectiveness of the system of internal controls. Absent these types of controls, auditors may consider modifying the tests of transactions to compensate for these potential deficiencies. A good auditor maintains a sense of “professional skepticism,” which means he or she assumes that everyone has their “hands in the cookie jar” unless proven otherwise. Good auditors are diplomatic in carrying out this directive. In a world of corruption, greed, and blurred lines of right and wrong, CPAs continue as sentinels of integrity and independence.

The true value of an audit is the fulfillment of the fiduciary responsibility of the Board in helping to assure that amounts used in the budgeting and operation phases of the financial process are correct and to assure the membership that everything possible is being accomplished to protect the financial investment that owners have in their unit and community assets. Boards should view an audit as an investment in the financial health of the Association and care should be taken to choose an audit firm with industry experience and the understanding that the evaluation of internal controls and the communication of weaknesses to the Board is an integral part of the engagement.

David T. Schwindt, CPA, RS, PRA, owner of Schwindt & Co. works with over 500 associations in the Pacific Northwest providing audit, tax, and reserve study services.

APPENDIX E: EXAMPLE CHART OF ACCOUNTS FOR HOMEOWNERS ASSOCIATIONS

Account Number	Description	Type
10100	Cash in Bank - Operating Checking	Asset
10200	Cash in Bank - Operating Money Market	Asset
10300	Investments - Operating CDs	Asset
10310	Unamortized Premium/Discount on Investments - Operating	Asset
10400	Petty Cash	Asset
10500	Cash in Bank - Operating Payroll	Asset
11110	Interfund Balance - Due from Operating to Replacement Reserve	Asset
11120	Interfund Balance - Due from Operating to Working Capital	Asset
11130	Interfund Balance - Due from Operating to Special Assessment	Asset
11140	Interfund Balance - Due from Operating to Litigation	Asset
12110	Accounts Receivable - Assessments - Operating	Asset
12210	Accounts Receivable - Assessments - Replacement Reserves	Asset
12120	Accounts Receivable - Assessments - Developer Operating	Asset
12220	Accounts Receivable - Assessments - Developer Replacement Reserves	Asset
12310	Accounts Receivable - Special Assessments	Asset
12410	Accounts Receivable - Working Capital Contributions	Asset
12420	Accounts Receivable - Working Capital Contributions - Developer	Asset
12510	Litigation Proceeds Receivable	Asset
12610	Accounts Receivable - Architectural Control Fees	Asset
12620	Accounts Receivable - Reimbursements	Asset
12630	Accounts Receivable - Other	Asset
12900	Contract Asset	Asset
13100	Prepaid Insurance	Asset
13200	Prepaid Expenses	Asset
13310	Prepaid Federal Tax	Asset
13320	Prepaid State Tax (not applicable in some states)	Asset
13330	Prepaid Property Tax	Asset
13400	Deferred Expenses	Asset
14110	Automobile	Asset
14120	Accumulated Depreciation on Automobile	Asset
14210	Capital Improvements	Asset
14220	Accumulated Depreciation on Capital Improvements	Asset
14310	Equipment/Furnishings	Asset
14320	Accumulated Depreciation on Equipment/Furnishings	Asset
14410	Other Fixed Assets per Association's Capitalization Policy	Asset
14420	Accumulated Depreciation on Other Fixed Assets	Asset
14510	Land	Asset
15100	Cash in Bank - Replacement Reserve Checking	Asset
15200	Cash in Bank - Replacement Reserve Money Market	Asset
15300	Investments - Replacement Reserve CDs	Asset
15310	Unamortized Premium/Discount on Investments - Replacement Reserve	Asset
11210	Interfund Balance - Due from Replacement Reserve to Operating	Asset
11220	Interfund Balance - Due from Replacement Reserve to Working Capital	Asset
11230	Interfund Balance - Due from Replacement Reserve to Special Assessment	Asset
11240	Interfund Balance - Due from Replacement Reserve to Litigation	Asset
16100	Cash in Bank - Working Capital Checking	Asset
16200	Cash in Bank - Working Capital Money Market	Asset
16300	Investments - Working Capital CDs	Asset
16310	Unamortized Premium/Discount on Investments - Working Capital	Asset
11310	Interfund Balance - Due from Working Capital to Operating	Asset
11320	Interfund Balance - Due from Working Capital to Replacement Reserve	Asset
11330	Interfund Balance - Due from Working Capital to Special Assessment	Asset
11340	Interfund Balance - Due from Working Capital to Litigation	Asset
17100	Cash in Bank - Special Assessment Checking	Asset
17200	Cash in Bank - Special Assessment Money Market	Asset
17300	Investments - Special Assessment CDs	Asset
17310	Unamortized Premium/Discount on Investments - Special Assessment	Asset
11410	Interfund Balance - Due from Special Assessment to Operating	Asset
11420	Interfund Balance - Due from Special Assessment to Replacement Reserve	Asset
11430	Interfund Balance - Due from Special Assessment to Working Capital	Asset
11440	Interfund Balance - Due from Special Assessment to Litigation	Asset
20100	Accounts Payable - Operating	Liability
20110	Accrued Accounts Payable - Operating	Liability
20120	Payroll Payable	Liability
20130	Insurance Proceeds Payable	Liability
20210	Federal Tax Payable	Liability

Account Number	Description	Type
20220	State Tax Payable (not applicable in some states)	Liability
20230	Property Tax payable	Liability
20300	Refundable Deposits	Liability
21100	Accounts Payable - Replacement Reserves	Liability
21110	Accrued Accounts Payable - Replacement Reserves	Liability
22100	Accounts Payable - Special Assessments	Liability
22110	Accrued Accounts Payable - Special Assessments	Liability
23100	Accounts Payable - Litigation	Liability
23110	Accrued Accounts Payable - Litigation	Liability
24100	Line of Credit Payable	Liability
24210	Note Payable - Current Portion	Liability
24220	Note Payable - Long Term Portion	Liability
25100	Prepaid Assessments - Operating	Liability
25200	Prepaid Assessments - Operating - Developer	Liability
26100	Prepaid Assessments - Replacement Reserve	Liability
26200	Prepaid Assessments - Replacement Reserve - Developer	Liability
27000	Prepaid Assessments - Special Assessments	Liability
28000	Deferred Revenue - Special Assessments	Liability
28000	Deferred Revenue - Litigation	Liability
29000	Contract Liability	Liability
30000	Operating Fund	Fund Balance
31000	Replacement Reserve Fund	Fund Balance
32100	Working Capital Fund	Fund Balance
32200	Current Year Working Capital Contributions	Fund Balance
33000	Special Assessment Fund	Fund Balance
34000	Litigation Fund	Fund Balance
30100	Transfer from Operating to Replacement Reserves	Fund Balance
30200	Transfer from Operating to Special Assessment	Fund Balance
30300	Transfer from Operating to Litigation	Fund Balance
32100	Transfer from Working Capital to Operating	Fund Balance
32200	Transfer from Working Capital to Replacement Reserves	Fund Balance
32300	Transfer from Working Capital to Special Assessment	Fund Balance
32400	Transfer from Working Capital to Litigation	Fund Balance
33100	Transfer from Special Assessment to Operating	Fund Balance
33200	Transfer from Special Assessment to Replacement Reserves	Fund Balance
33300	Transfer from Special Assessment to Litigation	Fund Balance
34100	Transfer from Litigation to Operating	Fund Balance
34200	Transfer from Litigation to Replacement Reserves	Fund Balance
34300	Transfer from Litigation to Special Assessment	Fund Balance
40100	Operating Assessments	Operating Revenue
40150	Contra-Revenue (Current Year Uncollectible Assessments)	Operating Revenue
40200	Operating Assessments - Developer	Operating Revenue
41000	Interest Income - Operating	Operating Revenue
42100	Late Fees	Operating Revenue
42200	Interest on Late Assessments	Operating Revenue
43000	Architectural Control Fees	Operating Revenue
44100	Rental Income	Operating Revenue
44200	Laundry Income	Operating Revenue
44300	Key Income	Operating Revenue
44400	Tax Refund	Operating Revenue
44500	Advertising Income	Operating Revenue
44600	Vending Machine Income	Operating Revenue
44700	Cell Phone Tower Income	Operating Revenue
44800	Lease Income	Operating Revenue
45000	Miscellaneous Income	Operating Revenue
50010	Appliance Maintenance & Repair - Operating	Operating Expenses
50020	Automobile Gasoline	Operating Expenses
50030	Automobile Maintenance & Repair - Operating	Operating Expenses
50040	Backflow Testing	Operating Expenses
50050	Bark dust	Operating Expenses
50060	Boiler Maintenance & Repair - Operating	Operating Expenses
50070	Building Maintenance & Repair - Operating	Operating Expenses
50080	Carpet Cleaning	Operating Expenses
50090	Carpet Repairs	Operating Expenses
50100	Carport Maintenance & Repair - Operating	Operating Expenses
50110	Chimney Maintenance & Repair - Operating	Operating Expenses
50120	Dock Maintenance & Repair - Operating	Operating Expenses
50130	Drainage Maintenance & Repair - Operating	Operating Expenses
50140	Elevator - Other	Operating Expenses
50150	Elevator Contract	Operating Expenses

Account Number	Description	Type
50160	–Emergency Contingency	Operating Expenses
50170	Exterior Maintenance & Repair - Operating	Operating Expenses
50180	Fences Maintenance & Repair – Operating	Operating Expenses
50190	Fire Protection Maintenance & Repair - Operating	Operating Expenses
50200	Floors Maintenance & Repair - Operating	Operating Expenses
50210	Garage Maintenance & Repair - Operating	Operating Expenses
50220	Gutter/Downspout Maintenance & Repair - Operating	Operating Expenses
50230	HVAC - Other Maintenance & Repair - Operating	Operating Expenses
50240	HVAC Contract	Operating Expenses
50250	Interior Maintenance & Repair - Operating	Operating Expenses
50260	Irrigation Maintenance & Repair - Operating	Operating Expenses
50270	Janitorial - Contract	Operating Expenses
50280	Janitorial - Supplies	Operating Expenses
50290	Landscape - Payroll Taxes	Operating Expenses
50300	Landscape - Contract	Operating Expenses
50310	Landscape - Improvements	Operating Expenses
50320	Landscape - Payroll	Operating Expenses
50330	Laundry Machine Maintenance & Repair - Operating	Operating Expenses
50340	Light Fixtures Maintenance & Repair - Operating	Operating Expenses
50350	Maintenance Staff - Payroll	Operating Expenses
50360	Maintenance Staff - Payroll Taxes	Operating Expenses
50370	Painting Maintenance & Repair - Operating	Operating Expenses
50380	Parking & Street Cleaning	Operating Expenses
50390	Paths/Sidewalks Maintenance & Repair - Operating	Operating Expenses
50400	Patio/Deck Maintenance & Repair - Operating	Operating Expenses
50410	Pest Control	Operating Expenses
50420	Plant Maintenance & Repair - Operating	Operating Expenses
50430	Plumbing Maintenance & Repair - Operating	Operating Expenses
50440	Pond Maintenance & Repair - Operating	Operating Expenses
50450	Pool/Spa - Supplies	Operating Expenses
50460	Pool/Spa Maintenance - Contract	Operating Expenses
50470	Pump Maintenance & Repair - Operating	Operating Expenses
50480	Roof Maintenance & Repair - Operating	Operating Expenses
50490	Security Gate Maintenance & Repair - Operating	Operating Expenses
50500	Security System Maintenance & Repair - Operating	Operating Expenses
50510	Siding Maintenance & Repair - Operating	Operating Expenses
50520	Stairwells Maintenance & Repair - Operating	Operating Expenses
50530	Supplies for Maintenance & Repair - Operating	Operating Expenses
50540	Tree Pruning/Spraying	Operating Expenses
50550	Vending Machine Maintenance & Repair - Operating	Operating Expenses
50560	Water Lines Maintenance & Repair - Operating	Operating Expenses
50570	Window Cleaning	Operating Expenses
51010	Cable TV	Operating Expenses
51020	Dumpster	Operating Expenses
51030	Electricity	Operating Expenses
51040	Elevator Telephone	Operating Expenses
51050	Garbage	Operating Expenses
51060	Gas	Operating Expenses
51070	Oil	Operating Expenses
51080	Sewer	Operating Expenses
51090	Telephone	Operating Expenses
51100	Water	Operating Expenses
51110	Water/Sewer	Operating Expenses
51120	Accounting	Operating Expenses
51130	Administrator - Payroll	Operating Expenses
51140	Administrator - Payroll Taxes	Operating Expenses
51150	Annual Meeting Expenses	Operating Expenses
51160	Art/Flowers	Operating Expenses
51170	Audit/Review	Operating Expenses
51180	Bad Debt	Operating Expenses
51190	Bank Fees	Operating Expenses
51200	Bank Fees on Loan/Note	Operating Expenses
51210	Depreciation	Operating Expenses
51220	Employee Benefits	Operating Expenses
51230	Equipment Leases	Operating Expenses
51240	Income Tax	Operating Expenses
51250	Gain/Loss on Sale of Asset	Operating Expenses
51260	Insurance	Operating Expenses
51270	Interest on Loan/Note Payable	Operating Expenses
51280	Legal	Operating Expenses

Account Number	Description	Type
51290	License/Fees	Operating Expenses
51300	Miscellaneous	Operating Expenses
51310	Office	Operating Expenses
51320	Operations	Operating Expenses
51330	Property Tax	Operating Expenses
51340	Rental Expenses	Operating Expenses
51350	Tax Preparation	Operating Expenses
51360	Website	Operating Expenses
52010	Management - Contract	Operating Expenses
52020	Management - Payroll	Operating Expenses
52030	Management - Payroll Taxes	Operating Expenses
52040	Reserve Study Consultants	Operating Expenses
52050	Security - Contract	Operating Expenses
60100	Replacement Reserve Assessments	Replacement Reserve Revenue
60200	Replacement Reserve Assessments - Developer	Replacement Reserve Revenue
61000	Interest Income - Replacement Reserves	Replacement Reserve Revenue
65010	Administration Expenses Related to Replacement Reserves	Replacement Reserve Expenses
65020	Bank Fees	Replacement Reserve Expenses
66010	Bark Dust	Replacement Reserve Expenses
66020	Carpet	Replacement Reserve Expenses
66030	Carport	Replacement Reserve Expenses
66040	Chimney	Replacement Reserve Expenses
66050	Consultants	Replacement Reserve Expenses
66060	Contingency	Replacement Reserve Expenses
66070	Dock	Replacement Reserve Expenses
66080	Doors	Replacement Reserve Expenses
66090	Elevator	Replacement Reserve Expenses
66100	Fences	Replacement Reserve Expenses
66110	Floors	Replacement Reserve Expenses
66120	Garage	Replacement Reserve Expenses
66130	Gutters/Downspout	Replacement Reserve Expenses
66140	HVAC	Replacement Reserve Expenses
66150	Interior	Replacement Reserve Expenses
66160	Irrigation	Replacement Reserve Expenses
66170	Landscape	Replacement Reserve Expenses
66180	Painting	Replacement Reserve Expenses
66190	Paths/Sidewalks	Replacement Reserve Expenses
66200	Patio/Deck	Replacement Reserve Expenses
66210	Paving & Curbs	Replacement Reserve Expenses
66220	Plumbing	Replacement Reserve Expenses
66230	Pool/Spa	Replacement Reserve Expenses
66240	Road	Replacement Reserve Expenses
66250	Roof	Replacement Reserve Expenses
66260	Security Gate	Replacement Reserve Expenses
66270	Security System	Replacement Reserve Expenses
66280	Siding Stairwells	Replacement Reserve Expenses
66290	Signs	Replacement Reserve Expenses
66300	Storeroom	Replacement Reserve Expenses
66310	Tree Pruning/Spraying	Replacement Reserve Expenses
66320	Tree Replacement	Replacement Reserve Expenses
66330	Windows	Replacement Reserve Expenses
70100	Special Assessments	Other Revenue
71000	Interest Income - Special Assessments	Other Revenue
75010	Administration Expenses Related to Special Assessment	Other Expenses
75020	Bank Fees - Related to Special Assessment	Other Expenses
76010	Expenses Related to Special Assessment	Other Expenses
75030	Interest on Loan/Note Payable - Special Assessment	Other Expenses
80100	Litigation Proceeds	Other Revenue
81000	Interest Income - Litigation Proceeds	Other Revenue
85010	Administration Expenses Related to Litigation	Other Expenses
85020	Bank Fees - Related to Litigation	Other Expenses
86010	Consultants Expense Related to Litigation	Other Expenses
85030	Interest on Loan/Note Payable - Litigation	Other Expenses
86020	Legal Expenses Related to Litigation	Other Expenses
86030	Other Expenses Related to Litigation	Other Expenses
91000	Interest Income - Working Capital	Other Revenue
95000	Working Capital Expenditures	Other Expenses

[NAME OF ASSOCIATION]

Resolution of the Board of Directors

INVESTMENT POLICY

The Association's investment objective is to earn as much as possible while protecting the Association's principal.

Resolved, funds deposited in any one financial institution will not exceed $250,000 which is the maximum balance insured by the Federal Deposit Insurance Corporation (FDIC) at each financial institution, and

Resolved, if the rate of return on certificates of deposit (CDs) exceeds the rate of return on money market accounts, the Association will move funds to CDs and will ladder the CDs to ensure the availability of cash when needed.

ATTEST:

[Name of Association]

____

Chairman

Date: _______________________________

____

Secretary

Date: _______________________________

Note: This resolution is for discussion purposes only. All legal resolutions should be approved by Association's legal counsel.

Resolution of the Board of Directors of [Name of Association]

[NAME OF ASSOCIATION]

Resolution of the Board of Directors

INTERFUND BORROWING
REPAYMENT PLAN

As of December 31, 20[XX], [$XXX,XXX] of replacement reserve assessments and [$X,XXX] of working capital contributions had been borrowed to pay for operating expenses.

Resolved, the Association plans to repay the amounts due to the replacement fund and working capital fund as follows: [Repayment plan to be entered here].

ATTEST:

[Name of Association]

____
Chairman

Date: ________________________________

____
Secretary

Date: ________________________________

Note: This resolution is for discussion purposes only. All legal resolutions should be approved by Association's legal counsel.

Resolution of the Board of Directors of [Name of Association]

[NAME OF ASSOCIATION]

Resolution of the Board of Directors

CAPITALIZATION POLICY

Resolved, all purchases of personal property less than [$X,XXX] shall be expensed. All expensed personal property shall be considered for inclusion in the reserve study as a component.

ATTEST:

[Name of Association]

____
Chairman

Date: _______________________________

____
Secretary

Date: _______________________________

Note: This resolution is for discussion purposes only. All legal resolutions should be approved by Association's legal counsel.

Resolution of the Board of Directors of [Name of Association]

[NAME OF ASSOCIATION]

Resolution of the Board of Directors

COMPETITIVE BIDDING POLICY

Resolved, management will place out to bid [from time to time, as specified by the Board], whenever practical, a minimum of 2 and a maximum of 3 bids for the work for repairs and maintenance as required by the Association. The value of work to be placed out to bid will be in excess of [$X,XXX].

ATTEST:

[Name of Association]

____
Chairman

Date: ______________________________

____
Secretary

Date: ______________________________

Note: This resolution is for discussion purposes only. All legal resolutions should be approved by Association's legal counsel.

Resolution of the Board of Directors of [Name of Association]

APPENDIX G: ONLINE BANKING, CYBER-THEFT, AND INTERNAL CONTROLS

By
David T. Schwindt, CPA RS PRA

Over the past several years, we have become increasingly aware of the potential of theft occurring when associations are involved with online banking. One of the greatest areas of concern is in the area of fraudulent electronic funds transfers (EFT) and ACH transaction fraud. Cyber criminals are now targeting associations due to the ease of accessibility because of weak or nonexistent controls.

Many Associations are implementing online activities without considering the necessity of additional internal controls. If the fraud can be traced to a security breach in the victim's computer (for example, viruses, malware, [malicious software programs] or hijacking programs), the bank may be able to avoid responsibility for the recovery of the lost funds. The bank also may find that the customer is not in compliance with its security authentication procedures which also may impair the victim's ability to recover lost funds.

External Attacks

Computer systems without effective firewalls and software protections to prevent criminals from accessing systems are at risk. In the past, cyber criminals primarily gained access through malware imbedded within email attachments. This was relatively simple to counter by simply not opening attachments from untrusted sources (though this assumes the sender also has good IT practices). These days, malware is more commonly found in website banner ads. Often these make their way onto reputable sites. For example, Facebook, NYTimes.com, and Yahoo! have all been victims of such poisoned ads. As such, one should never assume a site or email is safe. One should always install any software updates available (even if it sometimes means the inconvenience of restarting the computer). Even an up-to-date machine can be vulnerable if the user is tricked into providing confidential information to a malicious website. Phishing emails posing as legitimate messages from the bank or a website the association does business with will try to get the victim to enter the username and password or other sensitive information on a site that may look exactly like a legitimate site. As a general rule, no bank, email provider, government agency, or any other major institution will ever request personal information via email.

Limiting Access

All systems, especially the computer used to conduct online banking, should be protected by a firewall and monitored with updated security software. Access to online banking computers should be limited and incorporate all the proper physical and logical access controls including policies and procedures. In smaller association settings, using a computer that is not set up on a routing system to allow for wireless access may not be practical. Routers that require a security name are at risk by sophisticated hackers. Changing the association's router's administrative and Wi-Fi password from the default setting to something more secure can help prevent such attacks. If the equipment was issued by the association's internet service provider, technical support should be able to help change this feature. If the association purchased its router from another vendor, it may be necessary to contact the manufacturer if there are questions about making these changes. Physical controls to the computer and proper passwords (including numbers, letters, and special characters) that are changed periodically are necessary.

Internal Attacks

An effective system of internal controls includes the segregation of responsibilities involving financial transactions. This is especially true when it comes to online banking activities. Auditors refer to duties that are not segregated as incompatible duties. An example of an incompatible set of duties would be a bookkeeper who manages all aspects of the accounting process including billing, making deposits, signing checks, preparing bank reconciliations and preparing financial statements with little oversight by the manager or board. This person could have the opportunity to take funds from the association and conceal the theft by manipulating the financial records.

Strong internal controls include segregating the duties of performing and reviewing financial transactions among association personnel, community manager and board members to establish a system of checks and balances to help prevent fraud. Changes in board members, community managers, and accounting personnel require associations to constantly monitor the effectiveness of the system of internal controls. Many associations have strong controls as they pertain to traditional activities of paying bills by check. These same controls should be incorporated into the system when online activities are activated.

One of the controls many banks use to deter cyber theft is to authenticate the online transaction by a phone call or email to the person designated to authorize the transaction. However, if the person designated to authorize the transaction is also the person who has the ability to perpetrate and conceal the transaction, such as the bookkeeper, this valuable control is diminished. It is sometimes not practical to have a person designated for an online transaction who is not a member of the financial team. However, the person authorizing the transaction should not be able to make entries or adjustments to the books and records. If possible, the person authorizing the transaction should be contacted by email notification on a separate computer with different login credentials.

Regardless of the segregation of duties, monitoring and reconciling EFT/ACH accounts daily is important to quickly identify unauthorized transactions and to enable the Association to possibly reverse fraudulent transactions.

The following steps may be effective in developing controls:

- Perform a risk assessment including external and internal cyber theft fraud attributes.
- Dedicate a computer or system for online banking.
- Log and monitor key computers or systems.
- Segregate online banking functions.
- Reconcile EFT/ACH transactions daily.
- Consider a clearing bank account and make transfers from a separate system.
- Work with the bank to develop and understand security authentication procedures.
- Work with the independent auditor to understand effective internal control procedures.

Many Banks are now scrambling to increase controls over layered security, anomaly detection, administrative controls and customer awareness. Homeowner Associations should also be diligent in assessing and addressing cyber theft issues and related controls.

We also recommend that associations obtain computer fraud insurance. This is normally a rider on the existing fidelity insurance policy. The policy limits should include all reserve funds, investments and at least three months of operating assessments.

Responding to EFT fraud may require both technical and operating expertise. Trojan horse programs designed to facilitate these crimes are often difficult to detect and remove. In addition, an in-depth understanding of transaction and data flow throughout the EFT process plays a critical role in discovery.

APPENDIX H: RESERVE FUNDING AND THE RISK MITIGATION MATRIX

By
David T. Schwindt, CPA RS PRA

Reserve studies involve two distinct phases: the **physical analysis** and **the funding analysis**. The **physical analysis** includes, but is not limited to, determining the association's legal responsibility of repairing, replacing and maintaining association property (components) and identifying each component and its condition, cost and useful life. The **funding analysis** includes preparing a funding model that considers the cost and frequency of repairs/replacements/maintenance procedures. This funding model generally includes provisions for inflation on future expenditures, interest earned on reserves and income taxes.

Funding Theory

The theory behind funding is simple: determine how much money the association should set aside in the replacement reserve bank account each year so there is always enough money to pay for needed repair, replacement and maintenance expenses and assess accordingly. Since this funding model is based on numerous assumptions, many association professionals prefer to include a contingency amount in the funding model. Although the theory of funding is relatively simple, the calculation of the required contribution to reserves is complicated by the various methods of funding and the determination of the appropriate contingency. For purposes of this article, contingency is defined as "the amount of cash set aside in the replacement reserve over and above the calculated amount needed to fund 100 percent of needed expenditures". In other words, it is extra cash to fund unbudgeted expenditures or "surprises".

Community Association Institute (CAI) Reserve Specialist and Association of Professional Reserve Analyst standards include three acceptable funding models: **baseline, threshold and fully funded model**. (Note that there are other terms that describe these models; for sake of simplicity I am using the above terms).

The **baseline method** involves preparing a funding model that funds all expected costs over a specified period, in many cases thirty years. Although this model funds the replacement reserve bank account for all expected costs, it does **not** include a contingency amount should any components cost more than expected. Proponents of this method want to fund only expected costs to maintain, repair and replace common area components. Note that this model is the bare minimum of funding and assumes there will be no surprises. Over a thirty-year period, the baseline funding model shows a cash flow projection that funds all expenditures, and at some point, the cash balance in the replacement fund bank account drops close to a zero balance and then starts building cash for the next major expenditure. The year the cash balance drops close to zero is risky to the association since there is no extra cash to pay for surprises.

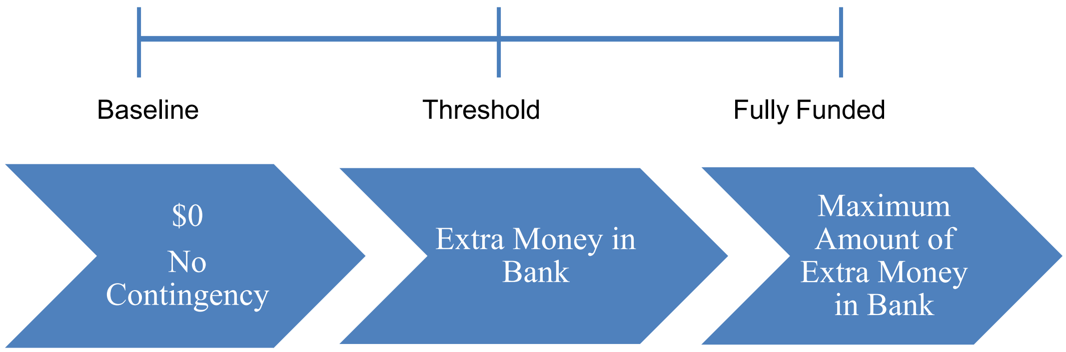
The **threshold method** involves preparing a funding model that funds all expected costs much like the baseline method but also includes a contingency amount for surprises. Reserve study specialists refer to this contingency as the "threshold". The **threshold** method provides an amount that the projected replacement reserve cash balance will not fall below, say $100,000. The $100,000 is called the threshold and provides needed funds to pay for surprises. Proponents of this method realize that over a thirty-year period, unexpected costs may arise and believe it is prudent to have extra cash to pay for these surprises. The challenge for reserve study providers is determining the amount of the threshold or extra cash.

The **fully funded method** uses a formula for computing the threshold. This formula mirrors the method used for computing depreciation. It computes a threshold that in some cases allows funding for twice the amount of expected costs. Knowing that the fully funded method, if 100 percent funded, provides for a very large threshold, reserve study providers often use a funding target of less than 100 percent. Please note that the higher the percentage funded, the more extra cash is kept in the replacement reserve bank account as a contingency, over and above the amount necessary to pay for all expected repairs and replacements. Proponents of this method realize associations have "surprises" and believe it is prudent to have as much cash as you can as a contingency to provide for these costs.

Graph I Illustrates the level of extra cash built into each model:

Graph I

Methods of Funding in Relation to Extra Cash (Contingency)



Risk of Special Assessment

Many reserve study professionals present statistics that show the risk of a special assessment based on the percentage funded. For instance, if an association is 50 percent funded, these statistics indicate there will be an 11.6 percent chance of a special assessment. The higher the percentage funded, the lower the potential of a special assessment. Please be aware that these statistics have been compiled by a reserve study provider and not vetted by CAI. However, if the contention is that the more extra cash an association has in the bank, the less likely the association will be likely to special assess due to surprises, then the underlying theory appears reasonable.

If your funding goal is to fund for all expected expenditures and to allow funding for surprises, how can you mitigate the risk of surprises, thus lowering the contingency amount?

What are some of the surprises that associations experience?

- The design, materials or workmanship on original construction is not adequate, thus requiring repairs or remediation, or may result in a significant reduction in the estimated useful lives of components. A complete building envelope inspection may catch issues early on that may reduce the cost of repairs and may allow the association to bring an action against the developer or contractor. This investigation may include intrusive openings around decks, windows, roofs and siding.

- The association does not adequately maintain the components which may lead to unexpected repairs or significantly reduced estimated useful lives. A maintenance plan consistently followed by the association may help components last longer with fewer repairs.

- The association does not perform ongoing inspections of components. Ongoing inspections may catch issues before they become worse and cost more to repair.

- The reserve study does not include all components that need to be funded. Missing components may include plumbing and irrigation systems, water/sewer lines, dry rot, windows and doors, deck assemblies, asphalt, major landscaping projects, concrete issues including spalling/ rusted rebar and replacement of siding and trim. Failure to include all components will likely lead to a special assessment to pay for unbudgeted repairs.

- The reserve study is not updated annually to account for increase in prices, changes in cash reserves, application of adjusted inflation in funding model and/or change in estimated useful lives. Failure to update the reserve study on an annual basis may lead to unbudgeted expenditures.
- The RFP (request for proposal) for repair and replacement projects is not written correctly, resulting in specifications that either are inadequate or do not address issues. Using a construction professional to assist with RFPs can help ensure that repair/replacement projects are performed by qualified professionals and includes all needed costs and procedures.
- The association does not use a construction consultant on major projects to ensure that work is performed properly. Not using a consultant increases the likelihood that the person hired will use substandard materials and workmanship and increases the possibility of re-repairing or replacing the components or may significantly reduce estimated useful lives.

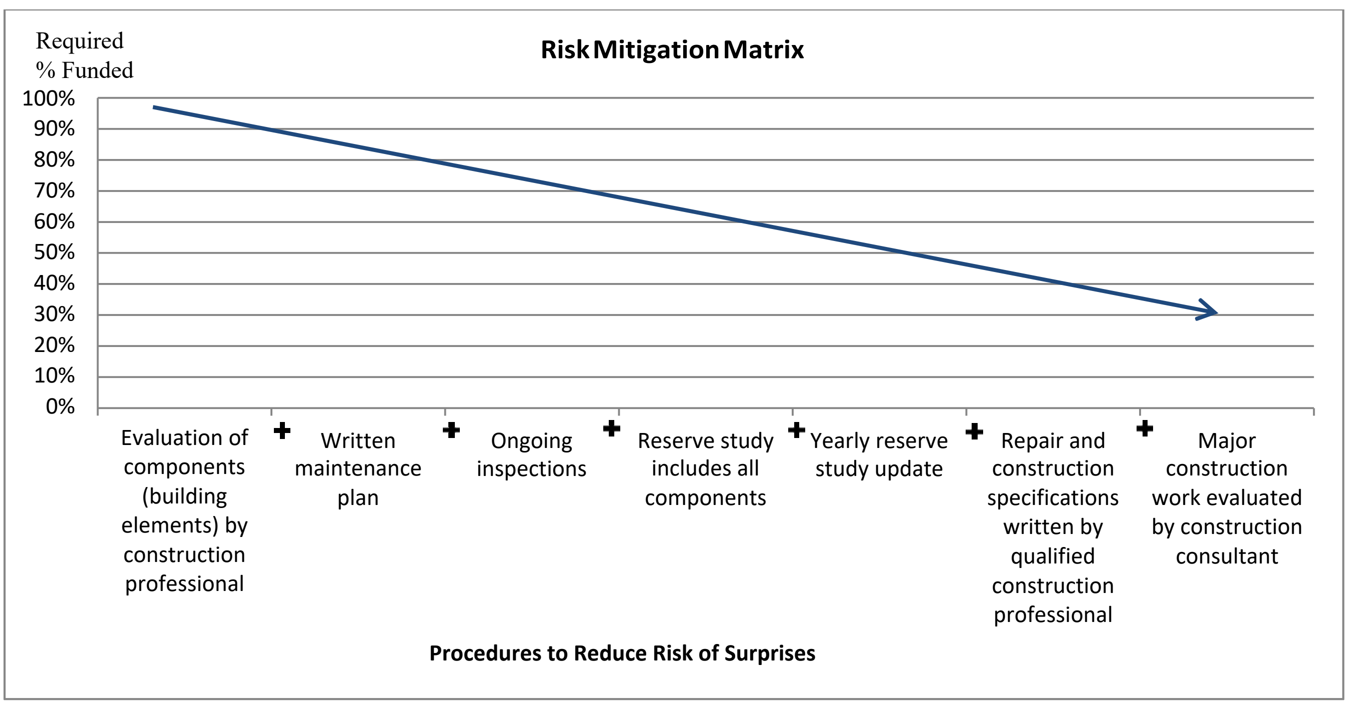
Since it appears that the threshold and fully funded model expect surprises, should associations that have procedures that address the risk of surprises be governed by the same funding rules as associations that do not?

Many reserve study providers recommend a percentage funded of at least 70 percent. The matrix below shows that if associations follow best practices in maintaining common area components, the percentage funded could be much lower because the likelihood of a surprise is diminished. Note that this matrix addresses the fully funded percentage but can also be used as a tool to determine the required threshold using the threshold method.

Graph II illustrates the relationship between employing best practices and the probability of surprises.

Graph II

Best Practices in Relation to the Need to Overfund



Associations that adopt best practice procedures and spend a little more each year on maintenance, inspections, reserve study updates and construction oversight can reduce the amount that is assessed to overfund the replacement reserve bank account to pay for unexpected costs.

As always, associations should look to the credentialed reserve study provider for guidance.

David T. Schwindt is a CPA and credentialed reserve study provider and is the owner of Schwindt & Co. Schwindt & Co provides accounting, tax and reserve study services to over 500 Associations in the Pacific Northwest. Comments should be directed to: dschwindt@schwindtco.com.

APPENDIX I: REVENUE FROM CONTRACTS WITH CUSTOMERS (FASB ASC 606)

Introduction
ASC 606 is a principles-based framework for recognizing revenue and replaces Generally Accepted Accounting Principles (GAAP) revenue recognition requirements and accounting guidance that homeowner associations have followed for many years. The intent of ASC 606 is to create **consistency** in and **comparability** of financial statements and improve the **usefulness** of financial statements.

For homeowner associations, adoption was required for annual reporting periods beginning after December 15, 2018 and for interim periods within annual reporting periods beginning after December 15, 2019. However, in May 2020, the FASB delayed the effective dates of ASC 606 for non-public companies that had not yet issued their financial statements by one year to give the entities more time to implement the new standards while dealing with the COVID-19 global pandemic. This means the standard will apply to all annual GAAP financial statements for the calendar year ended December 31, 2020 and for all monthly financial statements beginning January 2021.

This paper is meant to assist homeowner associations in applying ASC 606 to their accrual based financial statements with the following 5 steps:

1. Identifying an association's customer and contract with the customer;
2. Recognizing the rights and obligations of contracts;
3. Recognizing and valuing revenue from contracts;
4. Determining how the presentation of revenue from contracts and other financial information will be different than the current presentation;
5. Implementing steps to take in transitioning and reporting as required by ASC 606.

Step 1: Identifying an Association's Customer and Contract with the Customer
The new standards refer to contracts between the Association and its members as "performance obligations". The customers of an association are its members, including the declarant, and the contract between an association and its members is what the Association is obligated to provide its members based on its governing documents. Operating budgets, provisions in governing documents to assess initial working capital and budget for major repairs and replacements, and special assessment resolutions are contracts with association members.

The new standards make it clear that the accounting treatment for performance obligations take into consideration the understanding between the Association and members in determining the nature of the performance obligation as opposed to the theoretical application of accounting standards.

Step 2: Recognizing the Rights and Obligations in Contracts
A contract between an association and its members obligates the Association to provide goods and services defined in the contract, and members have the right to those goods and services for which they are assessed. Contracts promise services to members, such as management of day-to-day operations, maintenance, repairs, and replacements, and the facilitation of ancillary services. In return, members pay for those services through assessments.

The operating budget is a contract that gives an estimated cost of goods and services the Association plans to provide its members during the budget period (usually one year) and the amount of assessments the members will be billed for their right to the goods and services during the budget period. Such services are generally billed monthly for operating expenses.

The reserve study is a contract that gives the estimated costs of repairs and maintenance an association plans to provide to its members, but not necessarily in the same period as members are assessed. Members are also generally billed monthly for estimated future reserve expenditures.

Special assessment resolutions are contracts that obligate an association to provide goods or services to its members or other purposes such as funding shortfalls or repaying loans.

Step 3: Recognizing and Valuing Revenue from Contracts
Contract revenue is recognized when the obligation for which revenue is assessed is performed and ASC 606 requires revenue to be recognized in the amount estimated to be collectable. All expense items in the operating budget are defined as a single performance obligation. Major repair and replacement components are separate performance obligations.

Budgeted operating fund assessments are recognized in the same period as they are assessed. This may be a monthly, quarterly, semi-annual or annual assessment as required by the governing documents. **ASC 606 has not changed the current practice of revenue recognition for operating assessments except for the manner in which bad debts are reported as enumerated below.**

ASC 606 has not changed the current budget practice of including known bad debts in the budget as an expense line item. This practice in essence grosses up the total budgeted assessments to compensate for the bad debt. The current practice is to recognize all operating assessments billed and to record the bad debt as an expense when billed or when the account is analyzed for collectability. ASC 606 requires budgeted assessments to be reported net of budgeted uncollectible amounts. This does not mean assessments will not be assessed as budgeted, but it does mean that each time assessments are billed, an entry is posted to a contra-revenue account, in effect decreasing the amount of operating assessments recognized on the accrual method of accounting.

ASC 606 has changed the manner that budgeted reserve assessments are recognized. Budgeted replacement reserve assessments will now be recognized when the obligation for which they were assessed is fulfilled, that is, when major repairs and replacements included in an association's reserve study occur. **This is a significant change from current practice.**

The recognition of special assessment revenue will depend on the nature and purpose of the special assessment and should agree with the expectation of the members. For example, a special assessment to fund a shortfall will be recognized when it is assessed, but a special assessment to repay a loan will be recognized when loan payments are made. In the case of a serial assessment, there are typically two performance obligations; the first is repairs and replacements and the second is loan servicing. When members elect to pay a lump sum amount up front, this revenue is recognized when the repairs and replacements are completed and expensed. When members elect to be assessed the monthly serial assessments that are tied to a loan repayment, this revenue is recognized as the loan and loan interest is paid. This is not a change from current practice, it merely reinforces the current practice.

ASC 606 did not change the recognition of all income received by associations. For example, contract income as defined by the new standards does not include interest earned on deposits, insurance settlements, rents, rebates, and some income from ancillary operations. These types of revenue are now termed non-contract revenue. **The recognition of non-contract revenue has not changed from current practice.**

Step 4: Determining how the Presentation of Revenue from Contracts and Other Financial Information will be Different than the Current Presentation

To accommodate the required changes in the presentation of revenue from contracts, associations will need to create at least two new general ledger accounts.

- *Contract Liabilities* will be used to account for reserve assessments and special assessments that have not been spent on the obligation for which they were assessed.
- *Contra Revenue* will be used to adjust the value of operating assessments revenue. The account will be a revenue account with a normal debit balance.
- *Contract Assets* account can be created and used if appropriate. One example of this would be amounts owners were underbilled for property taxes in a timeshare association.

Any excess or deficit in net operating revenues and expenses is retained in the operating fund, similar to the current accounting treatment. No changes in the presentation of the operating fund balance are required.

Reserve assessment revenue will be recognized when the obligation for which they were assessed is fulfilled. Unspent reserve assessment revenue will be presented as contract liabilities on the balance sheet. A reclassification of the pre-ASC 606 replacement fund balance will most likely be required. Management will need to consider what portion of the prior period's ending replacement fund balance is contract revenue and reclassify that portion to the new contract liabilities account. As stated previously, interest earned as well as transfers from operating to reserve funds are not considered contract revenues and will most likely be retained in the replacement reserve fund unless these amounts are considered to be spent from the reserve fund in prior years.

Timing for recognition of special assessment revenue will depend on the purpose of the special assessment. Management should consider the nature and purpose of special assessments. A few examples: a) special assessments budgeted to repay an interfund balance will be recognized in the period in which they are assessed, b) special assessments budgeted to pay for a major repair will be recognized when that repair occurs, or c) special assessments budgeted to accumulate more reserve funds, will be posted to contract liabilities.

Step 5: Implementing Steps to Transitioning Accounts and Reporting as Required by ASC 606

Replacement Fund Balance/Contract Liabilities

The most significant change is the application of the cumulative effect of the new standard to the opening replacement fund for the year. The adjustment amount will depend on the types and amounts of revenue and amount of expenses recognized in prior periods. The easiest scenario, and one that will be true for most associations is one in which the Association has had only reserve assessments and interest income posted to their financial statements in the past and total expenditures in the replacement fund exceeds total interest. In that case, the Association may assume that all non-contract revenue such as interest was spent before member assessments and the entire balance will be reclassified to contract liabilities. The following are two examples showing the adjustment and the corresponding accounting of contract liabilities.

Example 1: The fund balance as of December 31, 2019 consists of accumulated assessments of $500,000, interest income of $2,500, and expenditures of $15,000.

Fund balance as of December 31, 2019	$ 487,500
Adjustment	(487,500)
Fund balance after adjustment on January 1, 2020	$ -
Contract liabilities after adjustment	$ 487,500

Example 2: The fund balance as of December 31, 2019 consists of accumulated assessments of $100,000, interest income of $1,000, and expenditures of $0.

Fund balance as of December 31, 2019	$ 101,000
Adjustment	(100,000)
Fund balance after adjustment on January 1, 2020	$ 1,000
Contract liabilities after adjustment	$ 100,000

Journal Entries for Recording and Recognizing Assessments

Operating assessments are recognized in the period in which they are budgeted and assessed. Reserve assessments are recognized in the period in which the promised obligation occurs (management will need to decide whether it wishes to spend non-contract income on expenditures before contract revenue). Following are two examples of accounting entries for recognizing assessment revenue.

Example 1: Monthly budgeted assessments are $4,000, $3,500 for operating and $500 for reserves, and the Association does not expect to collect from one owner whose unit is going into foreclosure. That unit's assessments are $60 per month.

	Debit (Credit)
Assessments receivable	4,000
Operating Assessments	(3,500)
Contra Revenue	60
Contract Liabilities	(500)
Allowance for doubtful accounts receivable	(60)

Some Associations may not use a contra revenue account but will instead exclude the expected uncollectible assessments directly from operating assessments.

Example 2: A major repair occurred that cost $7,000. The Association has earned and recognized interest of $80 YTD. The $7,000 will be expensed in the replacement reserve fund. The $80 is a part of the replacement reserve balance because it was not considered contract revenue and was not recorded as a contract liability. The Association wishes to spend interest income first.

	Debit (Credit)
Contract Liabilities	6,920
Reserve Assessments	(6,920)

Conclusion

For calendar years, the calendar year ended December 31, 2019 was to be the first year ASC 606 implementation was required for homeowner associations. In May 2020, FASB approved extending the effective date by one year for all nonpublic entities that had not yet issued their financial statements. Application is now required for calendar year December 31, 2020. As a result, we expect there may be questions from management companies, Boards and other professionals. Schwindt & Co has performed extensive research on ASC 606 and will be pleased to help with understanding the new requirements as well as implementation issues.