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In this issue...

1 FOR MANY ASSOCIATIONS... IT'S BUDGET TIME

by Jules C. Frankel, CPA, MBA and
Edward Guttenplan, CPA, MBA

3 CASH VERSUS ACCRUAL BASIS ACCOUNTING

by Marie D. Mirra, CPA

4 NEWS AT THE FIRM

Jules C. Frankel, CPA, MBA
Edward I. Guttenplan, CPA, MBA
Michael M. LoVerde, CPA
William J. McDevitt, CPA
Gary B. Rosen, CPA, CFE
Sefi Silverstein, CPA
H. Edward Wilkin III, CPA

Marie D. Mirra, CPA
Annette Murray, CPA
Vinay Navani, CPA

Lori Barnhart, CPA
Debbie Norwicke, CPA
Susan M. Klimcsak, CPA

FOR MANY ASSOCIATIONS... IT'S BUDGET TIME

By Jules C. Frankel, CPA, MBA and
Edward Guttenplan, CPA, MBA

This is the time of year when many Associations are developing their annual budget, which determines the level of maintenance fees to be assessed and collected from their homeowners. The purpose of this article is to provide some pointers to those responsible for putting together the Association's budget. Normally this process is a joint effort of the Association's Board, Finance Committee (if any) and the Association's Managing Agent. This article focuses on a suggested methodology, as well as, ten specific budget areas, to be carefully considered.

Methodology

The best method for preparing an Association budget is by creating a spreadsheet, with the data categorized in the following columns:

1. Year to date actual expenditures — based upon the current year's books and records

2. Anticipated expenditures — through the remainder of the year

3. Total estimated expenditures for the year — the first two columns added together

4. Current fiscal year's budget

5. Expected variance — between anticipated actual expenditures and budget for the current fiscal year

6. Next year's proposed budget — includes any known changes from the prior year

7. Explanatory notes — to provide explanations for each line item, including current year's estimated actual vs. budget variance, and the method by which next year's budget was derived.

Figure 1 is a sample budget planning spreadsheet that incorporates several representative budget items, to provide a practical illustration of the spreadsheet's use in the budget planning process.

Figure 1: Budget Planning Spreadsheet

(Column numbers in parentheses correlate to the data categories described above.)

	(1) Year to date actual expenditures (Jan. - Sept.)	(2) Anticipated expenditures (Oct. - Dec.)	(3) Total estimated expenditures for the year (Col.1 + Col.2)	(4) Current year's budget	(5) Expected variance (Col.4 - Col.3)	(6) Next year's proposed budget	(7) Explanatory notes
Insurance	\$80,000	\$20,000	\$100,000	\$65,000	(\$35,000)	\$115,000	Large increase experienced due to market conditions; further increases expected
Snow Removal	5,000	20,000	25,000	50,000	25,000	50,000	Light snow year – will budget for average snowfall
Replacement Funding	58,500	19,500	78,000	78,000	0	94,000	Increase for next year's budget based on updated Replacement Fund study – per engineer's recommendations

(Continued on Page 2)



Budget Time (Continued from Page 1)

This approach allows for a historical perspective, which can be very useful in both preparing the budget and presenting it to either Board members and/or homeowners.

Ten Budget Focus Issues

In preparing an Association's budget, we have addressed ten areas on which we believe Associations should focus:

1. Surplus Carryover

For Associations that are anticipating a surplus in the Operating Fund for the end of the current fiscal year and will be relying on IRS Revenue Ruling 70-604, we strongly advise that a surplus carryover be reflected in the following year's budget as a revenue line item. (A more detailed discussion of surplus resolutions and Revenue Ruling 70-604 can be found in our Summer 1996 issue of *CPA*).

2. Allowance for Bad Debts

Most Associations are experiencing some level of bad debt due to homeowner bankruptcies or other causes of individual homeowner inability to meet their financial obligations. Include in your budget a line item which reflects an estimate of the amount that the Association might not be able to collect this year. Prior historical experience is a good reference point to develop and estimate for this number.

3. Deficit Reductions

Just as an Association should consider including an anticipated Operating Fund surplus (see item 1- **Surplus Carryover**), Associations which have a cumulative deficit in their Operating Fund should include an expense line item called *Deficit Reduction* to reduce accumulated deficiencies in the Operating Fund. It is most common to see such deficiencies eliminated in a period ranging from 1 to 3 years. In conjunction with this deficit reduction, many Associations are able to generate sufficient cash flow to also eliminate any interfund balances that might have accumulated through the years.

4. Insurance

As discussed in our Winter 2002 issue of *CPA*, many Associations are experiencing significant increases in the cost of their insurance coverage. When formulating a budget for the new year, be realistic in planning for insurance costs, especially if the Association's insurance carrier has already communicated the expected amount of a premium increase.

5. Snow Removal

Although we have been lucky in that there has been relatively little snowfall over the past several years, consider a conserva-

tive approach in budgeting for snow removal to avoid some of the problems that were faced in prior years. Budgeting conservatively for this large unknown can often mitigate the need for special assessments or reduce the probability that an Association might create a deficiency in its Operating Fund.

6. Operating Contingencies

The only certainty in life is that nothing is certain. Due to this fact, budget for an operating contingency of approximately 3% to 5% of annual operating expenditures in order to absorb higher expenses or unanticipated expenditures.

7. Engineering Study Update

It is our experience that most Associations update their engineering study every 3 to 5 years or whenever significant replacement funds have been expended. If this is the year that your Association is due for an updated study, do not forget to include the cost for such a study in your Association's budget. (Spring 1998 and Spring 2000 issues of the *CPA* have information pertinent to the types of replacement study standards that are now in effect in the industry).

8. Replacement Funding

With respect to "updating studies", Associations should ensure that they are appropriately budgeting for their replacement funding needs. The Spring 2001 issue of *CPA* details the various funding options that an Association may choose. We are strong proponents that an Association's Board should understand which funding option it is using and be comfortable with that option.

9. Deferred Maintenance

Just as Associations should budget for replacement funding, similar care should be taken to budget monies for deferred maintenance, (i.e. painting, staining, caulking, mulching, etc. that may not be performed annually). The best practice is for an Association to budget such monies based upon a well-conceived deferred maintenance plan, in which the Association's Management, Board and/or engineer are involved.

10. Allocation of Interest

If the Association's policy is to allocate interest earned by the Replacement Fund and Deferred Maintenance Fund to those funds, then the Association should reflect this practice in its annual budget. Gross interest income should be shown as part of the revenue section of the budget; the replacement section and deferred maintenance funding section should show the amount of interest that will be left in those funds as allocations to those funds.

Budgeting Bottom Line

In the world in which we live, it is not unusual for expenses to rise each year. Food, utility costs, insurance, in short, the cost of living, increases. Therefore, it is not unreasonable for Associations to see their annual maintenance assessments rise at a moderate level each year. Boards have a balancing act to perform. Financial needs of the Association must be balanced with what may be considered reasonable assessment levels for the Community's geographic area and for the Association's homeowners. If your Wilkin & Guttenplan advisor can be of any assistance in this process, please feel free to contact us.

UPCOMING ISSUES:

- When To Use CPAs at Open Meetings
- Club "Do's and Don'ts"

This publication is prepared quarterly by Wilkin & Guttenplan, P.C. For further information or for complimentary copies or subscriptions, you may contact Jules C. Frankel at:

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CASH VERSUS ACCRUAL BASIS ACCOUNTING

By Marie D. Mirra, CPA

Introduction

“How can our bottom line show a loss when our checking account has thousands of dollars in it?” This is a question commonly asked by Board members who are unfamiliar with the fundamentals of accrual basis accounting. To “de-mystify” this important concept, this article provides a primer on the differences between cash basis and accrual basis accounting.

The Cash Vs. Accrual Basis of Accounting

Individuals generally operate their finances using the cash basis of accounting. We receive our income (salary, pension, investment, etc.) and typically record these cash receipts in our checkbook. We use these receipts to pay whichever of our outstanding bills that we choose, and then update our financial records to reflect the cash disbursements made. At the end of the year, we compile whatever information we need to pay our taxes, “close our books”, and begin our record keeping for the new year.

In contrast with an individual’s finances, organizations often use an accounting method that reflects transactions as they occur. Revenues are recognized when earned, and expenses are recognized when incurred, *even if the revenue has not yet been collected, or the expense has not yet been paid.*

In concept, this is the difference between the cash, and accrual, bases of accounting; the cash basis reflects *actual cash transactions* which occurred during a given time period, while the accrual basis of accounting records the *revenues and expenses* which were actually earned or incurred during that same period. (There are yet other bases of accounting, such as the modified cash basis, which is a hybrid of the cash and accrual basis. This, and other methods, are beyond the scope of this article.)

The Matching Principle

To get a true financial picture of an entity during a given time period, we need to match the revenues and associated expenses for that time period. In accounting, this concept is described as *The Matching Principle*, which, matches, or offsets, revenue with the expenses during the period in which they both occur. **Thus, the matching principle is fundamental to accrual accounting, which recognizes revenue when realized (i.e., earned) and expenses when incurred, regardless of when the related cash is collected or expended.** Therefore, the matching principle, and the accrual basis of accounting, provide a more realistic view of the Association’s financial performance during a given time period.

Example

The following example illustrates the differences in recording revenue and expense transactions using the cash and accrual bases of accounting. Using the information provided in **SECTION A**, the differences between cash and accrual basis accounting are illustrated in **SECTION B**:

SECTION A			
	YEAR		
	2001	2002	2003
Cash collections from unit owners for monthly maintenance fee income:			
From 2001 assessments	\$ 80,000 A	\$15,000 B	\$5,000 C
From 2002 assessments	\$10,000 D	\$90,000 E	\$30,000 F
Cash payments for Association maintenance expenses:			
On 2001 costs	\$80,000 G	\$27,000 H	\$ - I
On 2002 costs	\$6,000 J	\$50,000 K	\$14,000 L

SECTION B		
	YEAR	
	2001	2002
CASH BASIS:		
Revenue	\$ 90,000 A+D	\$105,000 C+E
Expenses	86,000 G+J	77,000 H+K
Excess of revenues collected over (under) expenses	\$4,000	\$ 28,000
ACCRUAL BASIS:		
Revenue	\$100,000 A+B+C	\$130,000 D+E+F
Expenses	107,000 G+H+I	70,000 J+K+L
Excess of revenues over (under) expenses	\$(7,000)	\$ 60,000

NOTE THIS DIFFERENCE

Using the cash basis, the entity generated a surplus of \$4,000, but the accrual basis actually shows a \$7,000 deficit!

This is because the accrual basis reflects the *actual revenues and expenses incurred for the calendar year*. Using the cash basis method of accounting, 2001 revenues were understated by \$10,000, which is the difference between the cash and accrual revenue amounts for 2001, and expenses were also understated, by \$21,000, which is the difference between the cash and accrual expense amounts for 2001. How does the accrual basis account for this variance? Because the accrual basis “matches” the Association’s expenses incurred (but not necessarily paid) with the revenue to be earned for the corresponding time period.

Thus, by totaling all of the 2001 anticipated revenue **A+B+C** the revenue *earned* in 2001 was \$100,000, rather than the \$90,000 collected, and recorded, using the cash basis method. Similarly, the expenses incurred using the accrual basis in 2001 were only \$70,000 **J+K+L**, rather than the sum of \$77,000 that was actually disbursed.

(Continued on Page 4)



Cash Versus Accrual (Continued from Page 3)

Therefore, an Association that used the cash basis method in our example would have overstated its financial performance by showing a surplus instead of a deficit in 2001, but the Association would have understated its surplus in 2002.

Industry Requirements/Conclusion

Before concluding this simplified overview of cash and accrual basis accounting, it is important to address the issue of appropriateness, and required use, of each basis. There are situations in which Management companies will choose, for practical and valid reasons, to maintain an Association's books and records using the cash basis of accounting, which is perfectly acceptable. However, a distinction must be made between maintaining these books and records, and an Association's year-end audited financial statements. In this regard, the AICPA Audit and Accounting Guide on Common Interest Realty Associations, provides specific requirements:

"Generally Accepted Accounting Principles (GAAP) requires the use of accrual basis accounting. Financial statements prepared on a accrual basis are particularly useful for CIRAs, which assess members based on annual budgets, because they include information about amounts payable and assessments receivable from members and thus enable users to compare the results of operations to budgeted amounts."

Therefore, regardless of the basis chosen for an Association's own record keeping, **audited financial statements must be prepared using the accrual basis of accounting.**

We recommend that Board members, Management companies and unit owners become familiar with each of the various accounting methods, as well as the appropriate application and use of each method. We would be happy to assist you with any questions or with a consultation for a specific situation.



NEWS AT THE FIRM

ANNIVERSARIES (October–December)

Congratulations to the following W&G staffers who celebrated the following years of service anniversaries:

- | | | | |
|----------|--------------------------|----------|-------------------------|
| 18 years | Annette Murray | 13 years | Suzanne Hughes |
| 17 years | Janine Zirrieth | | Marie D. Mirra |
| | | | Carol Rosenvinge |
| 16 years | Margot Julis | 8 years | Shiela Engelman |
| | Jeannette Everett | | |
| | Susan Klimcsak | | |

WELCOME

Please join us in welcoming new W&G staffers:

- | | | |
|----------------------|--------------------------|-----------------------|
| Emily Alvarez | Gail Higginbotham | Daphne Milosky |
| Desiree Brown | Meredith Latham | Sarah Wilson |

PROFESSIONAL ACHIEVEMENTS

W&G is pleased to announce the following promotions at the firm. Congratulations to all who worked so hard and grew professionally this year. Special recognition goes to the following individuals who have achieved milestones.

- Sefi Silverstein** – Principal
- Marie D. Mirra** – Senior Manager
- Victoria Veth** – Supervisor
- Jill Perrapato, Anissa Telle, Joseph Zanna** – Senior Staff Accountant
- Cristina Czerwinski** – Advanced Staff Accountant
- Desiree Brown, Patty Falck** – Intermediate Staff Accountant

APPOINTMENTS

Edward Guttenplan, CPA, MBA, has been appointed Chairman of *Main Street* Highland Park.

NEW ARRIVAL

Congratulations to **Allyson Seitz** and her husband, Josh, on the birth of their daughter, Zoe Nicole.



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