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INTERFUND BALANCES: What, Why and How?

By Jules C. Frankel, CPA, MBA

As Board members receive copies of their Association's annual audited financial statements, the issue of Interfund Balances often surfaces. The purpose of this article is to explain what Interfund Balances are, why they exist, and how Associations should deal with them.

Fund Accounting – The “Envelope System”

As we have discussed in this publication on a number of occasions, Associations generally follow the principles of *Fund Accounting* in order to ensure observance of limitations, restrictions, and accountability placed on the use of their available resources. This allows Associations to track financial transactions by major type of activity.

A good way to think of fund accounting is to think of the “envelope system” that might have been used by your parents or grandparents to manage their financial affairs. As recently as a generation or two ago, it was not uncommon for monies to be segregated into various envelopes, one for the rent, another for food, yet another for utilities, etc. (You may even know someone who still uses this system!) Ideally, the monies in each envelope would be used only for

the intended purpose. In addition, there would be enough money in each envelope to cover the planned expense and monies would not have to be “borrowed” from one envelope to another.

Fund accounting is conceptually similar to the “envelope system”; it uses separate bank or brokerage accounts instead of envelopes. Ideally, in fund accounting, each fund should:

- ◆ Stand on its own.
- ◆ Be segregated and kept in separate bank accounts.
- ◆ Used only for its intended purpose.

This approach helps to ensure that sufficient funds will be available to pay for the particular fund's designated expenditures, and, that monies will not be “co-mingled”—that is, loaned/borrowed between/amongst, funds.

Typical Association Funds

While Associations may establish any number of funds, there are generally three common funds, as described in the following table:

| Fund | Purpose | Sample Expenditures |
|----------------------|---|---|
| Operating | Daily operating expenses | Lawn care, snow removal, management expenses, professional fees, etc. |
| Deferred Maintenance | Scheduled maintenance expenses that recur on a less than annual basis | Painting, staining, caulking, etc. |
| Replacement | Accumulates monies over the lives of capital assets to ensure sufficient funds are available for the asset's eventual replacement | Roofs, sidewalks, swimming pools, etc. |

At times, other special purpose funds are designated; these may include:

| Special Purpose Fund | Designation |
|--------------------------------------|---|
| Capital Improvement | Future capital improvements (as opposed to capital replacements) |
| Fire-Retardant Treated (FRT) Plywood | Replacement of FRT Plywood |
| Sponsor/Developer Settlement | To rectify construction defects (paid for by a sponsor/developer) |

(Continued on Page 2)



The Reality: Interfund Balances

Although the vast majority of Associations do maintain separate bank and/or brokerage accounts for each fund, the reality of Association financial life is that Interfund Balances are not unusual. A variety of circumstances may contribute to the creation of Interfund Balances including:

| Reason for Interfund Balance Creation | Possible Cause |
|---------------------------------------|---|
| Cash Flow | Associations earmark a certain amount of money per year for the Replacement Fund, but the Association lacks sufficient cash flow to do so. As a result, at the end of the year, the Operating Fund “owes” this shortfall in funds not transferred to the Replacement Fund |
| Investment Considerations | An Association does not want to prematurely break a certificate of deposit which is due to mature, so another fund “fronts” the money for a given transaction |
| Timing Issues | Immediate need or desire for maintenance; lack of sufficient funds in the Deferred Maintenance account causes the Association to “borrow” from another fund, which will be replenished in future budget periods |
| Bookkeeping Procedures | Checks are issued from the Operating Fund for all expenses; monies are then transferred back to reimburse the Operating Fund |
| Mislabeled Bank Accounts | Incorrectly labeled bank account; (for example-an Operating account is labeled as a Deferred Maintenance account) |
| Disbursements from Incorrect Account | A major repair or replacement was made that should have been funded by the Replacement Fund; instead funding came from the Deferred Maintenance account |

“Interest”ing?

Another item that often adds to the creation of Interfund Balances is interest (and other investment) income. Before the beginning of each year, Associations generally prepare and approve a budget that both estimates the Association’s expenses, and establishes the level of assessments for the coming fiscal year. The budget reflects the expectation that interest income will either be retained by each respective fund, or will all be allocated to the Operating Fund.

“The goal of each fund is to ‘stand on its own.’ The bottom line, therefore, is that money should be transferred between and/or amongst funds, so that no fund owes any money to another fund.”

If the budget calls for each fund to retain its own interest income, and each fund actually does earn- and keep- its own interest income, then no additional Interfund Balances are created. However, if the budget calls for some, or all interest income to be utilized by the Operating Fund and the interest income is not physically transferred to the Operating Fund from the other funds, then Interfund Balances are created.

A Taxing Situation

Income tax payments on the interest income can further complicate the situation. Some Associations budget for, and pay the income taxes due on all Association interest income out of one fund, usually the Operating Fund. Other Associations, however, budget for each fund to pay the income taxes applicable to the interest earned by each respective fund. If however, one fund (i.e. the Operating Fund) issues the check for all of the taxes due, then an Interfund Balance is created. These other funds would “owe” the Operating Fund the amount of income taxes paid on each fund’s behalf.

One last note should be considered regarding income taxes. Associations can file Federal tax returns under either *Internal Revenue Code Section 528* (as a Homeowners Association) or under *Internal Revenue Code Section 277* (as a regular corporation). While it is beyond the scope of this article to discuss the implications of Association filing status, it should be noted that Associations choosing to file as regular corporations are at greater audit risk if large Interfund Balances are not rectified.

How Do I Know Whether My Association Has Interfund Balances?

Interfund Balances can be identified by looking at an Association’s balance sheet. Interfund Balances are usually shown as the last line in the **Asset** section of the balance sheet. If a columnar format is used, the **Total** column will be a dash or zero. The other columns will be positives and negatives that “net” to zero. (On some financial statements, the **Due To** line will be shown in the liabilities section.)

Figure 1 on the following page will help to illustrate our point:





FIGURE 1
Sample Condominium Association Balance Sheet
12/31/01

| ASSETS | TOTAL | OPERATING FUND | DEFERRED MAINTENANCE FUND | REPLACEMENT FUND |
|--|------------------|------------------|---------------------------|------------------|
| Cash (and cash equivalents) | \$395,954 | \$185,954 | \$10,000 | \$200,000 |
| Money market mutual funds | | | | |
| Certificates of deposit | 139,479 | | | 139,479 |
| Accrued interest receivable | 4,906 | | | 4,906 |
| Assessments receivable, net of allowance for doubtful accounts of \$15,500 | 9,234 | 9,234 | | |
| Prepaid insurance | 14,750 | 14,750 | | |
| Property, plant and equipment, net | 6,286 | 6,286 | | |
| Interfund Balances | | (45,963) | | 45,963 |
| TOTAL ASSETS | \$570,609 | \$170,261 | \$10,000 | \$385,442 |

The blue numbers indicate the Interfund Balance due from the Operating Fund to the Replacement Fund.

For example, let's assume that the **OPERATING FUND** shows (\$45,963) on the **Interfund Balances** line and the **REPLACEMENT FUND** shows \$45,963. This means, that as of the balance sheet date, the **OPERATING FUND** "owed" the **REPLACEMENT FUND** \$45,963.

Because there are so many possible ways for Interfund Balances to occur, many Associations wait for the conclusion of the year-end audit to make sure that exact interfund numbers are identified. Often, a Management Letter accompanies draft and/or final financial statements to clearly indicate what these numbers are.

As we discussed at the beginning of this article, the goal of each fund is to "stand on its own." The bottom line, therefore, is that money should be transferred between and/or amongst funds, so that no fund owes another fund any money. While this seems relatively straightforward, the practical application of these principles should consider the following issues, as appropriate:

- ◆ Audits are conducted and discussed with Associations' Boards after the close of the fiscal year. Although the Management Letter may indicate the amounts that should be transferred, make sure that the amounts were not already transferred during the time in between the end of the fiscal year and the review of the audit.
- ◆ Boards should have a clear understanding with their managing agents regarding the procedures that will be followed to authorize and make the required transfers. Some management companies automatically move the funds as recommended in the Management Letter. Other management companies wait for the Board's directive to take the appropriate action. Still others start the process and then get the appropriate Board approvals. Communication "before the fact" can help avoid uncomfortable situations regarding the authorization and appropriate timing of these fund transfers.





Interfund Balances (Continued from Page 3)

- ◆ Don't ignore Interfund Balances and allow them to grow larger with each passing year. This will compound the problem, and often creates confusion and difficulties for future Board members, as well as the professionals who are servicing the Association.
- ◆ Make sure that all bank and brokerage accounts are appropriately labeled. Mis-labeled accounts can create confusion and cause unnecessary time and resources to be expended to identify and correct the cause of an interfund problem.
- ◆ At times, there may be insufficient cash flow to make the required transfers. Often, this is due to a cumulative deficit in the Operating Fund. If this is the case, the Board should adopt a plan to extinguish the deficit and eliminate the Interfund Balances over time.

As always, please feel free to contact me, or your Wilkin & Guttenplan advisor, if we can be of any help to your particular Association.

UPCOMING ISSUES:

- Lending Money to Associations/Bank Loans
- Taxability of Clubs
- How Association Investments are Insured

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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NEWS AT THE FIRM

ANNIVERSARIES (April—June)

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

18 years **Gary B. Rosen**

15 years **Sara Gierloff**

APPOINTMENTS, COMMITTEES, PRESENTATIONS, PUBLICATIONS...

Marie Mirra, CPA has been named an associate member of the Association of Certified Fraud Examiners and Vice-Chair of the CAI-NJ Conference & Expo Committee.

Edward Guttenplan, CPA, MBA has become a member of the CAI-NJ Education Committee.

Jules C. Frankel, CPA, MBA, has become a member of the CAI-NJ Legislative Action Committee.

Jules C. Frankel, CPA, MBA, was a presenter/panelist on *Community Living – Co-ops and Condos* at the 2nd Annual Convention and Trade Expo jointly sponsored by the NY, NJ and PA Associations of Realtors held in December. He was also a featured speaker at CAI-NJ's February seminar on *Sponsor Transitions*.

Additionally, Jules received 2 awards at the CAI-NJ Annual Awards Dinner held in January:

- Completion of 6 years of Service as a Board Member
- **Author of the Year**—for the article he contributed to *Community Trends* magazine titled: "Using an Accountant for Management Transition Procedures."

Wilkin & Guttenplan conducted a very successful extended internship program this past winter. Three students from The College of New Jersey participated in the program: Mario Duca, Susan Merry, Thomas Pedersen.



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