Financial Reporting

This Course is approved by the DBPR Council of Community Association Managers, for 4 hours of continuing education credit in the area of:

Insurance/Finance

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Introduction

This Financial & Insurance Course discusses reading of the major financial reports. Students will review financial reports required annually, as well as those that they should use on a monthly basis, including: Balance Sheets, Income Statement (Profit & Loss), Cash Flow Statements, and Statement regarding Changes in Equity. They will learn how to analyze these reports, what components should be included, and when to use specific statements. At the end of the class, each student will have developed an understanding of financial reporting and will be able to read and interpret basic financial reports. The class is designed for CAMs new to the industry, those with limited financial experience, and those wishing to review and update their skills.

Some of the information presented in this course may not apply to every community association. However, the DBPR requires that community association managers be familiar with the laws and rules governing all types of associations. Further, by doing so, a manager may find him- or herself more qualified to advance within the community association management profession.

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Table of Contents

Topic Page

Financial Statements ... 1

Purpose of financial statements by business entities ... 1

Government financial statements ... 2

Financial statements of non-profit organizations ... 2

Personal financial statements ... 2

Audit and legal implications ... 2

Standards and regulations ... 3

Inclusion in annual reports ... 3

Moving to electronic financial statements ... 3

Twelve Basic Principles ... 3

General Rule ... 8

Revenue vs. cash timing ... 8
- Accrued revenue ... 8
- Deferred revenue ... 8
- Advances ... 8
- Exceptions ... 9

Basic Equation of Accounting ... 10

Statement of Financial Position (Balance Sheet) ... 10
- What are Assets? ... 10
- Grouping Assets for Presentation ... 11
- Current Assets ... 11
- Current Asset Cycle ... 13
- Other Asset Types ... 13
- Other Assets ... 14
- What are Liabilities ... 15
- Shareholders' Equity ... 18
- Summary: Balance Sheet ... 19

Topic | Page

Statement of Comprehensive Income (Income Statement – Profit & Loss (P&L) Statement 20
Revenues 21
Comments on Reading & Reviewing the Income Statement 22
Accrual versus Cash Basis 23
Income Statement & Balance Sheet 23
Statement of Changes in Equity 23
Statement of Cash Flows 24
Sources and Uses of Cash 25
Other Elements of Cash Flow 25
Summary: Cash Flow Statement 26
Summary 26
Appendices: Comparison of Financial Statements 27
Questions 37

Financial statements

A **financial statement** (or **financial report**) is a formal record of the financial activities of a business, person, or other entity. In British English—including United Kingdom company law—a financial statement is often referred to as an **account**, although the term financial statement is also used, particularly by accountants.

For a business enterprise, all the relevant financial information, presented in a structured manner and in a form easy to understand, are called the financial statements. They typically include four basic financial statements, accompanied by a management discussion and analysis:

1. **Statement of Financial Position**: also referred to as a balance sheet, reports on a company's assets, liabilities, and ownership equity at a given point in time.
2. **Statement of Comprehensive Income**: also referred to as Profit and Loss statement (or a "P&L"), reports on a company's income, expenses, and profits over a period of time. A Profit & Loss statement provides information on the operation of the enterprise. These include sale and the various expenses incurred during the processing state.
3. **Statement of Changes in Equity**: explains the changes of the company's equity throughout the reporting period
4. **Statement of cash flows**: reports on a company's cash flow activities, particularly its operating, investing and financing activities.

We will show you have to read the Balance Sheet and Profit & Loss Statement, and will briefly discuss the Statement of Changes in Equity and Statement of Cash Flows.

For large corporations, these statements are often complex and may include an extensive set of notes to the financial statements and management discussion and analysis. The notes typically describe each item on the balance sheet, income statement and cash flow statement in further detail. Notes to financial statements are considered an integral part of the financial statements.

Purpose of financial statements by business entities

"The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions." Financial statements should be understandable, relevant, reliable and comparable. Reported assets, liabilities, equity, income and expenses are directly related to an organization's financial position.

Financial statements are intended to be understandable by readers who have "a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently." Financial statements may be used by users for different purposes:

- Owners and managers require financial statements to make important business decisions that affect its continued operations. Financial analysis is then performed on these statements to provide management with a more detailed understanding of the figures. These statements are also used as part of management's annual report to the stockholders.
- Employees also need these reports in making collective bargaining agreements (CBA) with the management, in the case of labor unions or for individuals in discussing their compensation, promotion and rankings.
- Prospective investors make use of financial statements to assess the viability of investing in a business. Financial analyses are often used by investors and are prepared by professionals (financial analysts), thus providing them with the basis for making investment decisions.

- Financial institutions (banks and other lending companies) use them to decide whether to grant a company with fresh working capital or extend debt securities (such as a long-term bank loan or debentures) to finance expansion and other significant expenditures.
- Government entities (tax authorities) need financial statements to ascertain the propriety and accuracy of taxes and other duties declared and paid by a company.
- Vendors who extend credit to a business require financial statements to assess the creditworthiness of the business.
- Media and the general public are also interested in financial statements for a variety of reasons.

Government financial statements

The rules for the recording, measurement and presentation of government financial statements may be different from those required for business and even for non-profit organizations. They may use either of two accounting methods: accrual accounting, or cash accounting, or a combination of the two (OCBOA). A complete set of chart of accounts is also used that is substantially different from the chart of a profit-oriented business.

Financial statements of non-profit organizations

The financial statements that non-profit organizations such as charitable organizations and large voluntary associations publish tend to be simpler than those of for-profit corporations. Often they consist of just a balance sheet and a "statement of activities" (listing income and expenses) similar to the "Profit and Loss statement" of a for-profit. Charitable organizations in the United States are required to show their income and net assets (equity) in three categories: Unrestricted (available for general use), Temporarily Restricted (to be released after the donor's time or purpose restrictions have been met), and Permanently Restricted (to be held perpetually, e.g., in an Endowment).

Personal financial statements

Personal financial statements may be required from persons applying for a personal loan or financial aid. Typically, a personal financial statement consists of a single form for reporting personally held assets and liabilities (debts), or personal sources of income and expenses, or both. The form to be filled out is determined by the organization supplying the loan or aid.

Audit and legal implications

Although laws differ from country to country, an audit of the financial statements of a public company is usually required for investment, financing, and tax purposes. These are usually performed by independent accountants or auditing firms. Results of the audit are summarized in an audit report that either provides an unqualified opinion on the financial statements or qualifications as to its fairness and accuracy. The audit opinion on the financial statements is usually included in the annual report.

There has been much legal debate over who an auditor is liable to. Since audit reports tend to be addressed to the current shareholders, it is commonly thought that they owe a legal duty of care to them. But this may not be the case as determined by common law precedent. In Canada, auditors are liable only to investors using a prospectus to buy shares in the primary market. In the United Kingdom, they have been held liable to potential investors when the auditor was aware of the potential investor and how they would use the information in the financial statements. Nowadays auditors tend to include in their report liability restricting language, discouraging anyone other than the addressees of their report from relying on it. Liability is an important issue: in the UK, for example, auditors have unlimited liability.

Standards and regulations

Different countries have developed their own accounting principles over time, making international comparisons of companies difficult. To ensure uniformity and comparability between financial statements prepared by different companies, a set of guidelines and rules are used. Commonly referred to as Generally Accepted Accounting Principles (GAAP), these set of guidelines provide the basis in the preparation of financial statements.

Recently there has been a push towards standardizing accounting rules made by the International Accounting Standards Board ("IASB"). IASB develops International Financial Reporting Standards that have been adopted by Australia, Canada and the European Union (for publicly quoted companies only), are under consideration in South Africa and other countries. The United States Financial Accounting Standards Board has made a commitment to converge the U.S. GAAP and IFRS over time.

Inclusion in annual reports

To entice new investors, most public companies assemble their financial statements on fine paper with pleasing graphics and photos in an annual report to shareholders, attempting to capture the excitement and culture of the organization in a "marketing brochure" of sorts. Usually the company's chief executive will write a letter to shareholders, describing management's performance and the company's financial highlights.

In the United States, prior to the advent of the internet, the annual report was considered the most effective way for corporations to communicate with individual shareholders. Blue chip companies went to great expense to produce and mail out attractive annual reports to every shareholder. The annual report was often prepared in the style of a coffee table book.

Moving to electronic financial statements

Financial statements have been created on paper for hundreds of years. The growth of the Web has seen more and more financial statements created in an electronic form which is exchangeable over the Web. Common forms of electronic financial statements are PDF and HTML. These types of electronic financial statements have their drawbacks in that it still takes a human to read the information in order to reuse the information contained in a financial statement.

More recently a market driven global standard, XBRL (Extensible Business Reporting Language), which can be used for creating financial statements in a structured and computer readable format, has become more popular as a format for creating financial statements. Many regulators around the world such as the U.S. Securities and Exchange Commission have mandated XBRL for the submission of financial information.

The UNICEFACT created, with respect to Generally Accepted Accounting Principles, (GAAP), internal or external financial reporting XML messages to be used between enterprises and their partners, such as private interested parties (e.g. bank) and public collecting bodies (e.g. taxation authorities). Many regulators use such messages to collect financial and economic information.

Twelve Basic Principles

Accountants operate under certain guiding principles and rules, developed by the Financial Accounting Standards Board (FASB). The FASB mission is to establish and improve standards of financial accounting and reporting for guidance and education of the public, including issuers, auditors, and users of financial information. The Security & Exchange Commission (SEC) designates the FASB as the entity responsible for setting accounting standards for all U.S. public companies. Government entities, non-profits, and not-for-profits operate within similar guidelines. The guidelines are referred to as the Generally Accepted Accounting Principles (GAAP). GAAP is a series of rules, procedures, and practices for preparing and reporting financial statements. It

establishes certain basic assumptions upon which preparation of financial statements is based. The assumptions control **what** financial items to assess and when and how to assess them.

Below are twelve basic principles that serve to explain financial reporting.

1. **Accounting Entity**: Business unit for, separate from its owners, which the financial statements are being prepared. This is usually a fictitious entity, such as a company or partnership. In community associations, it is most often a non-profit corporation established under Florida Statutes 617.
2. **Going Concern**: Assumption that the life of the business is "infinitely long," or "enduring." If, during the review, the accountant concludes that the company may go bankrupt, he must issue, as part of the financial report, a "qualified opinion," stating the potential for the company's termination.
3. **Measurement**: Financial statements contain only quantifiable estimates of assets (what the association owns) and liabilities (what the association owes). The financial reports focus on things that can be quantified; that is, resources and obligations upon which there is an agreed upon valuation. The difference between assets and liabilities are usually referred to as "owners' interests."
4. **Units of Measure**: Accountants use the U.S. dollar as the standard. Any foreign subsidiaries or assets are translated into dollars, at the current exchange rate. Note that exchange rates vary, as do values of foreign currency denominated assets and liabilities.
5. **Historical Cost**: What an association owns and what is owes are recorded at their original (historic) cost, with no adjustment for inflation (or deflation). While this assumption can greatly overvalue assets that were purchase in past years and have now depreciated, it is the simplest method of recording and tracking assets, without having to reevaluate every year.
6. **Materiality**: The relative importance of different financial information. While small transactions may be omitted, any transaction that would materially affect the financial condition of the association must be included. Materiality is a judgment call.
7. **Estimates and Judgments**: Complexity and ambiguity will require that the accountant use judgments and estimates in financial reports. Accounts should consider the methods they use to "guessimate" – and be consistent in guesses between periods.
8. **Consistency**: Each individual association should choose a single method of reporting and use it consistently over time. An association should not switch among measurement techniques. They must be uniform from year to year. Note that this is a particular problem among associations. Each time an association changes accounting programs, or contracts with a different management company, how income and expenses are recorded often change. This makes it very difficult, if not impossible, to compare progress from one year to the next.
9. **Conservatism**: Accountants have a downward bias, preferring understatement to overstatement. For instance, losses are recorded when one believes that they have a greater probability of occurring – not later at the actual time they occur, whereas gains are postponed until they actually occur.
10. **Periodicity**: Assumption that the life of the association can be divided into periods of time for which income and expense are reported – such as a quarter or a month. All corporations, including associations report revenues and expenses over a year (fiscal year), and report to the government losses and profits, on which they may pay taxes.

11. **Substance over Form**: Accounting principle to ensure that financial statements give a complete, relevant and accurate picture of transactions and events. If an entity practices the 'substance over form' concept, the financial statements will show the financial reality of the entity (economic substance), rather than the legal form of transactions (form). In accounting for business transactions and other events we measure and report the economic impact of an event instead of its legal form. Substance over form is critical for reliable financial reporting. It is particularly relevant in case of revenue recognition, sale and purchase agreements, etc.

    Examples: A lease might not transfer ownership to the lessee but the lessee has to record the leased items as an asset if it intends to use it for major portion of its useful life or where the present value of lease payment is fairly equal to the fair value of the asset, etc. Although legally the lessee is not the owner, so the leased item is not his asset, but from the perspective of the underlying economics the lessee is entitled to the benefits embedded in the use of the item and hence it has to be recorded as an asset. A company is short of cash, so it sells its machinery to the bank and obtains it back on a lease. It is called sale and leaseback. Although the legal ownership has transferred but the underlying economics remain the same and hence under the substance over form principle the sale and subsequent leaseback are considered one transaction. If two companies swap their inventories they will not be allowed to record sales because not sales has occurred even if they have entered into valid enforceable contracts.

12. **Accrual Basis of Presentation**: an accounting method that includes income and expense items as they are earned or incurred irrespective of when money is received or paid out. Revenue and costs are both reported during the period to which they refer and not during the period when payments are received or made.

    The modified accrual basis is the accrual basis adapted to the non-profit fund-type measurement focus. Under it, revenues and other financial resource increments are recognized when they become susceptible to accrual, that is, when they become both "measurable" and "available to finance expenditures of the current period." "Available" means collectible in the current period or soon enough thereafter to be used to pay liabilities of the current period. Expenditures are recognized when the fund liability is incurred, except for (1) inventories of materials and supplies that may be considered expenditures either when purchased or used, and (2) prepaid insurance items that may be considered expenditures either when paid for or when consumed. All non-profit funds, expendable trust funds and agency funds are accounted for using the modified accrual basis of accounting.

    The accrual basis of accounting is the recording of the financial effects on a non-profit of transactions and other events and circumstances that have cash consequences for the government in the periods in which those transactions, events and circumstances occur, rather than only in the periods in which cash is received or paid by the association. Those revenues susceptible to accrual are assessments and related collections. Fees for services, fines, valet, and laundry room revenues are not susceptible to accrual because generally they are not measurable until received in cash.

    Fundamental to accrual accounting is determining (1) when one may report revenue on the financial statement, (2) matching and reporting the appropriate expenses related to those revenues, and (3) using a methodical and logical system allocating all other costs of being in business for that fiscal period.

    Revenue Recognition - Two Tests for Revenue Recognition

For revenue to be recognized, there are two key conditions that must be met according to SFAC 5, Recognition and Measurement in Financial Statements of Business Enterprises. They are:

- Completion of the earnings process: Under this test, the seller must have no significant remaining obligation to the customer. If an order for five hundred football helmets has been placed and only two hundred delivered, the transaction is not complete. Likewise, if the seller is the manufacturer of appliances and promises extensive warranty coverage, it should not book the sale as revenue unless the cost of providing that service (i.e., warranty repair labor and parts) can be reasonably estimated. Additionally, a company that sells a product with an unconditional return policy cannot book the sale until the window has expired (e.g., a company that promises unrestricted returns for cash until ninety days after the sale should not record the revenue until that period has elapsed.)
- Assurance of payment: In order to book revenue, the selling company must be able to reasonably estimate the probability that it will be paid for the order.

Revenue Recognition Method 1: Sales Basis

This is the method that probably makes the most sense to investors. Under the sales basis method, revenue is recognized at the time of sale (defined as the moment when the title of the goods or services is transferred to the buyer.) The sale can be for cash or credit (i.e., accounts receivable.) This means that revenue is not recognized even if cash is received before the transaction is complete. A magazine publisher, for example, that receives $120 a year for an annual subscription, will only recognize $10 of revenue every month. The reason is simple: if they went out of business, they would have to return a pro-rated portion of the annual subscription price to the customer since it had not yet delivered the merchandise for which it had been paid.

Revenue Recognition Method 2: Percentage of Completion

Companies that build bridges or aircraft take years to deliver the product to the customer. In this case, the company responsible for building the product wants to be able to show its shareholders that it is generating revenue and profits even though the project itself is not yet complete. As a result, it will use the percentage of completion method for revenue recognition if two conditions are met: 1.) there is a long-term legally enforceable contract and 2.) it is possible to estimate the percentage of the project complete, revenues and costs.

Under this method, there are two ways revenue recognition can occur:

- Using milestones such as number of railway track complete. A construction company is paid $100,000 to build fifty miles of highway. For every mile the company completes, it is going to recognize $2,000 in revenue on its income statement ($100,000 / 50 miles = $2,000 per mile.)
- Cost incurred to estimated total cost: Using this metric, the construction company would approach revenue recognition by comparing the cost incurred to-date by the estimated total cost. For example: The business expects the same $100,000 of highway to cost it $80,000 in parts, material, labor, etc. At the end of the first month, it has spent $5,000 working on the project. $5,000 is 6.25% of $80,000; therefore, it would multiply the total revenue ($100,000) by the percentage of the cost incurred (6.25%), or $6,250, and recognize this amount as revenue on its income statement.

One caveat: if you find yourself reading through the 10K of a company that is utilizing the percentage of completion revenue recognition method, you may want to watch out for premature booking of expenses such as the purchase of raw goods. Until the goods have

actually been used in the production cycle (e.g., pouring the actual concrete on the job site, not purchasing the concrete at Home Depot), the cost should not be counted. A business that does not make this distinction is prone to overstate revenue, gross profit, and net income for the period as a result.

Revenue Recognition Method 3: Cost Recoverability Method

The most conservative revenue recognition method of all, the cost recoverability approach is used when a company cannot reasonably estimate the total expense required to complete a project. The result is that no profit is recognized at all until all of the expenses incurred to complete the project have been recouped. Examples would include the development of internal software and certain types of land.

Assume a law firm developed its own software at a total cost of one million dollars. Several years later, the partners decide to start licensing the software to other firms. In the first quarter, they have total sales of $250,000. Under the cost recoverability method of revenue recognition, however, all of this would serve as an offset to the original $1 million in development expense. Nothing would appear in the income statement as revenue until the entire original balance of $1 million had been wiped out.

Revenue Recognition Method 5: Installment

When the actual collection of cash is suspect, a company should use the installment method of revenue recognition. This is primarily used in some real estate transactions where the sale may be agreed upon but the cash collection is subject to the risk of the buyer's financing falling through. As a result, gross profit is only calculated in proportion to cash received.

For example, assume a developer spent $500,000 improving an apartment. He sold the property for $750,000 but the buyer is going to pay in two installments – one on January 1st and one on July 31st. On the first payment due date, the developer receives a check for half of what he is owed, or $375,000. His income statement is now going to reflect fifty-percent of the revenue and gross profit earned since he has collected fifty-percent of the cash (i.e., $375,000 revenue, $125,000 gross profit ($250,000 total gross profit [$750K selling price - $500K cost = $250K] x 50% = $125,000.) (Realize the actual rules governing accounting for real estate sales are more complex; this example is for simplicity sake only to illustrate the concept of the installment method.)

Ways Management Can Manipulate the Income Statement Using Revenue Recognition: As you can see, management can, with only a change of revenue recognition accounting, drastically alter the appearance of the income statement, over or understating revenue and profit. The exact same contract using the percentage-of-completion method for revenue recognition instead of the completed contract method will result in higher assets, higher stockholder equity, lower liabilities, and a lower debt-to-equity ratio. The income statement will show much smoother earnings over a several year period despite the fact that the economic substance and health of the business would be exactly the same. This is where the investor must dig in and compare the revenue recognition of two companies in the same industry to truly get an idea of who is performing better. The irony is that, with certain exceptions, a business that uses the completed contract method is going to report no income in the first years of the contract, meaning no taxes will be paid. The result is that the shareholders of this business are going to be told they are earning less but their wealth is going to be greater because there is capital being used in the business tax-deferred; a phenomenon very similar to the use of LIFO for inventory valuation.

General rule

Received advances are not recognized as revenues, but as liabilities (deferred income), until the conditions (1.) and (2.) are met.

1. Revenues are realized when cash or claims to cash (receivable) are received in exchange for goods or services. Revenues are realizable when assets received in such exchange are readily convertible to cash or claim to cash.
2. Revenues are earned when such goods/services are transferred/rendered. Both, such payment assurance and final delivery completion (with a provision for returns, warranty claims, etc.), are required for revenue recognition.

Recognition of revenue from four types of transactions:

1. Revenues from selling inventory are recognized at the date of sale often interpreted as the date of delivery.
2. Revenues from rendering services are recognized when services are completed and billed.
3. Revenue from permission to use company's assets (e.g. interests for using money, rent for using fixed assets, and royalties for using intangible assets) is recognized as time passes or as assets are used.
4. Revenue from selling an asset other than inventory is recognized at the point of sale, when it takes place.

In practice, this means that revenue is recognized when an invoice has been sent.

Revenue vs. cash timing

Accrued revenue (or **accrued assets**) is an asset such as proceeds from a delivery of goods or services, at which such income item is earned and the related revenue item is recognized, while cash for them is to be received in a latter accounting period, when its amount is deducted from *accrued revenues*. It shares characteristics with *deferred expense* (or *prepaid expense*, or *prepayment*) with the difference that an asset to be covered later is cash paid out to a counterpart for goods or services to be received in a latter period when the obligation to pay is actually incurred, the related expense item is recognized, and the same amount is deducted from *prepayments*

Deferred revenue (or **deferred income**) is a liability, such as cash received *from a counterpart for goods or services* which are to be delivered in a later accounting period, when such income item is earned, the related revenue item is recognized, and the *deferred revenue* is reduced. It shares characteristics with *accrued expense* with the difference that a liability to be covered later is an obligation to pay for goods or services received solo *from a counterpart*, while cash for them is to be paid out in a later period when its amount is deducted from *accrued expenses*.

For example, a company receives an annual software license fee paid out by a customer upfront on the January 1. However the company's fiscal year ends on May 31. So, the company using accrual accounting adds only five months' worth (5/12) of the fee to its revenues in profit and loss for the fiscal year the fee was received. The rest is added to *deferred income* (liability) on the balance sheet for that year.

Advances

Advances are not considered to be a sufficient evidence of sale, thus no revenue is recorded until the sale is completed. Advances are considered a deferred income and are recorded as liabilities until the whole price is paid and the delivery made (i.e. matching obligations are incurred).

Exceptions

Revenues not recognized at sale

The rule says that revenue from selling inventory is recognized at the point of sale, but there are several exceptions.

- **Buyback agreements**: buyback agreement means that a company sells a product and agrees to buy it back after some time. If buyback price covers all costs of the inventory plus related holding costs, the inventory remains on the seller's books. In plain: there was no sale.
- **Returns**: companies which cannot reasonably estimate the amount of future returns and/or have extremely high rates of returns should recognize revenues only when the right to return expires. Those companies which can estimate the number of future returns and have a relatively small return rate can recognize revenues at the point of sale, but must deduct estimated future returns.

Revenues recognized before sale

Long-term contracts

This exception primarily deals with long-term contracts such as constructions (buildings, stadiums, bridges, highways, etc.), development of aircraft, weapons, and space exploration hardware. Such contracts must allow the builder (seller) to bill the purchaser at various parts of the project (e.g. every 10 miles of road built).

- **Percentage-of-completion method** says that if the contract clearly specifies the price and payment options with transfer of ownership, the buyer is expected to pay the whole amount and the seller is expected to complete the project, then revenues, costs, and gross profit can be recognized each period based upon the progress of construction (that is, percentage of completion). For example, if during the year, 25% of the building was completed, the builder can recognize 25% of the expected total profit on the contract. This method is preferred. However, expected loss should be recognized fully and immediately due to conservatism constraint.
- **Completed contract method** should be used only if percentage-of-completion is not applicable or the contract involves extremely high risks. Under this method, revenues, costs, and gross profit are recognized only after the project is fully completed. Thus, if a company is working only on one project, its income statement will show $0 revenues and $0 construction-related costs until the final year. However, expected loss should be recognized fully and immediately due to conservatism constraint.
- **Completion** of production basis: This method allows recognizing revenues even if no sale was made. This applies to agricultural products and minerals because there is a ready market for these products with reasonably assured prices, the units are interchangeable, and selling and distributing does not involve significant costs.

Revenues recognized after Sale

Sometimes, the collection of receivables involves a high level of risk. If there is a high degree of uncertainty regarding collectability then a company must defer the recognition of revenue. There are three methods which deal with this situation:

- **Installment sales method** allows recognizing income after the sale is made, and proportionately to the product of gross profit percentage and cash collected calculated. The unearned income is deferred and then recognized to income when cash is collected.[1] For example, if a company collected 45% of total product price, it can recognize 45% of total profit on that product.

- **Cost recovery method** is used when there is an extremely high probability of uncollectible payments. Under this method no profit is recognized until cash collections exceed the seller's cost of the merchandise sold. For example, if a company sold a machine worth $10,000 for $15,000, it can start recording profit only when the buyer pays more than $10,000. In other words, for each dollar collected greater than $10,000 goes towards your anticipated gross profit of $5,000.
- **Deposit method** is used when the company receives cash before sufficient transfer of ownership occurs. Revenue is not recognized because the risks and rewards of ownership have not transferred to the buyer.

Basis Equation of Accounting

The basis equation of accounting states:

Assets – Liabilities = Worth

(have) *(owe)* *(Value to owners)*

Worth, net worth, equity, owners' equity and shareholder equity all have the same meaning – the value of the association belonging to the owners.

Statement of Financial Position (Balance Sheet)

The Balance Sheet presents the equation above in a different manner:

Assets = Liabilities + Worth

(*have*) *(owe)* *(value to owners)*

This equation must always have the assets equaling the sum of the liabilities and worth – that, is, it must be "in Balance." If the manager adds an item on the asset side, he must also increase the liabilities section by either adding a liability or by increasing worth.

The Balance Sheet is a snapshot in time. It presents the financial picture of the association on a specific day, at an "instant in time." It presents:

What the association *has* today = assets

How much the association *owes* today = liabilities

What the association is *worth* today

That is, it reports:

Has today = Owes today + Worth today

Assets *liabilities* *shareholders' equity*

What are Assets?

Assets are all items the association has – including cash, inventory, machinery, property, etc. Assets include certain "right" the association has to monetary value, such as the right to collect cash owed by members (owners) for assessments, fines, fees, and so on. Assets are **valuable**. Value must be calculable for an asset to be included on the Balance. Every item in an association's financial statement must be stated in dollars (and cents).[1]

[1] Note: Some balance sheets are rounded to dollars (hundreds, thousands), and do not include pennies.

Grouping Assets for Presentation

We group assets on the Balance Sheet according to certain characteristics:

Very liquid assets ….cash & securities

Productive assets…..plant & machinery

Assets for sale………inventory[2]

Balance Sheet Format
as of a specific date

Assets	Formulas		Liabilities & Equities	
Cash	A	Most Liquid ↑	Accounts Payable	K
Accounts Receivable	B		Accrued Expenses	L
Inventory	C		Current Portion of Debt	M
Prepaid Expenses	D		Income Taxes Payable	N
Current Assets	A+B+C+D=E		Current Liabilities	K+L+M+N=O
Other Assets	F		Long Term Debt	P
Fixed Assets at Cost	G		Capital Stock	Q
Accumulated Depreciation	H	↓	Retained Earning	R
Net Fixed Asset	G-H=I	Least Liquid	Shareholder's Equity	Q+R=S
Total Assets	**E+F+I**		**Total Liabilities & Equity**	**O+P+S=T**

Accounts receivable (B) are a special asset group. It reflects the obligations of members (owners) of the association to pay assessments, fines, fees and other monies due to the association.

Assets are displayed in the asset part of the Balance Sheet in descending order of liquidity.[3] Cash is the most liquid of all assets. Fixed assets, such as physical property, are usually the least liquid.

Current Assets

Current assets, by definition, are those assets that are expected to be converted into cash in less than twelve (12) months. Assets are usually grouped in order of most liquid to least liquid:

- Cash (A)
- Accounts Receivable (B)

[2] Note: Association may not have any assets for sale, or it may include items such as keys, access cards, etc., in this category.

[3] Liquidity = The ability of an asset to be converted into cash quickly and without any price discount.

- Inventory (C)

The funds the association will use to pay bills within the year (near term) will come when its **current assets** are converted to cash (in the association of an association, since inventory is generally small, if it exists at all, this usually refers only to accounts receivable that are paid to the association by owners).

- **Cash (A)** is the basic liquid asset. It includes petty cash as well as on-demand deposits at the bank. It could include monies in checking, savings, and money market accounts, as long as the association has immediate access to the funds. When the association writes a check, or gives the maintenance man money from petty cash, it is removing assets from the cash account. Cash is expressed or denominated in U.S. dollars.

Balance Sheet Format

as of a specific date

Assets	Formulas	Most Liquid	**Liabilities & Equities**	
Cash	A	↑	Accounts Payable	K
Accounts Receivable	B		Accrued Expenses	L
Inventory	C		Current Portion of Debt	M
Prepaid Expenses	D		Income Taxes Payable	N
Current Assets	A+B+C+D=E		Current Liabilities	K+L+M+N=O
Other Assets	F		Long Term Debt	P
Fixed Assets at Cost	G		Capital Stock	Q
Accumulated Depreciation	H	↓	Retained Earning	R
Net Fixed Asset	G-H=I	Least Liquid	Shareholder's Equity	Q+R=S
Total Assets	**E+F+I**		**Total Liabilities & Equity**	**O+P+S=T**

- **Accounts receivable (B)** are monies owes to the association from members (owners) – usually assessments. It could include fines, fees for access cards or keys, reimbursements due for legal expenses in a lien action, etc.
- **Inventory (C)** in a corporation includes three categories:
  - Raw materials: unprocessed materials to be used in manufacturing products
  - Work-in process: partially finished products
  - Finished goods: completed products ready for shipment to customers.

  Normally, an association does not have raw materials or work-in process. It may have “finished goods,” such as access cards, decals, or keys, that it will sell to members (owners) for replacements. As a “finished good” is sold, it becomes an *accounts receivable*, until paid, then is moved into the *cash* category when paid.

- **Prepaid Expenses (D)** are bills that the association has already paid, but has not yet received the services. Insurance is a good example. The association may pay its entire premium in January for the January through December period. A Balance Sheet produced on February 28th would show 10 months of prepaid insurance costs. Prepaid expenses are considered current

Balance Sheet Format

as of a specific date

Assets	Formulas		Liabilities & Equities	
Cash	A	Most Liquid	Accounts Payable	K
Accounts Receivable	B	↑	Accrued Expenses	L
Inventory	C		Current Portion of Debt	M
Prepaid Expenses	D		Income Taxes Payable	N
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Fixed Assets at Cost	G		Capital Stock	Q
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Total Assets	**E+F+I**		**Total Liabilities & Equity**	**O+P+S=T**

assets because the association it already used cash to paid for them.

Current Asset Cycle

Current assets are considered "working assets" because they are continually being converted into "cash." The repeating current asset cycle of an association is:

Cash buys *inventory* (in the assets section only)

Assessments when due become *accounts receivable*; inventory (if any) when sold becomes *accounts receivable*

Accounts receivable upon collection become *cash*

Other Asset Types

The association may have two other major asset groups in addition to **Current Assets**. These are listed on the **Balance Sheet** as "**Other Assets**" and "**Fixed Assets**." **Other assets (F)** is a blanket category that may include intangible assets. In a private corporation, this may include value of patents, trade names, etc. Associations do not necessarily have an "**Other Asset**" category. **Fixed Assets (G)** represents property, plant and equipment (often referred to as PP&E). It is generally the largest and most important non-current asset group. In an association, this would include the value of the building and grounds owned by the association.

Fixed Assets (G) are reported on the **Balance Sheet** at original purchase cost. **Fixed assets** are not items that the association will sell or grant to its owners; e.g., not access cards or decals. . They include land, buildings, machinery, equipment, furniture, etc. Fixed assets are represented as is a net cost – the original cost minus an allowance for depreciation.

Balance Sheet Format

as of a specific date

Assets	Formulas	Most Liquid	**Liabilities & Equities**	
Cash	A	↑	Accounts Payable	K
Accounts Receivable	B		Accrued Expenses	L
Inventory	C		Current Portion of Debt	M
Prepaid Expenses	D		Income Taxes Payable	N
Current Assets	A+B+C+D=E		Current Liabilities	K+L+M+N=O
Other Assets	F		Long Term Debt	P
Fixed Assets at Cost	G		Capital Stock	Q
Accumulated Depreciation	H	↓	Retained Earning	R
Net Fixed Asset	G-H=I	Least Liquid	Shareholder's Equity	Q+R=S
Total Assets	**E+F+I**		**Total Liabilities & Equity**	**O+P+S=T**

Depreciation is an accounting convention which describes the decline in useful value of an asset due to the passage of time and wear & tear. “Depreciating” an asset entails distribution of the cost of an asset over the asset’s whole useful life.[4] **Accumulated depreciation (H)** is the sum of all the depreciation charges since the asset was first acquired (or last replaced or rehabbed). **Depreciation** taken in a period does lower “profits” or total assets, but do not lower cash. While **Cash** was required to purchase the fixed asset originally, it does not apply to the asset in the Balance Sheet.

Net Fixed Assets (I) represent the sum of its fixed assets’ purchase price (fixed assets at cost) minus the depreciation amounts which appear on the Income Statement over the years (accumulated depreciation). We will discuss this in more depth under Income Statement. The professed book value of an asset[5] is the asset’s purchase price minus its accumulated depreciation. While it is important to note that depreciation does not necessarily relate to an actual decrease in value, and that some assets appreciate in value over time, these assets are reported on the Balance Sheet at the lower book value.

Other Assets

Other Assets (F) on the Balance Sheet includes assets that cannot properly be classified into current assets or fixed assets. Other current assets are listed on a firm's balance sheet, and are a

[4] Keep in mind that “useful life” might refer to replacement of an asset, or rehab or repair of an asset to return it to its original condition.

[5] Value as reported on the books of the association

component of a firm's total assets. An association's assets that do not include cash, securities, receivables, inventory and prepaid assets, and can be convertible into cash within one business cycle, usually one year. For instance, this might include a 5-year CD that does not come due within the next 12 month period. Restricted cash or investments may be included in this figure. Intangible assets are items owned by the association that have value but are not tangible (e.g., are not physical property) – such as a copyright, patent, or brand name. For instance, "I-Phone 4S" name is an intangible asset for the Apple Corporation. The name itself may have an intrinsic value to Apple, but is not tangible, such as the phone inventory itself. Other assets may be valued by management according to differing accounting conventions.

What Are Liabilities?

Liabilities are obligations of the association, such as money that the association owes to vendors, employees, suppliers, and so on. **Liabilities** are classified and grouped on the Balance Sheet by:

- To whom the debt is owed and
- Whether the debt is payable within the year (***current liabilities***) or is a long-term obligation (such as a ten year bank loan).

Shareholders' equity is a special type of liability, representing the value of the corporation (association) that belongs to the members (owners). This "debt" is never repaid in the normal course of business.

Current Liabilities

Current Liabilities are bills that must be paid within one year of the date of the Balance Sheet. They are, in essence, the reverse of current assets:

Current assets…..obtain cash within 12 months

Current liabilities….. appropriate cash within 12 months

Balance Sheet Format

as of a specific date

Assets	Formulas	Most Liquid	**Liabilities & Equities**	
Cash	A	↑	Accounts Payable	K
Accounts Receivable	B		Accrued Expenses	L
Inventory	C		Current Portion of Debt	M
Prepaid Expenses	D		Income Taxes Payable	N
Current Assets	A+B+C+D=E		Current Liabilities	K+L+M+N=O
Other Assets	F		Long Term Debt	P
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Net Fixed Asset	G-H=I	Least Liquid	Shareholder's Equity	Q+R=S
Total Assets	**E+F+I**		**Total Liabilities & Equity**	**O+P+S=T**

Balance Sheet Format
as of a specific date

Assets	Formulas		Liabilities & Equities	
Cash	A	Most Liquid ↑	Accounts Payable	K
Accounts Receivable	B		Accrued Expenses	L
Inventory	C		Current Portion of Debt	M
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Fixed Assets at Cost	G		Capital Stock	Q
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Net Fixed Asset	G-H=I	Least Liquid	Shareholder's Equity	Q+R=S
Total Assets	**E+F+I**		**Total Liabilities & Equity**	**O+P+S=T**

Current liabilities are generally arranged based upon to whom a debt is owed:

Accounts payable owed to vendors, suppliers, etc.

Accrued expenses owed to employees and others for services

Current debt owed to lenders

Taxes owed to the government

Accounts Payable (K) are generally bills to vendors and companies for materials and equipment bought on credit,[6] that the association must pay soon**.** When the association receives the item(s), it can either pay immediately with cash, or wait until an invoice is received – thus the item becomes an **accounts payable**. During the period between when the item is received and the bill is paid is reflected as **accounts payable**. Business-to-business transactions are most often done on credit. Common business payment terms are often 30 or 60 days. Sometimes there is a discount for early payment (such as 2% if paid within 20 days.

Accrued expenses (L) are monetary commitments similar to accounts payable. The association will use one or the other, depending to whom the moneys are owed. While **accounts payable** are used for debts to suppliers or for services bought on credit, *accrued expenses* often refer to salaries earned , but not yet paid, by employees, attorney's invoices not yet paid, interest due but not yet paid on bank loans, etc.

[6] Keep in mind that "bought on credit" does not necessarily mean bought with a credit card. It may mean that the item was ordered, with payment due at the end of the month, for instance.

Balance Sheet Format
as of a specific date

Assets	Formulas	Most Liquid	**Liabilities & Equities**	
Cash	A	↑	Accounts Payable	K
Accounts Receivable	B		Accrued Expenses	L
Inventory	C		Current Portion of Debt	M
Prepaid Expenses	D		Income Taxes Payable	N
Current Assets	A+B+C+D=E		Current Liabilities	K+L+M+N=O
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Current portion of long term debt (M) includes *notes payable*. If the association owes money to a bank or credit union, and the terms of the loan state the monies must be repaid within 12 months, the debt is usually referred to as a *note payable* and is a current liability. A loan with an overall term of more than 12 months from the date of the Balance Sheet is referred to as a "Long-Term debt" – such as a 5 year loan for concrete restoration. The current portion of the long-term debt; that is, the amount due and payable within 12 months of the date on the Balance Sheet, is considered a current liability. It is included in **current portion of debt**.

Income Taxes Payable (N) are income taxes that the association owes but has not yet paid (if any). Every three months (quarterly) the association sends the government a check for income taxes owed. This may include monies owed for employee salaries.

Working Capital is the amount of money left after the association subtracts current liabilities from current assets:

Current Assets	**–**	**Current Liabilities**	**=**	**Working Capital**
Cash		*Accounts payable*		
Accounts receivable		*Accrued expenses*		
Inventory		*Current portion of debt*		
Prepaid expenses		*Income taxes payable*		

Working capital is the money available to the association to "work with" in the short term. Working capital is also referred to as "net current assets."

Sources of working capital are ways working capital increased in the normal course of business, for example when current liabilities decrease or current assets increase. Uses of working capital

(applications) are ways working capital decreases during the normal course of business, again, when current liabilities decrease or current assets increase.

Total Liabilities is the sum of current liabilities and long term debt. Note that most Balance Sheets do not have a separate line item for Total Liabilities. Long-term debt (P) is any loan to the association that must be repaid in more than 12 months after the date of the Balance Sheet. An example of long-term debt includes loans for multi-year capital projects, or equipment replacements bought over time (e.g., an air conditioner financed over 24 months).

Balance Sheet Format

as of a specific date

Assets	Formulas	Most Liquid	**Liabilities & Equities**	
Cash	A	↑	Accounts Payable	K
Accounts Receivable	B		Accrued Expenses	L
Inventory	C		Current Portion of Debt	M
Prepaid Expenses	D		Income Taxes Payable	N
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Shareholders' Equity

Shareholders' equity (S) has two elements:

Capital stock (Q) – the original amount of money the members (owners) contributed as their investment in the association

Retained earnings (R) – all the earnings of the association that have been retained (in a corporation, earnings not paid out as dividends to owners)

So, if the association subtracts what it owes (*total liabilities*) from what it has (*total assets*), the remainder is **shareholder equity**. "*Net worth*" and "*book value*" mean the same thing as **shareholder equity.**

Capital Stock is the original money to start and any additional money invested in the association. In a corporation, common stock is regular "*denomination of ownership*." All prof-profit companies issue common stock, and may issue other types of stocks. For instance, some corporation issue preferred stock that has certain preferences over the common stock. It may include a specific (higher) dividend, right to receive company assets if the company is liquidated, or right to purchase additional (preferred or common) stock at a set price. Note: in a private corporation, shareholder equity is the sum of the investment made in the stock of the entity plus any profits (less losses), minus any dividends that have been paid to shareholders.

Balance Sheet Format
as of a specific date

Assets	Formulas	Most Liquid	**Liabilities & Equities**	
Cash	A	↑	Accounts Payable	K
Accounts Receivable	B		Accrued Expenses	L
Inventory	C		Current Portion of Debt	M
Prepaid Expenses	D		Income Taxes Payable	N
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Retained Earnings are all the association profits that have not been returned to the members (owners). In a private corporation:

Retained earnings = sum of all profits – sum of all dividends

Retained earnings can be regarded as a pot of money from which future dividends (or expenses) could be paid. In fact, dividends cannot be paid to owners in a corporation unless sufficient retained earnings are on the Balance Sheet to cover the total amount of dividends due to be paid.

If the association has not made a “profit,” but instead has endured losses, it *has negative retained earnings* that are referred to as **accumulated deficit**.”

The value of the **shareholders’ equity** increases when the association makes a profit (has a surplus), thereby decreasing retained earnings, or in a provide corporation, sells new stock, thereby increasing capital stock. The value decreases when the association has a loss (deficit), lowering retained earnings, or when the corporation pays dividends to shareholders, thus lowering retained earnings.

Summary: Balance Sheet

The Balance Sheet presents the financial picture (snapshot) on a particular day, at an instant of time:

have today		*owe today*	*worth today*
Assets	=	Liabilities +	Shareholders Equity

This equation, by definition, must always be in balance, with assets equaling the sum of liabilities and equity. The Balance Sheet, along with the Income Statement, forms the two major statements for the association.

Statement of Comprehensive Income (Income Statement – Profit & Loss (P&L) Statement)

The **Income Statement (P&L)** gives an important perspective to the health of the association – its *profitability*. It does not communicate the complete picture. The Balance Sheet reports on assets, liabilities and equity; the Cash Flow Statement reports on cash movements, while the Income Statement reveals nothing about when the association receives cash or how much cash it has on hand.

In a corporation, a **P&L Statement** reports on the manufacture and sales activities of the business over a period of time:

what is sold in the period

minus

what it cost to make it

minus

selling & general expenses for the period

equals

income for the period

In an association, it represents:

what is assessed to members, plus

any fees or items sold[7] in the period

minus

what it cost to acquire items sold

minus

general expenses for the period

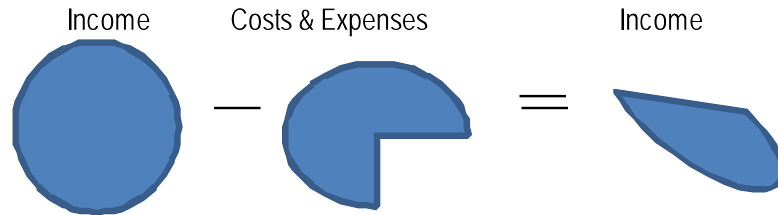
equals

income for the period

The **P&L** details for a specific period (month, quarter or year, for example) the basic equation of accounting:

Assessments/fees – Costs & expenses = Income

[7] Such as keys, access cards, decals



Income Statement Format

as of a specified date

	Budget		Actual
Revenues			
A		Assessments	
B		Late Fees	
C		Fines	
D		Valet	
E		Laundry Receipts	
F		Miscellanous Income	
A+B+C+D+E+F=G		Total Income	
Expenses			
H		Salaries & Wages	
I		General & Administrative Costs	
J		Contracts	
K		Maintenance	
L		Insurance	
M		Miscellaoeus Expense	
H+I+J+K+L+M=N		Total Expense	
O		Income from Operations	
P		Interest	
Q		Income Taxes	
O+P-Q=R		Net Surplus/Deficit	

Revenues

In a corporation, one normally encounters sales and related items. These are usually separated from the general & administrative costs of doing business, and from research & development. We do not routinely encounter these types of expenses in a community association. Therefore, we have shown an example of a simplified P&L one might see in a community association.

Accounting provides some measure of a firm's economic efficiency on its income statement. A large net income usually tells us that something has gone right, while a large loss indicates that something is amiss. The same cannot be said about a non-profit's income statements (usually called the Statements of Revenue and Expense). Since the central goal of a nonprofit is to provide services, not earn large profits, the absence of a profit is not a mark against the organization. As an alternative to the income statement, accounting attempts to measure a nonprofit's efficiency on a financial statement called the Statement of Functional Expenses (SFE). In theory, we should be able to compare the efficiency of various nonprofits by comparing the expense ratios reported on their SFEs. Alas, these reported ratios are not so reliable because nonprofits tirelessly diddle the accounting rules and definitions as to what constitutes a fund raising expense versus a program expense.

Examine the revenue lines in the **Income Statement (Lines A – G)**. Assessments should reflect the budgeted amount (since the P&L is on an accrual basis). Other revenues should be similarly reflected.

Look at the Expense lines in the **Income Statement** (**Lines H – N**). They are similar to the lines in the expense section of a for-profit income statement. The statement shows detailed expenses, and may include depreciation, contracts and insurance. Payment of a loan would be included under non-operating expense, while interest income is normally reported below the net income/(loss) from the overall operations.

The Net Surplus/(Deficit) is the difference between the two large numbers (1) revenues (G) and expenses (N, Q). Interest income is included in the revenues. If the association has a positive number, it has a surplus. If it has a negative number, it has a deficit, and will need to consider how it will either reduce costs for the remainder of the year, or increase revenues (special assessments, for instance).

Measure the efficiency of the association. The **Income Statement** expenses can be used to analyze how an association is spending its funds. Look at how much it has spent in each category. If a community association spends a lot in administration, for example, more than maintenance, then the organization is not efficient on how it spends its funding. A community association is in business to preserve, maintain and enhance the community association and its assets. If an association is not at that level, then the manager should conduct more research and figure out what has been happening. In a not-for-profit, usually, the program should have about 80 – 85% percent in expenses, and 15 – 20% percent for administration. We expect it to be similar in a community association.

Comments on Reading & Reviewing the Income Statement

Review the Income and Expenses for the Month: The first step in reviewing an **Income Statement** is to review the income the Association received during the preceding month and the expense that it paid. The raw figures for the month will provide an overview of the association financial health. For example, if the Income and Expense Statement showed that $35,000 was received in income and $29,500 was paid in expenses, the association had a relatively good month because income exceeded expenses.

Actual versus Budgeted Figures: It is important for the association to compare the actual income and expenses for the month with the amount that was projected in the budget. In the prior example, if the association budgeted $75,000 in income during the same period and only $15,000 in expenses and the actual income was $35,000 and expenses were $25,500, the association should be concerned that it is significantly over budget for the month.

The **Income Statement** should show the budgeted figures in the column next to the actual figures to determine whether the Association's actual revenues and expenses are higher or lower than the amount budgeted. Whenever the association experiences variances between the actual and budgeted income and expenses, it should determine if the variance is good or bad for the Association and whether it requires some action on the part of the Board.

Determine the Reason for Any Variances between Actual and Budgeted Amounts: A variance that shows revenues are less than the amount budgeted for the month may be a sign that delinquencies are excessive and that more aggressive collection efforts are required. Similarly, if the association's expenses are significantly higher than what was budgeted, the association should assess if it can reduce expenses to continue paying bills for the remainder of the year.

Review the Income and Expenses for the Year: The **Income Statement** may also have the year-to-date revenues and expenses in a column next to the year-to-date budgeted amounts so the association can assess the Association's financial and determine whether any changes need to be made to come in under budget.

When Reviewing the Income and Expense Statement:

1. How much of the fiscal year has passed? Has the budget been met?
2. Is the association over budget or under budget?
3. If the association continues as is for the remainder of the year, will it be over budget or under budget? Anytime the association can finish the year under budget, it is in a good financial position.
4. If the association is going to have a budget shortfall, does it have funds it can draw upon to cover the shortfall or will it need a special assessment or increase in assessments?
5. Can the association determine the reason for any unexpected variances; do the variances indicate a problem in association's finances?
6. What, if anything, does the association need to be doing differently to increase income or decrease expenses?

Once a manager becomes familiar with the Income Statement, he can readily scan it for potential areas of concern to discuss with the board.

Accrual Basis vs. Cash Basis

Accrual basis: Income is measured when the transactions occur (regardless of the physical flow of cash). The Income Statement does not reflect the movement of cash, but instead the obligations (receivables) and payables to receive or pay cash in the future. Expenses occur when the association incurs the obligation; revenues are recorded when the member is charged for the assessment (or fine, fee, etc.). Using the accrual basis, an individual would lower his net worth when he used his charge card, rather than when he pays the bill.

Cash basis: Income is measured when cash is received and expenses measured when cash is spent – like a checkbook. Cash basis is the siplist means of accounting. When one uses a cash basis accounting approach, Income Statements and Cash Flow Statements are identical. While most people operate on a cash basis in their personal lives, the IRS requires certain companies to operate according to accruals.

Income Statement & Balance Sheet

The association's Balance Sheet and Income Statement are inexorably connected. It the association's Income Statement shows income, then retained earnings on increased on the Balance Sheet. Likewise, either the association's assets must increase or its liabilities decrease for the Balance Sheet to remain in balance. The Income Statement, therefore, displays all taken by the association, for a period, to either decrease liabilities or increase assets on the Balance Sheet.

Statement of Changes in Equity

A statement of changes in equity summarizes the movement in the equity accounts during the year namely share capital, share premium, retained earnings, revaluation surplus, unrealized gains on investments, etc. It is an important component of financial statements since it explains the composition of equity and how has it changed over the year. Typical information we can get from a statement of changes in equity include:

- The amount of new share capital issued
- The amount of dividend paid during the year to shareholders
- The amount by which PPE is valued up or valued down
- The amount of net income earned during the year
- The amount of net income retained during the year
- Any movement in the unrealized loss or gain reserve and reserve for changes in foreign exchange gain or loss, etc.

Cash Flow Statement
for the period x through y

Beginning Cash Balance	A
Cash Receipts	B
Cash Disbursements	C
Cash Flow from Operations	B - C = D
Fixed Assets Purchases	E
Net Borrowings	F
Income Taxes Paid	G
Sale of Capital Stock	H
Ending Cash Balances	A + D - E + F - G + H = I

Statement of Cash Flows

The Cash Flow Statement tracks the movement of cash through the association over a period of time. An association's Cash Flow Statement is similar to a check register. It records all of the association's transactions that use cash (checks) or supply cash (deposits). The Cash Flow Statement shows:

cash on hand at the start of the period

plus

cash received during the period

minus

cash spent during the period

equals

cash on hand at the end of the period

We refer to certain transactions as "Cash Transactions." These include items such as:

Paying salaries (*lowers cash*)

Paying for repairs & supplies (*lowers cash*)

Receiving assessment due (*increases cash*)

Borrowing money from a bank (*increase cash*)

Paying or receiving means cash (or check) actually exchanges hands.

Non-cash transactions have no effect on association **Cash Flow Statements**, but they may affect the **Balance Sheet** and **Income Statement**. A non-cash transaction could refer to replacement of a member's gate card with a new one, where the old one is returned. It could also refer to replacement of a gate card where the owner will be invoiced for the card, and pay at a later date. Remember, it is only when the cash comes into the association that it appears on the **Cash Flow Statement**.

A positive cash flow for a period means that the association has more cash at the end of the period than at the beginning. A negative cash flow means that the association had less money at the end of the period than at the beginning. If the association has a continuing negative cash flow, it may run out of cash and not be able to operate the association – since it will have insufficient cash on hand to pay invoices due.

Sources and Uses of Cash

Cash comes into the association from certain sources: receiving payment from the members (owners) for assessments, fees, fines and other costs, and financing activities – such as borrowing money from a bank. Cash leaves the association in four major ways:

- Operating activities – such as paying employees and vendors
- Financial activities – such as paying principals and interest on loans
- Capital investments – such as replacing the roof
- Income taxes – to the federal government

Cash Flow Statement	
for the period x through y	
Beginning Cash Balance	A
Cash Receipts	B
Cash Disbursements	C
Cash Flow from Operations	B - C = D
Fixed Assets Purchases	E
Net Borrowings	F
Income Taxes Paid	G
Sale of Capital Stock	H
Ending Cash Balances	A + D - E + F - G + H = I

Normal day-to-day operations of an association are called its *operations*. The Cash Flow Statement shows **cash from operations (D**) separately from other cash flows. **Cash receipts (B)** are inflows of money coming from operating the association**. Cash disbursements (C)** are outflows on money used in operating the association. Cash receipts (money in) minus cash disbursements (money out) equal **Cash from Operations (D)**.

Cash receipts come from collecting monies from members (owners). They increase the amount of cash on hand. However, it decreases the amount that is due to the company as accounts receivable on the Balance Sheet. Cash receipts are not surplus. These are found on the *Income (P&L) Statement*.

Cash disbursements lower the amount of cash an association has on hand. This usually occurs via check signed by two board members, although occasionally it could occur via petty cash. A credit card would not affect cash disbursements. Cash disbursements may also be referred to as payments or disbursement.

Other Elements of Cash Flow

Cash from operations reports the flow of monies into and out of the association. It is a good measure of how well the association is doing on a day-to-day basis. But, it does not measure the overall financial health of the association. To do that, one must also examine Investment in Fixed Assets and Financial Activities, such as paying taxes to government.

Fixed asset purchases are money spent to buy or make major repairs of property, plant and equipment (PP&E). These are investments in the long-term capability of the association to preserve, maintain and enhance the property and its assets. Paying for PP&E is not deemed a part of operations and is therefore not reported in cash disbursements from operations. Cash payments for PP&E appear on a separate line on the **Cash Flow Statement (E)**. PP&E are investments in the association. When Cash is expended for PP&E, it must be reflected as a decrease on the Balance Sheet.

Cash Flow Statement	
for the period x through y	
Beginning Cash Balance	A
Cash Receipts	B
Cash Disbursements	C
Cash Flow from Operations	B - C = D
Fixed Assets Purchases	E
Net Borrowings	F
Income Taxes Paid	G
Sale of Capital Stock	H
Ending Cash Balances	A + D - E + F - G + H = I

Net borrowings (F) increase the amount of cash available to the association. Note that paying back a loan decreases the association supply of cash on hand (in the Balance Sheet). Net borrowings are reported on a separate line in the Cash Flow Statement.

Taxes paid (usually income taxes) **(G)** also affects the Cash Flow Statement. Owing taxes is not the same as paying them. Writing the check to the government for the taxes owed reduces the cash on hand, and is reflected as a separate line on the Cash Flow Statement.

We have included a line for **Sale of Stock (H)**. However, an association will not have a sale of stock. This is limited to for profit corporations.

The Beginning Cash Balance (A) plus or minus all cash transactions that took place during the period equals the Ending Cash Balance (I). That is:

beginning cash on hand

plus cash received

less cash spent

equals ending cash on hand

Summary: Cash Flow Statement

The association's cash flow statement can be thought of as a check register that reports all the association's payments for a specific period (*cash outflows*) as well as all its deposits (*cash inflows*). If no cash changes hands in a particular transaction, the Cash Flow Statement remains unchanged. However, the Balance Sheet and Income Statements may be changed by non-cash transactions. Also, some non-cash transactions are reported on the Cash Flow Statement, and do have an effect on the Balance Sheet and Income Statement.

Summary:

Remember the fundamental reporting function of each of the three main financial statements:

- Income Statement shows the operations and income actions of the association that results in profit or loss (surplus or deficit).
- Cash Flow Statement details the movements of cash into and out of the coffers of the association.
- Balance Sheet records what the association owns and what it owes, including the owner's stake.

Each statement views the association's financial health from a different and very necessary perspective. And also, each statement relates to the other two. Remember the fundamental reporting function of each of the three main financial statements:

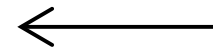
Appendices:

Comparisons 1 - 4

Balance Sheet Connections

Cash Flow Statement
for the period x through y

Beginning Cash Balance	A
Cash Receipts	B
Cash Disbursements	C
Cash Flow from Operations	B - C = D
Fixed Assets Purchases	E
Net Borrowings	F
Income Taxes Paid	G
Sale of Capital Stock	H
Ending Cash Balances	A + D - E + F - G + H = I



Ending Cash on *Cash Flow* always equals Cash on *Balance Sheet*

Income Statement Format
as of a specified date

Revenues	
Assessments	A
Late Fees	B
Fines	C
Valet	D
Laundry Receipts	E
Miscellaneous Income	F
Total Income	A+B+C+D+E+F=G
Expenses	
Salaries & Wages	H
General & Administrative Costs	I
Contracts	J
Maintenance	K
Insurance	L
Miscellaneous Expense	M
Total Expense	H+I+J+K+L+M=N

Comparison 1

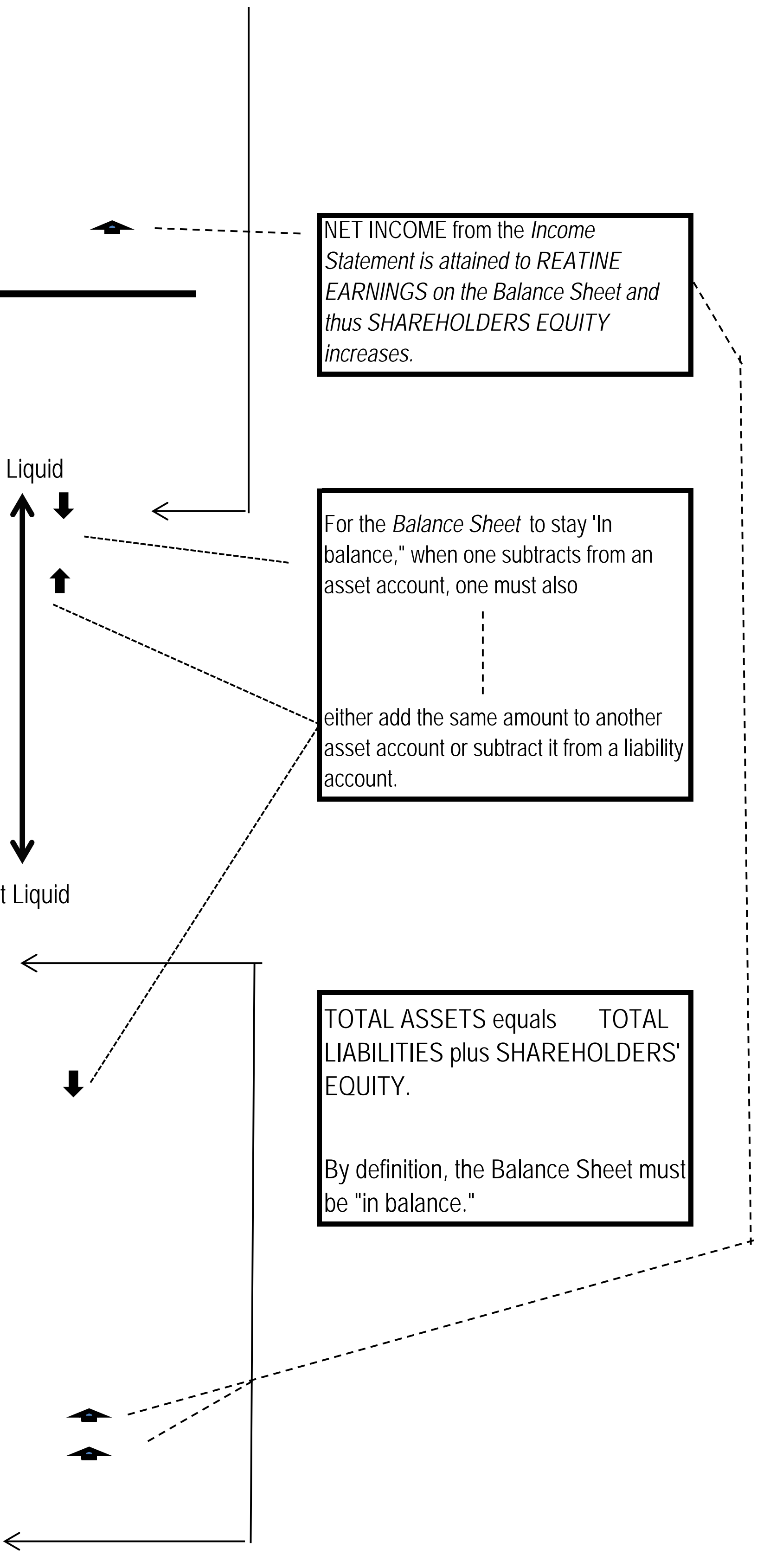
Income from Operations	O
Interest	P
Income Taxes	Q
Net Surplus/Deficit	O+P-Q=R

Balance Sheet Format

as of a specific date

Assets	Formulas	Most Liquid
Cash	A	
Accounts Receivable	B	
Inventory	C	
Prepaid Expenses	D	
Current Assets	A+B+C+D=E	
Other Assets	F	
Fixed Assets at Cost	G	
Accumulated Depreciation	H	
Net Fixed Asset	G-H=I	Least Liquid
Total Assets	**E+F+I**	

Liabilities & Equities	
Accounts Payable	K
Accrued Expenses	L
Current Portion of Debt	M
Income Taxes Payable	N
Current Liabilities	K+L+M+N=O
Long Term Debt	P
Capital Stock	Q
Retained Earning	R
Shareholder's Equity	Q+R=S
Total Liabilities & Equity	**O+P+S=T**



Comparison 2

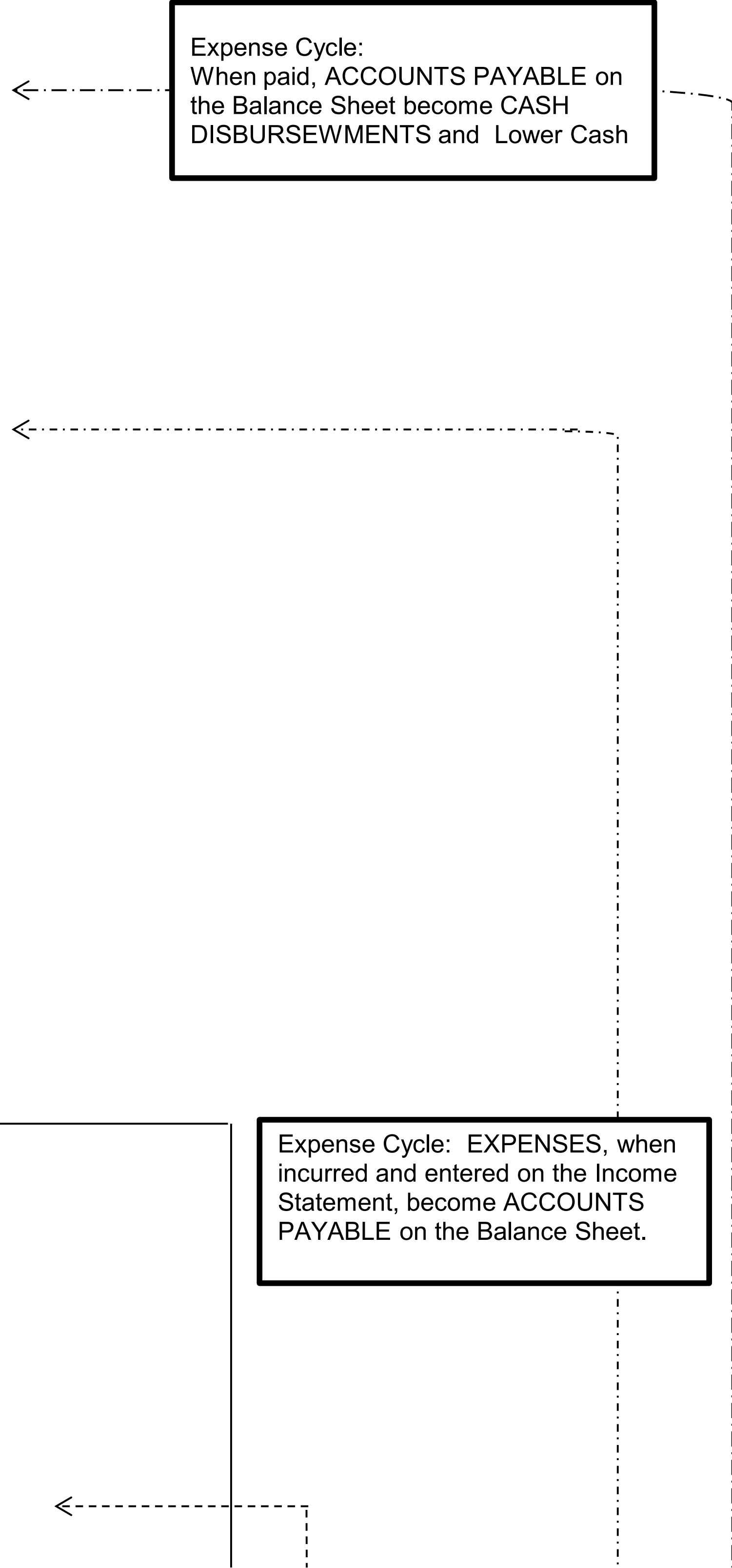
Balance Sheet Connections

Cash Flow Statement
for the period x through y

Beginning Cash Balance	A
Cash Receipts	B
Cash Disbursements	C
Cash Flow from Operations	B - C = D
Fixed Assets Purchases	E
Net Borrowings	F
Income Taxes Paid	G
Sale of Capital Stock	H
Ending Cash Balances	A + D - E + F - G + H = I

Income Statement Format
as of a specified date

Revenues	
Assessments	A
Late Fees	B
Fines	C
Valet	D
Laundry Receipts	E
Miscellaneous Income	F
Total Income	A+B+C+D+E+F=G
Expenses	
Salaries & Wages	H
General & Administrative Costs	I
Contracts	J
Maintenance	K
Insurance	L
	M
Total Expense	H+I+J+K+L+M=N
Income from Operations	O
Interest	P
Income Taxes	Q
Net Surplus/Deficit	O+P-Q=R



Comparison 2

Balance Sheet Format

as of a specific date

Assets	Formulas	Most Liquid
Cash	A	
Accounts Receivable	B	
Inventory	C	
Prepaid Expenses	D	
Current Assets	A+B+C+D=E	
Other Assets	F	
Fixed Assets at Cost	G	
Accumulated Depreciation	H	
Net Fixed Asset	G-H=I	Least Liquid
Total Assets	**E+F+I**	
Liabilities & Equities		
Accounts Payable	K	
Accrued Expenses	L	
Current Portion of Debt	M	
Income Taxes Payable	N	
Current Liabilities	K+L+M+N=O	
Long Term Debt	P	
Capital Stock	Q	
Retained Earning	R	
Shareholder's Equity	Q+R=S	
Total Liabilities & Equity	**O+P+S=T**	

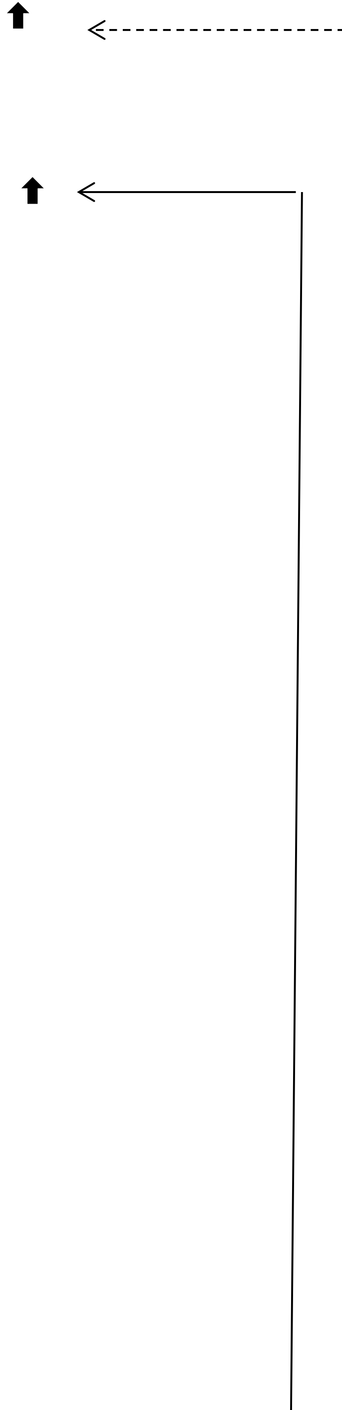
EXPENSES reduce NET INCOME on the Income Statement and also in RETAINED EARNINGS on the Balance Sheet.

Balance Sheet Connections

Cash Flow Statement

for the period x through y

Beginning Cash Balance	A
Cash Receipts	B
Cash Disbursements	C
Cash Flow from Operations	B - C = D
Fixed Assets Purchases	E
Net Borrowings	F
Income Taxes Paid	G
Sale of Capital Stock	H
Ending Cash Balances	A + D - E + F - G + H = I



Income Statement Format

as of a specified date

Revenues	
Assessments	A
Late Fees	B
Fines	C
Valet	D
Laundry Receipts	E
Miscellaneous Income	F
Total Income	A+B+C+D+E+F=G
Expenses	
Salaries & Wages	H
General & Administrative Costs	I
Contracts	J
Maintenance	K
Insurance	L
	M
Total Expense	H+I+J+K+L+M=N
Income from Operations	O
Interest	P
Income Taxes	Q
Net Surplus/Deficit	O+P-Q=R

Investment Cycle:
NET BORROWINGS, when entered in the Cash Flow Statement, increase both CASH and DEBT on the Balance Sheet.

Comparison 3

Balance Sheet Format
as of a specific date

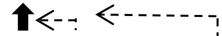
Assets	Formulas	Most Liquid
Cash	A	
Accounts Receivable	B	
Inventory	C	
Prepaid Expenses	D	
Current Assets	A+B+C+D=E	
Other Assets	F	
Fixed Assets at Cost	G	
Accumulated Depreciation	H	
Net Fixed Asset	G-H=I	Least Liquid
Total Assets	**E+F+I**	
Liabilities & Equities		
Accounts Payable	K	
Accrued Expenses	L	
Current Portion of Debt	M	
Income Taxes Payable	N	
Current Liabilities	K+L+M+N=O	
Long Term Debt	P	
Capital Stock	Q	
Retained Earning	R	
Shareholder's Equity	Q+R=S	
Total Liabilities & Equity	**O+P+S=T**	

Repayment in less than one year
or
Repayment in more than one year

Balance Sheet Connections

Cash Flow Statement
for the period x through y

Beginning Cash Balance	A
Cash Receipts	B
Cash Disbursements	C
Cash Flow from Operations	B - C = D
Fixed Assets Purchases	E
Net Borrowings	F
Income Taxes Paid	G
Sale of Capital Stock	H
Ending Cash Balances	A + D - E + F - G + H = I



Income Statement Format
as of a specified date

Revenues	
Assessments	A
Late Fees/Fines	B & C
Valet/Laundry	D & E
Miscellaneous Income	F
Total Income	A+B+C+D+E+F=G
Expenses	
Salaries & Wages	H
General & Administrative Costs	I
Contracts	J
Maintenance	K
Insurance	L
	M
Total Expense	H+I+J+K+L+M=N
Income from Operations	O
Interest	P
Income Taxes	Q
Net Surplus/Deficit	O+P-Q=R

Fixed Asset Cycle: Over time, depreciation expenses on the Income Statement increases ACCUMULATED DEPRECIATION lowering NET ASSET

When equipment (PP&E) is purchase, FIXED ASSETS at COST increases and CASH decreases

Balance Sheet Format
as of a specific date

Assets	Formulas	
Cash	A	Most Liquid
Accounts Receivable	B	
Inventory	C	
Prepaid Expenses	D	
Current Assets	A+B+C+D=E	
Other Assets	F	
Fixed Assets at Cost	G	
Accumulated Depreciation	H	
Net Fixed Asset	G-H=I	Least Liquid
Total Assets	**E+F+I**	
Liabilities & Equities		
Accounts Payable	K	
Accrued Expenses	L	
Current Portion of Debt	M	
Income Taxes Payable	N	
Current Liabilities	K+L+M+N=O	
Long Term Debt	P	
Capital Stock	Q	
Retained Earning	R	
Shareholder's Equity	Q+R=S	
Total Liabilities & Equity	**O+P+S=T**	

1. Financial statements include every report except:
   a) Statement of Financial Position
   b) Income Statement
   c) Expense Statement
   d) Statement of Cash Flows

2. The purpose of financial statement is to provide useful information about the financial position, performance and changes of an financial enterprise that is useful to:
   a) The comptroller of the company only
   b) The manager of an association only
   c) Vendors of an association
   d) A wide range of users

3. An audit of financial statements of public companies is usually required for:
   a) Investment, financing and tax purposes
   b) To prove to the shareholders that the entity is liquid
   c) Audits are not usually required for any company
   d) Tax purposes only

4. Accountant use what as the unit of measure:
   a) The Euro
   b) The U.S. dollar
   c) The Canadian dollar
   d) Whichever currency the corporation chooses

5. Capital items that the association owns are recorded in a financial report:
   a) At the price for which they can be salvaged
   b) At the original price adjusted for inflation but not deflation
   c) At the original price, less any depreciation
   d) At the original price, with no adjustment for inflation or deflation

6. Periodicity means:
    a) How often the association invoices its members for assessments
    b) Life of association can be divided into periods for which income and expense are reported to create an accurate picture of financial health
    c) How often financial reports must be given to shareholders
    d) How often an accountant must produce a financial report for an association

7. “Substance over form” refers to an accounting principle that:
    a) Financial statements show the legal realty of an association
    b) Financial statements show the legal and financial realty of an association
    c) Financial statements show the financial reality of an association
    d) Financial statements can be in any form as long as the substance is the same

8. Fundamental to accrual accounting is:
    a) One must always report cash only transaction
    b) Determining when one reports revenue in the financial statement
    c) Using the same method for maintaining the check register and preparing the financial reports
    d) Matching revenues with association expenditures before including in the financial report

9. Deferred revenue is:
    a) A liability
    b) An asset
    c) A loan to the association it has not yet received
    d) Delinquent assessments

10. The Balance Sheet basic equation is:
    a) Have + owe = current assets
    b) Assets = Liabilities + Worth
    c) Shareholders equity = assets + liabilities
    d) Have today + owe today = current debt

11. Balance Sheet Assets including all exception:
    a) Cash
    b) Inventory
    c) Capital Stock
    d) Prepaid expenses

12. Balance Sheet Liabilities & Equities include all but the following:
    a) Accumulated Depreciation
    b) Accounts Payable
    c) Long Term Debt
    d) Retained Earnings

13. Current assets, by definition, are those assets that are expected to be converted into cash in less than ___ months.
    a) 24
    b) 18
    c) 9
    d) 12

14. Inventory includes all but the following for a corporation:
    a) Materials on order but not yet received
    b) Completed products ready to be shipped to customers
    c) partially completed products
    d) materials in stock but not yet used

15. Prepaid expenses are:
    a) Invoices already paid by the association, where services have not yet been received
    b) Assessments already paid by owners
    c) Retained earnings less fixed assets
    d) Capital stock less accounts payable

16. Current liabilities are bills that must be paid within ___ months of the date on the Balance Sheet:
    a) 18
    b) 12
    c) 24
    d) 15

17. Accounts payable are:
    a) Assessments owed by owners
    b) Long term loans outstanding to the bank
    c) Bills to vendors not yet paid by the association
    d) Accrued Expenses less Retained Earnings

18. Working Capital is amount of money left after the association subtracts:
    a) Fixed Assets from Capital Stock
    b) Current Assets from Current Liabilities
    c) Inventory from Long Term Debt
    d) Prepaid Expenses from Accrued Expenses

19. Shareholders' Equity has two elements:
    a) Capital stock and retained earnings
    b) Fixed Assets and Accumulated Depreciation
    c) Accounts Payable and Accounts Receivable
    d) Accrued Expenses and Prepaid Expenses

20. The Income Statement is the same thing as:
    a) Balance Sheet
    b) P & L
    c) Statement of Cash Flows
    d) Statement of Changes in Equity