BASIS OF ACCOUNTING – WHICH ONE SHOULD YOU USE?

From time to time a question is raised by managers and board members regarding the basis of accounting that should be used when preparing interim financial statements for a homeowners’ association. Before this question can be answered, it is probably a good idea to first define the term “Basis of Accounting”. “Basis of Accounting” simply defines the timing of the recording of various financial transactions for an entity (when revenues and expenses are recognized, and assets and liabilities are reported), in this case for your homeowners’ association.

WE RECOMMEND THE ACCRUAL BASIS OF ACCOUNTING

We, at James Ernst Accounting, recommend that you prepare your interim financial statements on the Accrual Basis of Accounting simply because we believe it provides the most meaningful and comprehensive interim financial reporting for your homeowners’ association.

In this article, we will describe the 3 most common basis of accounting (Accrual, Cash, and Modified Accrual), highlight their differences, and discuss their effect on financial reporting. Then, we will examine the various sections in the California Civil Code (Davis-Stirling Common Interest Development Act) that support the Accrual Basis of Accounting, and we will address the year-end review or audit report prepared by your independent CPA, which is issued using the Accrual Basis of Accounting.

3 DIFFERENT BASIS OF ACCOUNTING – DEFINITIONS

For the homeowners’ association industry in California, you can elect to use any one of 3 different basis of accounting when preparing your interim financial statements (Accrual Basis of Accounting, Cash Basis of Accounting or Modified Accrual Basis of Accounting).

Although there are other variations available, we will limit the definitions to these 3 basis of accounting only.

ACCRUAL BASIS OF ACCOUNTING

The Accrual Basis of Accounting, which is in conformity with Generally Accepted Accounting Principles (GAAP), means that revenue is recorded when earned and expenses are recorded when incurred, regardless of when cash is exchanged.

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Revenues – All revenues of the association are reported when earned, not when received.

*For Example:* Members’ Assessments are reported as revenues on the association’s Income Statement (Statement of Revenues and Expenses) when they are charged to the members (i.e., earned by the association, usually on the first day of the month).

At the same time, a corresponding asset titled “Assessments Receivable” is reported on the face of the Balance Sheet. As payments are received from the members, they increase the association’s Cash balance while either reducing Assessments Receivable (if the payment is received after the assessment has been charged) or increasing Prepaid Assessments (if the payment is received before the assessment is actually earned).

Expenses – All expenses of the association are reported when incurred, not when paid.

*For Example:* The costs of various services that are provided to the association (e.g., bookkeeping, insurance, landscaping, management, utilities, etc.) are reported as expenses on the Income Statement when these services have actually been provided.

At the same time, a corresponding liability titled “Accounts Payable” is reported on the face of the Balance Sheet. As these items are paid, the association’s Cash balance and Accounts Payable are reduced.

**CASH BASIS OF ACCOUNTING**

The Cash Basis of Accounting, which is not in conformity with Generally Accepted Accounting Principles (GAAP), means that income and expenses are recorded when cash is exchanged.

Revenues – All revenues of the association are reported when received, not when earned.

*For Example:* Members’ Assessments are reported as revenues on the association’s Income Statement only when payments are actually received from members.

At the same time, however, only Cash is increased on the Balance Sheet. There are no adjustments to Assessments Receivable because they were not recorded when the members’ assessments were charged; nor is there an adjustment to Prepaid Assessments because neither of these accounts exist on the Balance Sheet when using the Cash Basis, they are used only when recording revenues under the Accrual Basis.

Expenses – All expenses of the association are reported when paid, not when incurred.

*For Example:* The costs of these same services (e.g., bookkeeping, insurance, landscaping, management, utilities, etc.) are reported as expenses on the Income Statement only when they are actually paid (generally, when a check is issued).

Again, at the same time, only the Cash balance is decreased. There are no adjustments to Accounts Payable on the Balance Sheet because this account is used only when recording expenses under the Accrual Basis.
MODIFIED ACCRUAL BASIS OF ACCOUNTING

The Modified Accrual Basis of Accounting (sometimes called the Modified Cash Basis of Accounting) is a combination of the Accrual and Cash Basis.

Revenues – All revenues of the association are reported when earned, not when received. The timing for recording revenues is the same as for the Accrual Basis.

Expenses – All expenses of the association are reported when paid, not when incurred. The timing for recording expenses is the same as for the Cash Basis.

There has been considerable discussion in our industry regarding the term Modified Accrual Basis of Accounting. Although the Modified Accrual Basis is not in conformity with Generally Accepted Accounting Principles (GAAP), which requires the Accrual Basis, it is considered to be an acceptable basis of accounting for interim reporting purposes for homeowners’ associations because the use of the Modified Accrual Basis has been codified in the Davis-Stirling Common Interest Development Act under sub-section (a)(1)(C)(iv) of Section 1365.2 of the California Civil Code, “Right to Inspect and Copy Association Records”.

EFFECT ON INTERIM FINANCIAL STATEMENTS

As indicated above, an association’s interim financial statements can be prepared using any one of these 3 basis of accounting. However, the effect on the interim financial statements of your choice is as follows:

ACCRUAL BASIS OF ACCOUNTING

When interim financial statements are prepared on the Accrual Basis, the recording of the various daily, weekly and monthly transactions (i.e., revenues when earned and expenses when incurred), will result in the automatic generation of three different, but very important, detailed reports (Aged Assessments Receivable, Prepaid Assessments and Accounts Payable).

Aged Assessments Receivable – When revenue is recorded on the Accrual Basis, a detailed report will be created, which lists all owners who have not paid their assessments or other charges in full at the end of the accounting period.

This report is called an “Aged Assessments Receivable Report” and it shows who owes money to the association (the member’s name), how much they owe (the unpaid balance), how long it has been outstanding (current, over 30, over 60, and over 90 days), and the total balance due to the association. The total balance due that is listed at the end of this report must agree to the amount reported as an asset (Assessments Receivable) on the face of the Balance Sheet, at least until the assessment has been paid or written off as uncollectible.

Prepaid Assessments – In addition, when revenue is recorded on the Accrual Basis, another detailed report will be created, which lists all owners who have paid their assessments in advance of their due date (e.g., January’s assessments are paid in December).
This report is called a “Prepaid Assessments Report” and it shows who has paid their assessments in advance of their due date (the member’s name), how much they have prepaid, and the total prepaid balance. The total prepaid balance that is listed at the end of this report must agree to the amount reported as a liability (Prepaid Assessments) on the face of the Balance Sheet, at least until these assessments have been earned.

Prepaid Assessments are a liability of the association because the payments received by the association have not yet been earned, and in the event a member sells their unit before these assessments have been earned, the association would have to refund these prepaid assessments to the member.

Accounts Payable – Finally, when expenses are recorded on the Accrual Basis, a detailed report will be created, which lists all unpaid invoices as of the end of the accounting period.

This report is called an “Accounts Payable Report”. The total that is shown at the end of this report must agree to the amount reported as a liability (Accounts Payable) on the face of the Balance Sheet, at least until these invoices are paid.

**Cash Basis of Accounting**

If you elect to prepare your interim financial statements on the Cash Basis, the effect will be that the amounts for Assessments Receivable, Prepaid Assessments, and Accounts Payable will not be reported on the face of the Balance Sheet.

Although detailed reports for Assessments Receivable, Prepaid Assessments, and Accounts Payable could be prepared and included with the financial information at the end of an accounting period, you could not verify their accuracy by simply comparing the totals in these reports to the amounts reported on the face of the Balance Sheet. This is simply because there are no amounts reported on the Balance Sheet for these accounts when using the Cash Basis.

**Modified Accrual Basis of Accounting**

If you elect to prepare your interim financial statements using the Modified Accrual Basis, the amounts reported in the detailed reports for Assessments Receivable and Prepaid Assessments would agree to the amounts reported on the face of the Balance Sheet, which is the same as when using the Accrual Basis.

However, the total amount of the unpaid invoices listed in the Accounts Payable Report, if provided, would not be recorded on the face of the Balance Sheet. Again, this is simply because these expenses are recorded on the Cash Basis, not the Accrual Basis.
**ACCRUAL BASIS OF ACCOUNTING IS RECOMMENDED**

As indicated above, an association’s interim financial statements can be prepared using any one of 3 different basis of accounting. However, we recommend that the interim financial statements of a homeowners’ association be prepared using the Accrual Basis of Accounting.

There are a variety of reasons that we recommend using the Accrual Basis of Accounting for interim financial statement reporting, as follows:

**ACCRUAL BASIS OF ACCOUNTING** *(Recommended)*

When using the Accrual Basis of Accounting, which we recommend, all financial activity of an association for the accounting period (month and year-to-date) will be reported on the interim financial statements. All revenues that have been earned and all expenses that have been incurred will be reflected in the Income Statement; therefore, amounts will be comparable to the budget. Further, the Balance Sheet will include Assessments Receivable, Prepaid Assessments and Accounts Payable, and the totals for each will agree to their respective detailed reports.

**CASH BASIS OF ACCOUNTING** *(Not Recommended)*

As for the Cash Basis of Accounting, it is the least desirable basis of accounting. Although this basis of accounting is often thought to be the easiest approach to accounting, it can create reports that are misleading to the readers of the financial statements. This is primarily because the Income Statement may not reflect all revenues earned nor all expenses incurred during the period; therefore, amounts may not be comparable to the budget. Further, the Balance Sheet does not list Assessments Receivable, Prepaid Assessments or Accounts Payable. Therefore, the financial information reflected on the interim financial statements may not be complete.

The argument often presented in favor of the Cash Basis is that actual cash received and cash disbursed are reported on the face of Income Statement when using this basis of accounting, and many managers as well as board members want to know exactly how much cash was received and disbursed during any accounting period. Therefore, they believe that this is the only basis of accounting that can capture this cash flow information.

Although the Accrual Basis does not necessarily show actual cash received or cash disbursed, this cash flow information can be obtained fairly easily from the other financial information that accompanies, or should accompany, the interim financial reports.

**How to Obtain Cash Flow Information**

Bank Statements, Bank Reconciliations and Check Register – Please keep in mind that one of the duties of the board of directors, as specified in California Civil Code Section 1365.5(a)(1),(2) and (4), is to review a reconciliation of the association’s operating and reserve bank statements on at least a quarterly basis (we recommend a monthly review). Therefore, this bank information should be readily available to management and the board of directors for each interim financial reporting period. By simply looking at the actual bank statements at the end of each month you can see how much cash was actually deposited into the bank (cash received).
In addition, to get a better sense of the amount of cash actually spent each month, you can simply look at the Check Register. This report lists all checks issued during the month, and should be a part of the interim financial information. The Check Register is more closely related to the Cash Basis for expenses because it represents all payments made regardless of whether or not a vendor presented their check to the bank for payment (cash disbursed).

**MODIFIED ACCRUAL BASIS OF ACCOUNTING (A Compromise)**

As a compromise, the California Civil Code under Section 1365.2(a)(1)(C)(iv), does allow for interim financial statements to be prepared on the Modified Accrual Basis. Therefore, a large number of associations have elected to use this basis primarily because they recognize that revenue should be recorded when earned (accrual), but they believe it is easier to record expenses when paid rather than when incurred (cash).

However, by keeping an association’s books open for up to 2 weeks after the end of an accounting period, you should be able to record most, if not all, of the expenses on the accrual basis (expenses reported when incurred, not when paid) without any significant extra effort. Therefore, if the books are kept open and the expenses are reported in their proper period, these financial statements will then be reported on the Accrual Basis of Accounting (no compromise).

**CALIFORNIA CIVIL CODE**

As further support for our position that you should use the Accrual Basis of Accounting for your interim financial statements, there are several sections of the California Civil Code, under the Davis-Stirling Common Interest Development Act, which require or suggest that interim financial statements should be prepared on the Accrual Basis.

*Civil Code § 1365(a)(1) – Financial Documents*

Under this section of the Civil Code, the association shall prepare a pro forma operating budget that includes “…estimated revenues and expenses on an accrual basis.”

If the annual operating budget is required to be prepared on the Accrual Basis, then the Income Statement should be prepared on the same basis. Remember, the Income Statement compares the actual revenues and expenses that are reported for the period with the estimated revenues and expenses that were reflected in the budget for the same period. Otherwise, management may not be able to have a valid comparison between the two.

*Civil Code § 1365.2(a)(1)(C)(iv) – Right to Inspect and Copy Association Records*

Whenever a member requests copies of the financial records of the association, this section of the Civil Code states that these records “…shall be prepared in accordance with an accrual or modified accrual basis of accounting.”

As noted above, the Modified Accrual Basis is an acceptable compromise according to the Civil Code, but you still have the issue where actual and budgeted expenses may not be comparable for the accounting period reflected in the interim financial statements. However,
by simply keeping the books open for a short period of time each month, you can have financial statements that are prepared on the Accrual Basis.

_Civil Code § 1365.5(a)(3) – Board of Directors; Duties; Reserve Accounts_

This section of the civil code states that the board shall “review, on at least a quarterly basis, the current year’s actual…revenues and expenses compared to the current year’s budget.”

Although this specific sub-section of the code addresses “reserves”, the implication in the other sub-sections under § 1365.5(a), is that the board is required to periodically review the financial information for both the operating and reserve activity of the association. Given that the budget is supposed to be prepared on the Accrual Basis (see Civil Code § 1365(a)(1) above), then it stands to reason that the interim financial statements should also be prepared on the Accrual Basis. By using the Accrual Basis, the board of directors and management will be able to more effectively review the interim financial activity of the association.

_YEAR-END CPA REVIEWED OR AUDITED FINANCIAL STATEMENTS_

Finally, please keep in mind that regardless of which basis of accounting that was chosen for the interim financial statements, whenever these same year-end financial statements are reviewed (required by Civil Code § 1365(c) if annual gross income exceed $75,000) or audited by the association’s independent CPA, the CPA reviewed or audited financial statements will be presented using the Accrual Basis of Accounting. Therefore, it makes sense that the interim financial statements should be prepared on the same basis as the year-end reviewed or audited financial statements, with the added benefit of minimizing year-end adjustments.

_CONCLUSION_

I hope this information has clearly defined the 3 basis of accounting that are available for the interim financial statements of a homeowners’ association (Accrual Basis, Cash Basis or Modified Accrual Basis of Accounting).

More importantly, however, I hope this explains why our firm feels that it is more appropriate for these interim financial statements to be prepared on the Accrual Basis of Accounting.

Again, we recommend that you use the Accrual Basis of Accounting for your interim financial reporting because: Accrual Basis interim financial statements will be in conformity with Generally Accepted Accounting Principles (GAAP), while meeting the requirements of the California Civil Code; management and the board will have the ability to accurately compare actual revenues and expenses with budgeted amounts when both are prepared on the Accrual Basis; cash flow information is still available from bank statements, bank reconciliations and the Check Register while using the Accrual Basis for interim financial statements; and the year-end review or audit report provided by your independent CPA will be presented in the same manner as your interim financial statements at year-end, with minimal adjustments.