Which Basis of Accounting Should Your HOA Use?

Which basis of accounting should be used when preparing your homeowners association's interim (monthly, quarterly and annual) financial statements? First, let's define the term Basis of Accounting. Basis of Accounting - The timing of the recording of various financial transactions (when revenues and expenses are recognized, and assets and liabilities are reported). For the homeowners association industry in California, you can elect to use any one of three different basis of accounting when preparing your interim financial statements:

1. Accrual Basis of Accounting

2. Cash Basis of Accounting

3. Modified Accrual Basis of Accounting

We will describe these three bases of accounting, highlight their differences, and discuss their effect on financial reporting. We will examine various sections in the California Civil Code (Davis-Stirling Common Interest Development Act), and address the year-end review or audit report prepared by your independent CPA, which is issued using the Accrual Basis.

Accrual Basis of Accounting

Under the accrual basis, all financial activities of your HOA are reported on the homeowners association's financial statements. Accrual accounting is generally regarded as the superior accounting method since it gives a more complete picture of you HOA's financial health and status than the cash or modified accrual methods. The accrual basis, which is in conformity with Generally Accepted Accounting Principles (GAAP), means revenue is recorded when earned and expenses are recorded when incurred, regardless of when cash is exchanged.

Revenues & Expenses

Accrual accounting greatly affects the way an HOA records its revenues and expenses.
Revenues of the association are reported when earned, not when received. At the same time, an asset titled "Assessments Receivable" is reported on the Balance Sheet. As payments are received, they increase the association's Cash balance while either reducing Assessments Receivable or increasing Prepaid Assessments.

Example: Members' Assessments are reported as revenues when they are charged to the members (i.e., earned by the association, usually on the first day of the month).

Expenses of the association are reported when incurred, not when paid. At the same time, a liability titled "Accounts Payable" is reported on the Balance Sheet. As these items are paid, the association's Cash balance and Accounts Payable are reduced.

Example: The costs of various services that are provided to the association are reported as expenses when these services have actually been provided.

Effect on HOA's Financial Statements

The recording of the various daily, weekly and monthly transactions with the accrual method (i.e., revenues when earned and expenses when incurred), will result in the automatic generation of three very different detailed reports. For each of these types of reports, the total balances must agree to the amounts reported as an asset (or liability) on the Balance Sheet. Therefore, your balance sheet should include the Aged Assessments Receivable as an asset, and the Prepaid Assessments and Accounts Payable reports listed as liabilities, at least until the amounts have been paid.

Aged Assessments Receivable - An aged assessments receivable is a detailed report listing all owners who have not paid their assessments or other charges in full at the end of the accounting period. The Aged Assessments Receivable Report shows:

- Who owes money to the association (member's name),
- How much they owe (unpaid balance),
- How long it has been outstanding (current, over 30, over 60, over 90 days)
- Total balance due to the association.

Prepaid Assessments - The prepaid assessments list:

- All owners who have paid their assessments in advance of their due date (e.g., January's assessments are paid in December),
- How much each owner prepaid
- Total prepaid balance

Accounts Payable - The accounts payable report lists all unpaid invoices as of the end of the accounting period.

Cash Basis of Accounting

The Cash Basis, which is not in conformity with GAAP, records income and expenses when cash is exchanged.

Revenues and Expenses

All revenues of the association are reported when received, not when earned. At the same time Cash is increased on the Balance Sheet. Neither the Assessments Receivable or Prepaid Assessments accounts exists on the Balance Sheet when using the Cash Basis.

> Example: Members' Assessments are reported as revenues only when payments are actually received.

All expenses of the association are reported when paid, not when incurred. Only the Cash balance is decreased. The Accounts Payable account does not exist on the Balance Sheet in Cash Basis.

> Example: The costs of these same services are reported as expenses only when they are actually paid (generally, when a check is issued).

Effect on HOA's Financial Statements

If you elect the Cash Basis, the amounts for Assessments Receivable, Prepaid Assessments, and Accounts Payable will not be reported on the Balance Sheet. Although reports for Assessments Receivable, Prepaid Assessments, and Accounts Payable could be prepared, you could not verify their accuracy by comparing the totals in these reports to the amounts reported on the Balance Sheet since no amounts are ever reported on the Balance Sheet.

Modified Accrual Basis of Accounting

The Modified Accrual Basis (sometimes called the Modified Cash Basis) is a combination of the Accrual and Cash Basis. Although the Modified Accrual Basis is not in conformity with GAAP, which requires the Accrual Basis, it is considered to be an acceptable basis of accounting for interim reporting purposes for homeowners associations. The use of the Modified Accrual Basis has been codified in Civil Code Section 5200:

> *The records…shall be prepared in accordance with an accrual or modified accrual basis of accounting.*

Revenues and Expenses

Revenues of the HOA are reported when earned, not when received – the timing is the same as for the **Accrual Basis.**

Expenses of the HOA are reported when paid, not when incurred – the timing is the same as for the **Cash Basis.**

Effect on HOA's Financial Statements

If you elect the Modified Accrual Basis, amounts for Assessments Receivable and Prepaid Assessments will agree to the amounts on the Balance Sheet, the same as the Accrual Basis. However, the amount of the unpaid invoices in the Accounts Payable Report, if provided, would not be on the Balance Sheet because these expenses are recorded on the Cash Basis, not the Accrual Basis.

HOA Law on Financial Statements

There are several sections of the California Civil Code which require or suggest that interim financial statements be prepared on the Accrual Basis.

Financial Documents

Civil Code Section 5300(b)(1) states that the association shall prepare a *pro forma* operating budget that includes "estimated revenues and expenses on an accrual basis."
Since 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.

Right to Inspect and Copy Association Records

Whenever a member requests copies of the financial records of the association, Civil Code Section 5200(a)(3)(d) states these records shall be prepared "in accordance with an accrual or modified accrual basis of accounting."

Board of Directors Budget Review

Civil Code Section 5500(c) states 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 sub-section addresses reserves, the implication in the other sub-sections is that the homeowners association board is required to review the financial information for both operating and reserve activities. Given that the budget is supposed to be prepared on the Accrual Basis, then it stands to reason that the financial statements should also be prepared on the Accrual Basis.

Benefits and Shortcomings of the 3 Methods of Accounting

Accrual Basis of Accounting – Recommended for HOAs

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 totals for each will agree to their respective detailed reports.

Accrual Basis

Accrual Basis financial statements will be in conformity with GAAP, while meeting the requirements of the Civil Code; cash flow information is still available from bank statements and Check Registers; 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.

Cash Basis of Accounting

Under the Cash Basis, the reports can be misleading to the readers of the HOA financial statements:

- Income Statement may not reflect all revenues earned nor all expenses incurred during the period
- Amounts may not be comparable to the budget
- Balance Sheet does not list Assessments Receivable, Prepaid Assessments or Accounts Payable;
- Most importantly, the financial information may not be complete

Those in favor of the Cash Basis often argue that many HOA managers and board members are more interested in exactly how much cash was received and disbursed during a financial period. However, this cash flow information can be obtained from the other financial information that should accompany the financial reports. To simplify the cash basis method of accounting, look at the bank statements at the end of each month and you can see how much cash was deposited into the bank. Then look at the Check Register to see how many checks were issued during the month.

Modified Accrual Basis of Accounting

A large number of homeowners associations have use the Modified Accrual Basis because they recognize that revenues should be recorded when earned (accrual basis), but they believe it is easier to record expenses when paid rather than when incurred (cash basis). However, if your HOA keeps its books open for up to two weeks after the end of the accounting period, it can record most, if not all, expenses in their proper period. Therefore, your financial statements can be presented on the Accrual Basis without compromise.

If you're interested in using accrual based accounting, find out how your HOA can adopt accrual financial statements.