INFORMATION AND KNOWLEDGE BASE

FINANCES AND INFORMATION TECHNOLOGY

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6. Finances and Information Technology

"You only live once but if you do it right, once is enough" – Mae West

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FINANCES AND INFORMATION TECHNOLOGY

6.1 Introduction and Basic Accounting

The financial department is one of the most important functions in the organization and hence the detailed explanations of the various disciplines within the department.

We start with a few basic accounting concepts that should be understood:

Going Concern

This concept assumes that the governing body will continue to operate in the future and that the financial position of the governing body and the expected surplus to be made going forward will establish whether the governing body is a going concern or not.

Full Disclosure

All information that affects the full understanding of the governing body’s financial statements is disclosed.

Matching Principle

Each expense is recorded in the same period as the revenue that is earned.

Revenue Recognition

Revenue is considered at the time the transaction is completed and not only when the cash is received.

Consistency

This requires the application of the same methods and procedures from one period to another. When a method or procedure is changed, it should be disclosed in the annual financial statements.

Prudence

The calculations, when evaluations and estimates are made, must be fair and reasonable and should neither over- nor understate the affairs of the governing body.

Accounting Standards

The International Financial Reporting governing body and the *South African Accounting Practices* governing body set accounting and reporting standards that must be adhered to in the preparation of the annual financial statements. Your accountant or auditor will be *au fait* with these standards.

6.2 Financial Planning and Control

The following are, *inter alia*, key areas in the financial planning and control function:

Responsible Person

The person in charge of the finance department should be qualified to keep and record adequate accounting records. The governing body needs more than a good bookkeeper; it needs a financial manager who can take well-considered financial decisions, recommend well-thought-through financial proposals, ensure that all financial controls are in place and is able to report accurate and reliable figures to the governing body in a sensible way.

Budgeting

The budget should be prepared before the start of the new fiscal year. The budgeting process is used to rethink the level of income generating activities and the cost to be incurred supporting these sources of income. The budget should be directed by the governing body's strategic plan with its goals and objectives.

The following suggestions might be useful when preparing the budget:

- Use the ten months actual and the two months estimate to establish the base year for the budget for the new year. Remove abnormal items from the current year to portray the correct "normalised" base.
- Use a spreadsheet to prepare the budget and incorporate the detailed calculations of the major income and expense items on the same sheet. These should be linked to the income statement and balance sheet and automated.
- The assumptions made for the increases of both income and expenses must be cleared by the

governing body in advance. This will prevent changes to the numbers at the budget approval meeting.

- At the time of budgeting, it is appropriate to look at cost reductions and additional income generation possibilities.
- The funds required to achieve the strategic objectives of the governing body must be provided for and highlighted as additional expenditure for the budget year.
- The budget is prepared in R 000s. Nobody is interested in a few Rand here and there.
- Increases that are above the assumed guidelines, compared to the previous year, need to be justified individually to the governing body.
- It is important for director of finance to have a good understanding of the numbers and fully understand the budget, and what needs to be achieved to be able to assist other members of the governing body during the discussion and approval process.

Cash Flow

A cash flow statement for the budget year is just as important for the governing body to understand. The cash flow statement considers the current financial position, projected profit, depreciation, and capex, to see if the cash balance at the end of the period is in fact that for which the governing body aimed. The cash flow is especially important where the current cash position is not acceptable and to establish if the forecast with the corrective steps being undertaken will in fact produce the required results. Special reserves must be accounted for separately.

Three-year Forecast

The budget is used as a base to prepare a three-year income and expense forecast in combination with a cash flow statement. The detail is of less importance as the bigger picture must be understood. The question to be asked is where the governing body is heading and whether the longer-term objectives are being achieved with the funds available.

6.3 The Accounting System

There are simple but extremely effective accounting systems on the market, and it is impossible to pick a wrong system for the purpose of your governing body. One of the most important principles in the use of any accounting system is of course the “KISS” principle. Simplicity is indeed the core to a successful accounting system. The following proposals may help to achieve this:

- Keep your income and cost centres to a minimum.
- Use the budget and annual financial figures with a spread sheet to do an income and cost analysis by department.

- No allocation of indirect cost or splitting of cost in the accounting system itself is recommended.
- Only create a new account if there is sufficient reason to do so. For example, there is nothing wrong to have an account “other income” or expenses “general administration” to group small costs together.
- Do not maintain unnecessary spread sheets to back up or provide the details of the general ledger accounts. All accounting systems provide for sub-accounts, and these can be used for the details instead of referring to a separate spread sheet. Accuracy and automatic balancing are guaranteed by using it in this way.
- Do not incorporate difficult creditors’ systems into the accounting system if not required. You can use a month-end journal for all unpaid accounts and reverse the journal in the new month. Develop a control mechanism to ensure that you do account for all suppliers at month-end.
- All balance sheet accounts must be verified at month-end.
- Daily transactions must be correctly processed and not parked in a suspense account. If the bookkeeper is not sure of how to process the transaction, then this needs to be addressed by the manager without delay.
- A balanced trail balance is an automatic result from the accounting system and financial accounts can be printed from the accounting system.
- Results directed to the governing body need to be rounded-off to the nearest R’000. The governing body is there to exercise overall control and is not interested in immaterial amounts.
- Comparative figures for the budget need to be shown in the management accounts. Showing last year’s figures is optional.
- The most qualified person, either the manager or governing body member responsible for finance, must explain financial figures to the governing body in a simple but effective way. Start with the bottom line and explain the major variances from there. Also use the cumulative figures, as this is what the governing body is interested in.
- Key balance sheet figures need to be shared with the governing body monthly or quarterly.
- A deadline of three days after month-end should be set to publish the previous month’s management accounts.

6.4 Accounting Policies and Guidelines

The governing body needs to approve the policies and procedures for specific financial areas and for the financial staff to follow. The following fields must be supported by a policy:

- Credit and collection of outstanding debt.
- Supply of utility services.
- Purchasing and payment of services.

- Cash management and investment of funds.
- Gift and entertainment rules.
- Terms of reference for all governing body.
- Document retention.

6.5 Standard Operating Procedures (SOP)

Strict adherence to prescribed procedures by the finance department is non-negotiable. These rules are accommodated in the SOP. The financial policies and guidelines shown above form the basis for the SOP. These must be seen as strict rules. Employees who do not adhere to the rules should be subject to disciplinary action. Changes should periodically be made to the SOP to correct shortcomings in the system and to change the way specific tasks must be performed in future.

The SOP must, *inter alia*, cover the following accounting and control areas:

- Financial policies.
- The financial reporting structure.
- Reference to the various financial policies.
- Specific financial policies such as depreciation, basis for preparing the accounts, etc.
- Preparation process for the annual financial statements.
- The budget processes.
- Income Tax.
- Value Added Tax.
- The invoicing and receipts process.
- Purchases and goods delivery procedures.
- Petty cash.
- Garage- or petrol cards.
- Bank accounts, and payment procedures and reconciliations.
- Salaries and wages.
- General ledger codes and the maintenance thereof.
- Journals.
- Accounts receivable and debt collection.
- Insurance.
- Levels of authority and delegation of tasks.
- Asset management.
- Financial reporting.
- Back-up procedures.
- Contracts and the management thereof.

- Safekeeping of documents and keys.
- Document retention rules.
- Year planner (by month) for the department.
- Any other tasks that the finance department is responsible for such as employee leave records, risk management, building plans and management thereof.

6.6 Credit Policy

A credit management policy must be in place. The policy will describe the procedures to be followed and the applicable authorizations that apply to the granting of credit and the payment of accounts. It is important that overdue accounts are followed up regularly to prevent the account to accumulate to exorbitant amounts.

Debt collecting is a vital part of credit management. The governing body cannot afford to let unpaid accounts get out of control. This is also unfair towards those that do settle their accounts on time.

The debtors that are "sponsored" (i.e., the persons that cannot afford the bill, a fact known from the start), should be transferred to a "sponsorship" account under supervision of two managers. The transfers should be reported to the governing body monthly.

The following is a summary of the steps taken to collect outstanding debts:

- A letter of demand is issued.
- Failure to respond results in a handover to the governing body's legal representative.
- It is important to consider making a deal with the debtor concerning the repayment, if at any stage a response is forthcoming. Arbitration of existing disputes might also be considered.
- Court action is started by issuing a summons and legal proceedings are initiated. Claims that are in arrears might be settled by the Sectional Title Ombudsman, but the right to proceed with legal action under Common Law is not excluded.
- The debtor must respond by paying the amount or negotiate an instalment of debt deal or formally oppose the action.
- Failing to respond to results in a default judgement: Legal costs are recovered from the debtor.
- Once judgement has been obtained either the debtor's assets are attached, the debtor is summoned to appear in court for a ruling by the judge, or a salary attachment order is obtained.
- A debtor may be sequestrated or liquidated.
- Debtors placed under administration could opt for debt restructuring or die whilst the company is trying to collect the due amounts. In these cases, advice from the governing body's

legal team should be obtained.

Please take note that the *Debt Collectors Act* applies to any person who is not an attorney and who is employed to collect debts for the governing body. Registration of such a person is also required and the fees chargeable are fixed.

There are attorneys that offer their services without charging the governing body but recovering all cost from the debtor with no cost risk to the governing body.

6.7 Year-end and the preparation of the Annual Financial Statements (AFS)

The preparation of the AFS and the audit is not such a huge event as some accountants make it out to be. If the monthly accounts are in order, the auditors can be called the second week after the financial year-end to do their work.

The AFS are particularly important as they show the results of the year's activities, the financial position at year end and how cash was generated and spent, in a comprehensive and understandable way. The AGM approves these accounts after they have been audited and provisionally approved by the governing body.

6.8 The Maintenance Reserve

It is advisable for the governing body, and obligatory for a body corporate, to create a maintenance reserve. The governing body must have the necessary funds available when major repairs, maintenance (expected and unexpected), upgrades and replacements must take place. It is only fair that all members contribute towards the maintenance and future maintenance before it takes place. The governing body should not have to wait until the maintenance repairs need to be done and then must burden members but rather keep members fully informed of ongoing as well as planned maintenance repairs.

The maintenance reserve is calculated as follows:

- List all the governing body's assets and the major components thereof.
- Give a rating of the state of the asset or component.
- Estimate the current replacement cost.
- Determine the expected life of the asset or component and the year in which it needs to be replaced.
- Yearly provide the amount needed for each asset or component in the year of replacement.
- Add the yearly replacement values per item together to establish the total "reserve" yearly required.

- Adjust the yearly reserve with the expected inflation figure.

The current funds on hand and the future funds required are now established. How the additional funds are going to be raised and the investment strategy to be followed must be clarified. A special monthly levy or a buy-in levy on new homeowners, are ways to provide the necessary funds for the reserve fund.

The governing body should also have plans to extend the life of each asset or component and have a rule to not replace components until necessary. This makes good business sense.

Financing by way of a loan can also be considered if one or two maintenance projects are urgent and members can be convinced that this is a viable alternative to the build-up of the funds over a number of years.

For body corporates the following rules apply as set out in the *Section Title Schemes Management Act* (STSMA). A reserve fund must be established to finance future maintenance, repair, and replacements on the common property. The fund must consist of 100% of the yearly budgeted levy income (called the administrative fund) and must be available in cash in a separate bank account to be used for emergency maintenance, repairs, and planned replacements. The Act specifies how the reserve should be built up over time.

6.9 Taxation

6.9.1 Introduction

Taxation is a cost like any other expense that the governing body incurs and therefore needs to be understood and managed as such. The governing body’s accountant or auditor is the right person to assist you with this task. Tax planning and obtaining professional advice from time-to-time is highly recommended.

Value Added Tax (VAT) compliance in the governing body could be quite tricky. In the financial SOP the VAT rules should be explained in detail. The governing body’s auditor should assist with or approve these rules.

6.9.2 Normal Taxation

The following normal income tax (including capital gains tax) rules apply to a registered Public Benefit Organization (PBO) as well as all non-PBO:

All income is exempt from normal tax if not derived from trading activities. Income derived from trading activities is also exempt if the activity is an integral part of and related to the objectives of the PBO. The activity should be conducted directly towards the recovery of cost and must not result in unfair competition with other tax entities. The Minister of Finance may exempt trading activities as well. If the trading activities do not fall under any of the above exemptions, then the biggest of 5% of the PBO turnover or R200 000 is exempt. Investment income of surplus funds is not regarded as trading activities.

6.9.3 Value Added Tax

Value Added Tax (VAT) must be accurately dealt with by all governing bodies. Because this is a specialist area it is highly recommended that a VAT review is done by an auditor every three to five years. The following basic VAT rules apply:

- Because your governing body is a non-profit governing body and/or registered as a PBO does not exempt the governing body from VAT automatically.
- Homeowners' associations, resident associations and body corporates are specifically exempt from VAT for their levy income and related cost.
- Other business activities are subject to VAT, and it is recommended that these activities are accounted for separately.
- The following sales and services are exempt from VAT:
  - Rental income.
  - Life rights accrued to the governing body.
  - Interest.
  - 40% of frail care income.
- Input VAT may be claimed but where the exempt income is a material part of the total income, then only a percentage of the input VAT is claimable. This is calculated on the percentage of vatable sales against the amount total sales multiplied by the VAT rate.

6.10 Document Retention

The importance of retaining the governing body's documents and proper numbering of different versions of policies and rules cannot be underestimated. Permanent files of the documents need to be created with proper indexes for easy reference. There is nothing more frustrating than documents that cannot be found, especially with the departure of a staff member responsible for the filing of these documents. A document retention policy is recommended.

6.11 Investments

Excess cash whether temporary or more permanent should be invested to obtain the maximum interest with the governing body's risk appetite considered. The industry might offer investment solutions with reasonable risk, after tax returns above inflation, with no initial commissions, no fixed terms, and penalties on withdrawal. It is advised to shop around for the best possible solution when investing excess funds.

The following investment possibilities exist with the risk increasing on every alternative. A combination of these funds is also possible and local and overseas investments are possible.

- Cash in the bank using a current or savings account
- Money market
- Income funds
- Property funds
- Equity funds

6.12 Outsourcing of Financial Services

Most governing bodies manage their financial affairs in-house as this most probably is much cheaper as the person/s involved in finance are allocated other task as well. Examples are secretarial and reception, property transfers, communications, and other general office work.

Outsourcing could have its benefits, but this must be correctly calculated and justified. Better controls and the lack of segregation of duties when the task is performed in-house are often claimed as beneficial for the estate/body corporate. All these benefits are addressed if proper SOP is in place, and these are followed.

The outsourcing vs insourcing decision needs a thorough analysis with its pros and cons considered. If the out-sourced decision is taken, then the following need to be in place:

- A suitable agreement that covers all aspects of the agreement between the parties, including the fact that the books and records belong to the governing body.
- Right to access to all records to be inspected at short notice.
- An SLA with specific and measurable objectives and deliverables with penalty clauses for not achieving the set targets
- That the governing body has and maintains its own bank account and that access to it by the governing body continues as well.
- The outsourced company's internal controls need to be investigated or a certificate issued by their auditors.
- Professional indemnity and fidelity insurance must be in place.

6.13 Integrated Data Base

A good integrated data base is essential for the effective running of the governing body. One entry point feeding various systems is essential. We are talking about the integration with the accounting system, the security system, the property management system, and the communication with and by members and any other system which share a lot of the same information.

Many good systems are on offer by IT providers and modular implementation can be done justifying each model on its own merit.

6.14 Audits

Trusts, non-profit companies, and associations must be audited or reviewed if certain conditions apply. A full audit needs to be performed if assets exceed R5m, the governing body is state owned, or the public interest score exceeds 350. A review by a registered auditor is required with a public interest score of more than 100 or by an accounting official if less than 100. The public interest calculation is as follows: 1 point per average employee in service during the year, 1 point per R1m liability, 1 point per R1m turnover and 1 point per individual who has a beneficial interest in the governing body or is a member of the governing body. The auditor must be independent and not a member of the governing body.

6.15 Information Technology

Information technology can best be controlled and managed starting with a well-defined policy. From the policy, the procedures and rules are established, and implementation and regular checks can then follow.

The following areas need to be covered in the policy procedures and rules:

- Overall purpose is to ensure integrity, privacy, security, and confidentiality.
- Personnel having access to the information systems must be limited and set out.
- Internal control procedures must spell out the control measures for accessing the systems.
- To ensure optimal use and safeguarding of the IT systems the following needs to be addressed:
    - Removal of all unnecessary and unused software and operating systems
    - Removal of unused and unwanted functionalities in the software
    - Implementation of access control and limiting access to approved administrators and users
    - Removal of unused customer accounts
    - The installation of a proper “firewall”
    - Installation and updating of anti-virus software

  - Good password control which is reviewed and updated regularly
  - Preventing software from being loaded on the system without proper approval
  - Separate the internet use by residents from the system
- Appoint an IT specialist that takes responsibility for background monitoring and control which will include:
  - Maintenance and monitoring of the “firewall”
  - Monitoring of external unwanted attempts to access the facility’s system and to report such attempts
  - Maintaining the passwords
  - Reporting security breach incidents
  - Security over emails, off-the-shelf software loading and loading of “patches”
  - General security of the systems
  - Security on the data base and applications on the server
  - Virus protection
- Appoint a manager who takes responsibility for:
  - Maintaining the access control per system and per person and ensuring passwords are not shared
  - Making back-ups of the database, the data, and the emails
  - Version control of documents with an acceptable method of doing so
  - Archiving old documents on the system
- Change control needs to be performed and will include:
  - Initiating the change with the necessary motivation
  - Assess the impact of the change on the wider environment
  - Documentation of the change
  - Allocate responsibilities for documentation, testing, approval, and implementation of the change to be made
  - Document an effective roll-back plan if something goes wrong with the implementation
  - Control emergency changes
- Software loaded on the system must:
  - Be limited to that which is necessary for the performance required
  - Legal and licenced software to be used only
  - Ensure identical configurator software on all systems
- Physical security of the computer environment must include:
  - Be operative in a safe environment with strict access to the environment and the system
  - To be protected against smoke, heat, water etc.
- Removal media (equipment with which information and data is copied to and from the system, e.g., laptops, tablets, and memory sticks). The following controls are necessary:

- Computers must be configured to do an automatic virus scan when these media are attached to the facility's computers.
- Limited the linking of external equipment as far as possible

- Permanent scrapping of data on computers must be performed where equipment is taken out of use or where data is not required any longer in line with the various acts that apply.
- Business continuation is just as important, and a "ghost" of the server must be always available to be able to rebuild the system on a new server. Some additional rules are:
  - Make daily back-ups
  - Maintain a register with date, time, what has been backed up and where the back-up can be found
  - Back-up copies must be stored both on site and at an external source