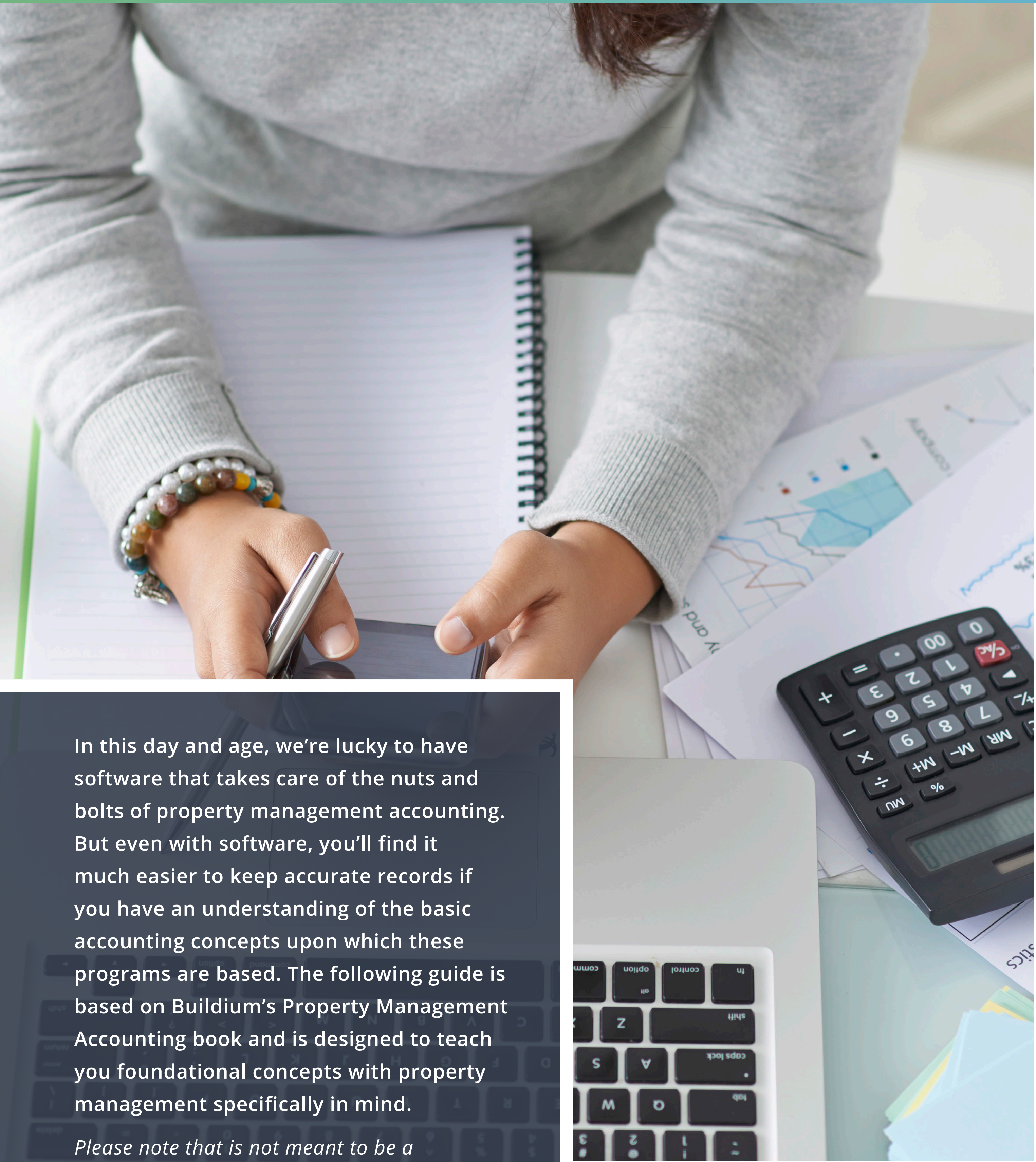
KNOWING YOUR BOOKS:

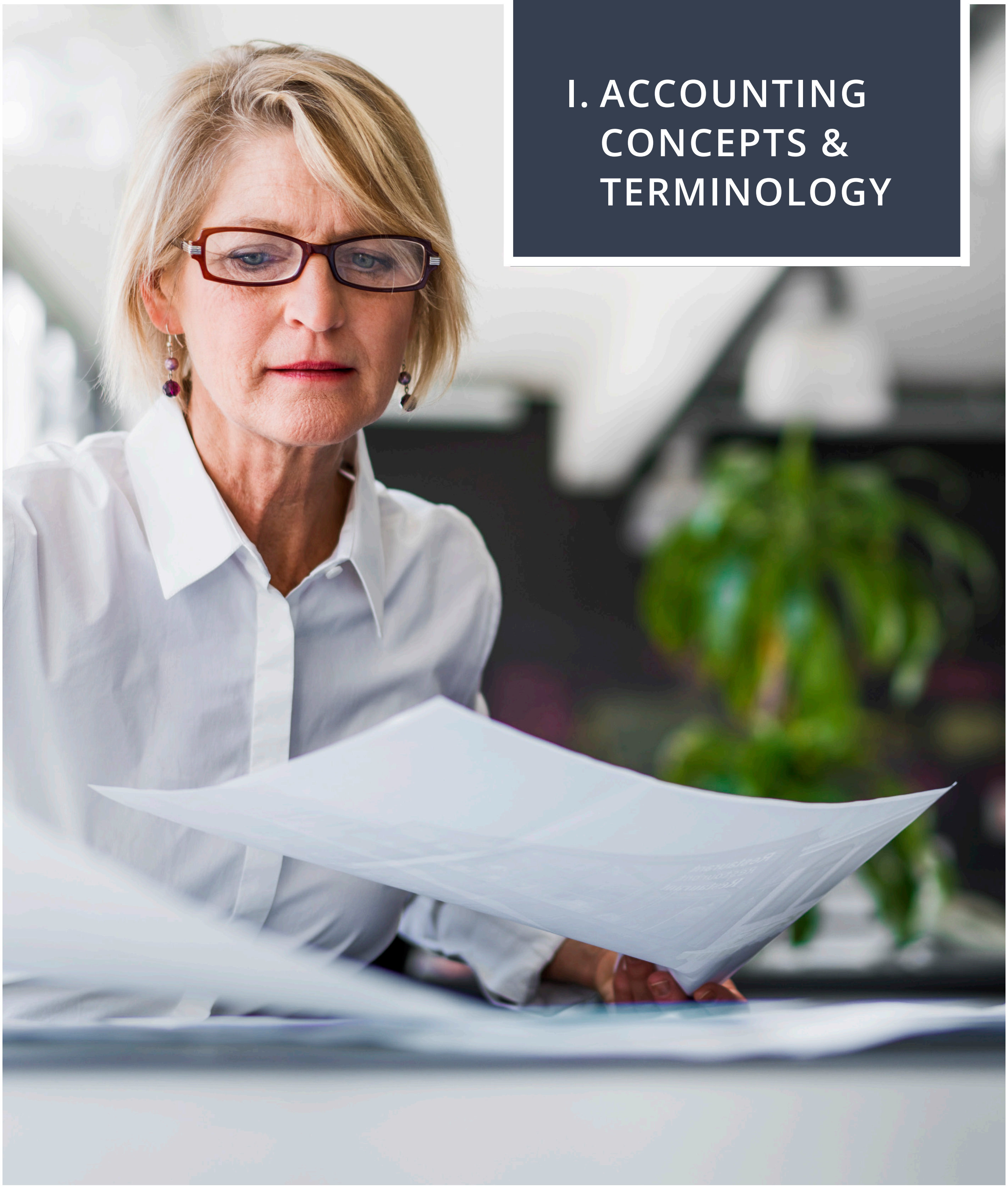
PROPERTY MANAGEMENT ACCOUNTING

A Survival Guide for Non-Accountants (Abridged Version)



In this day and age, we're lucky to have software that takes care of the nuts and bolts of property management accounting. But even with software, you'll find it much easier to keep accurate records if you have an understanding of the basic accounting concepts upon which these programs are based. The following guide is based on Buildium's Property Management Accounting book and is designed to teach you foundational concepts with property management specifically in mind.

Please note that is not meant to be a comprehensive guide, but rather a general overview of basic accounting practices.



I. ACCOUNTING CONCEPTS & TERMINOLOGY

THE BOOKS

As a property manager, it's your job to manage the books for your rental owners and homeowners' associations—even if you're working with software rather than real books. Each property, condominium, and association has its own set of books. When recording any financial transaction, it's important that you consider *where* it should be recorded. Always remember that a single transaction between two parties is actually recorded in two different sets of books; this can be especially confusing when the two parties are you and the rental owner. For example, when you collect management fees, the fees are recorded as an expense on the owner's books and as income on your books.

DOUBLE-ENTRY BOOKKEEPING

Double-entry bookkeeping is at the very center of modern accounting. The primary rules of this system are simple:

1. For every transaction listed in the general journal (see page 5), there must be at least one debit and one credit.
2. The sum of all debits must equal the sum of all credits.

CHART OF ACCOUNTS

At its simplest, an account is a category. Formally, an account is a summary of all debits and credits of a certain type for a company or property. *A chart of accounts* is a list of all accounts a landlord or property manager uses to categorize his transactions. The five major *types* of accounts are:

1. **Assets:** things a property owns
2. **Liabilities:** amounts a property owes
3. **Equity:** amounts that belong to the property's owners after subtracting what's owed
4. **Income:** amounts a property earns
5. **Expenses:** amounts a property spends

There are a couple of important things to keep in mind. First, while there are only five different *types* of accounts, you can have as many actual accounts as you want. It's entirely up to you and really just depends on your needs. For example, you can have a single account for tracking all utility expenses or you can have separate accounts for electricity, natural gas, water, and sewer.

Second, if you're working with a bookkeeper or an accounting firm, don't be shy about asking for advice. While there's no "right way" to set up your chart of accounts, there are a standard set of accounts most property managers will want to include— accounts for tracking things like rental income and management fees, for example.

Finally, when it comes to naming accounts, everyone seems to have an opinion. Some people like to give their accounts descriptive names; others prefer to use numbers. And still others insist that using both is the only way to go. Whatever your preference, be sure your software can accommodate it.

GENERAL JOURNAL

The *general journal* (or book of original entry) is a chronological list of each and every financial transaction that occurs during the course of business. These transactions are called *general journal entries*. **When you record a journal entry, you must have at least one debit and one credit and your debits and credits must balance out.** In other words, the sum of all debits must equal the sum of all credits for a single transaction.

Here's an outline of a general journal entry:

Trans. No.	Date	Account Names & Explanation	Debit	Credit
		Name of account being debited	Amount	
		Name of account being credited		Amount
		Optional: short description		

And here are a few examples:

Trans. No.	Date	Account Names & Explanation	Debit	Credit
1	Jan. 1	Checking account	1,000	
		Rent Income		1,000
		Rent payment from Sam Paul		

Trans. No.	Date	Account Names & Explanation	Debit	Credit
150	June 5	Checking account	1,050	
		Rent Income		1,000
		Late Fee Income		50
		Rent payment from Sam Paul		

When it comes to double-entry bookkeeping, remember that each transaction in the general journal must have at least one debit and at least one credit. That doesn't mean you need an equal number of debits and credits. For example, you may have a journal entry with one debit and two credits—that's okay as long as the total amount of all the debits equals the total of all the credits.

GENERAL LEDGER

The *general ledger* is a compilation of individual accounts, also called *T accounts* because they are shaped like the letter T. Here are the T accounts for the general journal entries we made above.

Checking Account

Trans. No.	Debit	Credit
1	1,000	
—	—	—
150	1,050	

Rent Income

Trans. No.	Debit	Credit
1		1,000
—	—	—
150		1,000

Late Fee Income

Trans. No.	Debit	Credit
—	—	—
150		50

RELATING THE GENERAL JOURNAL TO THE GENERAL LEDGER

The general journal and the general ledger are really two different views of the same information. The general journal shows transactions in chronological order, while the general ledger shows transaction totals by account.

So why do you need both? Think of the general journal as a diary of all the transactions that affect your property. Though the journal is a great way of seeing what happened when, it's not so good for summarizing information. For example, while it can tell you how much you spent for supplies on a particular purchase, it can't tell you how much you've spent for supplies across all purchases. That's where the general ledger comes in.

DEBIT & CREDIT ACCOUNTS

As we've already discussed, each transaction has at least one debit and one credit. You'll also recall that each individual transaction must balance to zero—that is, the sum of the debits must equal the sum of the credits.

But how do you know when to debit and when to credit a particular account? You start by knowing whether the account is a *debit* account or *credit* account. Once you know this, the rest is easy.

- Debits ***increase*** the value of ***debit*** accounts.
- Credits ***increase*** the value of ***credit*** accounts.

If you're working with a debit account and if you want to increase its value, you debit it. If you want to decrease its value, you credit it.

The opposite is true for credit accounts. The rule is easy—the trickier part is figuring out what kind of account you're dealing with. For that, you'll just have to commit the following to memory:

• Assets and expenses are ***debit*** accounts; debits ***increase*** the value of debit accounts.

• Income, equity, and liabilities are ***credit*** accounts; credits ***increase*** the value of credit accounts.

Here's a handy chart to help you remember all of this. Be sure to read the chart from the outside in. For example, debits increase the value of an asset account, while credits decrease them.

Debits	Account Type	Credits
Increase	Assets *(things a property owns)* Bank Accounts, Prepaid Expenses, Accounts Receivable, Property and Equipment, Other Amounts Due to the Company Accumulated Depreciation	Decrease
Decrease	Liabilities *(amounts a property owes)* Security Deposits, Prepaid Rent, Accounts Payable, Pet Deposits, Credit Cards, Loans	Increase
Decrease	Equity *(amounts that belong to the property's owners after subtracting what's owed)* Owner Equity, Loans	Increase
Decrease	Income *(amounts a property earns)* Rent Income, Late Fee Income, Utility Income, Laundry Income, Repairs Income	Increase
Increase	Expenses *(amounts a property spends)* Management Fees, Repairs, Supplies, Insurance, Utilities, Advertising, Depreciation Expenses, Interest	Decrease

ACCRUAL VS. CASH ACCOUNTING

The last concept to consider is *when* to record a transaction on your property's books. The answer depends on which accounting method you choose: *cash* or *accrual*.

With the *cash method of accounting*, you record income and expenses only when money changes hands. You record income when your tenants pay you and you record expenses when you pay your vendors.

With the *accrual method*, you record income and expenses the moment you earn money or owe it, regardless of when the money actually changes hands.

So which method should you use? The answer is: It's up to you. While the vast majority of property managers keep their books on a cash basis for the sake of simplicity, some choose accrual accounting because they believe it provides a more accurate picture of how a property is doing.

You can choose different accounting methods for your company and each of the properties you manage, but the IRS requires that you receive their approval before changing your method once your initial choice has been made. If you're not sure which method is right for you, consult your accountant.

REAL WORLD SCENARIO: *COLLECTING RENT*

Your tenant, Sam Paul, owes $1,000 in rent on January 1. Let's assume that Sam Paul pays on January 5.

Cash Accounting

With cash accounting, you record the income on January 5 when Sam Paul pays his rent.

Trans. No.	Date	Account Names & Explanation	Debit	Credit
1	Jan. 5	Checking account	1,000	
		Rent Income		1,000
		Rent payment from Sam Paul		

Accrual Accounting

With accrual accounting, you record the income on January 1 when Sam Paul's rent is due.

Trans. No.	Date	Account Names & Explanation	Debit	Credit
1	Jan. 1	Accounts Receivable	1,000	
		Rent Income		1,000
		January rent due from Sam Paul		

REAL WORLD SCENARIO: *PAYING BILLS*

In this example, let's say you receive a $100 electric bill on January 1 and pay it three days later on January 4.

Cash Accounting

When you're on a cash basis, you record the expense on January 4 when you pay the bill.

Trans. No.	Date	Account Names & Explanation	Debit	Credit
1	Jan. 4	Utility Expense	100	
		Checking Account		100
		Payment to electric company		

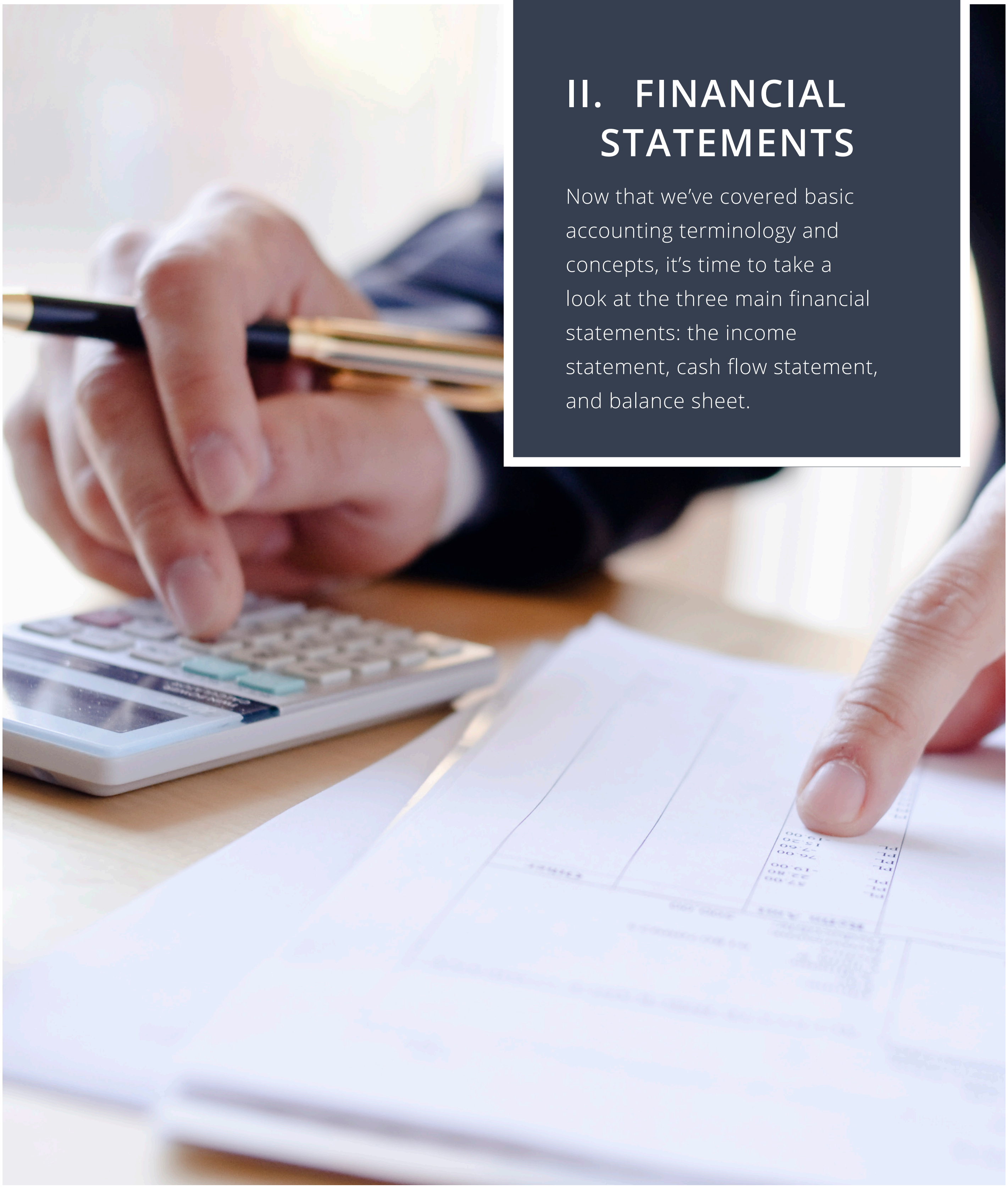
Accrual Accounting

When you're on an accrual basis, you record the expense on January 1 when you receive the bill.

Trans. No.	Date	Account Names & Explanation	Debit	Credit
1	Jan. 1	Utility Expense	100	
		Accounts Payable		100
		Bill from electric company		

II. FINANCIAL STATEMENTS

Now that we've covered basic accounting terminology and concepts, it's time to take a look at the three main financial statements: the income statement, cash flow statement, and balance sheet.



INCOME STATEMENT

An *income statement* (also called a *profit and loss statement* or *P&L*) is a summary of a property's profit or loss during a given period of time. It shows total income, expenses, and net income—the amount of income that remains after subtracting expenses.

The purpose of the income statement is to show whether a property made or lost money during the specified period. The important thing to remember is that it represents a period of time.

1 Main Street Income Statement
Jan. 1- Jan. 31

Income	
Rent Income	1,000
Late Fee Income	100
Total Income	**1,100**
Expenses	
Repairs Management Fees	200 200
Total Expenses	**400**
Net Income	**700**

CASH FLOW STATEMENT

A *cash flow statement* shows a company's cash inflows and outflows over a specific period of time. The cash flow statement is important because it shows whether a company has enough cash to pay its bills. While an income statement tells you whether a property made a profit, a cash flow statement tells you whether a property generated cash. Like the income statement, the cash flow statement represents a specific period of time.

1 Main Street Cash Flow Statement
Jan. 1- Jan. 31

Net Income	**700**
Accounts Receivable	0
Accounts Payable	0
Net cash increase for period	**700**
Cash at beginning of period	0
Cash at end of period	**700**

BALANCE SHEET

A *balance sheet* shows what a company owns and what it owes at a **specific point in time**. It's important to note that while income and cash flow statements show an overview over a *period* of time, balance sheets show a snapshot of a specific *point* in time.

A balance sheet is divided into three parts: assets, liabilities, and equity. Remember assets are things a company owns, liabilities are amounts a company owes, and equity is what belongs to the company's owners after subtracting what's owed.

1 Main Street Balance Sheet
(as of Jan. 31)

Assets		Liabilities	
Rent Bank Account	1,700	Security Deposit Liability	1,000
Deposit Bank Account	2,000	Prepaid Rent Liability	1,000
Accounts Receivable	0	Accounts Payable	0
		Total Liabilities	**2,000**
		Equity	
		Net Income	700
		Retained Earnings	1,000
		Total Equity	**1,700**
Total Assets	**3,700**	**Total Liabilities and Equity**	**3,700**

Retained earnings: net profits or losses from prior years that have been not been distributed to the company's owners

Net income: year-to-date profits or losses

RELATING THE MAIN FINANCIAL STATEMENTS

Although each financial statement is different, keep in mind that they're all related. For example, a company's assets and equity increase (or decrease) when a company makes a profit (or loss).

While no one financial statement provides the whole picture, together they provide the information necessary to determine how a company or property is doing.

1 Main Street Balance Sheet
(as of Jan. 31)

Assets		**Liabilities**	
Rent Bank Account	1,700	Security Deposit Liability	1,000
Deposit Bank Account	2,000	Prepaid Rent Liability	1,000
Accounts Receivable	0	Accounts Payable	0
		Total Liabilities	**2,000**
		Equity	
		Net Income	700
		Retained Earnings	1,000
		Total Equity	**1,700**
Total Assets	**3,700**	**Total Liabilities and Equity**	**3,700**

1 Main Street Income Statement
Jan. 1- Jan. 31

Income	
Rent Income	1,000
Late Fee Income	100
Total Income	**1,100**
Expenses	
Repairs Management Fees	200 200
Total Expenses	**400**
Net Income	**700**

1 Main Street Cash Flow Statement
Jan. 1- Jan. 31

Net Income	**700**
Accounts Receivable	0
Accounts Payable	0
Net cash increase for period	**700**
Cash at beginning of period	0
Cash at end of period	**700**

PUTTING IT ALL TOGETHER: THE ACCOUNTING CYCLE

We've already discussed a number of accounting concepts, including the chart of accounts, journal entries, and general ledger. But how do they fit together and how are they used in the real world? The answer is the accounting cycle.

It sounds complicated, but the accounting cycle is nothing more than a series of steps for recording business transactions from the time they take place to the time they appear in financial statements. The chart of accounts, general journal, and general ledger are the tools you'll use along the way to complete these steps:

1. The transaction takes place (for example, you collect rent, pay a bill, or refund a tenant's security deposit).
2. You journalize or record the transaction in the general journal in chronological order.
3. You post the entries to the appropriate T accounts on the general ledger.
4. You total your accounts and use those totals to prepare your financial statements.

IN CONCLUSION

Whether you are a seasoned pro or new to property management, hopefully this refresher on accounting concepts will help you manage your owners' properties more efficiently, while balancing the books and maintaining your sanity. If you would like to know how all of these learnings should be integrated into a software solution like Buildium, we recommend you check out our blog post—The Property Management Accounting Software Survival Kit: 5 Must-Have Tools—for even more recommendations on accounting best practices for property managers.

ABOUT BUILDIUM

Buildium is the only property management solution that helps real estate professionals win new business from property owners and community associations seeking services. Backed by expert advice and relentless support, Buildium enables you to outperform across all facets of your business with intuitive software that balances power, simplicity, and ease of use. Buildium services property managers in more than 50 countries, totaling over 1.8 million residential units under management. In 2015, Buildium acquired All Property Management, a leading online marketing service for property managers, making Buildium the only company to give property managers a way to acquire new customers and increase revenue.