Help Our Scheme – Balance Sheet Risk Guide

What is Balance Sheet Risk?

Balance Sheet and Liquidity Risks are risks arising from specific weaknesses in asset and liability management as well as in financial disciplines and financial controls which impact on the balance sheet.

Sound financial control and discipline is essential for a healthy balance sheet. The balance sheet and accompanying financial statements of a Community Scheme need to be up to date and audited by reputable auditors. A Community Scheme needs to be a going concern and its financial statements should accurately reflect the state of the Scheme and should not be qualified in any way. This is particularly important if the Scheme is going to require the support and commitment of service providers, external parties and potential providers of finance.

Before any liabilities are incurred, whether as a result of loans, finance, trade credit or expenditure, a Community Scheme needs to be certain that it can repay these when they fall due. The same applies to any contingent liabilities it may incur, e.g. lease obligations, finance arrangements, contractual undertakings.

Introduction to Balance Sheet and Liquidity Risk

The Balance Sheet is a snapshot of the financial position of an organisation at any point in time. It is a function of all the financial transactions in the Community Scheme and reflects the "financial health" of the Community Scheme. A Community Scheme must protect its Balance Sheet's integrity by understanding the impact of its decisions and operations on its balance sheet.

A robust and stable Balance Sheet is essential for the effective running and sustainability of a Community Scheme. Solvency and liquidity are integral if a Scheme is to be sustainable.

Sound financial control and discipline are also essential for a healthy Balance Sheet. The Balance Sheet and accompanying financial statements of a Community Scheme need to be up to date and audited or reviewed, by reputable auditors. A Community Scheme needs to be a going concern at all times, and its financial statements should not be qualified in any way. This is particularly important if the Community Scheme will require the support and commitment of external parties, lenders, suppliers and other stakeholders.

All Community Schemes require funding to finance their operations, and the level of owner's funds and reserves is at the heart of the balance sheet. The extent of funding needed by the Community Scheme will be dictated by the scale and nature of the operations and activities being undertaken. Capital is invariably initially provided by developers, owners, lessees, shareholders and/or third parties who extend credit or loans to the Community Scheme.

Successful operations of a Community Scheme will require on-going adequate funding and capital. Community Schemes undertaking capital expenditure or with large, fixed asset infrastructure requiring continued investment and maintenance will require greater funding than those whose expenditure is purely operational. Community Schemes who receive advanced cash-payment of levies and memberships etc require less capital than Community Scheme's which carry a big arrears debtor's book, provide extended credit or make the use of loans and debt. As soon as a Scheme finds itself carrying an increasing debtor's book, it will require more capital to fund its operations. Cash reserves can be easily depleted if funding is not tightly managed. There needs to be an alignment between the individual Community Scheme's operational model and the required funding level. There needs to be an appropriate mix and balance between owner's funds/reserves, loan funding, asset-based financing and trade/supplier credit.

Given the dynamics of a Community Scheme, the availability of owners funding and owner support is integral to a Community Scheme's sustainability. As such, the Trustees/Directors and management's relationship with owners or prospective owners and strategic thinking/value alignment, is essential. Any expansion or diversification of the Community Scheme will require funding in some form and bring into play additional risk.

Before a Community Scheme takes on any debt, it needs to be capable of supporting the level of debt from its cash flow in terms of both the servicing of interest where applicable and in being able to repay the capital when due. Simultaneously, the Trustees/Directors, owners and management always need to ensure that the Community Scheme is both solvent and liquid. It must also ensure that its assets exceed its liabilities at all times, and that it can meet its immediate obligations from cash resources. Loans and credit facilities extended to a Community Scheme, could be subject to the Community Scheme meeting and maintaining specified covenants and conditions. These are typically linked to the Balance Sheet state, such as total debt to owner's funds, current assets to current liabilities, levels of surplus/income, expense cover and ability to cover interest from income. The Community Scheme must reflect its assets at their realisable or market values. When assets are not conservatively valued, the Community Scheme's financial position will be overstated. It will inevitably be reflected in a loss of owner's funds or write down at some stage.

Insolvent schemes can be placed under administration by creditors, resulting in complications to their operations and additional fees and costs for the administration.

There needs to be an alignment between the Schemes business model with the required level of funding being an appropriate mix and balance between reserves, trade credit and possibly finance.

Funding and Maintenance of Reserves

To ensure adequate funding, a Community Scheme must on a consistent basis recover sufficient levy income from owners/shareholders/lessees and generate other revenue for services provided/rendered to meet on-going operating expenses and ensure that an operating surplus/profit is made. On top of this, reserves to meet the strategic objectives of the Community Scheme must be accumulated/put in place, and statutory reserve requirements built up and met. Solar energy projects are a good example of the need for specific reserve accumulation.

The maintenance of reserves, for both statutory and operational requirements, are at the heart of a Community Scheme's financing challenges. Reserves should ideally translate directly into cash resources on hand. The more reserves and surpluses are tied up in fixed assets or debtors, the greater the Community Scheme's liquidity will be compromised. The preservation and maintenance of cash resources is a key component of operational cash flow management, the building up reserves and maintenance capacity planning.

All Community Schemes will require continual re-investment in them by owners/shareholders/members to remain sustainable. In a continually evolving technology environment, on-going changes will be required in areas such as security, technology and IT systems, monitoring and surveillance, access control, CCTV, solar energy, lighting management, utility usage recording etc. The building up of reserves for this type of expenditures and other technology-related purposes will be on-going and essential.

Every Community Scheme will face an unexpected event or surprise that will impact cash flow or require urgent funding, e.g. the need to replace a major asset, rectify infrastructure, deal with the impact of a natural disaster, or fund an uninsured event. Examples of these are – rectification of latent construction defects, replacing decayed plumbing and wiring, replacement of cracked/lifting tiles, failing balustrades, peeling/cracking wooden doors and window frames, decaying/broken fittings and rusting/broken lights or parking net poles. Most of these will have financial implications that could have a material effect on the Community Scheme's cash resources and reserves. Some disasters can have extensive and lasting impacts. Maintaining reserves and cash for emergencies or disasters is a critical part of Balance Sheet management. To meet these unexpected events, a Community Scheme needs to build up cash reserves or formalise credit facilities that can be availed off to address these situations if and when they occur. As a rule of thumb, you should have a reserve of at least three months of operating expenses. Owner's funds and reserves are a scarce commodity and need to be effectively deployed. The use of reserves must be focused on those areas and activities that will add the most value to the Community Scheme and owners' long-term viability. Once reserves have been committed to expenditure and the cash utilised, these are not easily reversible without some loss or costs being incurred.

The level of statutory reserves should be directly linked to/aligned with specifically planned maintenance/upgrading/repair/replacement of infrastructure as per the 10 year maintenance, repair and replacement plan ("MR&R plan"). Any withdrawal from reserves should be authorised by a resolution passed by the Trustees/Directors.

A Community Scheme can never have enough reserves and while it is important to meet and maintain the required statutory level of reserves, this should be the base case. With inflation and time, the costs of maintaining infrastructure, upgrading facilities and technology and doing essential maintenance, will continue to escalate. As such levies and fees recovered for facilities and services provided, should be driven by the likely future needs of the Community Scheme to meet not just expected operational expenditure but capital replacement, extended maintenance requirements, upgrades, unknown events and future strategic expenditure of the Scheme.

Cash and Liquidity Management

The cash flow cycle of a Community Scheme is dictated by the level and timing of inflows from levy collections, membership fees, sales of services or products provided by the Community Scheme, collections from debtors where credit has been extended and the level and timing of outflows from the payment of overhead and expense obligations, capital expenditure, loan/debt repayments, tax obligations and the payment of creditors, other expenses and salaries.

In simple terms, for a Balance Sheet of the Community Scheme to strengthen, more cash must flow into a Community Scheme than leaves it. The overall surplus will primarily dictate the net cash available in the Community Scheme. Liquidity and liquidity management are everything in managing a Community Scheme's day-to-day affairs and is a critical part of cash flow management.

A profitable Community Scheme will see a net increase in cash resources, low outstanding debtors or a reduction of debt or liabilities, and a strengthening of the balance sheet. On the other hand, a loss-making Community Scheme will see a net reduction in cash resources, an increase in outstanding dues, an increase in liabilities or debt and a weakening of the balance sheet. Where inflows into the Community Scheme do not consistently fully cover the outflow on general expenditure and expenses, there will be a steady loss of cash and reserves and a weakening of the Community Schemes Balance Sheet over time.

In simple terms, for the Balance Sheet to strengthen, more cash must flow into the Community Scheme than leaves it over a given period. Liquidity and cash flow management are everything in managing the day-to-day affairs of a Community Scheme.

The preservation and maintenance of cash resources is a key component of cash flow management and business planning. Operations have to be funded from cash resources or borrowings. Maintaining reserves and cash for emergencies or disasters is also a critical part of Balance Sheet management.

Expansion of infrastructure and the funding of a debtor's book requires owners funds/cash reserves or the use of credit facilities or loan funding. The expansion of the Community Scheme or the investment in new infrastructure etc., will in the ordinary course need to be funded by cash reserves built up or supported by strong positive cash flows from the Community Scheme's current operations.

Managing liquidity is a critical part of cash flow management. Cash inflow from levies and operations, credit or loan facilities, or asset maturities must be managed to ensure the Scheme can meet its liabilities as and when they fall due. This is particularly important to ensure debt or loan repayments, interest due, the meeting of core operating expenses, other overheads, salaries and tax payments are met as scheduled/required.

Capital expenditure and the funding of a debtor's book requires reserves and cash or the use of credit facilities or loan funding. Any long-term debt or funding raised should be matched with the funding of fixed assets and infrastructure. These obligations should be in line with the future cash flow generation of the Community Scheme as debt servicing and repayments will need to be made as per the loan, or debt conditions agreed.

Other key aspects of cash and liquidity management are:

- Levy collections must translate into immediate cash flow.
- Focus on the collection of debtors within agreed payment terms.
- Monitor bank accounts regularly and check for unpaid debit orders or unexplained debits.
- Invest surplus funds in money market accounts to improve the yield on surplus funds and earn sundry interest income.
- Capital expenditure must be carefully planned for and met out of accumulated reserves. Be aware of ego or vanity projects.
- Avoid concentration risk by becoming overexposed to any single owner/debtor/owner who might default on or dispute payment.
- Focus on cost/expenditure management, particularly fixed and non-essential costs.
- Use trade credit from service providers where possible.
- Be aware of debit order activity and recurring debits that are processed automatically through the Community Scheme bank accounts, e.g. security services, gardening services.
- Check all utility accounts and service provider invoices before paying.
- Monitor insurance claims and ensure all settlement payments are received.

It is also important not to over-pay or duplicate electronic payments to creditors or employees, as it is often difficult to recover or recoup amounts. There is always the risk of amounts being expunged or used up with small businesses or employees or parties disappearing or folding before recovery is made.

Asset Management

In addition to the maintenance and protection of the fixed assets and common property of the Community Scheme, other movable assets such as vehicles, maintenance equipment, gardening equipment, irrigation equipment, security/electronic equipment, furniture, pool equipment etc and consumables such as paint, plants, pots, fertilisers must be controlled and managed.

To ensure the on-going good condition, productivity, and longevity of its fixed and movable assets, a Community Scheme must maintain and service these regularly, i.e. communal buildings, machines, plant, equipment, vehicles, pools and gates etc.

A maintenance schedule for all assets should be drawn up and followed. This should reflect laid down/required service intervals, warranties held, guarantee periods and any specific conditions where applicable. The long-term costs of not maintaining assets are difficult to quantify, but these can be substantial. These might not only be from a performance perspective but from a cost to run and potential breakdown or accident perspective.

Physical control and security of assets is essential and vital. The more valuable movable assets should be insured. Insurance should cover liability, loss, theft or accidental damage and be appropriate and sufficient to cover replacement.

A comprehensive list of all assets with serial numbers/unique identification numbers should be maintained in a register. Regularly check assets against the register. This register should also be used for insurance purposes.

All the Community Scheme's fixed assets should be fairly-valued, not over-stated, and be depreciated appropriately.

The Community Scheme should not only depreciate fixed assets but also ensure that they can be replaced when necessary or required. Depreciation periods should be in line with the useful life of the assets in question. This will require the retention of reserves and cash and/or the on-going formalisation of funding or credit lines for significant asset replacement such as lifts. To best facilitate and ensure this, Balance Sheet strength (cash and reserves), the on-going profitability and positive cash flow of the Community Scheme will need to be maintained.

The assets and communal property of the Community Scheme represent a key component of owner's funds. This covers cash resources, outstanding debtors, movable assets, improvements to the common property, the state of buildings and common infrastructure such as roads, walls, gates, dams, pathways, gardens, swimming pools, clubhouses, wildlife, golf courses, security and access control infrastructure. It is vital to secure, maintain the condition of and optimise the use of assets in the value proposition to owners. Communal facility assets dedicated to providing additional services should be measured and monitored to ensure that the expected additional income and cash flow are generated. Under-utilised assets, assets adding no value to owners/shareholders/lessees and those costing the Community Scheme money or not generating the income as envisaged should be sold, disposed of, or replaced/upgraded/re-positioned.

Key assets of any Community Scheme that do not appear on the balance sheet are the culture, image and reputation of the Community Scheme. These factors along with strong cash reserves, assets and infrastructure in tip top condition, will add considerable hidden value to the balance sheet of the Community Scheme.

Debtor Management

To ensure that the debtor's book forms a relevant component of the balance sheet, your debtors must remain current and collectable. To achieve good debtor management, you need to implement a robust debtor collection processes and key support systems.

On-going and regular review of your outstanding debtors is also a critical part of debtor and collections management. Your owners' financial position and, in turn, their debtors (tenants) will be continually changing, and in tandem with this, you will need to react accordingly. Concentration risk to any single owner of multiple units or properties needs to be closely monitored. Similarly, where a Community Scheme's owners are mostly employees of or the landlords to employees of a single major employer in the area, this needs to be monitored.

It needs to be remembered that bad debt is not just the loss of profitability but is effectively a loss of owner's funds/reserves and cash.

It may be beneficial to consider offering early settlement discounts to incentivise early payment of levies and dues. It is also possible to finance a debtor's book by discounting or selling specific debtors outright to generate liquidity/cash flow for the improvement of the Balance Sheet and running of the Community Scheme.

Given the prevalent global post-COVID-19 socio-economic conditions and higher interest rates, Community Schemes will not be spared from this fallout. It remains prudent for Community Schemes to raise and maintain a provision for bad debts in their financial accounts.

While Community Schemes control the provision of levy clearance certificates for the sale and transfer of a property, they might well still not be able to recover all of their outstanding dues from the sale of the property or member's interest.

Management of Liabilities

Before any liabilities are incurred, whether as a result of expenditure, employee engagement, contracts entered into, trade credit extended to the Community Scheme or where loans or finance are to be availed for capital expenditure to be undertaken, the Community Scheme needs to be certain that it can repay these obligations as and when they fall due or become payable.

The same applies to any contingent liabilities the Community Scheme may incur, contemplate entering into or have, e.g. guarantees issued, lease obligations, contractual undertakings, leave pay obligations, finance arrangements, legal action, insurance excesses, owner claims.

The extent to which a Community Scheme can grow its liabilities are dictated mainly and limited by the level of owner's funds/cash reserves i.e. accumulated owners funds and reserves relative to outside liabilities.

Cash flow forecasts must show that before taking on any additional liabilities or debt, the Community Scheme can comfortably repay these and service any interest.

Levels of debt should always be kept as low as possible to avoid over-extension of the Community Scheme and its ability to service and repay these.

Structuring credit facilities and liability repayments in line with cash flow is crucial in liability management. Cash flow needs to be managed to ensure cash is available to repay liabilities and the capital and interest on any debt when it falls due for payment.

Managing Contingent Liabilities

A contingent liability is a possible liability that may occur, depending on the outcome of an uncertain future event. These may be claims under contracts against the Community Scheme, unresolved legal action, liability claims, tax claims, employee claims, recourse in respect of sold/factored levy book, sureties issued, guarantees issued on behalf of the Community Scheme etc.

Once a contingent liability becomes a real liability, it becomes payable at some point in time. This could have an immediate significant impact on the Community Scheme's balance sheet, solvency and cash resources. The inability to pay could result in the Community Scheme failing or being forced to raise a special levy.

It is important that before trustees/directors/estate management enter into any contracts or arrangements that could ultimately result in a liability to the Community Scheme, that the worst-case scenario of these be considered.