

Reserve Fund Accounting

Homeowner association governing documents (generally, the “Declarations”) often require the establishment of the operating fund and the reserve fund (also called the replacement fund). One of the primary duties of homeowner associations is to maintain and preserve the common property. The reserve fund is intended to assist in the achievement of that duty by providing information regarding the balance of the reserve fund as well as the income and expenses that are recorded to that fund. In practice we find that the information presented in the monthly financial statements regarding the operating fund and the reserve fund is often confusing and misleading. We will discuss the two most common situations:

Situation 1) Association XYZ budgeted \$60,000 for the reserve fund for 2008. \$5,000 was contributed every month except for one month when cash was short.

The \$5,000 shortfall in contributions creates an operating fund payable to the reserve fund. This should be reflected on the balance sheet as a operating fund payable and a reserve fund receivable. Our experience is that it often is not. More misleading is that the income statement often shows that the correct amount was transferred to the reserve fund, in this example \$60,000. This happens when the accounting entry recording the monthly transfer occurs as a result of a recurring journal entry, as opposed to the actual transfer of cash to the reserve fund. This error can result in a board believing that the full budgeted amount was transferred to the reserve fund when in reality only part of the budgeted transfer occurred. If the operating fund is unable or does not intend to repay the shortfall a permanent transfer between the funds should be recorded in the minutes of the board meetings and reported in the financial statements.

Situation 2) Association XYZ incurred reserve fund expenses of \$10,000. This was coded to a reserve fund expense account, but it was paid from the operating checking account.

Operating fund payment of reserve fund expenses is another common source of interfund balances. When the operating fund has paid for a reserve fund expense, a reserve fund payable to the operating fund is created. This should be reflected on the balance sheet, but again in our experience, it often is not. If the board makes a decision to not reimburse the operating fund (typically this is done to maintain as much cash in the reserve fund as possible), a permanent transfer between the funds should be recorded in the minutes of the board meetings and the inter-fund payable and receivable balances should be eliminated from the balance sheet.

We find that managers and boards are often surprised that the audited financial statements contain very different information regarding balances of the operating and reserve funds and transactions that occurred within those funds. A few simple changes to the accounting treatment can provide significantly improved information regarding the activities and balances of these funds.