Reserve Fund Accounting “Ground Rules”
By Tom Weidner, CPA

Homeowner association governing documents (generally, the “Declarations”) often require a reserve fund. Those documents don’t usually detail the reserve fund ground rules – they usually just say, “…the association must have a reserve fund.”

Colorado law does not mandate a reserve fund, nor does it mandate a reserve study. Thus, no reserve fund “ground rules” spring from state law in Colorado. At least twelve states do require homeowner associations to have reserve funds and / or reserve studies. For example, Hawaii law mandates reserve funds and even mandates funding of at least 50% of the identified annual reserve fund requirement.

Whether the reserve fund is mandated by the HOA’s governing documents, by state law, or not at all, the accounting ground rules regarding how much money went into or came out of the reserve fund are often hazy.

Maybe you’ve participated in the following discussion:

> *How much did we add to and use from the reserve fund last year?*
>
> *Lets see – we budgeted $24,000 to be added to the reserve fund for the year. We transferred $2,000 a month into that bank account except for July when we ran short of cash. So I guess we added $22,000 to the reserve fund for the year.*
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> *Yeah, but the December transfer to the reserve account wasn’t made until January, so I think we added just $20,000 to the reserve fund last year.*
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> *But you remember - in the April meeting we got our new reserve study. It concluded that we were not putting enough money into the reserve fund. So we talked about adding another $500 each month. Seems to me that we intended to put another $500 a month into the reserve fund this year starting April – nine months with an extra $500 a month - that’s another $4,500 for the year.*
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> *And in the September Board of Directors meeting we voted to <u>not</u> use reserve fund money to pay for the new clubhouse roof. We voted to use operating fund money for the roof. We had the roof money in the reserve fund, but we wanted to keep that money in the reserve fund to build up the reserve fund for other things..*
>
> *Gee, aren’t there some ground rules about these things?*

Well, maybe. As a CPA who does lots of homeowner association audits and reviews, I have some ground rules - suggestions really - about these things.

First, it would help to focus on exactly what we are talking about. We might be discussing the reserve fund bank account, or we might be discussing an accounting creation called the “Reserve Fund.” If the discussion is focusing on the bank account, then the ground rules are clear: whatever is there <u>is</u> there, and whatever isn’t, <u>isn’t</u>. It’s that simple. Budgets and reserve studies and Board resolutions and such things are irrelevant if that’s the focus.

Alternatively, we might be discussing this accounting creation called the "Reserve Fund." The accounting "Reserve Fund" includes the reserve fund bank account. It might also include other items (such as accrued interest, amounts receivable from the operating fund or, amounts payable to the operating fund). Ultimately it is this accounting creation that provides the best measure of the "Reserve Fund" balance since it reflects all of the assets and obligations of the reserve fund.

So, what are the ground rules for this accounting creation? As a general rule, reserve fund additions are the result of documented decisions. For example, the approved budget establishes how much assessment revenue is to be allocated to the reserve fund for the year. Cash shortfalls (see "July" above) or delays of transfers to the reserve fund (see "December" above) do not decrease the allocation to the reserve fund for the year - they were, if you will, accidental events, not documented decisions. The budgeted amount (and any <u>approved</u> modifications to the reserve fund revenue budget) dictates the reserve fund revenue amount.

General discussions don't count (see April above). For example, in its monthly meetings the Board may have discussions about how the reserve fund <u>might</u> be increased or decreased. That's not the same as a decision – so when you want to impact the reserve fund, document the discussion, put a motion on the table, and note the approval or disapproval of the motion in the minutes.

Only approved reserve fund expenditures will reduce the reserve fund. Further, Board approval to use operating fund resources to pay for a "reserve fund item" results in an operating fund expenditure, not a reserve fund expenditure (see September above)

> *So, if I were involved in the discussion at the front-end of this article, I'd give this view: the budget that you approved allocated $24,000 from assessments to the reserve fund for this year. That is the amount of reserve fund revenues for the year. You ran short of cash in July and did not move July's $2,000 to the reserve fund. You also did not make the $2,000 transfer for December until after year-end. But you did not change the budget for these two events. That means that at December 31 the reserve fund had a receivable from the operating fund of $4,000 for the two unmade transfers. The April discussion about increasing the reserve fund assessment allocation was not a decision; it was just a discussion, so it had no impact. Finally, the Board approved the use of operating fund money to pay for the clubhouse roof. That decision means that operating fund money, not reserve fund money was used for the new roof.*

Reserve fund management is a critical homeowner association task. It's useful to have some ground rules that determine how much goes into or comes out of the reserve fund. The basic ground rule is simple: reserve fund additions and reductions are the result of documented decisions; reserve fund additions and reductions do not result from serendipitous out-of-cash or cash transfer events, or from mere discussions on the topic.

Next Month: "Ground Rules II" OK - but our Declarations talk about putting all "excess" operating funds into the reserve fund at the end of the year. When do we ever have "excess" operating funds and how do we ID them? Also, we are a development stage HOA (still not fully built-out). As a result, our budget (including the reserve fund revenue budget) is an educated guess at best. How do we ID the reserve fund revenues in this situation?