Reserve Fund Accounting "Ground Rules" - The Sequel
By Tom Weidner, CPA

The accounting "ground rules" concerning how much money went into or came out of an association's reserve fund are often hazy. An article in last months' <u>Common Interests</u> (Reserve Fund Accounting "Ground Rules") presented a few concepts to help sort things out. 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 or other delays of transfers to the reserve fund do not decrease the allocation to the reserve fund for the year. Such shortfalls and delays are, 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. On the expenditure side, 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.

The framework for the above is a conventional HOA environment (a mature association, an annual budget that allocates part of the assessment revenue stream to the reserve fund, and standard Declarations that don't prescribe unique handling of any "excess" annual operating fund revenues).

In this sequel, I'd like to provide some reserve fund logic for two "unconventional" situations. One such situation: What logic applies to a development-stage HOA (not fully built-out) where all elements in the budget - including budgeted assessment revenues and budgeted reserve fund revenues - are really rough estimates? How might reserve fund revenues be determined in this situation? Another situation: What happens if your Declarations specify putting all "excess" operating funds into the reserve fund at the end of the year? Is this "excess" determined before or after an allocation of assessments is made to the reserve fund? When do you really have "excess" operating funds? How do you show this additional allocation to the reserve fund in the financial statements?

<u>The pre-build out problem</u>

Pre-build-out HOAs often have budgets that use assumed lot annexation and unit sales information. Many of the budget items, including assessment revenues and reserve fund revenues are a function of those assumptions. Actual assessment revenues may be on target - or they may below or above actual. What's the effect of this on the dollars to be allocated to the reserve fund?

One solution: We've found that a prorate process works well in dealing with this situation. For example: assume that the budget for a pre-build-out HOA has $80,000 total assessment revenue for the year. $20,000 of that is budgeted for the reserve fund. Assume that sales and annexations go faster that projected - total assessment revenue for the year is $110,000. What portion of that larger pot of assessment revenues might be allocated to the reserve fund? One solution is to view the original budget as providing a 25% ($20,000 / $80,000) reserve fund prorate guideline. Under that view, 25% of the $110,000 assessment revenue realized would be allocated to the reserve fund. Thus the reserve fund allocation would be $27,500 for the period. The same concept would apply if total assessment revenue for the year is less than the $80,000 budget - a prorate to the reserve fund of 25% of that lower amount of total assessment revenues for the year would be reasonable.

<u>The “excess operating funds” quandary</u>

Excess funds - nice problem to have in personal life or in an HOA. Some Declarations - or Board resolutions - direct that “excess operating funds” that remain at the end of an accounting period be added to the reserve fund. Not too confusing really - well, maybe not. <u>Before</u> identifying “excess funds” in the operating fund, it’s appropriate to go through normal allocations of assessment revenues to the reserve fund (see the above and see the first article on this topic). The “excess funds” amount is thus determined after making a proper (base) allocation of assessments to the reserve fund. If the operating fund then has an excess of revenues over expenditures, it has “excess operating funds” for the period. There are many ways to show this additional allocation to the reserve fund in the financial statements. One clarifying approach is to show the transfer of the excess from the operating fund to the reserve fund as a line-item in the income statement <u>after</u> the line captioned “excess of revenues over expenditures” for the year.
The transfer effectively zeros out the excess operating fund revenues.

The important concept here is that the normal reserve fund allocation should be made before arriving at the income statement line that might be called “excess operating funds.” After that, the transfer of additional dollars from the operating fund to the reserve fund can be made. If a transfer of this nature is made, a footnote such as the following provides insight into what has been done:

> **NOTE X. TRANSFER**
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> The Association transferred the 2002 operating fund excess of revenue collected over expenses paid to the reserve fund. This reflects the Board’s decision to direct all such excess operating revenues to the reserve fund.

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 first article in this two-part series suggested that the basic ground rule is simple: reserve fund additions and reductions are the result of <u>documented</u> <u>decisions</u>; reserve fund additions and reductions do not result from serendipitous out-of-cash or cash transfer events, or from mere discussions on the topic. This article provides some reserve fund logic for two “unconventional” situations - the pre-build out situation (use a <u>prorate</u> method) and the excess operating funds situation (determine the excess <u>after</u> making the base reserve allocation from the operating fund to the reserve fund).