The Operating Fund is Important Too!

By Sue Nelson, CCAM®

Probably every CAI member is aware of reserves, reserve studies and reserve funding. But what about the operating fund? What is it and why is it important?

For common interest developments (CIDs), the operating fund receipts are the HOA fees and other miscellaneous receipts such as laundry and late fees. Expenses are generally insurance, taxes, utilities, administrative and legal costs, maintenance and repair costs, etc. The detail of what is received and spent is shown on an income statement, and the overall net worth of the CID is shown on a balance sheet.

The Balance Sheet. To simplify the balance sheet concept, let's look at Joe Homeowner's net worth. He has assets, liabilities and equity (net worth). His assets are his cash, his investments, his house and his car. His liabilities are his mortgage, his credit card debt and his car loan. His equity is what is really his, without any encumbrances. So Joe's balance sheet would read:

ASSETS	
Cash	$ 2,000
Investments	10,000
House	1,000,000
Car	50,000
Total Assets	1,062,000
LIABILITIES	
House Mortgage	$ 955,000
Credit Card Balance	50,000
Car Loan	45,000
Total Liabilities	1,050,000
Joe's Equity	**$ 12,000**

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Assets – Liabilities = Equity. What you have minus what you owe equals your net worth. So, in this case, even though Joe thinks he is a hot-shot because he owns a $1,000,000 house and a nice car, he really only has $12,000 in net worth – what is *his* free and clear.

Using Your Audit or Review to Evaluate Your Operating Fund. Dig out the annual financial statements from your CID's CPA for the last few years and look at the balance sheets. Usually for CIDs, the equity or net worth is called the fund balance. ***Assets – Liabilities = Fund Balance***. The balance sheet will generally have columns for two or more funds—the operating fund, replacement fund (reserves) and possibly another fund. The operating fund's usual assets (what it has) are cash, assessments receivable (unpaid but collectible HOA fees), prepaid insurance and prepaid taxes. The operating fund's usual liabilities (what it owes) are assessments received in advance (those wonderful owners who paid their January HOA fees in December — it is a liability because it is cash the CID is holding that is not yet due), accounts payable (invoices that had not been paid as of year-end), and maybe deposits made by owners, such as remodeling deposits — the CID is holding the cash, but it really belongs to someone else.

How do we know if our CID's operating fund is healthy? Look in the "Operating Fund" column for the line named "Fund Balances," toward the bottom of the page. This is the operating fund's net worth or equity. The fund balance amount is cumulative, meaning that it takes all prior years' information into consideration. So, if the operating fund balance is $40,000, that means that since the very beginning of the CID when the operating fund started at zero, the fund has grown to $40,000. If next year's expenses are $5,000 more than revenues, then the operating fund balance at that time will be $35,000.

If you are looking at the monthly interim financial reports instead of the CPA's annual report to analyze your operating fund's health, cautions are in order. Some monthly financial reports may not provide enough information for an accurate assessment. For instance, if the monthly reports are on a modified accrual basis, the healthy operating fund target balance would need to be higher than the listed fund balance in order to take into consideration the accounts payable and bad debt reserve that would not be included on the balance sheet.

A Healthy Operating Fund. When budgets are created, normally the budgeted expenses + budgeted reserve transfers =

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the budgeted receipts. So theoretically, on an accrual basis, if all actual receipts and all actual expenses and reserve transfers are exactly on-budget every year, the operating fund balance or net worth would equal zero every year. Of course, this is never the case, as actual receipts and expenses fluctuate from the budget, and, therefore, the operating fund balance — the net worth of the operating fund —could be a positive or a negative number.

The operating fund balance should be a positive number. My general rule-of-thumb is that the operating fund balance on the audit or review should be at least one-half (½) of one month's total HOA fees. If the number is several times more than one month's HOA fees, the operating component of the HOA fees may be higher than needed, and your board may want to consider a permanent transfer of excess cash to reserves or may want to consider putting a line into the budget next year to reduce the operating fund. If the excess operating fund is used to subsidize the next year's HOA fees, be very conservative and draw it down over several years, as once the excess is used, there will need to be an increase in the HOA fees to cover the lack of subsidy.

There are, of course, many valid reasons to keep a higher operating fund balance. One reason would be so that the CID can prepay insurance to keep from having to finance the premium or borrow from reserves. In that case, a higher operating fund balance would be proper.

How do you fix a negative operating fund? The two remedies are increasing revenue and decreasing expenses. The board and management need to take a hard look at the HOA fees and the realistic costs to run the association.

But What if the Operating Fund Balance is Negative? If the operating fund balance is negative, that means that the HOA fees have been historically insufficient to cover the actual costs of operating the association and making the reserve transfers. If the HOA fees have not been significantly increased recently, the downward spiral will most likely continue. If the negative number is reasonably close to zero, perhaps 10% of one month's HOA fees or less, there may be little cause for concern. If the number is large and/or growing increasingly negative year-over-year, then there may be serious cause for concern.

What Happens with a Negative Operating Fund? Usually, first the operating cash dwindles. There isn't enough money

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to pay the bills and make the reserve transfers, so fewer reserve transfers or no reserve transfers are made. Borrowing from reserves is necessary to pay the operating bills. Decisions have to be made to prioritize which bills are paid first and which are aged. The cash flow has to be watched on a daily or weekly basis to decide when to pay the bills, based on the bank account balance.

Why Did It Happen? Usually this happens because the board decided to not increase HOA fees or did not increase them enough to cover the actual expenses of the community. Maybe the insurance or utility costs increased or there have been large water damage or mold remediation costs and the budget wasn't adjusted to reflect the higher numbers. Maybe there have been significant bad debt write-offs. Or maybe board members campaigned on the promise of not increasing HOA fees. Those CIDs where the HOA fees have not increased substantially for five or ten years are often the ones with the most serious operating fund (and usually also reserve fund) deficits.

How Do You Fix a Negative Operating Fund? The two remedies are increasing revenue and decreasing expenses. The board and management need to take a hard look at the HOA fees and the realistic costs to run the association. Divide the operating fund balance by the number of units. That figure is the total amount that the HOA fees were deficient, on a per-unit basis, at the end of the last fiscal year. If the operating fund balance is ($12,000) for a 100-unit complex, $12,000/100 = $120 per unit deficit. $12,000/12 months = $1,000 per month. This deficit could be remedied by adding an "increase operating capital" line to the budget in the amount of $1,000 per month for the next fiscal year. If the deficit is extremely large, it may need to be addressed over several years or addressed as a special assessment. Note: this "increase operating capital" budget line is independent of and in addition to any contingency expense or bad debt write-off expense in the budget and is over and above any HOA fee increases needed for the next year's anticipated expenses.

How to Avoid the Problem? To avoid this problem, budget to correct the past mistakes and react quickly when expenses go out-of-whack. When working on the next year's budget, be sure to look at the operating fund balance from the last audit/review and also look at any current year loss and factor them into the budget as an "increase operating capital" line. And when significant unusual expenses occur that will put the budget in the red, special assess. It is much easier to special assess right when the earthquake insurance increases instead of trying to catch up years later when there is a cash crunch because prior years' expenses were over-budget.

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It's Only Fair. A large negative operating fund balance needs to be addressed and turned around, the sooner the better, as these things tend to snowball and get worse every year. Not only is this an issue of financial health for the CID, but just like reserve deficits, it is an issue of fairness. The reality is that the owners who historically lived in the complex did not pay enough to cover the costs of the services they received. The sooner the deficit is addressed, the more likely the people who received the services will also be the ones to pay for them, instead of pushing the deficit into the hands of future homeowners who will have to pay the prior owner's bills. This should also improve the salability and sales price of the homes in the CID, as the financial condition of the CID is important to savvy buyers, lenders and real estate professionals.

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