

Financial Statement Explanation - 9/2/12

In my summary of the August 2012 Board meeting, I included a section on the “Contingency” account and a related proposed policy. I ended with the following comment:

“Further, it was noted that, if the Board decides to spend more than is allowed in the budget, it simply means that the contribution to the road reserve fund for that year will be lower than budgeted”.

I noted that my sentence would only make sense with a good understanding of our financial statements; primarily the income and expense statement. This paper will hopefully provide a basic explanation of that statement; following which I will try to explain that sentence.

If you wish to skip straight to the explanation of the sentence, feel free to go to page five to the section entitled: **Summary and Explanation of “the sentence”**.

But I strongly suggest you not do so unless you already feel comfortable with the format of the income and expense statement. My explanation may look daunting, but it really isn't that bad. If you follow along step by step, it may take a little time, but it will hopefully be easy to understand. For those rolling your eyes at the length of this, please understand that this cannot be explained in a few sentences. If you want that, go to twitter. Absent the ability to present this in person with flip charts, this was the best I could do.

To make this explanation work, you will need to print just the income and expense statement (not the balance sheet) from our 6/30/12 statements. It is five pages long, located after the first two pages consisting of the balance sheet, and can be found on the web site here:

http://www.governorsclubpoa.com/document/2884174326fund_balance_balance_sheet_income_statement_-_june_12.pdf

As I refer to specific accounts, it will help a great deal if you can follow along by looking at the statement itself and finding the numbers that I have referenced. Please note that, in this summary explanation, I will show negative numbers or losses in parentheses.

First key point: The statement is divided into two parts; an Operating Statement and a Replacement Fund Statement. Both have income and expenses. In the June statement, the Operating Statement ends in the middle of page four and shows a year-to-date variance of a positive \$106,887.85. Immediately following that is the Replacement Fund statement which ends on page five with a year-to-date Net Reserve Activity negative variance of (\$25,221.56). These two variances net out against each other to show a year to date “Current Year Net” positive variance of \$81,666.29. The simple equation for netting out the two numbers is: $106,877.85 - 25,221.56 = 81,666.29$

The differences between the income and expense items in the Operating Statement and the Replacement Fund Statement generally have to do with whether the item is of a “capital” nature. Anything generally related to capital expenditures is coded to the Replacement Fund Statement; the two largest categories being road repairs and storm water drainage repairs. For our purposes, it doesn't matter too much

whether the expenses are in the Operating or the Replacement Fund statement. We will look more closely at the nature of the Replacement Fund accounts later.

Let's first look at a simplified format of this statement. I will use the account names and column headings used in the statement; and provide year-to-date actual numbers (not variances) and total 2012 budget numbers so that you can follow along. Please note that I will use the total numbers in each category and not show the sub-categories. The totals I show will match those on the statement so that you can follow along. I recommend not proceeding any further until you find the numbers I have referenced; as that will allow you to better see the statement format.

<u>Operating Statement</u>	<u>YTD 6/30/12</u>	<u>2012 Budget</u>
Operating Revenue (labeled "Subtotal Revenue")	\$2,250,692.96	\$2,293,426.00
Less "Total Operating Expenses"	<u>(\$1,110,640.11)</u>	<u>(\$2,293,426.00)</u>
"Net Operating Income (Loss)"	\$1,140,052.85	0.00
 <u>Replacement Fund</u>		
"Replacement Fund Income"	\$ 304,312.21	\$ 584,765.00
"Replacement Fund Expenditures"	(\$ 180,820.76)	(\$ 255,000.00)
"Capital Contribution Expense"	<u>(\$ 49,525.01)</u>	<u>(\$ 30,950.00)</u>
Replacement Fund Income (Loss) ("Net Reserve Activity")	(\$ 73,966.44)	\$ 298,815.00
 <u>Combined Result</u>		
"Current Year Net Income (Loss)"	\$1,214,019.29	\$ 298,815.00

Note: That last figure of \$1,214,019.29 is the net of the Operating Statement income of \$1,140,052.85 less the Replacement Fund loss of (\$73,966.44). Same with the budget column.

To fully understand our cash position, you need to look at the net bottom line of both statements (the last number); not just the Operating Statement result.

Second Key Point: The vast majority of our income (from dues) is accrued at the beginning of the year. Therefore, our monthly "year-to-date" statements will show a gradually decreasing Net Income position from January to December. Essentially, we get all the money early in the year and then use it to pay expenses over the course of the entire year. Therefore, showing a net income of over a million dollars at the middle of the year should not be misinterpreted as a stupendous result. During the year, the more important numbers to watch are the variances.

If you look at the budget for the entire year (right hand column), you will see that the Operating Statement for the entire year was budgeted to show a fully break-even position; no net income or loss. Then, in the Replacement Fund Income, you will see \$584,765.00. You might ask where that money came from. The answer, which we will get to shortly, will show the interrelationship between these two sets of accounts.

Third Key Point: The total amount of dues we pay each year exceeds the cost of running our community. This is deliberate. Starting in 2008, dues were increased so that there would be a large surplus every year, and these excess funds have been accumulating in a reserve account for future road work.

The amount allocated to the road reserve fund has varied year to year between \$300,000 and \$500,000. At the beginning of 2012, there was roughly \$1,350,000 in available cash in the road reserve fund.

Now, look at the summary 2012 budget numbers I outlined above, and you will see the expected contribution to the road fund for 2102 which totals \$298,815; that being the bottom line number after netting out the two sets of accounts. This \$298,815 is essentially what we budgeted to have at the end of the year after all expenses were paid. Assuming the budget is met, this amount will be added to the road reserve fund at the end of the year resulting in a new total of approximately \$1,650,000.

Let's go back to that figure of \$584,765; which represents the Replacement Fund Income. To understand where this came from, go back to the income and expense statement you printed out from the web site. Look at page 4 at the Replacement Fund Income section. The line coded as "08130" on the far left side is labeled "Operating Contribution" and totals \$544,765 in the far right "Yearly Budget" column. You will see that this is by far the largest portion of the budgeted total income figure of \$584,765.

Now, as to where that income came from, look further up on the same page to the bottom of the Operating Statement. You will see a line coded "08000" and labeled "Replacement Fund Contribution". Lo and behold, the budget figure for the year (far right column) is \$544,765; which is exactly the same number in the "Operating Contribution" line of the Replacement Fund Income.

What is happening is simply a reallocation of income out of the Operating Statement (showing it as an expense) and into the Replacement Fund account (where it is shown as income). It is nothing more than an accounting method to move the income down into the Replacement Fund.

So, why is this being done? The answer has to do with the nature of expenditures in the Replacement Fund accounts and the fact that there has to be some income to offset those expenses. And this shifting of funds provides the "income" to offset the expenses in the Replacement Fund. Frankly, all of this activity could be consolidated into one statement; but somewhere along the line, it was decided to arrange the accounts in this manner. So, let's just run with that.

There are essentially four important accounts within the Replacement Fund Account numbers. There are other accounts, and they do have a slight impact, but there are really only four that are significant. Let's describe them in reverse order from bottom to top; and you can follow on your copy of the statement in the far right hand column. Note that any capitalized terms shown below will match those on the statement. All numbers used are "Yearly Budget" numbers; which are in the far right column.

Also, to the extent I can, I will refer to coded line numbers for particular lines, and these are on the far left side of the statements. These references will allow you to track the exact numbers that I use in these explanations.

“Net Reserve Activity”

This is the second to last number on the statement and is shown as \$298,815. This is the net after accounting for all Replacement Account expenses. This number is then netted against the Operating Statement profit or loss to determine the Current Year Net Income; which is essentially what can go into the road reserve fund. In this budget, the entire \$285,815 becomes the Current Year Net Income (one line below) because the Operating Statement was budgeted to break even at zero.

Let’s examine one hypothetical situation to ensure that the understanding is complete. Had the Operating Statement budget shown a loss of \$100,000 (instead of breaking even), then the \$298,815 would have been netted against that loss to result in a budgeted Current Year Net Income of only \$198,815; or \$100,000 less than the original budget of \$288,815; and that smaller amount would have gone into the road reserve fund.

“Storm Water Management”

This is on page 4 in line 08210. The budgeted amount of \$135,000 represents the anticipated cost of two groups of storm water repair projects. The first group consists of what I refer to as a “to-do” list of items which have been identified as needing remediation. Some of these “to-do” projects may be more critical than others, and some can probably be put off for a while. Nevertheless, they represent work which eventually needs to be done to preserve our infrastructure and the value of the community.

The second group consists of projects that are unexpected; for example, some type of broken or failed line that was not anticipated.

As you can easily see, the budget number of \$135,000 of something of a guess; since we can’t predict what might fail and require replacement during the year. Furthermore, it is sometimes difficult to estimate the cost of the projects on the “to-do” list; because the extent of work needed on these jobs is often not known until the problem is literally uncovered.

Therefore, whether or how soon during the year we reach the budget limit is a function of many factors; such as the actual cost of the “to-do” projects, the number of unexpected projects that arise during the year, and the cost of those unexpected projects. If the number and cost of unexpected jobs results in the budget number being met before the “to-do” projects are finished, there are two ways to address the unfinished work. Either funds will be pulled from other areas of the budget or the projects will be put off until the following year.

“Road Expenses”

This is also on page 4 in line 08220. This budget number of \$120,000 is handled in exactly the same way as the Storm Water Management line; except that it deals with road repairs. Some road repair projects are on the “to-do” list, and some are unexpected. Shortages here are handled the same way as the storm water repair shortages.

These two expense categories are by far the largest in the Replacement Fund accounts. There are others, however, and one serves as a good example. If you look at the bottom of page 4 in line 08350, you will see the Lystra Gate Improvements. This is the line containing expenses related to the conversion of the back gate to allow for unmanned status at night. You will see the budgeted amount of \$14,850 and an amount spent to date of \$40,857; resulting in a negative variance (or cost overrun) to date of just over \$26,000. Since this is a capital related item, somebody decided to put it in the Replacement Fund accounts; driving home the point that you need to look at both sets of accounts to see how we are doing.

“Operating Contribution”

This item is on page 4 in line 08130 with a budget number of \$544,765. This is the amount budgeted by the Board to cover anticipated expenditures in the Replacement Fund accounts. But you can now see that most of this is for the storm water system and road repairs; along with anything else of a capital nature that crops up; and then whatever is left over goes into the road replacement fund. As noted earlier, there are other minor sources of income for the Replacement Fund, but this is by far the largest.

To summarize, the \$544,765 was moved from the Operating Statement down into the Replacement Fund accounts where it primarily funds road and storm drainage repairs; with the leftover balance going into the road reserve fund. (Yes, there are other miscellaneous income sources and expenses in the Replacement Fund Statement, but nothing of a significant nature.)

Summary and Explanation of “the sentence”

Now that we have covered the two sets of accounts and seen how they combine at the bottom of the statement, let’s go back to the sentence I mentioned earlier:

“Further, it was noted that, if the Board decides to spend more than is allowed in the budget, it simply means that the contribution to the road reserve fund for that year will be lower than budgeted”.

Hopefully, this should now make sense: especially if we re-visit the hypothetical situation I just used above:

Had the Operating Statement shown a loss of \$100,000 (instead of breaking even), then the \$298,815 would have been netted against that loss to result in a Current Year Net Income of only \$198,815; or \$100,000 less than the original budget of \$288,815; and that smaller amount would have gone into the road reserve fund.

Let’s put it a different way. For example, if more money is spent this year than allowed in the budget, there is essentially a \$298,815 cushion that will absorb the hit. We will not, in a cash accounting sense, incur a loss. Rather, we will simply have less money to put into the road fund. Of course, if the budget is overspent by more than \$298,815, then we might have a cash flow problem; because the cushion is only so big. However, it seems highly unlikely that would ever happen.

Please don't think that the statement made by the directors implied that they were planning to exceed the budget just because of the presence of this cushion. I don't believe that was the case at all. In fact, since this road reserve funding process started, the contributions at the end of each year have been pretty much in line with budgeted numbers.

But the statement does highlight what is has been understood by those who are familiar with the nature of our statements; namely that the budget can, to a certain extent, be exceeded without an immediate cash impact. Rather, the cash impact will be longer term in the form of a lower than expected road reserve fund.

After this long explanation, hopefully, you now see that as well.

Understanding the Variances (in case you are interested....)

To better understand our year to date position, let's go back and examine the "Year-to-Date" numbers in this statement. First, remember what I said about income. It all comes in at the beginning of the year, and we gradually spend it over the course of the year. Therefore, when looking at a statement in the middle of the year, you don't really want to focus on the net income position. Rather, you want to look at the expenses and how they might have varied from the budget. In other words, the most important column is the year-to-date "variance" column, which is the second to last column on the right.

This statement covers the period from January 1 to June 30th. Let's summarize the significant variances that are in the statement. Please note; there are lots of small variances, and this will only cover significant items.

Line 06820 – Projects Storm Maintenance	\$57,323.55
Line 07040 – Legal	\$27,864.90
Line 08010 – Contingency	\$24,996.00
Line 08120 – Road User Fees	\$10,539.30
Line 07960 – Bad Debt Expense	(\$15,374.14)
Line 08210 – Storm Water Management	(\$21,491.59)
Line 08350 – Lystra Gate Improvements	(\$26,007.79)

So, we see plusses and minuses which, when taken with all the other less significant variances, result in a net total year to date variance of \$81,666.29; which you can see as the last number in the second to last column on page 5 of the statement.

Important Point: You cannot necessarily come to any conclusions by simply looking at these numbers on their own. In many cases, you need to understand the stories behind them. Let's look at a few, and you will see why I say this.

Project Storms Maintenance:

This number looks good mid year because we had a very mild winter with little in the way of snow removal costs. If there are no problems through the rest of the calendar year, then this may end up as a significant positive variance; which would be a good thing, because it would allow us to spend the

money on other projects or put the excess into the road reserve fund. On the other hand, if we get hit by a hurricane this fall, this is the account which will absorb any costs resulting from that event; downed trees, etc. So, it is too soon to say if this variance will last.

Lystra Gate Improvements:

This is a perfect contrast to the account above. Here we have a cost overrun of \$26,007.79 that is shown in the negative variance. The work is pretty much complete, so if there is any increase at all, it will probably be insignificant. But, you can count on this negative variance to be at least this large at the end of the year. There is nothing that will cause this negative variance to get smaller.

Storm Water Management:

Examining this one, in turn, provides a good contrast to the Lystra Gate account above. The year to date negative might be somewhat misleading. While it shows as a negative variance year to date, you can see that the actual amount spent of \$70,900 is well below the yearly budget of \$135,000. Timing of expenditures is the key issue here. The budget simply assumes that one twelfth of the \$135,000 yearly budget is spent each month; but there is little chance that the timing of our expenditures will match that assumption; and, in this case, it hasn't. So, the fact that there is a negative variance may not mean anything at all other than differences in timing.

Similarly, the Road Expenses account has the same issue. Therefore, in either of these accounts, there is really no way to tell from these statements whether we are on track to be under budget or well over budget. Knowing where we stand on these two accounts requires a detailed understanding of what projects have been completed to date (and at what cost) and what projects remain to be done before year end (and at what cost). You will not find that information in these statements. It can only be obtained through the infrastructure committee. More on that shortly.....

Contingency:

I almost hesitate to mention this, because it is primarily an accounting issue. But let's give it a shot.

This account has a budget of \$50,000 for the year, and it assumes that one twelfth of that amount is spent every month. As you can see from the statement, nothing has been "spent" (coded) here, so there is a positive variance equal to about half of the account value. But, that does not necessarily mean anything for two reasons. First, there are clearly overruns in numerous accounts, some significant and some not. But, rather than having coded the overruns to the "contingency" account, these overruns are shown in their respective accounts so that we can see where they occurred. In my humble opinion, that is precisely the way to handle any such expenditure. Because, if you code an amount to the "contingency" account, you have no idea what it represents; whether it was an overrun or even what type of an expense it was.

I suspect nothing will ever be coded to this account directly. Instead, the contingency will show as a positive variance and will be offset by other negative variances when getting to the bottom line number. Let's use a very simple example. Look at the budget for 2012 and assume that, at the end of the year, every single expenditure was exactly on budget. In that event, the Net Operating Income in the

Operating Statement would not be zero. It would be \$50,000; because that is the amount of budgeted contingency that we did not spend.

Alternatively, assume that every single expenditure was precisely on budget but that there was an unexpected expense of \$100,000 for a new expense line called “New Sewage Plant” for which there was no budget money allocated. In that event, the negative variance of (\$100,000) in this new account line would offset against the positive variance of \$50,000 in the contingency line to result in a Net Operating Loss of (\$50,000). But, at least you would know where the overrun occurred; because you did not code the unexpected expenditure to an amorphous “contingency” account.

Last item.....we’re almost there.....

Let’s go back to the Road Repairs and Storm Water Repairs accounts. I mentioned that there is no way to look at these statements and determine if we are on track to be on budget, under budget or over budget. You need to do a projection of expenditures to the end of the year in these two accounts (and pretty much every other account) to make that judgment. And that is one of the tasks of the Finance Committee. That committee periodically reviews expenditures to date, talks to the various committees and management, and then projects expenditures through the end of the year. With this information, the committee makes its best guess as to where we might stand at the end of the year in relation to the budget.

Now, if you go back and look at the following section from the August Meeting Summary, it might make more sense:

Last month, I reported the following:

Mike Donoghue reported that the Finance Committee expected a “surplus of \$100,000 at the end of the year assuming no unexpected emergency spending during the second half of the year”.

Three months ago, the Finance Committee forecasted being on budget for the year; including the budgeted \$300,000 contribution to the road fund. If we are now \$100,000 ahead of that forecast, that would be good news. I am still working on determining how this happened. If there is anything further to report, I will do so in a separate post.

I was still in the process of looking more closely at this when the subject was brought up at this meeting. Mike Donoghue reported that, after meeting again with the Finance Committee, it was felt that this prediction should be amended to remove the reference to a possible \$100,000 positive variance and indicate that the committee expects to be on budget for the year.

In other words, the committee’s best guess at this time is that we will have the \$298,815 to contribute to the road reserve at the end of the year.

If you got this far, thanks for your patience. I hope you found the effort worthwhile.

Feel free to e-mail me if you have any questions: enwiggen@nc.rr.com