INFORMATION

TAHOE DONNER

March 15, 2018

Financial Reporting: Net Operating Results (NOR)

The purpose of this discussion is to get Board insights into the feasibility of expanding NOR so that it would also include the 1) allocation of Overhead (NRAO)and 2) related depreciation and other charges (NRAOC) and thus provide Members with a stronger perspective on amenity profitability.

Background:
Current financial management reporting presents each amenity's Net Operating Results (NOR) which is simply operating revenues less operating costs. 2004 and prior, the association's annual report was simply a glossy of the auditor's report and audited financial statements and a one page of narrative. Starting in 2005, the association's annual report was expanded to include departmental results, which is the 1st noted introduction of the term 'Net Operating Results'. Current NOR does not fully reflect the overall costs of amenities financial performance, as current NOR does not include an overhead or capital cost charge, which are both real costs of the amenities.

Operating Fund and Overhead Charge to Amenities
There are certain operating costs of the association which are operating activities that service the entire association and are accounted for as a distinct operating unit., The services are for all of the operating amenities of the association. Allocated overhead is common in management accounting, particularly in certain industries such as manufacturing, financial services and many others Through 2008, the association allocated certain of these costs ($1,440,000 in 2008) to amenities receiving the services. This was a separate cost element, and therefore was reported as Net Operating Result Before Overhead (NORBO) less Allocated Overhead = Net Operating Result (NOR). This had the effect of moving $1.4 million from HOA grouping to Amenities grouping in the financials. During 2008, the Finance Committee recommended and Board approved elimination the Allocated Overhead cost charge to amenities starting in 2009. The overhead charge was deemed to not be adding value nor influencing decision making.

One of the cited benefits of allocating overhead costs to operating departments is to assist in pricing decisions and gain a better understanding of an amenities overall contribution. Further, with amenities reporting NOR without any overhead, their respective financial results are not wholly complete, as there is no administrative departments costs (nor capital costs). Users of financials solely focused on the NOR of an amenity can mistakenly take that NOR result as the operations net all-in result, which is not the case. For the cited drawbacks of allocating overhead costs is the lack of understanding by department managers and others, as well as, the cost/benefit of calculating and reporting with reasonable accuracy.

The annual review and establishment of amounts in Budget adds some complexity to budget process. The monthly recording of allocated overhead to budget amount is simple. If a overhead charge was reported, said would be after NOR, wherein, NOR minus Overhead Charge equates to Net Result after Overhead (NRAO). Allocating overhead is a Board decision, based on the pros and cons of adding value to decision making.

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<u>Operating Fund and Capital/Depreciation Charge to Amenities</u>

The cost of capital or depreciation has been generally viewed as a cost burden for all members. Capital investments benefit all members, whether participants or not in the specific amenity investment. However, by not showing a capital/depreciation charge at the amenity performance level, the amenities overall financial cost is not fairly presented.

T**he Annual Report has consistently included a capital charge** for the cost of replacement reserve funding (RR funding) by amenity/hoa operation as a reference and for information purposes. It historically has not been shown with NOR. This funding amount is greater than depreciation expense, as certain assets are fully depreciated. However, the reserve funding does not include building replacement. Further Land is not a depreciable asset. The question of rent (land and building) arises when conceptualizing a capital cost and or depreciation charge. Using the replacement reserve funding level provides consistency in analysis over time, versus actual expenditures, which can vary widely year to year.

Using the RR funding is also relevant, in that this is what drives the Annual Assessment. In other words, the Operating NOR drives Assessment operating portion, and capital funding level drives Assessment capital portion (not capital spend in the particular year). Although there would be intent to allocate depreciation from a management reporting perspective TD would not be changing the principles used in its legal accounting.

If a capital and or a depreciation charge was reported, said would be after NOR and Overhead, wherein, NOR minus Overhead and Capital/Depreciation Charge equates to Net Result after Overhead and Capital (NRAOC).

Allocating a capita/depreciation charge to amenities is a Board decision, based on the pros and cons of adding value to decision making.

Summary

Charging amenities for overhead and capital/depreciation costs adds additional financial performance and 'all-in' costs visibility for each amenity and can potentially serve as an important tool in providing the additional full 'complete picture' understanding of amenities financial performance. It may also lead to a greater pricing perspective as the total cost picture is better understood.

The next page Addendum provides certain additional overall financial accounting information regarding the association.

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Board Meeting Review Date: March 24, 2018

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ADDENDUM

Overview
The association maintains and reports its financial activities in accordance with Generally Accepted Accounting Principles (GAAP). The Association's governing documents provide certain guidelines for governing its financial activities. To ensure observance of limitations and restrictions on the use of financial resources, the Association maintains its accounts using fund accounting. Financial resources are classified for accounting and reporting purposes in the following funds established according to their nature and purpose:

Operating Fund – Used to account for financial resources available for the general operations of the Association.

Replacement Reserve Fund – Used to account for financial resources designated for the repair, restoration, replacement or maintenance of, or litigation involving repair, restoration, replacement or maintenance of, major components which the Association is obligated to repair, restore, replace or maintain and for which the replacement reserve fund was established.

New Equipment Fund – Used to account for financial resources designated for the purchase of new equipment, furnishings and fixtures.

Development Fund – Used to account for financial resources designated for use in the acquisition and enhancement of facilities, equipment and other resources.

Property Fund – Used to account for the Association's investment in its common property and equipment, and other Association real property. Accounts for the fixed assets and associated accumulated depreciation and depreciation expense.

Key Financial Reports
There are three key financial management reports produced for the Association.

1. Monthly Financials Report - comprehensive summary and detailed reports providing financial results as well as, numerous other information on a timely basis. [issued monthly via website]

2. Annual Report – a comprehensive summary report of actual financial results for the past year and includes the annual audited financials and auditor's report. [issued with May TDNews and website]

3. Budget Report – a comprehensive summary report of board approved upcoming budget year. [issued with December TDNews and website]

Commentary on Net Operating Results
by Dick Gander
3/28/18

While I was not able to attend the last board meeting and cannot attend the next, I did watch the discussion on Net Operating Results with interest. Please consider the following as input into your decision process.

Allocations and Argument

One of the key arguments for allocation was that line managers would argue for lower allocations if it was visible to them and presumably that tension would result in lower cost services from “corporate departments” such as HR, IT and Accounting. One thing it would certainly result in is pitting managers against each other and unproductive gaming of the system. Now, this is a common management philosophy across business but it is by no means the only management philosophy. In fact, I would argue it is an outdated philosophy. I believe it is particularly not appropriate for a hospitality business.

A better approach is to hold managers accountable for what they have control over and to encourage those managers to work together for the greater good. This includes the managers of those corporate departments. From my experience over the past 8 years in being deeply involved in the Association, this is in fact the philosophy practiced here.

Why is this appropriate?

As mentioned, we are in the hospitality business. Our members expect service, whether at a restaurant, a swimming pool or in a class. They want happy, attentive employees that anticipate their needs and provide excellent experiences as well as value. When you think about how our departments actually run, you will see that this *requires* our line managers to work *together* to deliver.

Let’s take Cross Country as an example. To make that a complete offering and support her pricing levels, Sally needs a well operated food and beverage operation to serve her guests (and Mike needs a well run CC operation to fill seats in his restaurant). She needs a responsive maintenance department to ensure her groomers and equipment are available and efficient. She needs a responsive marketing department to publicize her events. She needs a reasonable and insightful accounting department to set her rates. She needs a point of sale system and other IT infrastructure to run her department. She needs Operations to support her special events with additional staff. She needs the support of forestry and trails to help keep her trails maintained in the summer. She needs risk management to obtain the right insurance to protect our guests and members. This same intertwining of departments applies to every one of our ‘line’ departments. Also, please don’t forget that many times a given employee may work in more than one of those departments in any given year or even day.

You can see, the critical importance of managers working together to deliver the whole product. You can also see how allocations across profit/cost centers is challenging to say the least. Do we want the maintenance guy clocking his time working on the CC groomer vs the DH groomer vs changing the oil on a truck? Since the point of sale is used by Cross Country and Equestrian and BikeWorks, how would you cross charge the cost of the computer? Would that level of overhead provide value in this tiny operation or would it lead to people playing the system? Oh, you say that would be onerous, just allocate by formula. How does that really change what we do today? What is one decision that would be impacted by that data?

The last thing we need is for arguments in staff meetings about allocations! Now, all of intertwined costs need to be balanced and controlled because not everyone can have everything they want. Our senior staff know that very well - their bonus depends on it. They are the point where all of this comes together. This is where decisions of allocations belong. They decide the relative benefit of X is a better place to spend marketing or IT or maintenance budget than the alternative. I suppose sometimes this involves one manager against another as they ask for what they need, but I suspect (because I know these people) that is more of a discussion and consensus they all can support.

Fund Accounting

We use a concept called fund accounting in our management accounting that separates our focus when looking at the overall performance of our Association. Yes, this is different from most for profit businesses. But it is very common for non-profit businesses and HOAs. For those used to looking at Fortune 500 financial statements, it may seem odd and it certainly takes a bit of time to get used to.

At the highest level we have five basic funds: Operating, Replacement Reserve, New Equipment, Development and the Property Fund. Our members contribute directly to the first 4 of these and so, the concepts they represent need to be kept clear and simple.

The simplest way to show impact of a department's results on the Operating Fund is to show Net Operating Results - did this department make the Operating Fund go up or down? Factors that influence those results range from the weather to how a line manager sends staff home on a slow night at the Lodge to how the Chef orders food. Each manager has a different set of challenges that they need to manage while meeting their service levels and to keep overhead at a minimum, they need to be managed by senior management that know each operation intimately. We have built just such a staff today. And don't forget that their bonus pool is funded by their performance!

Replacement Reserve, New Equipment and Development are very different types of funds. Where the Operating Fund is our checking account, these our savings accounts. Estimates, especially involved for Replacement Reserve, are made and our assessment provides the primary funding. Should we have better than expected operating results, the excess can be moved to 'savings' from time to time to supplement assessment dollars. How this money is spent in any given year is a *completely* different process. Reserve Replacements are on a 30 year horizon but any given item may move up or down on priority from year to year - the point of the estimates is to make sure we have adequate savings to cover that item and any emergency. The Development Fund is spent largely through the Capital Spending Process and the GPC.

The Property Fund is yet another different type as it holds fixed assets and related accumulated depreciation and depreciation expense. For example, when a new building is finished or we buy a new truck, it's value is held in this fund going forward and depreciated as appropriate.

Keeping these funds separate keeps this entire process simple.

Home Owners Association

Lastly, I point out that as an HOA, the board has different obligations than a corporate board. You have fixed assets that you are *obligated* to maintain. Not investing in repair or replacement is not an option. Eliminating an original amenity is not an option. Now, you do have lots of options on how much to spend, how much to patch vs replace, what service level to provide, etc. That is a value choice you must make with the best interest of the Association as a whole at top of mind. That value choice will translate into something the membership values more than money - their enjoyment of our amenities and services. It isn't all about profit and loss.

Because you have limited options regarding plant and equipment, you have a sunk fixed cost to deal with. Could you close the Lodge restaurant? Sure, I suppose as our main restaurant was closed years ago. Should you? Don't think so.

So, how does one manage a business with large fixed costs? You manage your variable costs/income effectively. Every marginal dollar of variable income over variable cost results in those fixed costs delivering more value. So the key, in other words is, ta da, Net Operating Results!

Now I understand the discussion about understanding capital expenditures impact on the net result of a given operation, especially when considering a major decision like replacement of the Down Hill Lodge. That is easily handled in the context of that decision and once it is done and the building is open, you now have a new fixed cost to deal with vs the old, depreciated asset in need of repair. And, just like the example of Cross Country's interdependence on other departments, a new building will have impact across all of those departments too. All of which should enter into the decision on the operational impact of the new building and a revised business plan for the operation.

In closing, I'd like to point out that the decision to stop allocations some years ago was made in a clear and deliberate process by extremely competent people. It is a completely valid management philosophy that I have seen in many businesses over my years of consulting with the biggest companies in the country. It may not be what you are used to, but it is working for us. Go with the recommendation of our Treasurer, our Finance Committee, and our General Planning Committee. Put this to bed and spend your time understanding how we run at a deeper level.