

SLIDE 1 – Prorated Expenses (Cover Page)

SLIDE 2

**Financial Settlement of the Transaction**

**Prorated items** – Many of the items to be settled at the closing are partly the responsibility of the buyer and partly of the seller. Some are expense items that the seller has *paid in advance*, where the buyer owes the seller part of the expense.

Some are income items that the seller received in advance, and the seller owes the buyer a part of the income. Others are items the buyer will have to pay *in arrears*, and the seller owes the buyer part of the expense. The method of dividing financial responsibility for such items is proration. With a prorated item, there is always a debit to one party and a corresponding credit for the same amount to the other party.

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**Prorated items – Items paid in advance**

At the time of closing, the seller has paid some items in advance that cover a period of time that goes beyond the closing date. In effect, the seller has prepaid some of the buyer's expenses, and the buyer must reimburse the seller. Hazard and flood insurance premiums are typical items. By the same token, the seller of a rental property may have received rent or rental deposits in advance, and must reimburse the buyer for the part that belongs to the buyer.

For an expense the seller paid in advance, *the buyer receives a debit and the seller receives a credit.*

For income the seller received in advance, *the buyer receives a credit and the seller receives a debit.*

SLIDE 4

**Prorated items – Items paid in arrears**

At the time of closing, the seller has incurred certain expenses that have not been billed or paid at the time of closing and that the buyer will have to pay later. Typical items are real estate taxes, utility bills and interest on an assumed mortgage.

For an item the buyer will pay in arrears, *the buyer receives a credit and the seller receives a debit.*

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**Non-prorated items** – Non-prorated items are costs *incurred by one party only*. Items not prorated include those listed below:

|                          | Arrears | Advance |
|--------------------------|---------|---------|
| Real estate taxes        | X       |         |
| Insurance premiums       |         | X       |
| Mortgage interest        | X       |         |
| Rents received by seller |         | X       |
| Utilities                | X       |         |

## SLIDE 6

### Prorated items – Charging shares

If the seller has paid the buyer's share of an item, *charge the buyer for the buyer's share of the period*. If the buyer will pay the seller's share of an item, *charge the seller for the seller's share of the period*. If the seller has received the buyer's share of an income item, *charge the seller for the buyer's share of the period*.

## SLIDE 7

### Prorated items – Charging shares

Who gets charged?

For example, a seller has paid for hazard insurance in advance for the whole calendar year, and is transferring title to a buyer in the month of August. The buyer's share, already paid by the seller, is the amount that pertains to the remainder of the year after the day of closing. This amount should be charged to the buyer, i.e., be debited to the buyer and credited to the seller.

On the other hand, the buyer will receive a sewer and water bill in September for the month of August. The buyer will be paying the seller's share, which is the amount that pertains to the month of August up to and including the day of closing. This amount should be charged to the seller-- debited to the seller and credited to the buyer.

## SLIDE 8

### Computing Prorations

The primary methods of calculating prorations are the 360/30-day method, which computes prorations on the basis of a 360-day year and 30-day month, and the 365-day method, which computes prorations on the basis of a 365-day year.

The 360/30-day method is commonly used for prorating mortgage interest and insurance premiums. Either method may be used for real estate taxes, depending on local practice.

It is customary in most states that the seller owns the property up to and including the day of closing unless stated otherwise in the contract. Thus, the closing day is apportioned to the seller in computing prorations. The method of prorating, if not specified in the contract, will follow local custom.

## SLIDE 9

### **12-month / 30 day method –**

The 12-month/30-day method determines an average daily rate of payment for an item to be prorated *based on a 30-day month and a 360-day year*.

The method consists of the following steps for annual and monthly items.

#### **Annual items**

Identify the total amount to be prorated.

Divide this amount by 12 to obtain an average monthly rate.

Divide the monthly rate by 30 to obtain an average daily rate.

Multiply the monthly amount times the seller's number of months of ownership in the year of the sale up to the month of closing. For the month of closing, multiply the seller's number of days of ownership times the daily amount and add the result to the previous result. The final result is the seller's pro rata share of this item.

The buyer's pro rata share of an item is the total amount less the seller's pro rata share.

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### **12-month / 30 day method –**

#### **Monthly items**

Identify the total amount to be prorated.

Divide this amount by 30 to obtain the average daily amount.

Multiply the daily amount times the seller's number of days of ownership. The result is the seller's pro rata share of this item.

The buyer's pro rata share of an item is the total amount less the seller's pro rata share.

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12-month / 30 day method –

Example calculation for annual item

| Example calculation for annual item  |                                  |      |          |
|--|----------------------------------|------|----------|
| A sale transaction on a single-family house closes on March 2. County taxes for the previous year, to be paid in arrears, amount to \$1,730. The seller owns the house through the day of closing. What are the seller's and buyer's prorated shares |                                  |      |          |
| Total amount due   |                                  | = \$ | 1,730.00 |
| Monthly amount   | $1,730 \div 12$                  | = \$ | 144.17   |
| Daily amount   | $144.17 \div 30$                 | = \$ | 4.81     |
| Seller's shares  | $144.17 \times 2 \text{ months}$ | = \$ | 288.34   |
|  | $4.81 \times 2 \text{ days}$     | = \$ | 9.62     |
|  | $288.34 + 9.62$                  | = \$ | 297.96   |
| Buyer's share  | $1,730 - 297.96$                 | = \$ | 1,432.04 |

**Closing statement entries.** The seller will be charged for the seller's share of the proration; an amount of \$297.96 will be entered as a debit to the seller and a credit to the buyer because the buyer will have to pay the seller's share when the tax bill is received.

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Computing Prorations

12-month / 30 day method –

Example calculation for monthly rent

| Example calculation for monthly rent  |                               |      |        |
|---|-------------------------------|------|--------|
| The house in the previous example has been rented during the listing and selling period at a rate of \$900 per month. Rent for the month of March was paid to the seller on March 1. What is the buyer's prorated share of this rent? The day of closing belongs to the seller. |                               |      |        |
| Total amount received   |                               | = \$ | 900.00 |
| Daily amount  | $900.00 \div 30$              | = \$ | 30.00  |
| Seller's share  | $30.00 \times 2 \text{ days}$ | = \$ | 60.00  |
| Buyer's share   | $900.00 - 60.00$              | = \$ | 840.00 |

**Closing statement entries.** The seller will be charged for the buyer's share of the proration; an amount of \$840.00 will be debited to the seller's account and credited to the buyer's account because the seller has received rent that belongs to the new owner after closing.

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**Computing Prorations**

**365 day method –**

The 365-day method uses the actual number of days in the calendar. The steps in the calculation are the same for annual and monthly prorations.

The steps are:

1. Identify the total annual or monthly amount to be prorated.
2. For an annual proration, divide the total amount by 365 to obtain a daily amount (366 in a Leap Year). For a monthly proration, divide the total amount by the actual number of days in the month to obtain the daily amount.
3. Multiply the daily amount times the seller's number of days of ownership. The result is the seller's pro rata share of the item.
4. The buyer's pro rata share of an item is the total amount less the seller's pro rata share.

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**Computing Prorations**

**12-month / 30 day method –**

**Example calculation for monthly rent**

| Example calculation for prorating annual insurance   |                               |      |        |
|--|-------------------------------|------|--------|
| The buyer in the previous example is taking over the hazard insurance policy from the seller. The annual premium is \$330, paid annually in advance on December 1. Closing is on the following March 2. What is the buyer's prorated share of this item? |                               |      |        |
| Total amount due   |                               | = \$ | 330.00 |
| Daily amount   | $330.00 \div 365$             | = \$ | 0.90   |
| Seller's share   | $0.90 \times 92 \text{ days}$ | = \$ | 82.80  |
| Buyer's share  | $330.00 - 82.80$              | = \$ | 247.20 |

**Closing statement entries.** The buyer will be charged for the buyer's share of the proration; an amount of \$247.20 will be debited to the buyer's account and credited to the seller's account because the seller has paid the buyer's share of the insurance premium in advance.