

**A NEW REALITY SHOW
STARRING....**

YOUR RESERVES!!!

(OZZIE NELSON ?? OR OZZY OSBOURNE??... YOU DECIDE)

**YOU'RE IN THE SPOTLIGHT!!
BE SURE YOU KNOW AND
UNDERSTAND WHAT YOU ARE
TELLING YOUR BOARDS**

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CAGIANUT & COMPANY, CPA - MAY 20, 2010**





There is the “Ozzie Nelson” Association where~

1. There is a separate reserve cash account(s)
2. Fund accounting is used
3. The Association has had a recent reserve study by an onsite professional
4. The budgeted reserve allocations agree with the reserve study
5. The monthly budgeted reserve allocations are transferred each month
6. The reserve expenses are approved by the Board
7. The reserve expense is paid out of reserve cash, or if paid out of operating cash, reserves reimburses operating in a timely manner
8. The reserve expense was budgeted in the reserve study (and, if we really want to be perfect – the amount and timing of the reserve expense agrees with the amount and timing in the reserve study) or if it was not, the Board understands the impact on future cash flow.
9. If money was borrowed by operating it was approved by the Board, the membership was notified, there is a repayment schedule and the monies are repaid on schedule

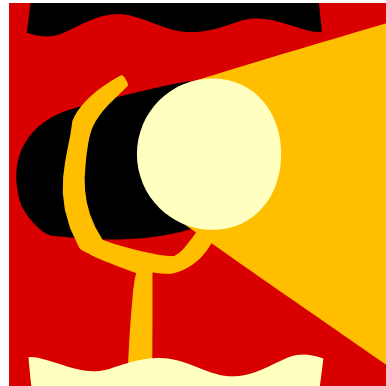
The “Ozzy Osbourne” Association is where~

- Few, if any, of the above are happening...it’s clearly dysfunctional

The REALITY is...your associations are somewhere in between.

We'll spotlight these 9 “perfect association” reserve techniques and view them from the following vantages ~

- ➔ **GAAP (generally accepted accounting principles)**
- ➔ **Industry Standards (National and Washington)**
- ➔ **Washington RCW** (to the best of my understanding ~ you may need to consult with an attorney for a legal opinion)
- ➔ **IRS tax code**





1. There is a separate reserve cash account(s)

GAAP	INDUSTRY STANDARD	RCW	IRS
Not strictly required	Yes!!	Condo – Yes HOA - No	Yes, if filing form 1120 No, if filing form 1120-H

RCW

RCW 64.34.372

(2)... Any reserve funds of an association shall be kept in a segregated account and any transaction affecting such funds, including the issuance of checks, shall require the signature of at least two persons who are officers or directors of the association.

RCW 64.34.380

(1) An association is encouraged to establish a reserve account to fund major maintenance, repair, and replacement of common elements, including limited common elements that will require major maintenance, repair, or replacement within thirty years. A reserve account shall be established in the name of the association. The board of directors is responsible for administering the reserve account.

Comments~

Many governing documents require a separate cash account.

A separate cash account, and not just a segregation of an operating cash account, allows for more controls on the monies and easier accounting.



2. Fund accounting is used

GAAP	INDUSTRY STANDARD	RCW	IRS
Not strictly required	Yes ~ Nationally Trending that way in WA	Not required	1120- Requires strict segregation of activity 1120-H No

GAAP Wording (and note the “real” name of the fund)

972-10-45-2 Common interest realty associations that assess owners annually for portions of future major repairs and replacements shall report those assessed amounts separately from amounts assessed for normal operations. If a common interest realty association uses fund reporting, amounts assessed for future major repairs and replacements shall be reported in the **major repair and replacement fund** separately from transactions in the operating fund. Transfers

GAAP allows nonfund reports but requires an appropriation of retained earnings

972-10-45-4 Nonfund reporting is an alternative to fund reporting. However, fund reporting is more informative to users, because financial statements using nonfund reporting often do not disclose whether assessments have been used for purposes other than those for which they were designated. For example, if nonfund reporting is used, a user of financial statements may be unable to determine whether assessments for future major repairs and replacements have been used in current operations.

972-10-45-5 Because this Subtopic primarily addresses the fund reporting approach, readers should substitute the term members' equity for the term fund balance if financial statements using nonfund reporting are presented. **Furthermore, the fund for major repairs and replacements would be presented as an appropriation of retained earnings in such financial statements.**

Comments – Insurance Fund

Washington is unique in that many of the governing documents are written requiring an “Insurance Fund” to set aside monies for payment of insurance premiums. This was very common 20-25 years ago (nationally) before insurance companies started financing insurance.

In reality, insurance “reserves” are operating in nature and should be included in operating and not in the Fund for Future Major Repairs and Replacement.

Comments – What CAN be included in the Reserve Fund?

Per GAAP – it is wide open. You can reserve for anything you want. Generally, it is for items that do not occur on an annual or recurring basis. You can include insurance deductibles, contingencies and slush funds for potential unexpected events. However, these may cause the fund to be “tainted” for IRS purposes.

IRS – Form 1120 - Capital items (generally those items that can be depreciated in a business). Noncapital items (like painting) need to be adjusted by the CPA at the time of preparation of the tax return. So, while these can be included in the reserve fund and, quite frankly, should be in many cases – there may be tax consequences and/or the tax preparer needs to understand how to adjust the tax returns to account for noncapital items.

Our company policy is that there can be standard noncapital items (e.g. painting, tree trimming) in the fund and we will still prepare form 1120; however, if there are many nonstandard noncapital items we may decide the risk exceeds the benefit.

Comments – Initial Capital Contributions

*The initial capital contributions collected in new developments or conversions are **WORKING** capital contributions. They are to provide the Association with operating monies to build up equity so that there is no cash flow shortfall. They are generally around 2 month's of assessments. This is in keeping with CAI's recommendation that an Association have a minimum of 1/2 a month of operating expenses in the operating fund and up to 2-3 months. Thus, these are not reserve funds and should not be arbitrarily transferred to reserves.*

Comments – Excess Monies

*IF the operating fund does have excess monies at any time, the Board can generally transfer the funds to reserves. If they choose to do so and wish to get the tax advantage, they need to do so based on a reserve study and they must notify the membership. **NOTE: Revenue Ruling 70-604 does not mention transferring monies to reserves. It is a tax election to carryover net membership income to the next year. Then, the next year the Board can transfer the actual monies to a reserve cash account.***



3. The Association has had a recent reserve study by an onsite professional

GAAP	INDUSTRY STANDARD	RCW	IRS
Not strictly required	Yes – Nationally Trending that way in WA	Condo – Yes (unless 10 or fewer units) HOAs - No	1120 - Must be “justification” which most CPAs interpret to me a reserve study 1120-H No

GAAP – Must disclose if there has been a reserve study and must disclose “unaudited supplementary information” or note in the audit report that this information has not been presented. Not required to be done by professional.

972-10-50-3 Common interest realty associations shall disclose the following as unaudited supplementary information:

a. Estimates of current or future costs of future major repairs and replacements of all existing components, such as roofs, including estimated amounts required, methods used to determine the costs, the basis for calculations (including assumptions, if any, about interest and inflation rates), sources used, and the dates of studies, made for this purpose, if any. There is no requirement for common interest realty associations to obtain studies prepared by professional engineers. The estimates may be made by the board of directors or estimates obtained from licensed contractors.

b. A presentation of components to be repaired and replaced, estimates of the remaining useful lives of those components, estimates of current or future replacement costs, and amounts of funds accumulated for each to the extent designated by the board.

RCW

RCW 64.34.380

(2) Unless doing so would impose an unreasonable hardship, an association shall prepare and update a reserve study, in accordance with the association's governing documents and RCW [64.34.224](#)(1). The initial reserve study must be based upon a visual site inspection conducted by a reserve study professional.

(3) Unless doing so would impose an unreasonable hardship, the association shall update the reserve study annually. At least every three years, an updated reserve study must be prepared and based upon a visual site inspection conducted by a reserve study professional.

RCW 64.34.392

(1) A condominium association with ten or fewer unit owners is not required to follow the requirements under RCW [64.34.380](#) through [64.34.390](#) if two-thirds of the owners agree to exempt the association from the requirements.

(2) The unit owners must agree to maintain an exemption under subsection (1) of this section by a two-thirds vote every three years.

RCW 64.34.382

(2) A reserve study shall include:

(a) A reserve component list, including quantities and estimates for useful life of each reserve component, remaining useful life of each reserve component, and current repair and replacement cost for each component;

(3) A reserve study shall include the following disclosure:

"This reserve study should be reviewed carefully. It may not include all common and limited common element components that will require major maintenance, repair, or replacement in future years, and may not include regular contributions to a reserve account for the cost of such maintenance, repair, or replacement. The failure to include a component in a reserve study, or to provide contributions to a reserve account for a component, may, under some circumstances, require you to pay on demand as a special assessment your share of common expenses for the cost of major maintenance, repair, or replacement of a reserve component."

Comments~

We often hear “reserve studies are not required for HOAs so why do them?” What??? Boards of Directors of HOAs need to know how to budget for the future as much as Boards for Condos. Just because RCW hasn’t caught up with the need doesn’t mean that it isn’t important!

I often tell Board’s that the “ostrich” approach of reserve funding is not business-like nor is it in the best interest of their Association. Ignoring the issue and pretending it doesn’t exist does not make the problem go away. So...even if you aren’t going to fund properly (and that is NOT a good choice), at least find out where you are! At least know when the ticking time bomb is set to go off – will a special assessment be needed in 2 years or 20 years?

Also, it is possible that through having the reserve study there may be maintenance techniques that will come to light to extend the life of the asset or reduce future costs.

The reserve study is an important financial planning tool and should be considered as important as the annual operating budget. It is the long term budget for the Association.



4. The budgeted reserve allocations agree with the reserve study

GAAP	INDUSTRY STANDARD	RCW	IRS
Not required	Nationally – trending that way WA – behind the curve	Not required	1120 – Yes “justification” 1120-H No

RCW 64.34.382

(h) Current reserve account contribution rate;

(i) Recommended reserve account contribution rate;

(j) Projected reserve account balance for thirty years and a funding plan to pay for projected costs from those reserves without reliance on future unplanned special assessments; and

Comments – I find it interesting that the law requires a reserve study with recommended contribution rates, but there is no tie-in with the budget.

I do think that the Board needs to consider its liability when it does not take the reserve professional’s advice.

We recommend that the Board document its reasoning for not funding in accordance with the study and how the Association plans on making up future cash flow shortfalls.



5. The monthly budgeted reserve allocations are transferred each month

GAAP	INDUSTRY STANDARD	RCW	IRS
Not strictly required	Yes – Nationally & WA	Not required	1120 – Silent on the matter, but not funding may be seen as not strictly segregating 1120-H No requirement

GAAP – Income must be recognized when assessed per budget.

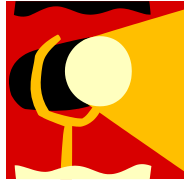
972-10-45-1 Periodic assessments for funding future major repairs and replacements shall be reported in the replacement fund in statements of revenues and expenses in the periods in which they are assessed, regardless of whether they have been collected or expended.

GAAP – Assessments must be used in the proper fund OR disclose the following:

- b. Assessments that were used for purposes other than those for which they were designated.

Comments – SO...per GAAP the budgeted allocations must be recorded each month as ASSESSED. If the cash does not follow, then there is an amount due between funds.

Question – for RCW and industry standard – is not funding reserves the same as borrowing? There is no one answer, by the way~



6. The reserve expenses are approved by the Board

GAAP	INDUSTRY STANDARD	RCW	IRS
Not required	Nationally – trending that way WA – behind the curve	Condos – Sort of HOAS - No	Not required

RCW 64.34.372

Any reserve funds of an association shall be kept in a segregated account and any transaction affecting such funds, including the issuance of checks, shall require the signature of at least two persons who are officers or directors of the association

Comments – So if the answer is “no” across this table, why do I include this in this list of perfect reserve choices? Here’s why~

- 1) *It seems to me that the intent behind most of the laws (especially nationally) is to make reserve monies “sacred” – that they cannot be invaded arbitrarily by Boards leaving the Association underfunded. Thus, it follows that the Board should be very aware when monies are spent.*
- 2) *Reserve expenses can be very arbitrary – what is a reserve expense vs. an operating expense? Some tips and considerations follow, but the final decision is generally up to the Board...thus, we feel that the minutes should reflect Board approval*
 - a. *Is it included in the reserve study? (More about this later)*
 - b. *Is it a major repair, replacement or extension of the life of a common area component?*
 - c. *Is it a health and safety issue requiring immediate attention?*
 - d. *Is it a water intrusion issue requiring immediate attention?*

We recommend that the approval be recorded in the Board meeting minutes noting the vendor, the dollar amount and the fact that it is an approved reserve expense. This also provides an audit trail at the end of the year, as well as permanent documentation for the corporation.

TAXES – you may not know it but some reserve studies compute a tax expense in their studies. Rather than showing as an expense item, it is shown in as “interest income, net of taxes”

Net Annual “After Tax” Interest Earnings Accruing to Reserves..... 3.00%

Thus, if most of the interest is earned by reserve cash and investments you may want to consider transferring monies from reserves to operating to pay for taxes.

Most associations budget for taxes in the operating fund and this is allowed, also. But, if an Association is having operating cash flow difficulties, this may be something to consider. Look to the reserve study and see if it was included in the cash flow projections.



7. The reserve expense is paid out of reserve cash, or if paid out of operating, reserves reimburses operating in a timely manner

GAAP	INDUSTRY STANDARD	RCW	IRS
No, but unreimbursed amounts are due between funds	Yes – Nationally Trending that way in WA	Not required	1120- Yes. Strict segregation of activity 1120-H No

Comments

If paying from operating and repaying reserves consider the following as “best practices”~

- *Reimburse the exact amount – don’t round*
- *If you reimburse multiple amounts, be sure and have a workpaper and provide that to the auditor at year end and possibly even outline it in the minutes*
- *Keep in mind that RCW requires two Board signers for withdrawals for condominiums – don’t do phone transfers*
- *Don’t “net” with the reserve transfer – it is difficult to trace the transactions*

Note: RCW requires that reserves repays operating, but not the other way around



8. The reserve expense was budgeted in the reserve study (and, if we really want to be perfect – the amount and timing of the reserve expense agrees with the amount and timing in the reserve study) or if it was not, the Board understands the impact on future cash flow.

GAAP	INDUSTRY STANDARD	RCW	IRS
Not required	Yes – Nationally Trending that way in WA	Open to interpretation for Condos	1120 – Yes, “used for the purpose it was set aside” 1120-H - No

Comments

We’ll let attorneys decide if RCW allows reserves to be spent on expenses not included in the reserve study. For GAAP there is no such requirement. The issue becomes the invading of reserve cash so that the money is not available in the future when a planned expenditure is ready. Because most all reserve studies use the cash flow method of funding reserves, the amount and timing of the expense is critical.

When an expense is paid that was not planned in the reserve study OR the amount of the expense is considerably more than planned OR earlier than planned, you would be doing your associations a service by recommending that a new study be performed to determine the impact on the future cash flow. This is especially important if the Association is very weakly funded.

The REALITY is that most associations are underfunded and to not warn them of the dangers of this makes for difficulties for everyone (including you as the manager) in the future.



9. If money was borrowed by operating it was approved by the Board, the membership was notified, there is a repayment schedule and the monies are repaid on schedule

GAAP	INDUSTRY STANDARD	RCW	IRS
Requires “due between funds” unless it is a permanent transfer – must use judgment if it is a true asset and liability	Who are we kidding?? BIG problem with this. See notes below...and the question of the day – what do we do if the Assn cannot repay???	Condo – Required HOA - No	1120 – Requires strict segregation of operating and reserve activity 1120-H No requirement

GAAP -

> Interfund Receivables and Payables

972-10-45-11 Common interest realty associations may have interfund receivables and payables resulting from any of the following:

- a. Obligations of one fund are paid for with the assets of another fund.
- b. Amounts assessed for the activities of one fund are collected, but not transferred, by another fund.

972-10-45-12 Corresponding interfund receivables and payables shall be presented to highlight the transactions resulting in those balances and to provide information about amounts assessed and collected that were not used in accordance with the budget.

RCW

RCW 64.34.384

An association may withdraw funds from its reserve account to pay for unforeseen or unbudgeted costs. The board of directors shall record any such withdrawal in the minute books of the association, cause notice of any such withdrawal to be hand delivered or sent prepaid by first-class United States mail to the mailing address of each unit or to any other mailing address designated in writing by the unit owner, and adopt a repayment schedule not to exceed twenty-four months unless it determines that repayment within twenty-four months would impose an unreasonable burden on the unit owners.

Comment ~

For GAAP we must REALISTICALLY assess (without consideration of RCW) if the Association has the ABILITY and INTENT to repay the monies. If not, for GAAP, it is not a valid interfund payable/receivable.

Something to consider

IF the Association has no current plans to repay the monies and no cash to do so

IF you can't get the Board to increase assessments to repay the monies or special assess NOW

THEN

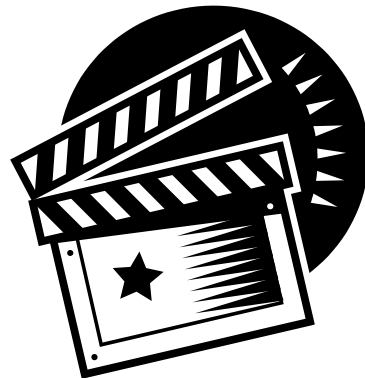
IF the Association has a new reserve study with the "real" cash amount

IF the reserve preparer works with the manager and the Board to come up with a reasonable funding plan that the Board can accept – without "creatively" changing the costs and years to make the number what they want

IF that new funding plan is adopted in the next year's budget and the Board commits to keep on schedule and fund in accordance with the new plan

THEN ~ effectively the "shortfall" is being repaid over the life of the reserve study. This is not something that can be done year after year, but it may be a "one-time" fix to realistically fund and plan for the future.

IT'S A WRAP!



FOR MORE INFORMATION VISIT

WWW.HOACPA.COM