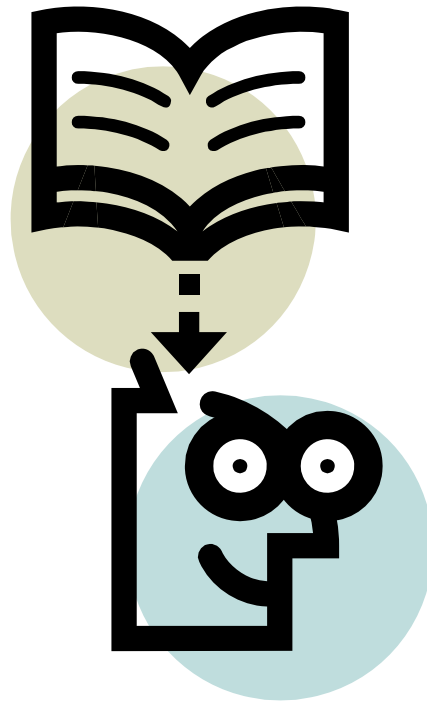


# Accounting Truths about Reserves What Do You Really Know???



**Play along with the quiz –  
Two Truths and One “Fib”**

By Gayle L. Cagianut, CPA  
Cagianut & Company, CPAs

## **Two Truths and One “Fib”**

1. Replacement Fund is another name for Reserves
2. The AICPA (American Institute of CPAs) gives CPAs the option of using the term Reserves.
3. The Fund for Future Major Repairs and Replacements is an accepted name for Reserves.

### Discussion Notes:

*#2 is the “fib”. CPAs have to use the term Replacement Fund or Fund for Major Repairs and Replacements in the audit report.*

*The AICPA recommends fund accounting for Associations. They feel that this presents information that is most relevant for the Board and for homeowners. Industry standard (nationwide) is to have replacement fund activity segregated from operating fund activity. This includes having a separate fund balance on the financial statements and reconciling cash with the income and expenses charged to that fund.*

## **Two Truths and One “Fib”**

1. AICPA requires that the financial statements record the budgeted reserve allocations as income to the replacement fund – no matter what cash gets transferred.
2. If the Association does not fund reserves in accordance with their budget, but they plan to repay the money at some point, an amount is setup as “Due Between Funds”.
3. The CPA determines whether the Association will repay the monies owed between the funds.

### Discussion Notes:

*#3 is the fib. That determination really should be made by the Board of Directors and be documented in the Board meeting minutes. Washington law now has a provision requiring repayment – for condominiums – unless there it would impose an “unreasonable burden” on the owners.*

*For GAAP (generally accepted accounting principles) purposes, CPAs must record the transfer from operating fund to the replacement fund based on what was budgeted to be transferred, not the actual cash transfer.*

## **Two Truths and One “Fib”**

1. AICPA is silent with regards to the requirement to include reserve study data in an audit.

2. Reserve study is included in the audit as “Required Unaudited Supplementary Information”

3. Breakdown of the replacement fund balance by component is not required by AICPA.

### Discussion Notes:

*#1 is false. The reserve study information is “required unaudited supplemental information”. Certain information from the study must be included in the audit or the audit must be amended to state that it is missing, and why it is missing.*

*The required information to include in the audit is as follows:*

- *When the study was performed and whether it was performed by the Board or a professional.*
- *Components (however, how much detail is left to the Board).*
- *Current or future replacement costs*
- *Interest and inflation rates, if any*
- *Remaining useful lives*

*In addition, the CPA must disclose if the Association does not fund in accordance with its reserve study.*

# Two Truths and One “Fib”

1. It is somewhat subjective as to what is an operating expense versus a reserve expense.

2. Board meeting minutes must indicate whether it is an operating or reserve expense.

3. The reserve study and governing documents are the best tools for determining a reserve expense.

## Discussion Notes:

*#2 is the fib. However, I strongly recommend that approval of all reserve expenses be recorded in the Board meeting minutes. This is an important internal control and it provides an audit trail at the end of the year.*

*What are operating expenses versus reserves expenses? The reason it is subjective is for a few reasons. 1) What one association chooses to fund in reserves might be taken care of in the operating fund in another association. For example, one association builds up the replacement fund to paint every 7 years. Another association paints 1/7<sup>th</sup> of its buildings every year as an operating expense. 2) An expense that extends the life of the component may be considered to be a replacement fund expense in some instances. For example, simple roof repairs may be operating expenses; however, fixing a section of roof may allow to put off replacing the whole roof for an addition 3 years, so they will use replacement fund monies. 3) If the issue is a health & safety, water intrusion or other required repair, many attorneys feel that it is appropriate to spend replacement fund monies, even when the component is not in the reserve study.*

## **Two Truths and One “Fib”**

1. The IRS does not consider painting as a legitimate reserve component. It is considered to be “noncapital” or an operating expense.

2. Painting should not be included in the reserve study if the Association wants to maximize their tax savings.

3. Tax savings can still be realized with painting in the reserve study; however, there should be a replacement fund on the books and a reserve study that agrees with the budgeted allocations.

### Discussion Notes:

*#2 is the fib. Anything the Board wants can, and should, be included in the reserve study. This is a tool to be used for the Board. The CPA can make the appropriate, necessary adjustments for tax purposes.*

## Sample Balance Sheet with Due Between Funds

	OPERATING FUND	REPLACEMENT FUND	TOTAL
<b>ASSETS</b>			
Cash, including interest bearing deposits	\$ 38,567	\$ 149,524	\$ 188,091
Assessments Receivable	7,723		7,723
Prepaid Insurance	63,138		63,138
Prepaid Income Taxes	386		386
Prepaid Expenses	9,115		9,115
Due Between Funds	(21,066)	21,066	
<b>TOTAL ASSETS</b>	<b>\$ 97,863</b>	<b>\$ 170,590</b>	<b>\$ 268,453</b>
 <b>LIABILITIES AND FUND BALANCES</b>			
<b>LIABILITIES</b>			
Accounts Payable	\$ 24,542		\$ 24,542
Assessments Received In Advance	13,497		13,497
Prepaid Special Assessments	1,132		1,132
<b>TOTAL LIABILITIES</b>	<b>\$ 39,171</b>		<b>\$ 39,171</b>
 <b>FUND BALANCES (NOTE 1)</b>			
Operating	58,692		58,692
Replacement (Note 2)		\$ 170,590	170,590
<b>TOTAL FUND BALANCES</b>	<b>\$ 58,692</b>	<b>\$ 170,590</b>	<b>\$ 229,282</b>
<b>TOTAL LIABILITIES AND FUND BALANCES</b>	<b>\$ 97,863</b>	<b>\$ 170,590</b>	<b>\$ 268,453</b>



Here is the amount shown as being due between funds. The amount in the operating fund is a credit as the money is owed from the operating fund and is due to the replacement fund.

Due Between Funds usually occur because:

- The budgeted amount was not transferred as planned by year end
- Expenses of one fund were paid by the other fund.
- There was money actually borrowed from one fund and will be repaid, e.g. sometimes for the insurance premium or when funds are short.

## Sample Fund Balance Income Statement

	OPERATING FUND	REPLACEMENT FUND	TOTAL
<b>REVENUES</b>			
Assessments	\$ 450,801	\$ 75,012	\$ 525,813
Late Fees /Violations	1,405		1,405
Move In/Move Out	5,400		5,400
Access Device	1,675		1,675
Guest Suite Usage Fee	14,300		14,300
Roof Lease	14,400		14,400
Interest	775	5,546	6,321
Insurance Settlement Income		24,510	24,510
Miscellaneous	572		572
<b>TOTAL REVENUES</b>	<b>489,328</b>	<b>105,068</b>	<b>594,396</b>
<b>EXPENSES</b>			
Accounting & Tax Preparation	2,000		2,000
Cable	1,306		1,306
Electricity	17,887		17,887
Elevator	16,589		16,589
Gas	6,111		6,111
Guest Suite Maintenance	2,763		2,763
HVAC	4,728		4,728
Insurance	77,368		77,368
Landscape	4,523		4,523
Legal	446		446
Life Safety	13,198		13,198
Management	31,661		31,661
Miscellaneous	22,824		22,824
Office Supplies	10,012		10,012
Other/Misc	2,308		2,308
Payroll	171,306		171,306
Payroll Other	415		415
Payroll Service	1,444		1,444
Payroll Tax	19,462		19,462
Pest Control	980		980
Professional Fees	633		633
Repairs & Maintenance	21,406		21,406
Rubbish	7,435		7,435
Sewer Capacity	16,606		16,606
Social Committee	1,027		1,027
Tax & License	1,538		1,538
Telephone	5,074		5,074
Water & Sewer	36,880		36,880
Federal Taxes	4,138		4,138
Reserve Expenses			
Bird Control		2,902	2,902
Clubroom Blinds		2,737	2,737
<b>TOTAL EXPENSES</b>	<b>502,088</b>	<b>5,639</b>	<b>507,727</b>
<b>EXCESS -&gt;DEFICIENCY-&gt; OF REVENUES OVER EXPENSES</b>	<b>\$ (12,760)</b>	<b>\$ 99,429</b>	<b>\$ 86,669</b>

This is the budgeted reserve allocation. Thus, the total assessments were \$525,813, and of that amount \$75,012 was budgeted to go to the replacement fund.

## Sample Required Unaudited Supplemental Information in Audit Report

*A full reserve study with an on-site inspection was performed on June 28, 2006 by McCaffery Reserve Consulting as of December 31, 2006 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were based on current estimated replacement costs. Funding requirements consider an annual inflation rate of 3% and interest of 2%, net of taxes, on amounts funded for future major repairs and replacements. The following table is based on the study and presents significant information about the components of common property.*

Component	Estimated Remaining Useful Life	Estimated Current Replacement Costs	Fund Balance at Year End
Roofing - Built Up	14 yrs.	\$ 51,425	
Roofing - Standing Seam Metal	24 yrs.	4,550	
Roof Deck	19 yrs.	9,000	
Building Exterior - Painting	11 yrs.	56,100	
Window Sealing	24 yrs.	89,250	
Exterior Repairs	11 yrs.	17,850	
Concrete Repairs	14 yrs.	8,000	
Terrace Membranes	24 yrs.	57,600	
Awnings	7 yrs.	8,000	
Air Conditioning	14 yrs.	20,500	
Roof & Garage Exhaust Fans	9-14 yrs.	31,000	
Emergency Supply Fans	19 yrs.	45,000	
Plumbing Repairs	29 yrs.	100,000	
Fire Pumps & Fire Control Panel	24 yrs.	50,000	
Backup Generator	29 yrs.	75,000	
Security Cameras	7 yrs.	2,500	
Garage Gate	24 yrs.	6,500	
Gate Operator	11 yrs.	2,800	
Elevators - Modernization	24 yrs.	180,000	
Elevators - Cab Remodel	19 yrs.	16,000	
Gym Equipment	7 yrs.	15,000	
Club Room Furnishings	11 yrs.	15,000	
Club Room Audio/Video	11 yrs.	3,000	
Kitchen Remodel	19 yrs.	15,000	
Guest Suite Furnishings & Remodel	9-19 yrs.	22,500	
Lobby Furnishings	19 yrs.	7,500	
Front Desk Remodel	19 yrs.	4,000	
Hall Art/Furnishings	14 yrs.	10,000	
Restroom Refurbish	24 yrs.	2,500	
Computer Equipment	4 yrs.	2,500	
Exterior Furniture	9 yrs.	4,000	
Grills	7 yrs.	1,400	
Planters	29 yrs.	25,000	
Hallways Carpet	7 yrs.	34,650	
Hallways Paint, Including Doors & Stairway	7-11 yrs.	52,600	
Balcony Railings Paint	2 yrs.	13,200	
Balcony Railing Repairs	24 yrs.	24,750	
Balcony Deck Resurface	14 yrs.	45,000	
Lighting - Hall & Garage	24 yrs.	55,500	
Mailboxes	29 yrs.	7,200	
Trash Compactor	9 yrs.	10,000	
Entry Intercom	11 yrs.	3,000	
Card Access System	7 yrs.	5,000	
<b>TOTAL</b>			<u>\$ 170,590</u>

Percent Funded as of December 31, 2006 - 00%

Note: Percent Funded – Optional Disclosure

### Sample Wording in Audit Report

The supplementary information on major repairs and replacements is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

If there was no reserve study the last two lines would be omitted and it would state “That information has not been presented.”

# Approval of Reserve Expenses Q&A

Q-

During our annual audit, our accountant requested that all reserve expenses be approved in the board meeting minutes. Why? Is this required? This seems like a lot of work and we have a reserve study which has our reserve components listed. Can you explain this recommendation?

A-

An accountant is charged with the duty of ensuring that the financial statements are properly stated. The auditor also has a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. This requires the auditor to use judgment in determining the procedures they will use.

Each auditor will have different ideas as to what procedures are necessary to fulfill these requirements. There is little guidance in the CPA industry with regards to homeowner association audits. The American Institute of CPAs does publish periodic "Audit Risk Alerts" and this question was addressed in the 2000/01 edition as follows:

*"What might you (the CPA) consider when reviewing the minutes of your CIRA client?"*  
*Replacement fund transactions. Minutes highlight replacement fund transactions, including replacement expenditures and other additions or subtractions to or from the fund. In addition, minutes reveal the approval of any replacement fund expenditures, accompanied by specific details related to the expenditure.*

On a related subject of internal control, the 1999/2000 edition stated the following:  
*"...more than one board member should review and indicate approvals of requests for all major work to be performed by contractors to help eliminate the opportunity for noncompetitive bidding."*

So is it REQUIRED to be in the minutes, from an auditor's standpoint? No. It depends on what the individual accountant feels enhances their ability to determine the correctness of the financial statements and reduces the chance of fraud.

I have four additional reasons why I strongly advise that all reserve expenditures be approved in the board meeting minutes.

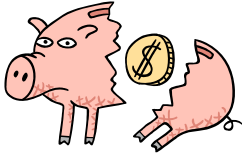
1. Washington law makes the point in various sections that reserve monies are "sacred". Such items as requiring two board signers, defining reserve accounts, requiring disclosure of reserve components and requiring payback of reserve monies in a timely manner emphasize the point that reserve monies are to be used as intended and not for operating type of expenditures. Because Washington law specifically places the responsibility for reserve accounts on the board of directors, I feel that the board needs to document their approval of use of monies out of the reserve (replacement) fund.

2. Reserve expenses are still not clearly defined. There is much judgment involved to determine when it is a reserve expense rather than an operating expense. What one board feels is a roof repair extending the life of the roof (thus, being a reserve expense) may be an operating expense in another Association. Of course, the board should go to the reserve study to determine the definition of the component to assist in their decision. Also, we have found that a board may choose to pay for a reserve expense out of operating when there are excess operating monies.
3. Reserve studies are still an art and a science (as noted by Robert Nordlund, R.S. of Association Reserves). As such, estimates are set up as to replacement cost and remaining useful lives. Thus, even if the board agrees that the expense should come from reserves, and the component is in the reserve study, it is seldom at that exact amount nor on the exact date/year of projected replacement. If the expense is dramatically more than projected or significantly sooner than planned, this could impact the viability of the reserve fund in the future. Thus, the auditor cannot look to the reserve study to determine if the expense is correct as the amount and the replacement date will differ. Only the board can make that determination.
4. Approval in the minutes provides an audit trail as to the amount to be expended. There have been cases of error (and even fraud) where the board approved one amount and a larger amount was paid by the Association. Because this is a “non-standard” type of expense, it cannot be compared with past history or other analytical means. And, as noted in #3 above, the reserve study will not show the exact replacement amount either.

So to answer your questions~

Is it a requirement of an audit to record approval of reserve expenses in the minutes? No. Do I feel that it is a good thing to include board approval of reserve expenses in the meeting minutes? Yes. Does it take more time? Yes. Remember that the board of directors is responsible for running the Association in a fiscally prudent manner and their decisions may be questioned at a later date. Minutes are an important corporate record. Talk with the Association’s attorney if there are additional questions regarding minutes as a corporate record.

Gayle L. Cagianut, CPA  
Cagianut & Company, CPA



# *Financial Q & A*

## *Capital & Non Capital Reserves*

*by Gayle L. Cagianut, CPA*

**Question:** What is meant by “capital” and “non-capital” and why should our board care?

**Answer:** Your CPA is interested in capital and non-capital reserves for Federal income tax purposes. Briefly, homeowners associations are allowed to file one of two tax forms (1120 or 1120-H) and this can change from year to year. Form 1120-H is the tax form designed for homeowners associations. When form 1120-H is filed, an association does not need to worry about reserves - capital or non-capital. However, the tax rate is 30%. Taxable income to an association on 1120-H is interest income and “per use” fees, such as clubhouse rentals, parking fees, etc.

The alternative tax form is the corporate tax form used by all for-profit corporations. It is form 1120. The benefit to this tax form is that the tax rate is 15% and most “per use” fees are not taxable. However, to be able to file form 1120, the Association must abide by specific requirements. Some of those requirements are 1) segregation of operating and reserve cash 2) segregation of capital and non-capital reserves 3) notification to owners regarding reserves 4) having the budget and reserve study agree with the reserve allocations and balances and 5) making certain elections and tax filings to carryover excess operating expenses or net income.

With regards to capital and non-capital reserves, the strict interpretation of IRS rulings is that separate cash accounts should be set up for capital and non-capital reserves. A few CPAs require this. As an industry, however, it is more prevalent that capital and non-capital reserves are combined in cash accounts; however, they are strictly segregated on the books of the Association. Most CPAs follow this rule of thought, in that there are specific accounts for which there is verification of the separate balances.

That said, what are capital and non-capital reserve items? Capital items are generally those items that in a for-profit business would be capitalized as assets and generally depreciated. (Note: Assets are not generally capitalized in homeowner associations as the Association either does not have title or does not have the authority to sell the asset.)

Non-capital items are those maintenance or operational expenses that are not generally capitalized on the books of a business. For example, the IRS has repeatedly ruled that painting is a maintenance item and should not be capitalized. Thus, it is clearly non-capital. The IRS has also ruled that “contingency” balances are non-capital. Other items that may be considered as non-capital are tree trimming, landscape, pest control and amounts left in “unallocated interest”.

For that reason, it is a good idea to reclassify amounts in unallocated interest to other reserve items before the end of each year. Also, many associations keep the contingency account at a minimum and, instead, increase the funding of each reserve item.

In summary, if the Association wishes to file form 1120-H there is no need to worry about capital and non-capital reserves. However, if at any time the Association wishes to take advantage of the option to be able to file form 1120, it is in their best interest to strictly segregate capital and non-capital reserve items on the financial statements of the Association. For further information and discussion regarding your Association’s situation, contact your CPA as they will have information specific to your Association.



## *Can Painting and Tree Trimming Be Included in Reserves?*

*by Gayle L. Cagianut, CPA*

There is a lot of confusion with regards to this issue and there are probably several different opinions. I will give you my opinion on the subject, and my reasoning.

There is some reluctance to include painting and tree trimming in the reserve study by some professionals. This stems from IRS rulings and audit findings which state that these are maintenance items and not "contributions to capital". That is, the assessments being collected for these types of reserve items cannot be excluded from income of the association under the "contributions to capital" definition. Other items that may fall into this category include termite repairs, contingency allocations, reserve study fees and other repair types of expenses. This only applies if the association is filing form 1120 (Corporation Tax Return) rather than form 1120-H (Homeowners Association Tax Return). Then, for IRS purposes these are operating expenses.

For IRS purposes is the key phrase. There are ways that your accountant can adjust for these tax differences on the tax return. It is not uncommon to have differences between generally accepted accounting principles and tax laws. With regards to non-capital reserves, your accountant may also suggest that the cash set aside be segregated from other reserves. Once again, this depends on the type of tax return filed.

It is my opinion that an association should be run like a business and, as such, decisions should be based on what is best for the association operationally, not just for tax purposes. Therefore those items which are not annual in nature (or two years at the most) are best budgeted in the reserve fund rather than the operating fund. Then, the accountant can adjust the tax returns accordingly. Many reserve preparers will segregate capital and non-capital in their reports so the accountant can easily make this adjustment.

*In Reserve...*