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Various Stages of Capital Replacement Fund

By Mohammed Salyani, CPA

Most Common Interests Realty Associations "CIRAs" in New Jersey set monies aside in a separate fund called the Capital Replacement Fund for the eventual major repair and/or replacement of the common elements. An association usually has a study prepared by an engineer to determine a recommended funding amount based upon an estimate of the remaining useful lives of these elements, the eventual replacement costs and funds accumulated to date. Like all other aspects of a CIRA, the Capital Replacement Fund goes through different stages as the association ages. At each stage, different factors are considered when calculating and allocating funds to the Capital Replacement Fund. We will look at each stage and go through the various factors that apply at each stage.

Developmental Stage/Developer Control

During the Developmental stage, the association is under Developer control while units are being built and sold. Different portions of the common elements are at various stages of completion therefore, the Capital Replacement Fund is often funded based on a pro-rata calculation, which reflects which common elements have been completed and which have not. For units that have been sold, the owners pay their portion through the maintenance fees. In addition, the Developer normally makes contributions to the replacement fund for unsold units. However, the following factors need to be considered:

- Does the association have a clubhouse and other recreational amenities? If so, have these common elements been completed? It is recommended from the date of completion, replacement funding for these amenities may be funded in full. Unit owners pay their share through maintenance assessments and the balance due on behalf of all the unsold units to the date of their sale may be funded by the Developer.
- If the association is a high-rise building, typically all of the common elements are completed prior to the sale of the first unit. Therefore, the Capital Replacement Fund may be funded in full with the Developer paying his share based upon the unsold units.
- Some associations consist of multiple low to mid rise buildings. In those cases, the capital replacement schedule should reflect each building separately and each building may be funded in full from the date the first unit is sold in that building. The same issue exists regarding the Developer paying his share for unsold units.
- If the association's Capital Replacement Schedule includes items such as roads, sidewalks and street lights, how should these be funded? One approach is to have only the sold units pay for these elements as the argument is that these elements are completed in proportion to units sold, therefore, there is no amount due from the
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- unsold units. Another approach is to calculate the percentage completion for each element and have both the unit owners and the Developer fund their respective portions. This raises an additional question, how often do you calculate the percentage completion and what happens if the unit owners pay more than their share? The answer is not always the same and each case should be considered separately.

Transition to Unit Owner Control

Transition is the process where control of the board and the common elements is conveyed from the Developer to the unit owners. The unit owner controlled board and the Developer go through a due diligence, a negotiation process to ensure that the association is left in the hands of the unit owners in a sound financial position and that construction defects have been appropriately addressed.

The board also needs to ensure that the Capital Replacement Fund has been adequately funded to this point. During the developmental stage, the Capital Replacement Fund is funded in accordance with a study prepared for the Public Offering Statement. This study is usually prepared prior to actual construction and is based on architectural drawings and discussions with the Developer. More often than not, the actual construction will be different from the initial plan and sometimes the differences may material. In addition, due to the time frame from issuance of the Public Offering Statement to transition, replacement costs and remaining useful lives usually have changed. Therefore, it is recommended that a full reserve study be conducted to evaluate potential deficiencies in the study that was used in the Public Offering Statement and to ensure that future funding is adequate. Any material differences found between the two studies usually become an item that is discussed as part of the transition negotiation process.

Unit Owner Control – The Early Years

Post transition, a significant question that the board faces is what type of funding methodology should the association follow. There are three main types of funding and their advantages and disadvantages are as follows:

1. Full Funding - Under this methodology, also known as component funding, the association funds for each common element separately based on each items remaining useful life and estimated replacement cost. The advantage is that this is the most conservative form of funding and if correctly followed, the association will usually have the funds to replace all of the common elements as, and when, needed. The disadvantage is that over time, the association builds up a pool of money that is unused since all the items are not replaced at the same time.

2. Threshold Funding - This is also known as the pooling method. Under this method, the association sets a replacement funding goal of keeping the replacement fund balance above a specified dollar amount (threshold) at its lowest accumulated amount, as specified by the board. The advantage here is that by lowering the contribution the association does not build as high a pool of unused money, and keeps the maintenance fee lower. The disadvantage is that this is a more aggressive form of funding and if certain elements age prematurely or cost more, then the association may be caught in a situation where it does not have sufficient funds to make the necessary repairs as needed. Threshold funding is often expressed as a percentage such as 10% threshold or 5% threshold of the total replacement cost of all the common elements. The lower the percentage, the lower the threshold level, and the lower the annual contribution. Also, the lower the percentage, the funding plan becomes less conservative.

3. Baseline Funding - This funding method sets a replacement funding goal of keeping the replacement fund balance at or above zero at its lowest point of accumulation. In essence, this is 0% threshold funding. The advantage to this method is that the annual contribution to the Capital Replacement Fund is at the lowest possible level. The disadvantage is this is the most aggressive, most risky form of funding, and if any major common element ages prematurely or costs more to replace than originally anticipated, the association most may not have sufficient funds. Boards who adopt this methodology, should clearly understand the risks to this approach.

From inception through the early years, we usually recommend that the association use the full funding methodology. This is because the association's funds are still relatively very low and it is recommended the board take a more conservative approach. In addition, there may be defects in construction that have not yet come to light. By using the full funding methodology, the board may be able to take care of unforeseen expenses while going through the transition process. As an association ages, it may consider using a form of threshold funding.

The Mature Association

At this point, transition is a distant memory and all construction defects have long ago been dealt with. The association is often at the stage where some major projects are being undertaken to replace some of the larger common elements. As projects become due, the board has to ensure that the association has the appropriate financial capability. The factors to be considered are:

- How old is the Capital Replacement Study? We typically

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The Role Of The Association Treasurer

By Jules C. Frankel, CPA, MBA

They say that there are three types of people in this world: those that make it happen, those that watch it happen, and those that ask "what happened." An association Treasurer needs to be all of these people. Why? Because the Treasurer has responsibilities before, during, and after an association's fiscal year. Here is an overview of a Treasurer's responsibilities along with some advice based upon our firm's experience. Finance committees might benefit from this overview as well.

Before the Fiscal Year

1. Preparation of the Annual Budget is a very important task of an association Treasurer. The budget determines the level of assessments that unit owners will pay for the upcoming year. The best way to prepare a realistic budget is to have the following revenue and expense information available

    - Year-to-date actual
    - Estimates for balance of the year
    - Known and anticipated changes
    - Anticipated surplus or deficit carryovers
    - Deferred maintenance needs
    - Replacement fund needs.
    - Avoid "targeting" a specific assessment level and backing into it. Remember, a realistic budget may cause small problems today, but can prevent large, future problems.

2. Review of replacement funding needs warrants special emphasis. A priority is determining whether a replacement study update is needed. It is prudent that an update be performed every three to five years. Further, we recommend that a study be updated immediately follow major replacement expenditures. We consider the development of an appropriate strategy for replacement funding to be the single, most important factor influencing an association's long-term fiscal health.

During the Fiscal Year

1. Control Over Disbursements is a significant, ongoing responsibility. To achieve such control:

    - Implement an appropriate approval process ensuring that only authorized vendors are paid for authorized services.

    - Ensure that complete accounting records are maintained.

    - Generate reports comparing actual vs. budget data. Review variances to determine any necessary board actions.

2. Payments of Periodic Obligations are payments made for periodic obligations such as estimated income taxes or transfers to the deferred maintenance and replacement funds. Have a system to pay these items promptly.

3. Collection of Receivables should be partly accomplished through a monthly review of aged receivable balances. Timely communication with the board, property manager, and the association's attorney is key to maximizing potential collections.

4. Monitoring the Investment of Association Funds is another obligation of the Treasurer. Many associations have established written investment policies.

5. Planning and Reacting to Special Situations such as excess snow clearing costs or damages from a hurricane comprise this responsibility.

After the Fiscal Year

1. Coordination of the Annual Audit Process includes the retention of a CPA firm, meeting with the board to review the draft of the financial statements, signing of the representation letter, and filing of the tax return(s).
2. Recommendations raised by the auditor should be discussed and acted upon when appropriate. Some associations follow the practice of responding to the auditor in writing, or including the disposition and/or planned action in the board minutes.

3. Communication to the Membership of Fiscal Results is often made at the annual meeting. Other approaches include an article in the association's newsletter, website or an announcement stating that copies of the annual audit are available upon request.

4. Planning for the Future, based upon the process described above both completes and restarts the cycle.

Conclusion

As evidenced by this brief overview, the association Treasurer position carries much responsibility. Hopefully. the time and effort involved contributes to the association's near and long-term financial stability.

This publication is prepared quarterly by Wilkin & Guttenplan, P.C. For further information, you may contact Jules Frankel at jfrankel@wgcpas.com.

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- recommend that the study be updated every three to five years or sooner if significant monies have been spent on replacement fund projects or issues with common elements surface. This will help ensure that association is adequately funding for cost increases and aging of common elements.

- What funding methodology should the association use? At this stage, using the threshold funding methodology is becoming more common. We still do not recommend baseline funding as we consider it too aggressive.

- Often, associations experience the inclusion of certain elements that were initially excluded due to their estimated useful lives. Different engineers have different "windows" which represent the time frame that dictates which components are included in a reserve study. If an engineer's window is thirty years, then the study prepared by the engineer would not include items that have a useful life of more than thirty years. If the window is forty years, than only components with a useful life of up to forty years would be included. Often there are components that are initially beyond an engineer's window and later fall into the window as time passes. The most common example is the siding of a building. Therefore, serious consideration should be given to identify and include items in the study.

CONCLUSION

There will always be situations that an association has to face that were unforeseen. However, by keeping in mind the age of the association and considering the various factors listed above at the different stages of the association's life, the impact of such circumstances can be minimized. In addition, if extra funding is needed, the association always has other options including the right to increase regular assessments, pass special assessments, borrow monies or delay major repairs and replacements until funds are available, if possible.

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