**Cagianut & Company CPA**

**Accounting Seminar for Accountants**

**Friday, June 7, 2013**

**8:30 – 11:30am**

**Bellevue – Embassy Suites**



**Off to the  
 Races!**

**Agenda**

* **Welcome – Gayle** (8:30 – 8:45**)**
* **Going Electronic: Moving Away from Paper - Panel**  **(8:45 – 9:15)**
  + Panel discussion from those who are doing it! Pro’s and Con’s. What works and what doesn’t ~
* What hardware/software are they using?
* What items are they scanning now?
* What percentage of an Association’s records are electronic now?
* Do they have plans to scan more items later? (If not 100% electronic)
* Do they shred the original after scanning?
* Who has access to these scanned documents?
  + Is it limited based on the type of document? If so, how do they handle security?
* What tips do they have?
  + Questions from the audience.
* **Audits & Best Practices - Gayle** **(9:15 – 9:45)**
  + Posting Adjusting Journal Entries
    - To Do? Not to Do? How to Do?
  + What were key areas this year?
    - Sheriff’s Sales
    - Controls on other income (e.g. Move In/Out Fees, Guest Suite, Transfer Fees)
  + Look at the audit process from a “best practices” viewpoint. How can you use the audit to improve your accounting processes and protect your association’s assets?
    - Best Practice handout
    - Tips handout
    - Using the Report of Internal Control as a tool
* **Replacement Fund Accounting - Gayle** **(9:45 – 10:15)**
  + Washington RCW disclosure requirements
  + RSI (Required Supplementary Information) –  Why auditors ask the questions we ask
    - Changes between reserve studies – be able to explain the reasons for the changes
    - “Accepted” reserve studies as RSI
  + Fund accounting and other options
  + Reconciling “Due Between Funds”
  + Reserve vs operating expenses
* **Special Assessments & Loans - Panel/Gayle** **(10:30 – 11:30)**
  + What are the pitfalls and traps to avoid when considering special assessments…especially those tied to loans?
  + What to know BEFORE you start the process and what you need to have in place DURING the time it is ongoing.
  + What are accounting presentation options – Use Reserve Fund? Set up 3rd Fund? Set up separate set of books?

(There is separate handout for this section of the presentation)

**Y** **ear End Adjusting Journal Entries from Audit**

\*\*What to do??? Do you book them? Or not?\*\*\*

Something to think about – once the audit is approved to be distributed to current and potential owners, it makes it the “official” financial statement of the Association. Thus, the management company books should reflect the REAL number at that point.

With regards to booking year-end audit adjustments, you can choose between two options:

1. Book **all** the AJEs

OR

1. Book **none** of the AJEs

**Note: There was NOT a choice to book some of the AJEs.**

If you choose to book ALL of the AJEs

* Consider booking the summarized AJEs (if audit done by C&C) (Example follows this section where we will walk through the AJE).
* Make sure that ending equity agrees with the audited ending equity.
  + DO NOT LET THIS CHANGE ALL YEAR LONG!!
  + There should only be one “official” beginning equity account balance…you may need to combine accounts, especially if you are on QuickBooks. (Sidenote: other equity adjustments during the year for the prior year would be recorded in a Prior Period Adjustment account – not the “official beginning equity” account.)

If you choose to reverse some of the AJEs

* Do this as a separate step AFTER booking the AJEs and reconciling equity.
* You will never reverse against equity – you would reverse against an income or expense item (e.g. AP expense accounts, insurance expense, interest income)

If you disagree with one or more of the AJEs OR the AJE does not “fit” into your monthly financial statement presentation

* AFTER you book the AJEs and ensure that equity balances, reverse out the AJE that you do not want to show on your monthly financial statements.
  + Reverse to an equity account that is separately setup and named – even consider naming it something unique like Audit Adjustments.
  + Book each entry separately and make sure that you have backup and/or explanation of the reason for the adjustment .(Note: you will not remember everything a year later when the auditor asks…so take a moment now to document your reasoning.)
* Make sure that you notify the auditor **immediately** if you disagree with an AJE. It is possible that the audit may need to be adjusted.
  + NOTE: An audit has to be closed out within 60 days of issuance of the report.
  + There may be reasons that the AJE is correct for audit purposes.
* Remember these are the Association’s financial statements. Make sure that the Board agrees with your adjustments.
* If the Board has requested changes in the financial statements (either as part of the year end audit process or at any time during the year), be sure to keep a copy of the Board meeting minutes authorizing the adjustments.

What about if you are on the CASH basis or modified cash basis? Should you book the AJEs? Some options/thoughts/comments:

* Some of our AJEs DO affect cash basis/modified cash basis financial statements
  + We clean up multiple equity accounts (some QB clients have 3-4 different equity account balances!).
  + We void old checks or deposits in transit.
  + We book interest on CDs that has not been recorded in a timely manner.
  + We clean up old balance sheet balances you brought over from a prior management company or just have not reconciled in awhile.
* Consider booking them all and leaving the accrual accounts on the books all year. This is “industry standard” in California.
* Consider booking them all to reconcile equity, then reverse the accrual type entries to a separate equity account – Accrual Audit Adjustments. If you do this, be sure and provide a clear audit trail by booking separate entries and not net/lump amounts (see notes on prior page).

**Sample HOA Working Trial Balance & Summarized AJEs**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Acct**  Booking a ONE BALANCE SHEET ENTRY  The  is an internal audit tool – ignore for your purposes. | **Account** | **12/31/2008** | **AJE's** | **12/31/2008** | **Prior Year** | **Bank Acct #** | **Comments** |
| **#** |  | **Balance** |  | **Adj. Balance** |  |  |  |
|  | **Assets** |  |  |  |  |  | crosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairscrosshairs   |  | | --- | | GLC | |
|  | **Cash - Operating** |  |  |  |  |  |  |
| 1000 | Foundation Bank |  |  |  | 90174.46 |  | Op Checking |
| 1001 | Petty Cash | 500.00 |  | 500.00 | 500.00 |  |  |
| 1002 | ABC Bank |  |  |  | 308456.28 |  | Working Capital |
| 1003 | Washington Trust Bank | 50000.00 |  | crosshairscrosshairscrosshairscrosshairscrosshairs   |  | | --- | | 50000.00 | |  |  | Operating Checking |
| 1004 | Washington Trust Bank | 183305.21 |  | 183305.21 |  |  | Operating Savings |
| 1005 | Washington Trust Bank | 200000.00 |  | 200000.00 |  |  | Contingency/Flexible Replacement |
| 1006 | Washington Trust Bank | 195000.00 |  | 195000.00 |  |  | Guest Suite Funds |
| 1007 | Washington Trust Bank | 1272.00 |  | 1272.00 |  |  | Security Deposit Account |
|  | **Total Operating Cash** | 630077.21 |  | 630077.21 | 399130.74 |  |  |
|  | **Cash - Reserves** |  |  |  |  |  |  |
| 1008 | Foundation Bank | 138030.88 |  | crosshairscrosshairs   |  | | --- | | 138030.88 | | 60387.66 |  | Common Reserve |
| 1009 | Foundation Bank | 125504.67 |  | 125504.67 | 55832.67 |  | Residential Reserve |
|  | **Total Reserve Cash** | 263535.55 |  | 263535.55 | 116220.33 |  |  |
|  | **Total Cash** | 893612.76 |  | 893612.76 | 515351.07 |  |  |
| 1200 | **Accounts Receivable** | 38926.22 |  | crosshairscrosshairscrosshairscrosshairscrosshairscrosshairs   |  | | --- | | 38926.22 | | 56638.54 |  |  |
| 1201 | **Allowance for Bad Debt** |  |  | 0 |  |  |  |
| 1300 | **PPD Insurance** | 14914.55 | 745.79 | 15660.34 | 15855.39 |  |  |
| 1500 | **PPD Tax** |  |  | 0 |  |  |  |
| 1600 | Prepaid Expense | 2500.00 |  | 2500.00 |  |  |  |
| 1700 | Other Receivable | 1874.80 | (501.40) | 1373.40 | 242988.00 |  |  |
|  | **Total Other** | 58215.57 | 244.39 | 58459.96 | 315481.93 |  |  |
|  | **Total Assets** | 951828.33 | 244.39 | 952072.72 | 830833.00 |  |  |
|  | **Liabilities** |  |  |  |  |  |  |
| 2000 | **Accounts Payable** | (64.98) | (65070.77) | crosshairs   |  | | --- | | (65135.75) | | (156595.70) | (20254.88) |  |
| 2001 | **Accounts Payable - Res** |  |  |  |  |  |  |
| 2200 | **PPD Accts Receivable** | (47436.68) |  | crosshairs   |  | | --- | | (47436.68) | | (40805.00) | Enter just as shown – they will zero out. Positive numbers are debits. Negative numbers are credits. ONLY BOOK YELLOW HIGHTLIGHTED AMOUNTS |  |
| 2300 | **Overdraft - Cash** |  |  |  |  |  |  |
| 2400 | **Taxes Payable** |  | (1557.00) | crosshairscrosshairscrosshairscrosshairscrosshairscrosshairs   |  | | --- | | (1557.00) | | (2077.00) |  |  |
| 2500 | Excise Taxes Payable | (1437.54) | (597.07) | (2034.61) |  |  |  |
| 2600 | Security Deposits | (1272.00) |  | (1272.00) |  |  |  |
| 2700 | Accounts Payable - Accrued | (44815.89) | 44815.89 | 0 |  |  |  |
| 2800 | Other Payable |  | (39006.00) | (39006.00) |  |  |  |
| 2900 | Developer Payable |  | (5163.00) | (5163.00) |  |  |  |
|  | **Total Liabilities** | (95027.09) | (66577.95) | (161605.04) | (199477.70) |  |  |
|  | **Fund Balance** |  |  |  |  |  |  |
| 3000 | **Reserves** | (263535.55) |  | crosshairscrosshairscrosshairs   |  | | --- | | (263535.55) | | (116220.33) |  |  |
| 4000 | **Members Equity** | (532187.90) | 17052.93 | (515134.97) | (515134.97) | 66333.56 | Summarized AJEs |
|  | **PPA** |  | 9122.00 | 9122.00 |  |  |  |
|  | Gain/Loss | (61077.79) |  | (20919.16) |  | (526932.13) | Year End Member's Equity |
|  | **Total Fund Balance** | (856801.24) |  | (790467.68) | (631355.30) | 0 | Prior Year = 0 |
|  | **Total Liab & Equity**  **This is the equity number you want to balance to!!!** | (951828.33) |  | (952072.72) | (830833.00) | 0 | Current Year = 0 |

**SHERIFF’S SALES**

**(The following is taken from a presentation that I did for the California Society of CPAs in 2011)**

**Foreclosures**

This section of the CIRA Conference deals with when an Association takes back a unit in foreclosure. We will not deal with the legal details about how that occurs, but instead discuss potential accounting, auditing and tax issues.

Caveat from the beginning – there is not a lot of written documentation on this subject either by the accounting authorities or by the Internal Revenue Service. Each accountant must take the information as presented, do their own due diligence and decide how to handle their particular situation.

Basic scenario ~

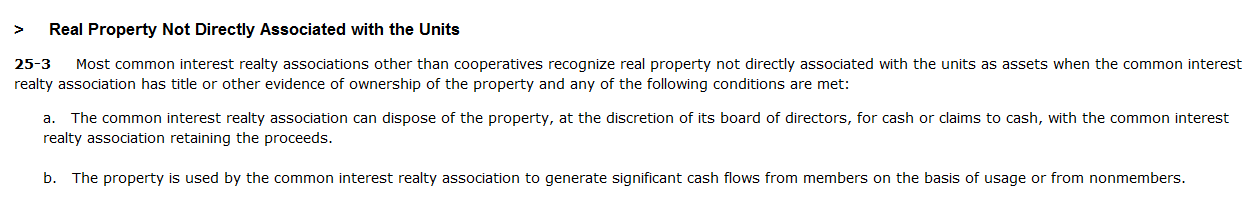
* The lender is slow to foreclose on a unit within the Association
* Association forecloses – the lender does not bid
* The Association is awarded title of the property
* Unit is still subject to loan
* The unit loan exceeds the value of the property
* At some point in the future the bank/mortgage company will foreclose and take possession of the unit

We will use this simple situation to base our discussion. But there are always exceptions. Here are a few:

* An association that took back a unit in foreclosure where the unit owner continued to make mortgage payments for a period of time.
* Several associations that took back a unit, fixed it up, and sold it at a profit.
* A couple of associations where the bank did not perfect their lien in the required time (Washington State) and instead of going before a judge to assert their mortgage position, they paid the associations $10,000 to $20,000 to release the unit.
* The Association is in the process of a quiet title action against the lenders to confirm that clear title is vested in the Association as the lenders missed their redemption period. (Ongoing – not resolved.)
* The IRS had a tax lien on the unit and the IRS paid the Association ½ of the Special Assessment in negotiations in order to speed up escrow.

**Recording the Asset on the Financial Statements**

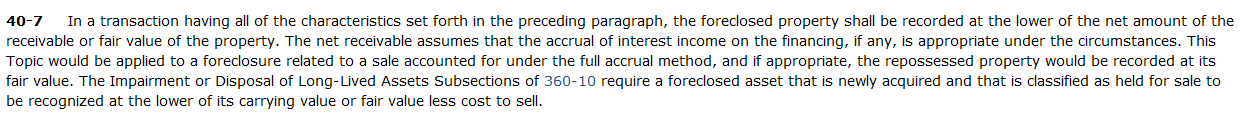
(References included herein are from FASB Codification)



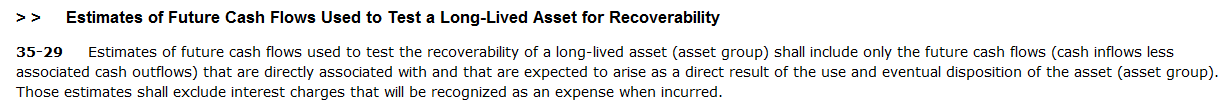
It is clear that the Association has taken title of the unit. Generally, it is clear that the Board can dispose of the property.

The loan cannot be recorded on the Association’s financial statements because the Association is not obligated to pay those loans.

Some guidance indicates that the Fair Value (less costs) should be recorded at the time of foreclosure and a gain recorded between that value and the value of delinquent assessments. However, that guidance does not seem to consider impairment of the asset.



We are to test an asset for recoverability by comparing its estimated future cash flows with its carrying value. The asset is not recoverable when the future cash flows are less than the carrying amount. The estimated cash flows must include future flows directly associated with the use of the unit and eventual disposal of the asset.



**Thus, it is my assertion that the carrying value as adjusted for impairment is usually zero**. Some believe that the amount of the receivable should be the value of the asset. This would be true if there was a probability of collection of that receivable. Otherwise, it seems to me that receivable would require an allowance for bad debt. ***Often the client wants to keep the asset on the books showing the receivable balance and any other costs. That seems reasonable to me; however, I also may set up an allowance to offset that balance.***

**Disclosures**

Sample Disclosures (Specific to Washington Law)

*The Association obtained title to Unit 101 on February 2, 2011 in a Sheriff’s Sale (judicial foreclosure) for the amount of the past due assessments and other costs. While the Association does have title to the unit, the original owner has a one-year redemption period to reclaim the property for the amount paid by the Association. In addition, the current mortgage on the unit exceeds the estimated fair market value of the unit. Thus, management has determined that the asset has no value and it has not been included on the financial statements of the Association. The Association has no legal responsibility with regards to the mortgage holder except what may be required under the law if rents are collected as the Association did not assume the loan. The Board has obtained legal counsel for advice about future actions with regards to this property. No outcome can be determined at this time.*

*The Association foreclosed on a unit December 10, 2010. The property is subject to a mortgage that exceeds the fair market value of the property. The future cash flows from the eventual disposal of this unit will not result in any monies due to the Association except for the six months of assessments as allowed under Washington Law. Thus, the asset is impaired and the carrying value on the books of the Association is zero.*

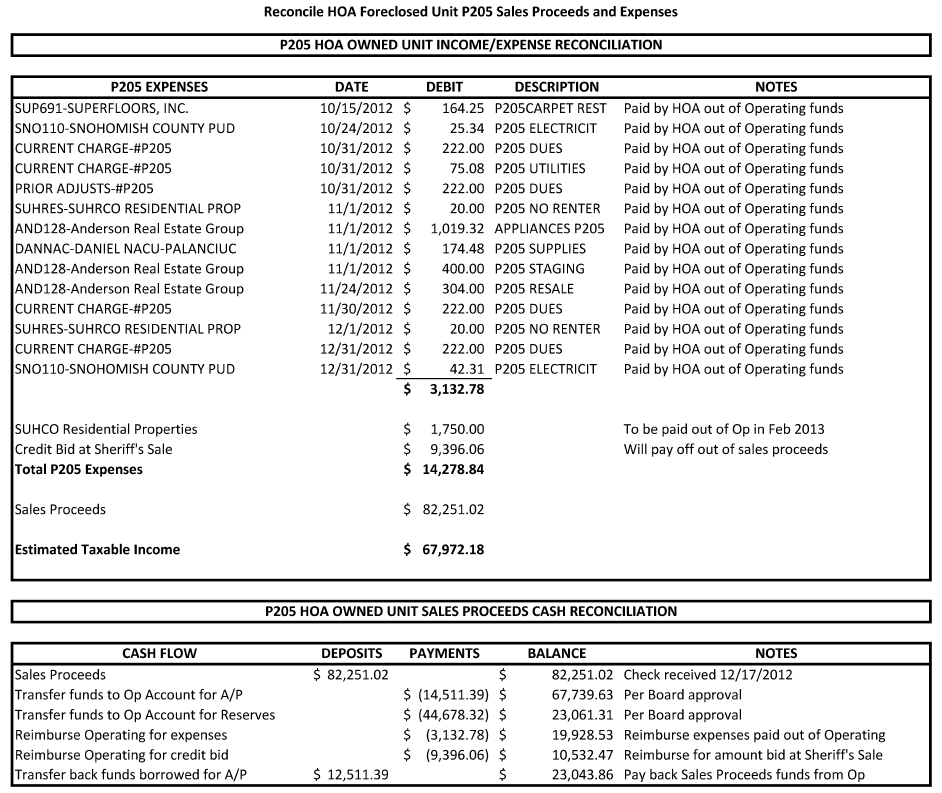
\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*

**Audit Procedures and Checklists**

* Obtain sale or escrow document (some sort of proof of sale) when unit was obtained
* Verify receipt of any monies received
* Inquire as to any redemption period
* Inquire as to whether there has been any correspondence from the bank/mortgage company
* Record outstanding receivable on foreclosed unit and any allowance for bad debts
* Determine if the asset is impaired and whether there is any future cash flow value to the Association
* Inquire of Association as to whether there was a legal opinion on the matter
* Inquire as to the Association’s plans for the unit
  + If Rental
    - Is there a legal opinion on this?
    - Has the Association obtained the proper insurances?
    - Has the Association captured the Rental Income and Expenses in separate account categories?
* Determine if unit was sold by the end of the year or by the audit report date.
  + If so, compute gain/loss – if any
  + Disclose sale as current or subsequent event

**Gain on Sale of Foreclosed Unit**

*(This was prepared by management company accounting department!)*



‘

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | AR | Accd W/O |  | Bad Debt | Legal Int |
| 12/31/12 | Beg Bal |  | 5660.55 | (5660.55) |  |  |  |
| 02/21/13 | Charge Legal Int | | 3735.51 |  |  |  | (3735.51) |
| 02/21/13 | #P205 MAGAT W/0 | | (9396.06) |  |  | 9396.06 |  |
| 02/21/13 | RVS 2012 YE ACC | |  | 5660.55 |  | (9396.06) | 3735.51 |
|  |  |  | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |

**Comments**

* Discuss taxation of gain on sale of foreclosed unit with CPA.
* Consider if there were prior year expenses that need to be considered
* If the unit has been offered for sale, that income and expense should be separate from gain on sale

**OTHER INCOME – MOVE IN/OUT FEES, GUEST SUITE USAGE, TRANSFER FEES)**

We are looking for ***completeness***…how do you really know that you have captured ***all*** of the income?? Think of the various ways that the money either might not be collected or might not be transferred to the Association (MATERIAL dollar amounts) ~ Seriously… take some time and think of everything that COULD go wrong with the association you manage.

What does NOT work:

* The onsite manager puts events/guest suite usage on the calendar and then sends the calendar and the money to accounting
* The concierge makes a list of the guest suite monies collected and sends the money with the list to accounting at the management company
* The Association deposits only what the escrow company sends them.

Look to procedures that allow an independent analysis and/or another party to be involved:

* A separate calendar is kept of usage & an independent person periodically checks the calendar against actual usage.
* An expense that is directly associated with the income is compared – e.g. housekeeping/guest suite; janitorial/clubhouse use; new pool key/change of owner/tenant.
* Tenant logs/contracts are compared against move in fees.
* An independent outside source or service is used to determine when there is a change in ownership.
* The Board is told to be alert for signs of new owners/tenants and makes note of move-ins. The management company/manager puts the number of Move In/Out fees in the agenda. These are compared.
* The Board randomly checks when a guest suite is being used or the clubhouse has an event. At the end of the month, they verify that there was a corresponding deposit for that date.

**The Report of Internal Control** is a required document. Whenever we find errors, prepare adjusting journal entries or note weaknesses in a system, we are required to document such and send with the audit. Use this as management tool. Don’t hide or ignore it! Don’t worry, you are not the only Association/management company getting these from us.

(Caveat – in prior years there was only a management letter and it was optional – see #2 in Tips Brochure. Management letters are still an option, for items that don’t rise to the level of an Internal Control point.)

The top IC comments this year ~

* Lack of compliance with Washington RCW regarding reserve disclosure requirement (discussed later)
* Over FDIC as of 1/1/13
  + As of 1/1/13 the FDIC limit went back to $250,000. Many associations did not adjust the cash balances.
  + Check the Association governing documents! Many of these documents required funds to be federally insured. Even if the governing documents don’t, it is industry standard to protect the principal.
  + Have an investment policy. (See #6 in Tips Brochure) This will document when, if ever, it is appropriate to invest in non-FDIC or non-government insured products.
* Reserve expenses are not approved in the Board meeting minutes. (See #5 in Tips Brochure)
  + There are more strict compliance matters with regards to the use of reserve monies; thus, knowing the Board approved the use and it is documented in the minutes is a good corporate record.
  + At times there is some subjectivity with regard to when an expense is operating or reserve expense. Thus, this ensures proper classification of the expense.
* Bad debt write-offs are not approved in the minutes.
  + It is possible for fraud or error to occur with regards to bad debt write-offs. Thus, the Board should be aware when an asset is written off – even when being advised to do so by an attorney or collection agency.
* Lack of controls on other income (discussed later)

**RCW 64.34.308 (New Act Condos) Note: Old Act Condos have no similar requirement**

(3) Within thirty days after adoption of any proposed budget for the condominium, the board of directors shall provide a summary of the budget to all the unit owners …

(4) As part of the summary of the budget provided to all unit owners, the board of directors shall disclose to the unit owners:  
  
(a) The current amount of regular assessments budgeted for contribution to the reserve account, the recommended contribution rate from the reserve study, and the funding plan upon which the recommended contribution rate is based;  
  
(b) If additional regular or special assessments are scheduled to be imposed, the date the assessments are due, the amount of the assessments per each unit per month or year, and the purpose of the assessments;  
  
(c) Based upon the most recent reserve study and other information, whether currently projected reserve account balances will be sufficient at the end of each year to meet the association's obligation for major maintenance, repair, or replacement of reserve components during the next thirty years;  
  
(d) If reserve account balances are not projected to be sufficient, what additional assessments may be necessary to ensure that sufficient reserve account funds will be available each year during the next thirty years, the approximate dates assessments may be due, and the amount of the assessments per unit per month or year;  
  
(e) The estimated amount recommended in the reserve account at the end of the current fiscal year based on the most recent reserve study, the projected reserve account cash balance at the end of the current fiscal year, and the percent funded at the date of the latest reserve study;  
  
(f) The estimated amount recommended in the reserve account based upon the most recent reserve study at the end of each of the next five budget years, the projected reserve account cash balance in each of those years, and the projected percent funded for each of those years; and  
  
(g) If the funding plan approved by the association is implemented, the projected reserve account cash balance in each of the next five budget years and the percent funded for each of those years.

**RCW 64.38.025 (Homeowners Associations)**

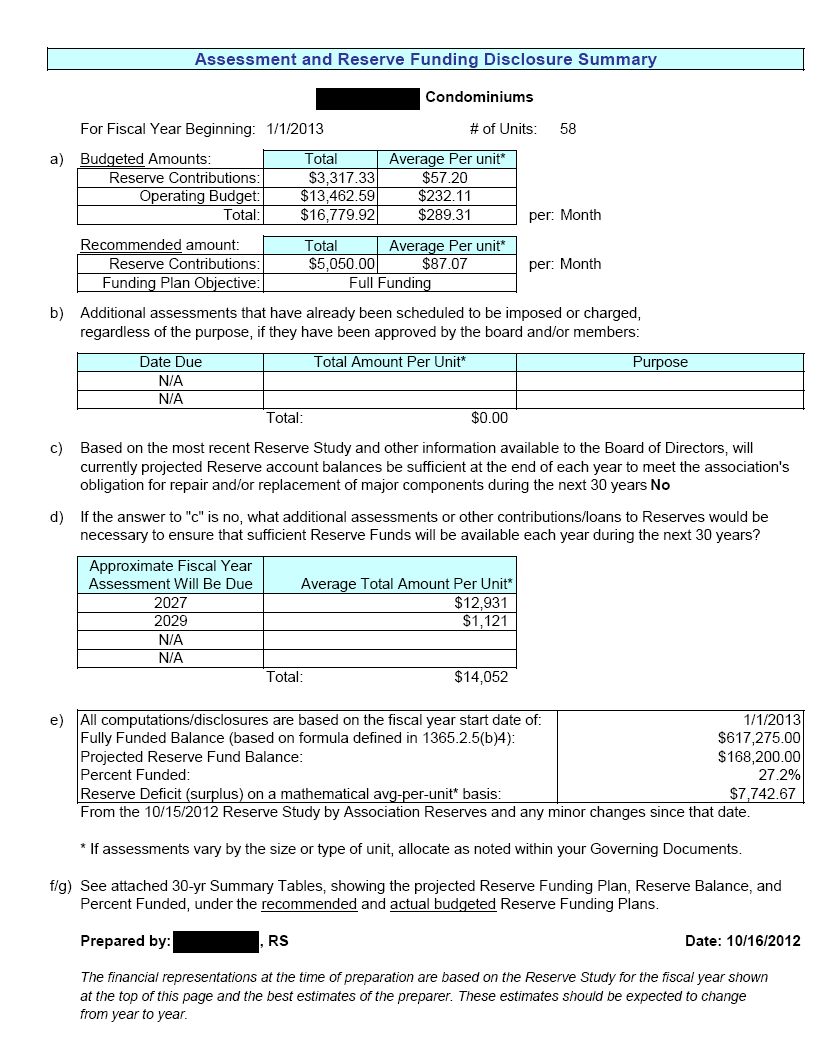
(3) Within thirty days after adoption by the board of directors of any proposed regular or special budget of the association, the board shall set a date for a meeting of the owners to consider ratification of the budget not less than fourteen nor more than sixty days after mailing of the summary…   
  
(4) As part of the summary of the budget provided to all owners, the board of directors shall disclose to the owners:  
  
(a) The current amount of regular assessments budgeted for contribution to the reserve account, the recommended contribution rate from the reserve study, and the funding plan upon which the recommended contribution rate is based;  
  
(b) If additional regular or special assessments are scheduled to be imposed, the date the assessments are due, the amount of the assessments per each owner per month or year, and the purpose of the assessments;  
  
(c) Based upon the most recent reserve study and other information, whether currently projected reserve account balances will be sufficient at the end of each year to meet the association's obligation for major maintenance, repair, or replacement of reserve components during the next thirty years;  
  
(d) If reserve account balances are not projected to be sufficient, what additional assessments may be necessary to ensure that sufficient reserve account funds will be available each year during the next thirty years, the approximate dates assessments may be due, and the amount of the assessments per owner per month or year;  
  
(e) The estimated amount recommended in the reserve account at the end of the current fiscal year based on the most recent reserve study, the projected reserve account cash balance at the end of the current fiscal year, and the percent funded at the date of the latest reserve study;  
  
(f) The estimated amount recommended in the reserve account based upon the most recent reserve study at the end of each of the next five budget years, the projected reserve account cash balance in each of those years, and the projected percent funded for each of those years; and  
  
(g) If the funding plan approved by the association is implemented, the projected reserve account cash balance in each of the next five budget years and the percent funded for each of those years.

|  |  |
| --- | --- |
| **RCW 64.38.090 Reserve study — Exemptions (HOAs)** |  |

An association is not required to follow the reserve study requirements under RCW [64.38.025](http://apps.leg.wa.gov/RCW/default.aspx?cite=64.38.025) and RCW [64.38.065](http://apps.leg.wa.gov/RCW/default.aspx?cite=64.38.065) through [64.38.085](http://apps.leg.wa.gov/RCW/default.aspx?cite=64.38.085) if the cost of the reserve study exceeds five percent of the association's annual budget, the association does not have significant assets, or there are ten or fewer homes in the association.

RCW 64.38.010 (19) "Significant assets" means that the current replacement value of the major reserve components is seventy-five percent or more of the gross budget of the association, excluding the association's reserve account funds.

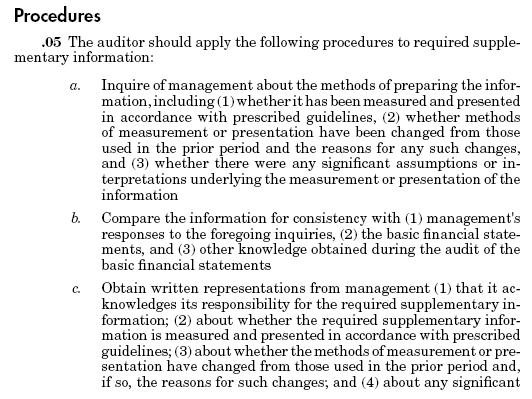
**SAMPLE RESERVE DISCLOSURE**



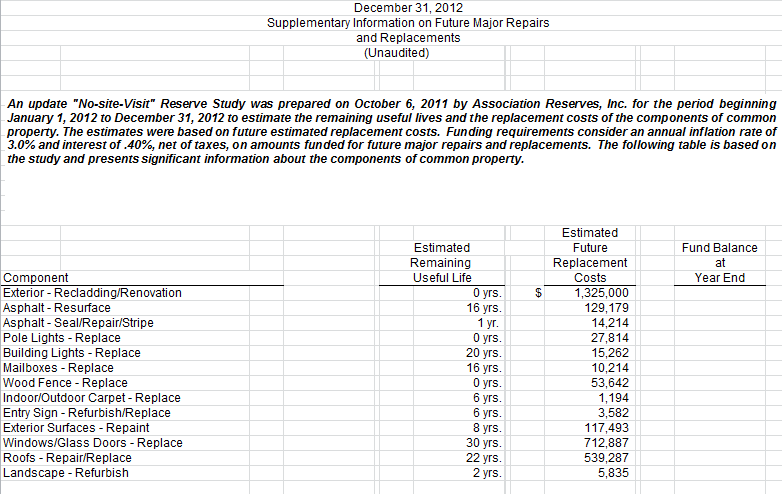
**REQUIRED SUPPLEMENTARY INFORMATION (RESERVE STUDY)**

**SAS 120 – Audit Standard effective for year ends beginning 12/31/11**

**Should = Mandatory**







**Sample RSI – Last page of audit report**

**(The following handout is from Manager’s Day presentation 2012 – CAI – it was a CIRCUS theme!)**

**Reserves And**

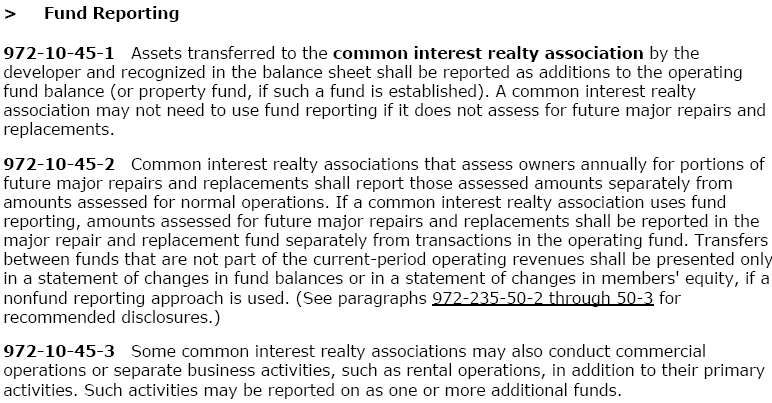
**Fund Accounting**

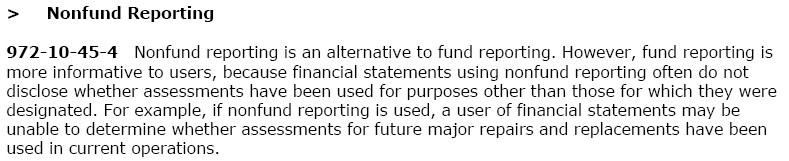
Reserves and the use (or lack thereof) of fund accounting is the most diverse area of accounting between the various management companies, self-managed or onsite-managed associations. It is also the most misunderstood area of accounting by even the most financially astute readers of the financial statements. When talking about “Reserves, there are four distinct areas of guidance to consider (and it is a balancing act!)~

* **GAAP – Generally accepted accounting principles as defined by FASB**
* **RCW – Washington law for condominiums and HOAs**
* **IRS – Internal Revenue Service rulings and guidance**
* **Industry Standards – Prevalent industry practices that are commonly held to be accepted**

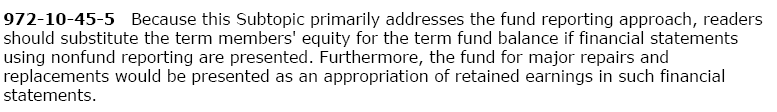
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The following are excerpts from FASB regarding Common Interest Realty Associations (CIRAs) and Fund accounting:





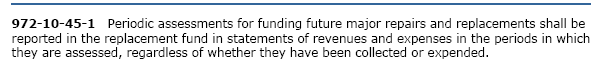
GAAP feels fund reporting is more informative



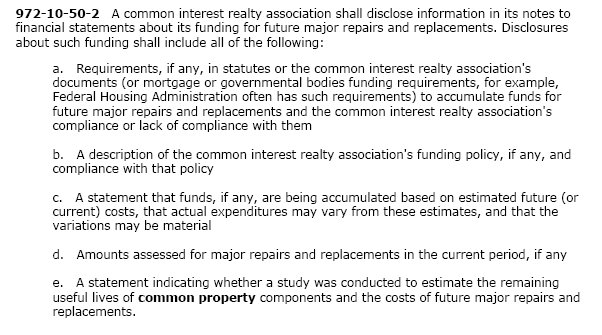
Note: that even if fund accounting is not used, replacement fund activity (reserves) should be presented as an appropriation of retained earnings.

**The bottom line is that there is a segregation of operating and reserve activity.**

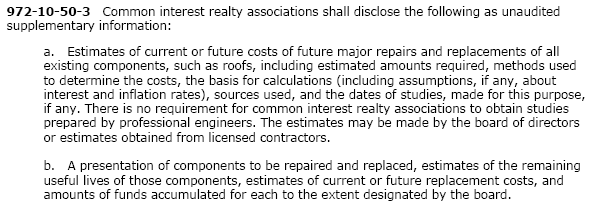
Assessments for major repairs and replacements (reserves) must be reported separately from operations – based on the BUDGET.



Footnotes as required:



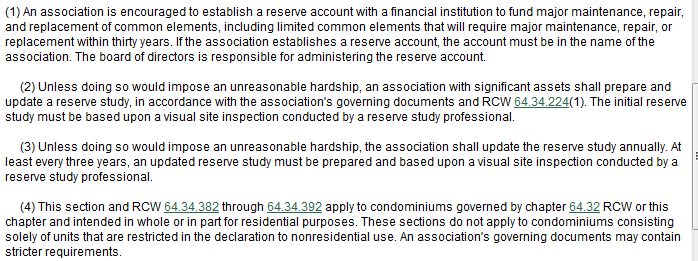
Required (unaudited) Supplemental Information:



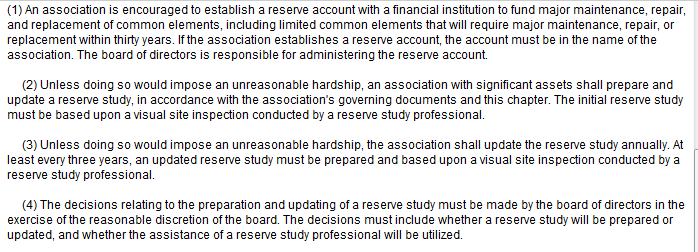
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**RCW**

Condos:



HOAs:



The Association is “encouraged” to set up a separate bank account for reserve activity. This implies (to me) a preference for segregated activity separate from operating fund.

**IRS**

**Form 1120-H** – No reserve requirements

**Form 1120** – STRICT requirements

* Segregation of operating and reserve cash
* Advance notification to membership
* Justification
* Use of monies as designated
* Capital purpose

**Revenue Ruling 70-604**

* Only relates to form 1120 (but it is a good “insurance policy” to have it approved every year)
* Has NOTHING to do with Reserves!
* It deals with transferring excess membership income to the next year
* After that has been done, a separate decision (not 70-604) can be made to transfer excess monies to the replacement fund.

**Industry Standards**

“Reserves” is the term commonly used for the Fund for Major Repairs and Replacements.

Fund accounting is definitely the industry standard and Washington is also trending to fund accounting.

You want to be among the TOP…so if you are not looking at some form of fund accounting you should be!

**Why Fund Accounting?**

Our recommendation – fund accounting! Almost all computer programs can now prepare fund accounting statements in some form – either as separate balance sheets and income statements or in the columnar format. The benefits ~

* Know when reserve deposits are not made
* Know when expenses are paid out of the wrong fund
* Know when monies are borrowed or transferred between funds
* Have a usable operating fund net income statement that can be used as a comparative with the budget
* Better chance of catching errors or missing transactions that SHOULD be made – between funds
* Better information for the Board and management to make decisions

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**Types of Funds**

**Operating**

Annual, operating type of income and expenses

**Replacement**

Future major repairs and replacements of common areas

**Insurance Reserve Fund - NOT**

Many documents require an “Insurance Reserve Fund” or similar wording. When monies are being set aside for insurance premium payments this is an operating function – not a reserve function. So, if you want this as a separate fund, it is a segregation of operating not reserves.

**Property Fund**

Some associations have significant property and wish to segregate these fixed assets into a separate fund. Seldom used, but is addressed and allowed per GAAP.

**Other – Special Project, Settlement, Special Assessment**

Discretionary. We highly recommend that separate funds be established when there is

a specific purpose of receipt and use of monies.

**Due Between Funds**

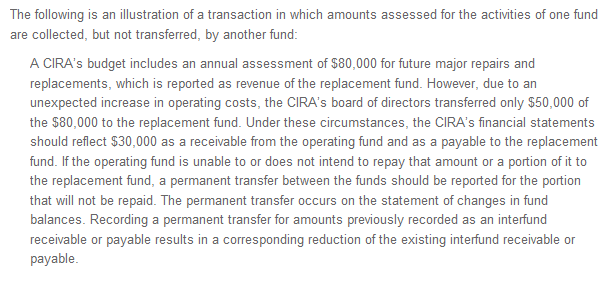
When one fund owes another fund money. It can be a result of ~

* Reserve deposits not made
* Expenses not paid out of right fund
* Wrong amounts – either deposited or paid
* Wrong coding of expense
* Monies borrowed
* Interest not properly posted
* Accounting errors (e.g. journal entries

**Transfer Between Funds**

When one fund moves assets from one fund to another. It can be a result of ~

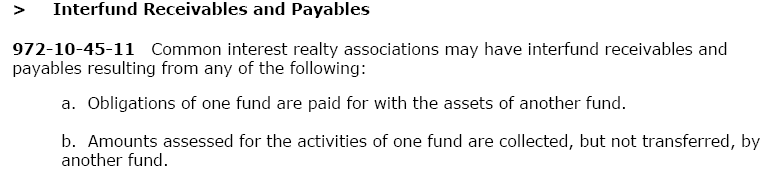
* Moving cash permanently between funds
* “Forgiving” loans or
* “Forgiving” amounts Due Between Funds
  + But like any asset and liability, they can be written off if not verifiable. For associations this is written off as a “transfer between funds” on the statement of changes in fund balance – not income statement.

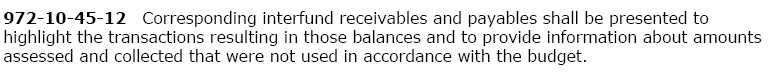


**Due Between Funds vs. Transfer – GAAP**

**Due Between Funds ~**

For GAAP –



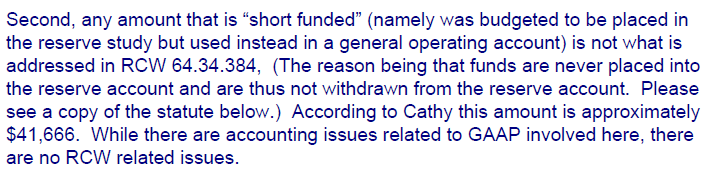


How to determine if it is a true receivable and payable?

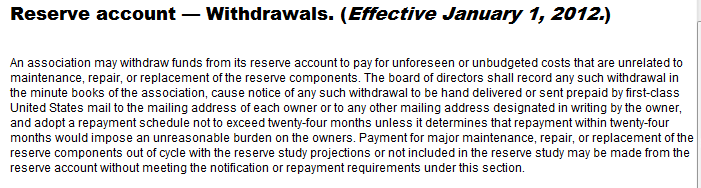
* Intention?
  + Are there documented plans to repay?
    - Budget
    - Minutes/Resolution
  + New Reserve Study?
    - Starting with new cash balance
* Ability?
  + Enough operating cash/fund balance?

**Due Between Funds vs. Transfer - RCW**

What if budgeted reserve allocations do not occur – is it a loan? Is NOT funding the same as borrowing? One attorney went on record for one association and said for RCW purposes it was not a loan:



“True” Borrowing ~ RCW –



**Due Between Funds vs. Transfer – IRS**

**Form 1120 – H**

* No Impact

**Form 1120**

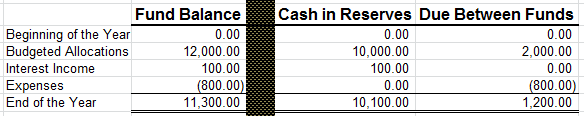
* May fail the test ~
  + Strict segregation of cash
  + Use of monies as intended
* Thus, if there are large Due Between Funds OR Transfers Between Funds often form 1120 is not a viable choice



**Balancing Reserves**

**Example #1**

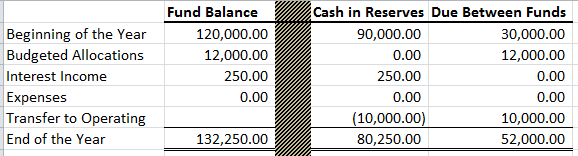
* Not all reserve allocations were transferred during the year.
* Interest was earned on reserve cash and posted to reserve fund
* Expenses were coded to reserve expenses, but were paid out of operating cash.



**Operating cash owes reserve cash $1,200.00**

**Example #2**

* You took over an Association and there was $30,000.00 shown as a shortfall between reserve cash and reserve fund balance.
* No reserve allocations were deposited during the year ($12,000)
* There was $10,000 borrowed due to the cash shortfall in operating.



**Operating cash owes reserves $52,000**

**What is required to be repaid per GAAP? What should be recorded for RCW?**

**Does the IRS Care?**

**Assume that the Association has no excess operating monies, no plans to repay reserves and the Board will not increase assessments.**

**Controls on Reserve Activity**

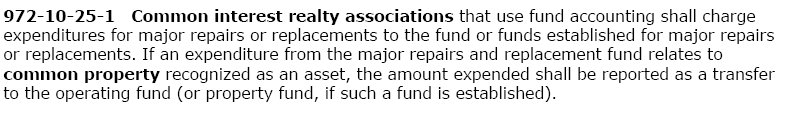
**Funding in accordance with the Budget**

* Does your Board know when reserve deposits are missed?

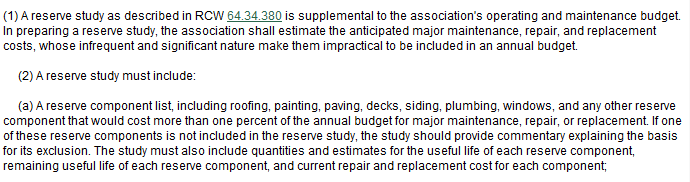
**Reserve Expenses**

How to determine if it is a reserve expense or not?

GAAP –



RCW – Reserve component definition



IRS – Must be “capital” in nature

Industry Standards - General indicators of reserve expenses (some or all may apply)~

* Major repair or replacement of a common area component that is not an annual event.
* Extends the life of a common area component.
* Included in the reserve study.
* Board determination.

We recommend that the Board meeting minutes record approval of all reserve expenses noting the vendor, the dollar amount and the fact that it is an approved reserve expense. This provides an audit trail at the end of the year and is a good internal control policy. Because this is a very subjective decision and because reserve monies are more strictly controlled, we want the Board to be very aware when monies are expended from reserve cash.

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.”*

These would be considered as “industry standards” rather than GAAP. 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 know from our firm’s standpoint that the minutes provide an audit trail and that both errors and fraud have been discovered when the minutes do not correlate with the actual expenditure.