AUDITING REPLACEMENT RESERVES

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Auditing in the homeowner association industry is unique, to say the least. If fact, the American Institute of Certified Public Accountants (AICPA) has prepared an audit and accounting guide specifically for Common Interest Realty Associations (CIRAs). The primary difference between common interest realty associations and other not-for-profit organizations is the existence of the replacement fund for major common area components. The replacement fund makes the audit process somewhat specialized as well, and in this article, we will take a look at some of the audit procedures, unusual problem areas, and required disclosures that are unique to replacement reserves. One unique aspect of this industry is the AICPA's requirement to include unaudited supplementary information on reserves as part of the standard required financial information attached to the audited financial statements.

Executive Summary:

Replacement funds in common interest realty associations (CIRAs) require special audit procedures and disclosures unique only to CIRAs

CPAs generally do not provide an opinion on reserves. The reserve study provides guidance on the adequacy of reserves.

Replacement funds need to be maintained separately from operating funds.

The audit process does involve verifying the validity of reserve revenues and expenditures that have been recorded by the CIRA

A CIRA's board of directors may elect not to adopt all recommendations of the reserve study.

The AICPA requires extensive disclosures in the notes to financial statements regarding reserve funding.

But, first, let's clarify what exactly is meant by the phrase "auditing reserves". In the audit of the financial statements, a statement is included in the auditor's report that disclaims any opinion on whether the funds designated for future major repairs and replacements are adequate to meet future costs because that determination is outside the scope of the audit. The reserve study is the report that concludes on whether or not the current reserve assets are adequate to meet the needs of future costs.

The auditor does however perform several limited procedures with respect to the required supplementary information on reserves, and performs other procedures in regard to reserve assets and reserve fund revenues and expenditures. The disclaimer is aimed at avoiding providing the board with an opinion on the ***adequacy*** of reserve funds.

The limited procedures that are required of auditors in regard to required supplementary information are the following:

- Inquiries of management about how the required supplementary information was prepared and whether it conforms to AICPA guidelines, significant assumptions used, and the consistency of preparation.
- Comparing the required supplementary information to management's responses to the above questions, financial statements and other available pertinent data.
- Consideration of representations concerning replacement reserves in the letter of representations.
- Any additional procedures that the auditor deems necessary if the required supplementary information does not appear to conform to the guidelines in the AICPA guide.

One of the first things CPA's do in relation to replacement reserves is determine whether or not the replacement fund is in balance, and whether the fund balance agrees with prior year's audit or review report. If not, each fund must be balanced separately, and necessary journal entries made to agree the replacement fund equity balances to the prior year report.

In many cases, the reserve revenues and expenditures have been recorded in the reserve equity accounts. These entries must be reversed, and reserve revenues and expenditures are moved by journal entry to the replacement fund statement of revenues and expenses. Usually, this will reconcile the replacement fund equity to prior year's ending balance, unless the prior year auditor's journal entries were not recorded.

If the individual operating and replacement funds do not balance, they are brought into balance with an entry such as "Due to/from Other Fund", or with an entry recording the difference as a "permanent transfer". It is up to management (the Board) to determine the intentions of how the funds should be brought into balance. Board members and HOA financial statements preparers should need to keep in mind that maintaining separate funds plays an important part in tax savings strategies, as well as simplifying the audit process.

Other procedures relate to replacement fund assets, liabilities, revenues and expenditures. Replacement fund assets typically consist of cash and investments, but may also include prepaid taxes, special assessments receivable, interest receivable on investments, and amortized discount or premium on investments. Many of these accounts are related to one another, and rely on some of the same substantive documentation to calculate. In auditing cash and investments, we perform the following basic procedures:

For **Cash,** the auditor should determine that:

- Separate accounts are maintained for replacement reserves
- Cash and other reserve assets, less liabilities, balance to reserve equity
- Banks confirm balances as of year end date

For **Investments,** the auditor should determine that:

- Investments are those permitted by law and the investment policy of the CC&Rs.
- They are reasonable - are they staggered for maturity, or all types the same?
- Banks confirm balances as of year end date
- Documentation exists for purchases and proceeds from sales of investments
- Interest income is properly recorded
- Amortization of discount or premium is properly recorded
- Change in market value from amortized costs basis is disclosed
- The accounting is appropriate for various types of investments held.

For Reserve Fund **Revenues and Expenses**, the auditor should:

- Trace significant expenditures from the reserve fund to supporting invoices for appropriateness
- Verify that major transactions are authorized by the board
- Verify that journal entries to record reserve transfers (credit to reserve fund, debit to expense on operating fund) agree to actual transfers from the operating cash accounts to the reserve cash accounts.
- Compare reserve funding and balances to the reserve study and to the budget

Often we are asked by board members if they are required to adhere to the reserve study as prepared by their reserve study professional. Final authority on the study plays an important part in the overall reserve fund balance and the balance sheet. The question usually arises when an association is having trouble meeting its operational needs in light of the funding requirement per the study, and they do not want to raise assessments to meet those needs. The answer to this question is that the Board of Directors always has the final authority on how the reserves should be funded. However, if the board decides on an alternative funding amount, the justification must be evident, and the board should adopt a resolution that the funding will be according to some other basis than the reserve study.

Another point of confusion in reserves is where large self-managed associations reserve for very expensive capital assets, such as trucks and buildings. Confusion arises because the AICPA guide for common interest realty associations states that these capital items belong in the operating fund.

Assuming that the association (as opposed to the members) holds title to the assets, there are two additional tests for determining whether property should be recorded as assets in the operating fund:

1). The association can dispose of the property at the discretion of the board of directors, for cash or claims to cash, and the association can retain the proceeds from the sale, or

2). The property is used to generate significant cash flows from members or nonmembers based on usage.

There is no need to be confused in this area. It's appropriate to reserve for major fixed assets when these needs are known. When a capital asset is actually purchased, the funds expended are recorded as a transfer from the reserve fund to the operating fund equity, thereby reducing the accumulation of funds for the particular item purchased. Funding for that particular item can start over again, and the asset is recorded in the operating fund and depreciated over its useful life.

Common interest realty associations also need to disclose certain information in the footnotes to its audited or reviewed financial statements about its funding for these items. The CIRA guide requires the following disclosures particular to major repairs and replacements:

- Any requirements in statutes or the association's documents to accumulate funds for future major repairs and replacements, and the association's compliance with those requirements.
- A description with the funding policy, and the association's compliance with that policy.
- A statement that funds, if any, are being accumulated based on estimated future or current costs, that actual expenditures may vary from those estimates, and that the variations may be material, or substantial.
- Current year assessment amounts for major repair and replacements.
- A statement indicating whether a study was conducted to estimate the remaining useful lives of common property components and the costs of future major repairs and replacements.

The CIRA guide also requires supplementary information as unaudited, which includes estimates of current or future costs of all existing reserve components, methods used to determine the costs, the basis for calculations including interest rate and inflation assumptions, sources used, and the date of the study, if any. A presentation of components reserved for repair and replacement, including estimates of remaining useful lives, current or future replacement cost, and amounts accumulated for each component is also required. An example of this presentation is shown below:

Component	*Estimated Remaining Useful Lives*	*Estimated Current Replacement Cost*	*12/31/1998 Balance*	*1999 Required Annual Funding*
Walls	*7 yrs*	*$ 50,275*	*$ 50,345*	*$*
Landscape	*0-52 yrs*	*266,660*	*84,739*	*18,720*
Unallocated Interest	*N/A*	*N/A*	*14,367*	*N/A*
Totals		***$ 316,935***	***$ 149,451***	***$ 18,720***

Failure of the association to provide this information will require that the auditor modify his report in the financial statements for the lack of required disclosures.

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