CAPITAL REPLACEMENT FUND: WHEN TO USE IT?

by Gary B. Rosen, CPA, CFE
Wilkin & Guttenplan, P.C
Certified Public Accountant
www.wgcpas.com

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Fund accounting segregates money according to different uses (Operating, Capital Replacement, Capital Improvement, etc.). The concept of fund accounting is based on the nature of the expense incurred by an association, and is a fundamental principle of an association's financial practice. Boards need to have a working understanding of the purpose and appropriate use of the capital replacement fund.

The key Capital Replacement Funding principle is that the money is collected and segregated, over a period of time, to cover the repair or replacement cost of existing common elements; that is, capital assets already in existence in the Association (for example, the replacement of an existing swimming pool, tennis court or clubhouse roof). Capital Replacement Funds are part of a long-term financial plan, which helps:

- Strengthen the Community's fiscal health and increase the market value of units
- Fulfill the fiduciary responsibilities of Board members

DOCUMENTING THE NEED/USE OF THE CAPITAL REPLACEMENT FUND

Associations encounter a challenge when they wish to spend money that has accumulated in the Capital Replacement Fund. The Board should document in its minutes justification of the expenditures, which may include:

- Necessity, and urgency of the need
- Appropriateness as a Capital Replacement (rather than an Operating expense or Capital Improvement) item
- The Board's vendor selection and proposed project costs
- Any other financial considerations (i.e. special assessments, bank loans, etc.).

APPROPRIATE USES OF CAPITAL REPLACEMENT FUNDS

To help Board members appropriately discharge their fiduciary responsibilities, we offer the following 10 guidelines for the appropriate use of Capital Replacement Funds:

1. Capital Items Included in the Most Recent Reserve Study—Should be charged to the Capital Replacement Fund. If the item's actual cost is significantly greater (or the useful life is shorter) than estimated, then the engineer should be consulted to update the Reserve Study as quickly as possible to reflect this transaction's impact. The updated study should be integrated with the coming year's budget.

2. Minor Repairs — Should not be charged to the Capital Replacement Fund. These should be funded via the operating budget. Associations should define thresholds for "minor" and "major" repairs with their managing agent and accountant.

3. Capital Items Excluded from the Replacement Study –May still be charged to the Capital Replacement Fund. Since Reserve Studies estimate common elements' replacement costs, certain items may have been missed during the preparation of the Reserve Study, or item replacement costs/conditions may have changed over time. The Association should recoup both the element's replacement cost and the deficit created by the expenditure through increased Reserve funding.

4. Deferred Maintenance Fund – Provides for periodic maintenance for items such as painting, caulking, and powerwashing. It would be inappropriate to use the Capital Replacement Fund for these types of maintenance expenditures. Boards should consider establishing a Deferred Maintenance Fund for maintenance on items which do not recur annually.

5. Capital Improvements – Should not be charged to the Capital Replacement Fund. Items not currently in existence should be funded via a Capital Improvement Fund, operations, special assessment, loan, excess working capital (if available), or any combination of the above. The items should be included in the next Reserve Study.

6. Transition-Related Items – May involve the Capital Replacement Fund. During the initial years of an Association's existence there may be situations in which a Sponsor/Developer is responsible for various replacements to the common elements. However, due to transition litigation, the Sponsor/Developer refuses to perform the necessary repairs or replacements. These expenditures can be charged to the fund, and any monies subsequently received should reimburse the replacement fund. If there is no settlement, the Engineer should be consulted to determine the impact on the Association's Capital Replacement Fund, and the association's Reserve funding policy.

7. Income Taxes – May be charged to the fund. Many Associations choose to allocate any interest or investment income earned by the Capital Replacement Fund back to the fund. Such income may be contributed net of the Federal income taxes, because Associations must pay tax

on such income. (Specific details regarding tax treatment of Association revenues are beyond the scope of this article).

8. Capital Reserve Study – Establishing contributions to the Capital Replacement Fund. Many Associations utilize an outside professional to prepare a schedule for this purpose. My opinion is that this is an operating expense, and should be charged to the Operating Fund; however many Associations charge the cost of the preparation of this study to the Capital Replacement Fund, which also may be done.

9. Interest Expense – If applicable, may be charged to the fund. Many Associations have authorized major capital replacement projects only to discover that they are unable to fund all of the planned replacements. Absent a special assessment, many Associations seek assistance from lending institutions to close these funding gaps. Proper practice is to include the expenditure, debt service, and the future assessments required for debt repayment in the Capital Replacement Fund budget.

10. Borrowing from the Replacement Fund – Is strongly discouraged! Borrowing could create negative tax implications and may ultimately lead the Association down the road of financial ruin. To avoid this, an Association should regularly monitor its operating budget to ensure that each year's deficit, if any, is addressed in the subsequent year. Of course, there are always exceptions to every rule.

Using these general Capital Replacement Fund guidelines, Boards should have a greater understanding of the appropriate use of the Capital Replacement Fund. For more situation-specific guidance, please feel free to contact our office or an experienced community association accounting professional.