

# What is a Capital Improvement Project-Funding and Implementation

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# Gary Porter Background

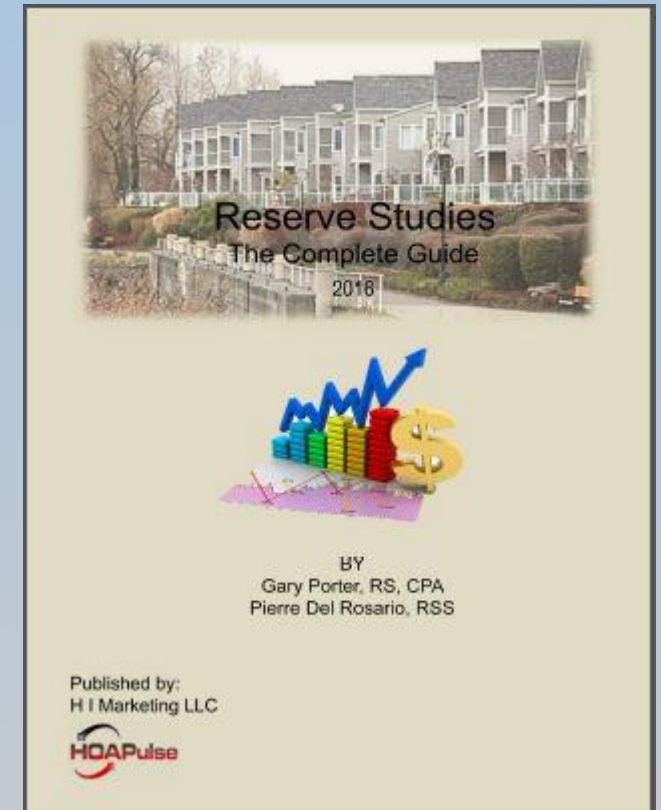
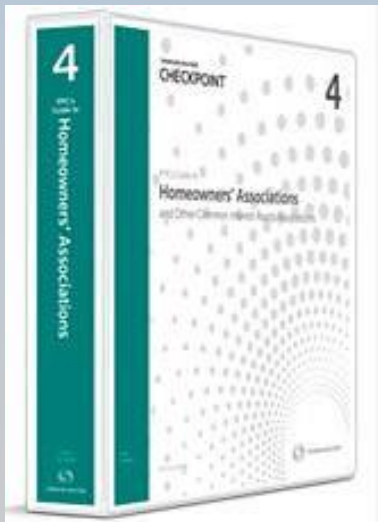
Author of PPC Guides used by CPA nationwide

Author of CEB tax section for community associations

Author of “Reserve Studies – The Complete Guide”

President of ICBI – International Capital Budgeting Institute

Past National President of CAI



# What is a capital project?

- Reserve Capital projects
  - Major repairs or replacements of existing components
- Capital Improvements Projects
  - Expenditures for new, not existing projects

# Reserve Capital Projects

- Major repairs or replacements of existing components
  - Roofing - Replace
  - Paving – Overlay
  - Equipment – Transmission Rebuild
- Davis-Stirling Requirements
  - 5510 (b) The board shall not expend funds designated as reserve funds for any purpose other than the repair, restoration, replacement, or maintenance of, or litigation involving the repair, restoration, replacement, or maintenance of, major components that the association is obligated to repair, restore, replace, or maintain **and** for which the reserve fund was established.

# Reserve Capital Projects

- Issues with Davis-Stirling requirements
  - Obligation to repair, restore, or replace
  - Components versus expenditures that are not components
  - For which reserve fund was established
- Obligation to repair, restore, or replace
  - Existing component
  - Governing documents

# Reserve Capital Projects

- Components versus expenditures that are not components - examples
  - Professional studies
  - Reserve study cost
  - Landscape replacement
  - Painting
  - Losing sight of the budget
- For which the reserve fund was established
  - Can you pay for it if it is not in your reserve study?
  - Governing documents
  - Davis-Stirling Act
  - Common sense

# Capital Improvements Projects

- New components versus existing components - Examples
  - Constructing a new gazebo in your park
  - Adding electric charging stations to your garage
  - Installing a new “monument” entry sign at your entrance
  - Adding new (not a replacement) fitness equipment
  - ??????
- Issues with respect to capital improvements projects
  - Governing documents restrictions
  - Davis-Stirling Act restrictions
  - Capital projects that are partially reserve, partially capital improvement

# Capital Improvements Projects

- Governing Documents Restrictions – common clauses
  - No capital improvements allowed
  - Membership approval requirements
  - Dollar limitations
- Projects that are partial reserve and partial capital improvement
  - Increasing the size of swimming pool as it is replastered/reconstructed
  - Some component “enhancements,” even if required by Building Code, are still a capital improvement
  - Membership approval required?
  - Potential for litigation



# Capital Improvements Projects

- Davis-Stirling Act Restrictions

- 5600 (a) Except as provided in Section 5605, the association shall levy regular and special assessments sufficient to perform its obligations under the governing documents and this act.
- 5600 (b) An association shall not impose or collect an assessment or fee that exceeds the amount necessary to defray the costs for which it is levied.
- 5605 (a) Annual increases in regular assessments for any fiscal year shall not be imposed unless the board has complied with paragraphs (1), (2), (4), (5), (6), (7), and (8) of subdivision (b) of Section 5300 with respect to that fiscal year, or has obtained the approval of a majority of a quorum of members.
- 5605 (b) Notwithstanding more restrictive limitations placed on the board by the governing documents, the board may not impose a regular assessment that is more than 20 percent greater than the regular assessment for the association's preceding fiscal year or impose special assessments which in the aggregate exceed 5 percent of the budgeted gross expenses of the association for that fiscal year without the approval of a majority of a quorum of members.

# Defining Capital Projects

- “Reserves” as used in HOA industry includes both capital and noncapital expenditures
  - Roofing – Capital
  - Painting – Noncapital
- IRS Rules - The IRS distinguishes between capital and noncapital expenditures for the sole purpose of determining what can be deducted in the year of expenditure versus what must be capitalized and depreciated over a period of years. Internal Revenue Code (IRC) Section 263 governs capitalization of expenditures. The related US Treasury Regulations to this section run in excess of 200 pages. So, not a simple issue.

# Defining Capital Projects

- The American Institute of CPAs (AICPA) and Financial Accounting Standards Board (FASB) establish rules for “Capital Projects” for accounting purposes.
- Section 972 of the FASB Codification contains all accounting rules for homeowners associations
- Capital expenditures considered in the context of reserves are those that extend the life of or replace existing components.
- Since reserves also include noncapital items, FASB uses the term as "Major Repairs and Replacements" (MRR) to describe reserve expenditures

# Funding Capital Projects

- Reserve funding plan – reserve budget
- Capital Improvements funding plan – capital improvements budget
- Essentials of the funding plan
  - How much money do you have?
  - How much money do you need?
  - How much time do you have?
- Regular monthly assessments versus special assessments

# Implementing Capital Projects

- Project Management – hire an expert
- Plan the project
- Reserve policies
- Accounting for capital expenditures – special issues for multi-year projects

Questions?