

Long-Term Capital Considerations in the Current Environment

In 1991, the American Institute of Certified Public Accounts (AICPA) issued an accounting guide for Common Interest Realty Associations (CIRA) which include Cooperatives and Condominiums. One of the most controversial aspects of the guide relates to major repairs and replacements. The guide includes required disclosure of supplementary information concerning any requirements to accumulate funds, funding policies, amounts assessed in the current period, as well as information on special assessments. It also requires disclosure of compliance or lack of compliance with requirements to accumulate funds and with the funding policies. Each year since, most Cooperative and Condominium Financial Statements have been issued without addressing these valid concerns, indicating that the survey has not been prepared.

The concept behind requiring these disclosures is that a CIRA is quite different than a For-Profit Corporation. Should the CIRA's structures not be properly maintained, both on an operations as well as long-term basis, the CIRA will likely not be in a position to build a new structure on separate piece of property. As these units are predominantly family's homes, it is crucial that the structure must be maintained properly.

Czarnowski & Beer, LLP has always suggested that both a budget for day-to-day operations, as well as one for long-term capital requirements, should be maintained. The former affords the ability to properly establish monthly carrying charges, while the later serves as a reminder that long-term projects that will eventually be required and provides a means to begin to provide for funding them. In addition, it is important to remember that the Board has a fiduciary responsibility to consider the long-term repair and replacement needs and their financial impact on the unit owners. For those properties that utilize both types of budgets, we find that our suggestions usually end up evolving into the notion of a requirement to add a small component to the operating budget to, at least partially, begin to fund the long-term requirements.

Cooperatives have often relied on the financing potential of the appreciated value of the real estate owned by the Corporation to fund such repairs. However, with the financing pendulum swinging from limitless to extremely tight credit, the ability to use that option appears to be fading. In addition, as interest rates rise, the option becomes more and more costly. The options for Condominiums are limited as they do not own the real estate, and therefore they do not have the real estate financing option to fund long-term requirements. Generally, this only leaves the option of special assessment for each specific project. In the current environment, prospective purchasers tend to prefer properties which don't rely on special assessments. Our firm's suggestion for an apportionment in the operating budget for long-term funding is now attracting renewed support in the industry. In fact, "end" loan servicers affiliated with Fannie Mae have started to verify that such a provision exists. It is no longer just your mortgage holder's requirements which your Board must be concerned with, but also those of your unit owners who seek financing.

A vast majority of "end" loans in the current market are being written by Fannie Mae Mortgage servicing agents. Armed with

qualification checklists, they are creating turmoil for sellers, prospective purchasers and along the way Boards. The checklist seeks verification of at least an annual provision in operating budget of 10% of carrying charges designated for major repairs and replacements. The good news is that the existence of such a provision, along with its periodic funding and ultimate use of those funds for qualified repairs offers a tax benefit to unit owners. While it is not deductible when paid, it does add to the purchase price of an owner's unit for determining capital gain or loss upon sale.

The bad news is that rarely do these provisions approach 10% of carrying charges. Most properties utilize some type of long-term funding vehicle, most commonly a transfer fee, and / or other fees to unit owners which are not included in the operating budget as income. Unfortunately it is nearly impossible to explain this to a mortgage servicing clerk with a checklist. In addition, in a soft real estate market, can sales activity be sufficient to meet the minimum funding requirement?

What are the options for a property which does not have such a 10% provision? Mortgage servicers are utilizing published long-term budgets as documented evidence that such a provision is unnecessary. The ability to document the strong long-term finances of a property can be a good thing enhancing the value of the property.

This leads us back to the beginning of this article and to the question of why almost every Cooperative and Condominium tends not to perform the required long-term survey. Predominantly we find that these are not performed due to the perceived risk of a potential lawsuit. The concern is that these surveys are prepared indicating the remaining expected life of specific components. In other words, how much longer these components are expected to last before they need to be replaced. Is there a risk of liability should it turn out that the estimate of the components expected remaining life has been too aggressive? These are concerns that only an attorney can address.

Ultimately, a long-term budget need not present sufficient detail to be considered a survey under the AICPA CIRA Guide, and therefore require disclosure in the financial statements. However, preparation of a long-term budget can still be done affording sufficient documentation of what repair work is expected to be required, and a baseline funding plan to adequately reflect the situation. Many times, the properly prepared long-term budget indicates that an annual provision, approaching or exceeding 10% of carrying charges is advisable.

Finally, perhaps unfortunately as well, the accounting literature is moving toward the consideration that the lack of a long-term budget and/or funding mechanism be considered a significant deficiency or material weakness in internal control. This would require recognition of the lack of a long-term budget and/or a funding mechanism in the management letter to the Board.

With the new support for these budgets and provisions coming from a variety of sources, we urge all clients consider adopting the premise of preparing a basic long-term capital budget and consider phasing in funding appropriations over time.