Deferred Replacement Expenses:

Exploring the accounting implications of Deferred Replacement Expenses for Community Associations

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Note: The information in this flyer is intended for guideline and example purposes only with respect to Deferred Replacement Expenses, and not to be used in lieu of any official legal, CPA, or professional opinion or any Federal or State Statute. This flyer is not legal counsel and should not be used for such purposes.

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Introduction

“Deferred Replacement Expenses” is an accounting approach used to capitalize (record to the Balance Sheet) the costs incurred as part of a capital project that is funded by a loan from a bank. The Deferred Replacement Expense approach is not considered to be a Generally Accepted Accounting Principle in the United States (US GAAP); however, Community Associations adopt the Deferred Replacement Expense approach because it offers Community Associations the opportunity to amortize (expense) the loan payments as incurred.

Recording Project Costs

Financing major capital projects is a common obstacle for Community Associations. When financing is successfully obtained, Associations often struggle to properly record the related expenditures associated with capital expenditures. Associations are further limited by budgeting correctly for the repayment of the related loan principal and interest payments due.

The Correct Way: US GAAP

US GAAP generally requires expenditures related to improvements made to a building be capitalized and then depreciated if the improvements extend the useful life or efficiency of the building; however, the Association itself does not have title to the common real property (buildings and improvements thereon) because any real property is owned by the unit owners in common. Therefore, capitalizing the improvements made to the Association’s building is not common or appropriate. Instead, Community Associations will expense the capital improvement project expenditures as incurred.

Additionally, because the loan proceeds as related to the capital improvement projects are not considered “income” and are not recorded as such on the Profit and Loss (Income) Statement, the repayment of the loan principal is not considered an “expense” and should not be recorded on the Profit and Loss (Income) Statement. The repayment of the loan principal is recorded as cash outflow in the Financial Statements.

Recording Project Costs - continued

The Correct Way: US GAAP - continued

The interest incurred as part of the loan is expensed as incurred and should be shown on the Profit and Loss (Income) Statement. The debt issuance costs, such as bank, legal, and accounting fees related to obtaining the loan are capitalized as a contra-liability account and amortized over the term of the loan agreement.

Drawbacks for Community Associations following US GAAP

Community Associations often struggle with following US GAAP for the following reasons:

- Oftentimes, the Operating Fund Balance will show a significant decrease from the prior year as the capital improvement project will result in significant expenditures that have not been budgeted for. A significant Operating Fund Balance decrease sometimes results in the implication by the Membership of mismanagement or wrongdoing by the Board of Directors, which often struggle to explain to the Membership why the Operating Fund Balance incurred such a decrease.

- Less financially savvy readers of the Financial Statements may not understand that there are ongoing payments on the loan principal and interest if the principal payments do not show as an expense in the Profit and Loss (Income) Statement.

- Community Associations are required to budget annually, as provided in Florida Statutes, for Operating and Reserve expenditures. Community Associations historically struggled to budget for loan principal and interest costs as the operating budget increase was capped at 115 percent of the prior year; however, the State Statute has been amended to allow for Associations to increase the budget without regard to the 115 percent rule when considering provisions for reasonable reserves for repairs and replacements, anticipated expenses for which the Board does not expect to be incurred on a regular or annual basis, insurance premiums, or assessments for betterments to the community property.

Deferred Replacement Expenses

To overcome the drawbacks associated with recording related project costs in accordance with US GAAP, Community Associations will often utilize the "Deferred Replacement Expenses" approach.

To utilize the Deferred Replacement Expenses approach, the Association will set up an Asset account to match the Loan Payable account on the books. The purpose of the Deferred Replacement Expense account is to allow the Association to expense the principal payments through the Profit and Loss (Income) Statement. The following journal entry would be recorded to expense the principal payments:

DEBIT: Expense – Principal Payments (on the Profit and Loss (Income) Statement)
CREDIT: Asset – Deferred Replacement Expenses (on the Balance Sheet)
To amortize deferred replacement expenses with the loan principal payments

Recording Project Costs – continued

Deferred Replacement Expenses - continued

The result is such that the Operating Fund Balance does not have a significant decrease in the year of the project expenses because the project expenses are deferred to the balance sheet, as opposed to expensed as incurred. The principal payments on the loan can subsequently be tracked through the Profit and Loss (Income) statement for the year, and the Operating Fund reconciles as the loan principal payments are made.

Drawbacks for Community Associations utilizing Deferred Replacement Expenses

Community Associations often struggle with utilizing the Deferred Replacement Expenses approach for the following reason:

- Utilizing the Deferred Replacement Expenses approach is not considered US GAAP and therefore results in an automatic Qualified Audit Report or a Qualified Conclusion on a Review Report. The effects of a Qualified Audit or Review Report should be discussed further with the Association's Audit team.

Conclusion

Community Associations struggle with properly recording project costs related to capital projects financed with a loan to a bank. There are two different approaches utilized by Community Associations to record these capital project related expenses. One approach is to follow US GAAP by expensing the costs as incurred and showing the principal payments through the cash flow statement. The second approach is to utilize the Deferred Replacement Expenses approach to allow for the expensing of the loan principal payments on the Profit and Loss (Income) Statement. Both approaches have their advantages and drawbacks. Community Associations should consult with their CPA team to finalize an approach that best suits the Association.