In Step with Community Associations

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RESERVE STUDIES:
An Important Resource, Required or Not

As a board member, have you ever thought about what would happen if a routine inspection of your community uncovers serious structural defects requiring immediate repair either due to a construction defect or the impact of weather over time? The Board would need to act quickly to address the concern, as the safety of the community's homeowners could be at risk. Such unexpected and urgent repairs can be quite costly, and associations often find themselves financially unprepared. However, if you think ahead and plan for the unexpected by collecting dues from homeowners for an amount that is more than what is needed to run the association day to day, you will be ready, and reserves help you do just that!

Reserves are funds set aside in an account to pay for necessary repairs or replacement parts in addition to the cost of maintaining the community on a daily basis.[1] Determining how much money needs to be in reserve is the responsibility of the association's board and should be part of its overall financial planning and part of planning the annual budget.[2] One method to determine adequate reserve requirements and the corresponding amounts to collect from homeowners in the form of dues is to hire an expert to conduct a reserve study (also known as a reserve review). Many states have established statutory requirements regarding reserve studies.[3] Some states, such as California, Colorado, Delaware, Hawaii, Nevada, Oregon, Utah, Virginia, and Washington, require a reserve study[4] or reserve schedule.[5] Others, such as Florida, do not require a reserve study but do require a reserve schedule for repair and replacement of major components.[6] As requirements vary by jurisdiction and these laws are subject to change, it is important to be aware of your state's requirements and to consult with an attorney and other experts to ensure that the association is compliant with state law.

Whether required or not, reserve studies are a great resource for boards. Although condominiums, cooperatives (co-ops), and homeowner associations (collectively, "associations") collect dues based on the day to day costs of running the community, it likely is not enough. A proactive board understands the significance of preparing for unanticipated future expenses. Reserve studies are a great way to help a board figure out just how much money is needed in reserve.

A reserve study is conducted by a licensed engineer or architect. This expert will survey the building structure and systems, estimate their remaining useful life, and determine any major repairs necessary to extend the life of these systems.[7] It is recommended to conduct such a review before, during, and after completing the construction of a community.[8] The expert will look at the common areas, assess the condition of its components, and evaluate what repairs need to be done and what may be needed in the future. In the financial analysis provided to the association, the expert will focus on the status of the community's reserves by assessing the balance and reserve status which is calculated by the cash available in the fund or percent by which it is funded. The goal is for the expert to provide a recommendation regarding how much more each homeowner needs to contribute to the fund to increase the reserve amount to a level that matches what is needed to cover the cost of current and future repairs. This is referred to as a reserve funding plan or reserve schedule.[9] In this way, a community not only can be sure that its day to day needs are met, but also that funds are available when larger repairs need to be made.[10]

The reserve funding plan is based on the expert's evaluation of the percent funded. The percent funded is calculated by taking the reserve fund balance (actual money in the association's account) and dividing it by the reserve fund needs. The reserve fund needs is a value calculated by determining the deterioration of the common area assets.[11] Some property managers even recommend that associations maintain two reserve funds,[12] one for maintaining the property on a daily basis and another for reaching the reserve fund balance goals, meant to cover the cost of that which is unexpected *and* for the repair of major systems that need replacement over time (such as a boiler, roof or the façade).

Reserve Funding Scenario:

Let's consider an association that has a reserve of $50,000 on March 1st. The association is planning to use the reserve to pay for the replacement of its pool and pool deck. An evaluation of the life of the pool predicts it will need to be replaced within 20 years of being installed. The pool was installed 10 years ago, and therefore it is expected to last another 10 years. The replacement cost of the pool is $150,000. The fully funded balance is 10/20ths of the replacement cost of $150,000 which is equal to $75,000. The pool deck stone is expected to last for 5 years and is 3 years old at the time. The cost of its replacement is $50,000. Therefore the fully funded balance is 3/5ths of $50,000 which is $30,000. The association's fully funded balance is calculated by adding $75,000 (the fully funded balance for the replacement of the pool) plus $30,000 (the fully funded balance for the replacement of the pool deck) which equals $105,000.

We then take the actual amount of money in the reserve ($50,000) and divide it by the fully funded balance ($105,000 and calculated above) which equals 48%.

The association is 48% funded. This means that the association only has $50,000 when it needs $105,000 in order to have the money it will need in the future. The current reserve is inadequate and action must be taken. The association should seek the assistance of an expert to calculate the necessary dues to be collected from its homeowners over time in order to meet its reserve fund goals.[13]

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In identifying the risk of inadequate reserves, the Federal National Mortgage Association (FNMA aka Fannie Mae) requires a 10 percent reserve as a line item in the budget of the co-op or condo when providing loans.[14] As well, the Federal Housing Administration (FHA) and the Federal Mortgage Loan Corporation (Freddie Mac) have set reserve requirements for associations where financing regulated by these agencies is provided to the homeowner.[15] Just as Fannie Mae requires, prior to approving a loan, 10% of the budget be reserved for maintenance, so too do these agencies, or in the alternative, evidence that a current reserve review has been completed within the last 24 months by a qualified and independent professional.[16]

When adequate reserves are not available and repairs or replacement of some component of the community is necessary, a special assessment may be needed. A special assessment is a determination of the amount of money that is needed to cover the association's expenses for which there is not enough money in the reserve fund to pay. It is a sum over and above the monthly assessment already paid by the homeowners of the community.[17] The whole point of proper reserving is to avoid having to levy a special assessment on homeowners - or at least minimize the amount needed so that the special assessment is low and more affordable. Remember, for homeowners (and you!) it is an unexpected expense that they will have to find the money to pay.[18] In addition, as a special assessment is unexpected, homeowners may become disgruntled if they have to pay it. The key is to make sure you are transparent about the need for the additional funds and communicate it to homeowners early, if possible. Discuss the association's plan for reserve funding before the need for a special assessment so that homeowners understand the costs involved in keeping the community running and additional costs that may be incurred to continue to keep the community safe.[19] Consider providing electronic postings, email notifications, and on-line access to homeowners of all inspection reports conducted, permits obtained, and any violations issued against the community in addition to any special assessments to be levied.[20]

It is also critical to conduct regular and routine maintenance of the building regardless of your particular locality's re-certification requirements.[21] It is suggested that an association consider creating a preventive maintenance manual in which guidelines are set for identifying maintenance needs and establishing periodic inspections.[22] By determining maintenance issues and addressing them when recognized, further deterioration may be avoided, preventing larger, more costly repairs later.[23] For example, painting every seven years has been shown to protect a structure from the elements. If accompanied by water proofing, the two combined help preserve and protect structures from water damage and water intrusion.[24] The cost of such routine maintenance is relatively low compared to the cost of making major repairs later.

It is important to realize that a condominium, cooperative, or homeowner's community is a business. It needs money to run and therefore incurs expenses just like any other business. Each member of the community is tied together in contributing the necessary funds to run the business, but the board is responsible for developing a plan of how to do so. In order to accomplish this, planning is key! Seek the help of experts who can analyze the needs of the community and provide you with a reserve review which not only will help you in running the community but also may be a legal requirement in your state. Remember, you can never be too prepared!

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ADDITIONAL RESOURCES

https://www.millionacres.com/real-estate-market/homebuying/what-hoa-special-assessment/
https://www.caionline.org/Chapters/Pages/default.aspx
For a list of Community Association Institute (CAI) credentialed reserve specialists, click here: https://www.caionline.org/Pages/Credentials-Directory.aspx#Default={%22k%22%3A%22%22%2C%22s%22%3A0%2C%22r%22%3A[{%22n%22:%22BCSCredentialsList%22,%22t%22:[%22RS%22],%22o%22:%22and%22,%22k%22:false,%22m%22:null}]}

[1] *Best Practices: report #1, Reserve Studies/Management*, p. 5, Foundation for Community Association Research, https://foundation.caionline.org/wp-content/uploads/2017/06/bprs.pdf
[2] *Id.*
[3] *Best Practices: report #1, Reserve Studies/Management*, p. 6.
[4] A reserve study helps with the financial planning of a community as it is a report generated by an onsite inspection of an association's property to determine the status of its assets. (*See* https://www.reserveadvisors.com/resources/blog/what-is-a-reserve-study-and-why-is-it-important/.)
[5] A reserve schedule is meant to provide transparency to homeowners with regard to the annual budget. It lists each item that makes up the reserve, its life expectancy and its cost of replacement. The schedule specifically provides the monetary balance for each reserve item and the additional funds that will be collected that year or that needs to be collected. (*See* https://reservestudyfl.com/reserve-schedule/)
[6] A full overview of state requirements is outlined by the CAI (*See* https://www.caionline.org/Advocacy/Priorities/ReserveStudy/Pages/default.aspx).
[7] A.J. Sidransky, *Capital Reserve Funds: How Much Do You Really Need?*, THE COOPERATOR, (April 2019), https://gumleyhaft.com/capital-reserve-funds-how-much-do-you-really-need/
[8] https://www.caionline.org/Advocacy/PublicPolicies/Pages/Community-Association-Budgets-and-Reserves.aspx
[9] *Best Practices: report #1, Reserve Studies/Management*, p. 5.
[10] *Id.*
[11] Robert M. Nordlund, PE, RS, *What Exactly is Percent Funded?*, ASSOCIATION RESERVES, https://www.reservestudy.com/resource/article/what-exactly-is-percent-funded/ (September 2011).
[12] A.J. Sidransky, *Capital Reserve Funds: How Much Do You Really Need?*, THE COOPERATOR (April 2019), https://gumleyhaft.com/capital-reserve-funds-how-much-do-you-really-need/
[13] Robert M. Nordlund, PE, RS, *What Exactly is Percent Funded?*, ASSOCIATION RESERVES (September 2011), https://www.reservestudy.com/resource/article/what-exactly-is-percent-funded/
[14] A.J. Sidransky, *Capital Reserve Funds: How Much Do You Really Need?*, THE COOPERATOR (April 2019), https://gumleyhaft.com/capital-reserve-funds-how-much-do-you-really-need/
[15] *Best Practices: report #1, Reserve Studies/Management*, p. 6.
[16] *Id.* In addition, the publication of the "National Reserve Study Standards of the Community Associations Institute" ("National Standards") established a set of standards for reserve funds stating that they are to be used for the repair or replacement of major physical components of the common areas and is not specific to any one type of association but rather for use by all.
[17] *Best Practices: report #1, Reserve Studies/Management*, p. 18.
[18] https://www.millionacres.com/real-estate-market/homebuying/what-hoa-special-assessment/
[19] https://www.caionline.org/HomeownerLeaders/DisasterResources/Documents/CondoSafetyResourceGuideWEB.pdf
[20] Final Report of the Miami-Dade County Grand Jury, in the Circuit Court of the Eleventh Judicial Circuit of Florida in and for the County of Miami-Dade, Spring Term A.D. 2021, State Attorney Katherine Fernandez Rundle, Chief Assistant State Attorney Don L. Horn, and Assistant State Attorney Laura Adams, filed December 15, 2021, p. 1.
[21] *Id.*
[22] Condominium Safety Public Policy Report, Community Associations Institute (October 2021), https://www.caionline.org/HomeownerLeaders/DisasterResources/Documents/CAI%20Condo%20Safety%20Public%20Policy%20Report%2010%2021.pdf
[23] Final Report of the Miami-Dade County Grand Jury1, p. 7.
[24] *Id.*, p. 6.

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