UNDERSTANDING RESERVES

A GUIDE TO YOUR ASSOCIATION'S RESERVE FUND & RESERVE STUDY

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CONCEPTS
STANDARDS
PRINCIPLES
FUNDAMENTALS

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INTRODUCTION

On October 9, 2007, the Dow Jones Industrial Average closed at its, then, all-time high of 14,164.53. On the surface, everything appeared fine. The economy was flourishing on the back of a seemingly stable housing market. Little did anyone know that this was all built on a house of cards. Sub-prime mortgages defaulted and major financial institutions only survived because of a bailout by the federal government. Nineteen months after October 2007, on March 6, 2009, the Dow Jones reached its, then, lowest level of 6,443.27.

The whole country was hit hard by the financial crisis—big banks, small businesses, and homeowners alike. Our clients desperately needed guidance during this difficult time. One particular association, a 100-unit townhome community in Southern California, came to us asking "What should we do about our reserves?"

They were 28% funded, contributing half as much to their reserves as the amount we had recommended, and they were facing close to $800,000 worth of shingle roof replacements.

An $8,000-per-unit special assessment was not something their owners could afford and they were reluctant to take out yet another loan (they had recently financed their latest asphalt project). We immediately got to work.

Their first course of action was to raise the monthly contribution rate as close to our recommendation as

possible. This did not provide significant assistance in the short term, but it was necessary to get them on the right track. Based on what they currently had in their reserves, we calculated that if they were able to phase out the roofing project over four years and defer other less significant projects, they might be able to squeeze by without requiring supplemental funding.

Instead of an $800,000 roofing project that year, they replaced the critical roofs and repaired others, delaying less immediate replacements over the following three years. This evened out to about $200,000 over four years. Their community room remodel was put on hold, and we extended the project cycle for wrought iron and wood painting from every four years to every five. The ten-foot-tall pole lights throughout the community would need to last a few more years than anticipated, and the pool/spa surfaces were destined to accumulate a few more cracks and chips before they would have the funds to resurface.

Four long years later, all building roofs had been replaced without the need for a special assessment. The board could finally let out a sigh of relief and focus on how to never let their association get into such a vulnerable position again.

Today, we are happy to report that they are currently 38% funded (not ideal, but considerably better than where they started) and they are making appropriately sized reserve contributions. Moving forward, the funding plan will ensure that enough funds will be available to

maintain and eventually replace their major common area components on schedule.

Successful reserve planning begins by acknowledging that most major components will not last forever. The plan is executed when the board performs their duty to protect, maintain, and enhance the common areas of their association by providing sufficient funds. This is possible when communication is clear and everyone involved, board members and managers alike, have a complete understanding of their reserve fund and reserve study.

Part I

RESERVE FUND BASICS

"Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pound ought and six, result misery." – Charles Dickens

Living in an HOA or CID (common-interest development) certainly has its pros and cons. The dues may be higher than you would like and you might not be able to choose the style of your own garage door, but there are benefits, too. You can have the security of living in a gated neighborhood with a community pool, tennis courts, bocce ball, golf course, or enjoy city life in a high-rise with a fitness center and coffee bar to satisfy your daily habit. The association handles all common area maintenance with "economies of scale," minimizing owner costs and responsibilities!

These shared benefits may be too expensive for a single homeowner to own and maintain, but with expenses divided among hundreds (or sometimes thousands) of community members, the benefits far outweigh the cost that an individual owner pays on a monthly basis. The key for community associations, since common area expenses are shared among all owners (both current and future), is to ensure that everyone pays *their fair share* along the way.

In addition to being the fairest option to pay for significant expenses, the following chapter will also address the fact that reserve funds are the least expensive option as well. An equitable distribution of the reserve burden across all owners of an association and using reserve funds as efficiently as possibly are two issues that drive the need for accurate budget planning.

Chapter 1

WHY RESERVE FUNDS?

Reserve funding is multi-faceted and brings to mind a famous Arnold Palmer quote: “Golf is deceptively simple and endlessly complicated.” We want to help you understand the “complicated” part of reserves, but the concepts can be very simple.

There are some things that never change:

- Reserve expenses are inevitable
- The association board is responsible for ensuring those expenses are paid
- Delays usually get expensive
- Homeowners always get stuck paying the bill

The overall concept of a reserve study is to identify an association’s predictable expenses and put together a responsible funding plan so that homeowners pay their fair share—no more, no less.

Expenses an association will incur over time can generally be split into two types: Operating and Reserves.

Operating Account

Funds used to pay for day-to-day functions of the association.

Reserve Account

Funds set aside for the replacement of major components the association is responsible to maintain.

On one hand, there will be routine costs paid for on a daily, weekly, or monthly basis (eg, management fees, insurance payments, and routine maintenance). These types of operating expenses do not vary greatly from year to year, which makes them simple to plan for in the annual operating budget.

Alternatively, reserves are commonly used for large, infrequent projects such as painting building exteriors or replacing perimeter fencing. It is money that an association saves over a long period of time to replace roads, roofs, or the rusted twenty-year-old boiler that has been making a strange groaning sound for the last three months.

Reserves are treated differently than operating funds because these expenses do not occur on a regular basis. Most operating budgets would not be able to absorb a $100,000 expense that pops up. This is why saving money over time is the ideal method for funding infrequent reserve projects.

Not only does it make sense to set aside reserve funds from a budgeting perspective, it is also the most equitable approach for any community. Remember, the key for community associations is that all owners (both current and future) pay their fair share of expenses. Over time, homeowners will come and go. Some will stay at their home for thirty years, others three years, but the common area components will be there indefinitely. Without adequately funded reserves and advance planning, only the owners living in the community at the time the roof

inevitably fails would be responsible for the total cost. This is inherently unfair. The roof had lasted twenty years, so each owner who benefitted from the roof over those twenty years should be responsible to pay his or her fair share.

The good news is that, while infrequent, reserve projects are very predictable. Reserve expenses do not pop up "randomly," they gradually deteriorate and fail on a predictable schedule. The useful life of the roof in this example is twenty years. As soon as the roof is installed, it begins to steadily deteriorate, shingle by shingle. As the roof ages, the reserve fund should grow proportionally so that, after twenty years, the association has enough money to pay for a new roof.

Let's say the roof replacement costs $200,000. Ideally, the association should collect and set aside approximately $10,000/year ($200,000 divided by twenty years). Done this way, after twenty years, when the roof's useful life has been "used up," they will have the money to pay for the full replacement. A steady contribution rate would ensure that all owners pay their fair share.

If homeowners in years one through ten do not foresee the need for the eventual replacement and do not set aside any money (granted, it is hard to see anything when their heads are buried in the sand), then homeowners in years eleven through twenty would only have ten years to collect enough money for replacement. They would need $20,000 per year—double their fair share!

In addition to being the most equitable way to fund capital replacement projects, making regular reserve contributions is the least expensive as well. Let us explain.

There are essentially four ways to pay for a reserve expense. First, associations can make regular budgeted contributions. This money is put into an interest-earning account until the time comes to replace the component. With the supplemental interest income, this method will cost the association less than the total replacement amount. Any dollar that can be contributed by an outside organization, such as a bank, means one less dollar the homeowners will have to pay.

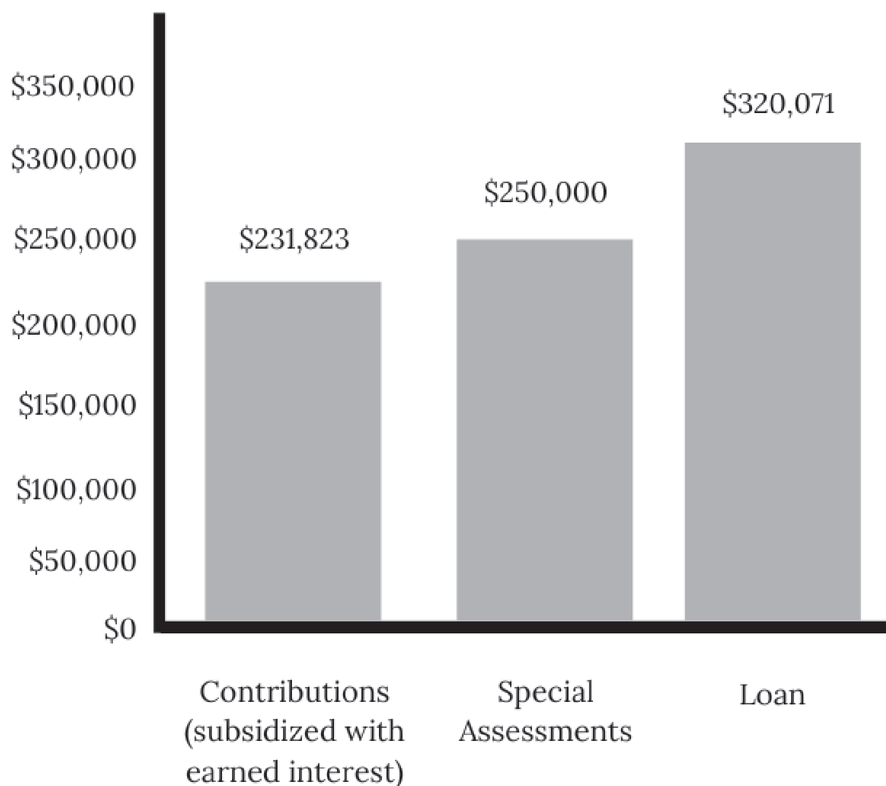
The second way is when the board is forced to pass a special assessment for the total amount of the roof. This method ends up costing the association the exact amount for the replacement but is unfair to the current owners.

Special Assessment

"A temporary assessment levied on the members of an association in addition to regular assessments. Note that special assessments are often regulated by governing documents or local statues."
- National Reserve Study Standards

In some cases, the board may not be able to pass a special assessment and they need to apply for a loan (paying interest to the bank, the opposite of the bank paying interest to the association). These second and third methods show a lack of foresight that hurts the association financially.

And lastly, the fourth way to “pay” for this roofing expense is to defer the replacement. This is possibly the most expensive option. It saves money in the short term, but damage due to deferred maintenance makes the project more costly, and the need to replace the roof never goes away. The community will eventually begin to look run-down with poor curbside appeal, leading to lower property values.



Boards have governing documents that define their responsibilities to preserve, maintain and enhance the common areas of the association. They also have the authority to collect funds to perform these duties. The only choice they have is how to pay for long-term, significant expenses. This decision affects when payments are made, how much is paid at a time, who pays, and additions or offsets to the cost.

A loan is paid on a regular basis in the future, it is paid over a certain term, it affects current and future owners, and interest will add to the cost.

A special assessment is paid today, it is paid in a lump sum, it affects only the current owners, and there is no addition or offset to the cost.

Regular contributions are paid on a regular basis, it is paid a little at a time, it affects all owners, and earned interest offsets some of the cost, making this option the fairest and lowest cost for an association.

Why reserve funds? Because expenses are inevitable and predictable. The board is responsible to maintain the common areas. Delaying major projects will usually compound expenses, and the homeowners always get stuck paying the bill. So, reserving funds on a regular basis is not only the most equitable approach for community associations, it is the most financially sound option as well.

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