

Untangling **RESERVE STUDIES**

YOUR PRIMER FOR WHAT THEY ARE,
AND WHY YOU NEED ONE

BY PAUL HUIJING, P.E.

WHAT ARE RESERVES AND HOW IS THAT RELATED TO A RESERVE STUDY?

Community associations are responsible for a list of common components defined in the governing documents. Typically, these components are exterior to units. These common elements must be repaired or replaced by association funds at the end of their useful lives. The reserve account is intended to supply the capital to fund these repairs and replacements.





Untangling **RESERVE STUDIES**

Determining contribution amounts to adequately fund the reserve account is the task of a reserve study. Performing the study involves quantifying the components that the association is responsible for and then evaluating their condition during a comprehensive site visit. A reserve study should present the inventory of common elements, anticipated year of replacement, current condition, and current cost in an easy to understand format. Based on a component's current condition, a remaining useful life can be estimated. Using current replacement costs and an inflation factor, a future cost for component replacement can be determined.

Aggregating all future component costs over the anticipated timeline of expenditures (typically 30 years) allows an organized expenditure plan to be developed. Using this plan, equitable funding of the reserve account with regular monthly contributions can be determined. Recommended regular funding plans can be used to eliminate special assessments. Special assessments are additional payments that unit owners are required to make, in addition to monthly regular assessments. If a regular funding plan does not cover the costs of maintaining the community, unplanned special assessments or loans will be required to fund repairs and replacements.

WHY DO WE NEED A RESERVE STUDY?

Community association trustee board members may ask why they need a reserve study. Some unit owners may also ask. Professional property managers will likely recommend a reserve study to fulfill their advisory role. All concerned parties should ask, but some involved may not know the importance of the question.

There are many answers to the question depending on your involvement with an association. I will highlight the following motivations in this introductory article:

- Fiduciary duty
- Aesthetics and property values
- Stable and logical financial planning
- Fairness

These motivations may be viewed differently depending on the perspective of those involved:

- Board of Trustees
- Unit owners
- Mortgage lenders
- Prospective buyers

BOARD OF TRUSTEES PERSPECTIVE

An association board typically has a legal and fiduciary duty to maintain the community in a good state of repair. Fiduciary duty is defined as the "highest standard of care." Community property values are significantly impacted by both the level of maintenance provided as well as the amount of the regular monthly assessment charged to each owner.

A high standard of care implies a prudent, implemented plan to address long-range maintenance, repair, and replacement of common components. Additionally, the plan should recognize that

the value of each unit is affected by the amount of the regular assessment charged to each unit. Reserve budgeting is a balance. A comprehensive reserve analysis is one of the most significant elements of any association’s long-range plan and provides the critical link between sound business judgment and good fiscal planning. The reserve analysis provides a “financial blueprint” for the future of an association.

Of course, board members also share the point of view of unit owners.

UNIT OWNER PERSPECTIVE

Owners are typically motivated to maintain:

- Aesthetics and functionality of community
- Stable and logical financial planning
- No surprises
- Fairness
- Stable or increased property values

Sometimes these motivations compete. A fine line exists between “not enough” and “too much.” Each unit owner should contribute to the reserve fund their proportionate amount of “depreciation” (or “use/deterioration”) of the reserve components.

For example, the anticipated useful life of an asphalt shingle roof is approximately 20 years. If Bob buys a condo when it is first constructed and lives in the unit 10 years, then he should pay for half of the new roof that will be needed about 10 years after he sells. After Jane buys the condo from Bob, she lives there nine years and then sells the unit to Pat. Jane should pay for almost half of the new roof required in the near future. Six months after Pat buys the condo, the trustees seek proposals to replace the roofs based on visible deterioration and a competent inspection. The trustees then award the contract and have the roof replaced in the final months of

Pat’s first year of ownership. If there is a sufficient balance in the reserve fund to pay for the roof, all is well. If the reserve fund is insufficient, then the roof cost will need to be funded by borrowing or assessing all the owners to cover the shortfall. In this case, the extra funds will be paid by the current owners, some of whom like Pat will have lived in the association for only a short time. The prior owners will not have contributed enough to pay for the roof during their ownership period. This fundamental unfairness is what a reserve study can help eliminate.

Through time, if each owner contributes their “fair share” into the reserve fund, then the possibility of large increases in regular assessments or unscheduled special assessments will be minimized. Appropriate reserve contributions enable the community to maintain common elements in a sustainable manner. Proper reserve

Untangling RESERVE STUDIES



funding promotes stability and allows owners to plan their financial lives logically with the comfort of knowing that special assessments are unlikely. Helping owners understand the relationship between monthly regular assessments and the health and appearance of their community will allow them to “buy in” to the process.

MORTGAGE LENDER PERSPECTIVE

Mortgage lenders want to promote conditions to:

- Maintain property values
- Ensure that an owner’s financial position is not negatively affected by special assessments

The Federal Housing Administration (FHA) requires information about association reserves for financing.

- FHA currently has a strict lending program for condominiums
 - FHA is a popular loan of choice for first-time condo buyers
 - FHA requires associations to set aside at least 10 percent of their operating income towards capital reserve accounts
 - The 10 percent rule is often applied to Fannie Mae and other lenders
 - Lender may review annual budget
 - If budget is deemed insufficient, then reserve study is mandated

■ Special Assessments

- FHA views special assessments as a potential red flag
 - Indicative of association financial problems and underfunding of reserves
- Thorough explanation of special assessment is required

- Unsatisfactory explanations can result in a reserve study requirement or rejection of the loan application

Lenders want assurance their equity in a community association unit is secure. Adequate reserves ensure that the community can perform needed repairs and replacements without the need for special assessments. Special assessments could be unaffordable to unit owners and cause mortgage defaults. Lenders want to minimize this possibility.

POTENTIAL BUYER PERSPECTIVE

Potential buyers share the concerns of both unit owners and lenders. They do not want to inherit under- or unfunded depreciation from prior owners. Fairness dictates that current and future homeowners pay only for the deterioration occurring during their ownership period.

Community association buyers are becoming more sophisticated and aware of the importance of reserves. Many realize the risk of special assessments if reserves are inadequate. Competent real estate agents will inform their buyers that condos have additional financial and legal issues to evaluate. They will describe operational items their buyers must analyze and review for a condominium purchase. Adequate reserves provide assurance to buyers.

THE ULTIMATE GOAL

Association boards, unit owners, property managers, lenders, and prospective buyers will all benefit from a stable, financially secure community owners’ association. Regardless of your perspective, adequate reserves will ensure that the community you love will continue successfully into the future. Performing a reserve study and updating it periodically is an essential part of creating a sustainable association. ■■



■ PAUL HUIJING, P.E., IS REGIONAL VICE PRESIDENT WITH ADVANCED RESERVE SOLUTIONS, INC., IN WILBRAHAM, MA..