

Why do we need a reserve study? *OR How to avoid special assessments!*

By Paul Huijing, P.E.

What is a reserve study and why do I need one is a frequently asked question.



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What are reserves and how is that related to a reserve study?

Condo 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 fund is intended to supply the capital to pay for these repairs and replacements.

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. Based on the current condition, a remaining useful component life can be estimated. Using current replacement costs and an inflation factor, a future cost for component replacement can be determined. Aggregating all component costs over the anticipated timeline of expenditure allows a financial plan to be developed. Using this plan, equitable funding of the reserve fund can be determined. A reserve study should present the inventory of elements, anticipated year of replacement, current condition, and current cost. Recommended funding plans to eliminate special assessments can then be recommended.

Why do we need a reserve study?

Condominium 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 ful-

fill 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 for a study 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 directors
- Unit owners
- Mortgage lenders
- Prospective buyers

Board of Directors Perspective:

An association board 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 area 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 ½ the roof that will be needed about 10 years after he sells. After Jane buys the condo from Bob, she lives there 9 years and then sells the unit to Pat. Six months after Pat buys the condo, the Board seeks proposals to

replace the roofs based on visible deterioration and a competent inspection. The Board then awards the contract and has 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 money to pay for the roof will need to be raised by borrowing or

assessing all of the owners to cover the shortfall. In this case, the extra funds needed 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 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


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

- FHA currently has strict lending program for condominiums
 - FHA is a popular loan of choice for first time condo buyers
 - FHA rules require associations to set aside at least 10% of their operating income towards their capital reserve accounts

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RESERVE STUDY...from page 37.

- This 10% rule is often applied to Fannie Mae and other lenders
- Lender may review annual budget
 - If the budget is deemed insufficient then a 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 condominium unit is secure. Adequate reserves ensure that the community can perform needed repairs and replacements without the need for special assessments. Special assess-

ments could be unaffordable to unit owners and cause mortgage defaults. Mortgage providers 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 un-funded depreciation from prior owners. Fairness dictates that current and future homeowners pay only for the deterioration occurring during their ownership period.

Condo 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 condominium owners' association. Regardless of your perspective, adequate condominium reserves will ensure that the community you love will continue successfully into the future. ■

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