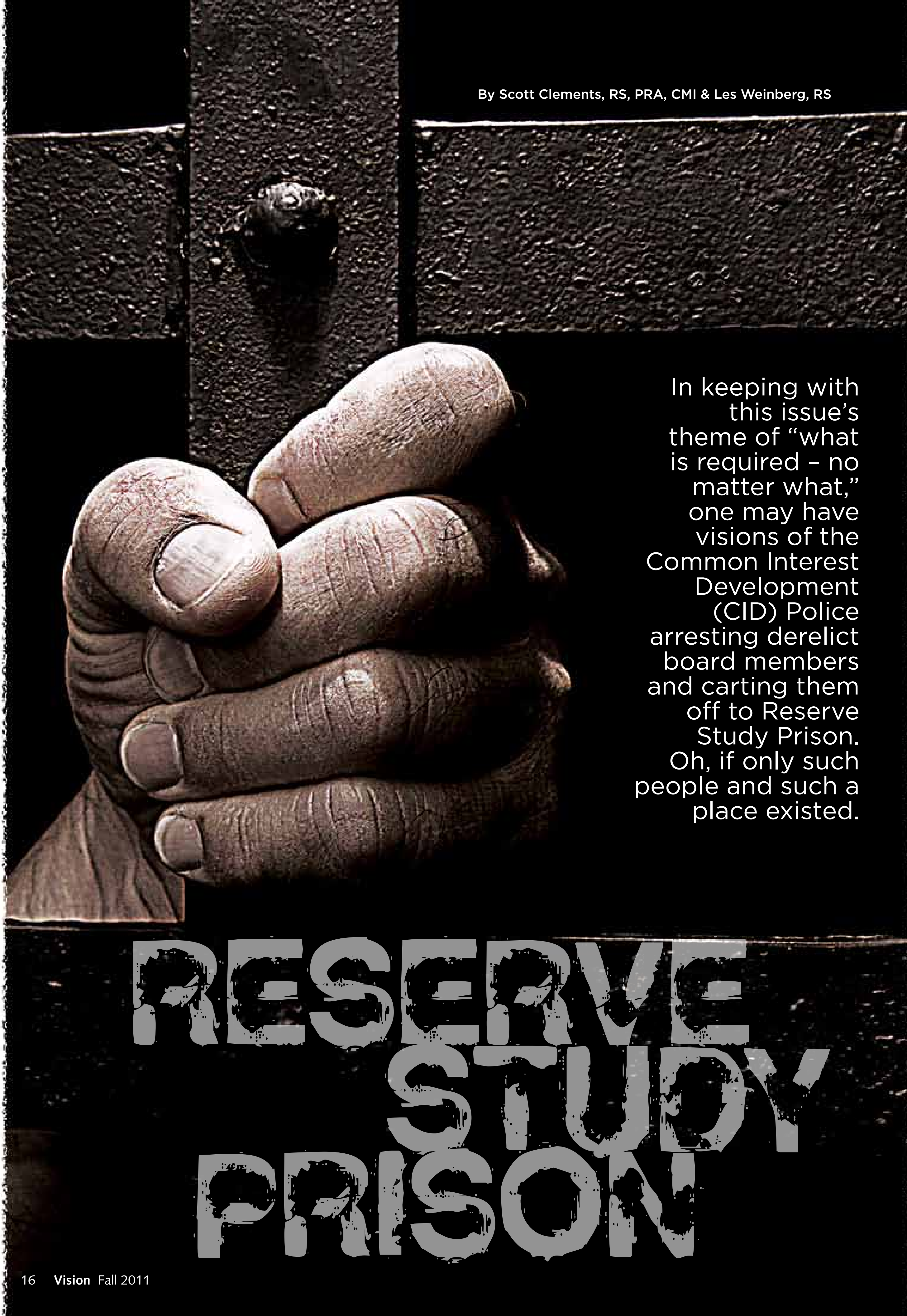

RESERVE STUDY PRISON

By Scott Clements, RS, PRA, CMI & Les Weinberg, RS

In keeping with this issue's theme of "what is required – no matter what," one may have visions of the Common Interest Development (CID) Police arresting derelict board members and carting them off to Reserve Study Prison. Oh, if only such people and such a place existed.

When discussing reserves with membership, you undoubtedly get questions about what has to be done and why it has to be done. There is a natural adverse reaction to a complex document, filled with mind-numbing figures and multiple charts and graphs, that is used to show members their assessments need to be increased. Community managers are often asked to explain the numbers and issues and their importance, and why the association should do this or that. All the while members believe the threat against them for doing something imprudent is limited, because, as we all know, there is (unfortunately) no CID police force and no Reserve Study Prison.

What Has to Be Done

There are three Reserve Study related documents that need to be updated and distributed to the membership on an annual basis:

- Annual Update of Reserve Study
- Reserve Funding Plan
- Assessment and Reserve Funding Disclosure Summary (ARFDS)

The "every three years" requirement of an on-site inspection remains (CC § 1365.5), and a few years ago the requirements for Annual Update (CC § 1363.005) and distribution of the adopted Funding Plan and the ARFDS (CC § 1365, 1365.5, 1365.2.5) were added. Thus, every year California HOAs must have their Reserve Study updated, adopt a Funding Plan, prepare an ARFDS, and distribute this information (summaries, but in their entirety upon request) to the membership 30-90 days prior to the beginning of the fiscal year (CC § 1365 (4)).

Since the process of procuring bids, selecting a provider, arranging an inspection (if necessary), providing financial documents, reviewing a draft, finalizing the Reserve Study, completing the HOA budget, and preparing the disclosure documents can take three to six months, it is recommended HOAs begin this process early enough to ensure timely completion.

Why It's Important

Guessing is, well, guessing, and the consequences for being broke are significant. Roofs wear out. Mechanical equipment eventually fails. HOAs are going to spend money. Some do it with greater reluctance than others, but, eventually, they all spend money. Therefore, they have the choice of guessing how much money they will need and when they will need it, or having a Reserve Study conducted.

We have all heard the popular "just keep some money in the bank and we'll be fine" line, which is slightly more favorable to the "we'll just special assess when we have to" line. What each of these theories lacks is the knowledge of whether individual members, or the collective HOA, are in fact paying too much, or too little for their benefits.

One of the key elements of common interest investment and living is the deferral of personal responsibility for maintenance. Thus, members are investing money to relieve themselves of a responsibility. What are they getting for their investment? Every component wears out over time. Using the accumulated depreciation method (CC § 1365.2.5) as an example, if a water heater costs $1,000 and lasts 10 years, its annual depreciation is $100. Over time, the water heater accumulates $100 per year in depreciation, regardless of when it may be replaced. Reserve Studies project out 30 years (CC § 1365.5); thus, multiple water heaters are anticipated to be replaced, but the actual timing of each may vary. However, financially you plan to save $100 every year for water heaters.

This calculation is done for every component and it adds up to a total annual depreciation for the HOA. Anticipated expenses will vary year to year, but the annual depreciation stays the same. If the HOA does not accumulate an amount equal to the annual depreciation each year, it is creating either negative equity or a financial liability for future years' owners. The opposite occurs if the HOA collects a greater amount. Without a Reserve Study, members do not know if they are paying the correct amount and the risk of special assessment is completely unknown. This is commonly referred to as "playing condo roulette."

When it comes to special assessments, depending on the timing and amount of the special assessment, members are not always aware they will likely be paying more than the annual prorated depreciation with the special assessment method versus

Continued on page 18

3 GOOD HOA RESERVE HABITS

1 KEEP GOOD MAINTENANCE RECORDS This increases the accuracy of the Reserve Study over time by allowing for adjustment of component life expectancies and replacement costs based on the actual performance in that community, versus the standard templates and cost guide estimates.

2 LET THE EXPERTS DO THE WORK Professional reserve analysts will analyze your documentation, including CC&Rs, financial statements, invoices for component replacements, as-built plans, etc., to determine the status of all the common area components required to be included in the Reserve Study. Consultants, such as roofing experts, arborists and architects, can determine the source of and work to solve any problems, as well as apprise you of more cost-effective replacements for existing reserve components. Attorneys can evaluate vague and/or conflicting information in the governing documents with respect to assignment of responsibility, thereby enabling clear-cut awareness of who needs to replace what.

3 RAISE ASSESSMENTS EVERY YEAR Raising assessments is never popular, so HOAs tend to put it off until a crucial point is reached, making it more painful when they finally do. Most companies, union contracts, and pension plans have some type of cost of living increase program. Inflation has been known for some time, and people should be able to factor that into their budgets. Utilizing a policy of small, regular incremental increases is the most prudent and fair method to maintain fiscal security.

Reserve Study Prison

Continued from page 17

a moderate annual contribution rate increase. In other words, if a member lives in the home 10 years, and is special assessed for a roof that took 30 years to wear out, he/she definitely got the bad end of the annual depreciation deal. And there is nothing they can do about that without a time machine.

However, had the member participated in moderate annual increases to the contribution rate from the start, thereby avoiding the special assessment, the total actual costs paid over the 10 years would have been lower, mostly due to the compounding of interest earned on retained savings.

As for going broke, if you have ever managed a “broke” HOA, you know the consequences: deferred maintenance, unsightly appearances, inoperative equipment, special assessments, liens, foreclosures, disgruntled members and lawsuits. Being broke is bad. Period.

The Math Takes Over

Community managers often get the “what’s a good percent funded?” question. Well, that depends on the HOA’s risk tolerance. If the HOA is 75% funded or more, the risk of special assessment is minimal. It would take a catastrophic event to create the need for a special assessment. If they are in the 50% range, the risk is typically pretty low. If they are in the 25% or more range, they have a medium to high risk. Depending on several variables, they should anticipate some type of special assessment in the future. Below 25%, a special assessment is usually inevitable; the only questions are when and how much.

More important than the percent funded, or current status, is the future projections. What are the financial liabilities? When are they anticipated? If the combination of current balances and current contribution rate is not sufficient to meet anticipated expenditures, the only real options are absent regular contribution rate increases, a special assessment, or deferral of the expenditures. Legally, HOAs may borrow or sell assets to fund reserves; however, neither of those are viable long-range strategies.

Members often mistakenly believe that deferral of expenses will have a significant positive impact on their funding status. That is rarely the case. One common misconception is that putting something off, like paint for example, will have an impact on the contribution rate need. The mathematical effect of pushing out the liabilities (i.e., adding remaining life expectancy) for a few components has little impact on the percent funded, and even less on the contribution rate recommendation.

Hypothetically, an HOA has a total replacement cost (all costs of replacements combined) of $500,000, of which $100,000, or 20%, is a paint cycle. A price tag of $100,000 sounds like a lot, but the annual depreciation is a fraction. Let’s say there is a 10 year life expectancy for that paint job, or $10,000 per year. Pushing that liability out two years results in reducing the amount required by $20,000, or 4% of the total replacement costs. There will be multiple variables that weigh against the percent funded; however, under the most extreme circumstances, it has a maximum potential of 4%.

Under probable scenarios, it would be in the .05-1% range of variance. A change of a few percents in the current status has a negligible impact on 30-year Funding Plans, as essentially the monies are due at the same time. Remember, they are not eliminating the expense, but only delaying it. The annual depreciation remains the same. There is likely to be little variance between alternative funding scenarios for the same community based simply on adjusting a few remaining life expectancies – except when there is a significant change in the current status or to the annual depreciation.

Who Cares?

Given the maturation of the common interest development living concept, in conjunction with the current dismal real estate market, buyers are more aware of the Reserve Study as an important tool for making informed purchase decisions.

The result of the fallout from the recent bank failures, as well as unprecedented levels of foreclosures and short sales, has produced a more stringent lending environment. HUD, FHA, VA, Fannie Mae, Freddie Mac and mortgage lenders in general are mandating current Reserve Studies as part of the verification process, and some are beginning to adopt funding level standards for HOAs as well.

As the baby-boomer generation is entering retirement years, reverse mortgages are increasing in popularity. Senior common interest developments are on the rise as well. Reserve Studies would be required to facilitate all of these situations.

So, perhaps the Common Interest Development Police really do exist in the members themselves, both current and future. Poorly funded HOAs could find it difficult to sell individual units, forcing members to stay, thus creating a form of, well, Reserve Study Prison.

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