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***DIAMOND REALTY MANAGEMENT***

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# RESERVE PLANNING



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## **DEFERRED CAPITAL IMPROVEMENTS**

Deferring the common area maintenance of an owners' association, although sometimes necessary, can have negative and lasting effects upon a community. Whatever the ultimate cause of not performing routine maintenance, the outcome will *often* be a net cost considerably higher than having properly anticipated (planned) the work and completed the work in a timely fashion.

## **A CASE FOR RESERVES**

How often do you hear the question "why do we need reserves? After all, this association is only a few years old?"

It became very clear to the owners of ABC Association, a twenty-year old community association, how important it is to put reserve funds aside from the moment an association is established. With no Reserve Plan in place until 2002 the community struggles with its immediate responsibilities as set forth in its declaration. Today it does not have the luxury of time to fund its Reserve Plan.

A modest community association built in the 1987, is made up mostly of senior citizens living on living income. The community's common area component inventory consists only of exterior paint, asphaltting and roof

replacement. Today asphaltting and roof replacement are required and funding is limited. Capital expenses are being deferred or done on an emergency basis only. The consequences to date include considerable interior unit damages from leaky roofs and a slip and fall claim due to uneven and broken asphalt surfaces.

Had previous Boards of Directors had the foresight to know that something like this could happen; they might have begun putting reserve funds away much earlier over the course of the Association's existence.

This fictitious story illustrates that a Board should always be encouraged and advised to start a reserve account as quickly as possible. Plan ahead and fund reserves!

## **RESERVE PLANNING**

As community association boards of directors quickly discover, maintaining the common area/elements of a community association is one of the main purposes of an association. Common area/elements can be limited to something as simple as a flowerbed at the community entrance or encompass, in a condominium regime, the entire building exterior including building roofs, stairs, siding/masonry, landscaping, and occasionally even roads. Funds must be available in order to expense the

replacement, repair, and/or upgrade of these items when it becomes necessary to do so.

A Reserve Fund is money (typically 20% to 30% of total budget) collected as part of the association's assessment that is set aside specifically for the purpose of maintaining those long-term components of the association. Planning for the replacement of those items and calculating the amount of money necessary to actually make the repairs or replacement is the *Reserve Plan*. The depth to which a Reserve Plan is researched and planned will depend on the scope of the common area to be maintained. Obviously, the more property an association must maintain, the more reserves/replacement funds the association will need to collect. The Reserve Plan must not be confused with ordinary and routine maintenance, which in itself must be properly budgeted for within the operational budget. Reserves for the purpose of deferring a capital expense should truly be identified as capital expenses under tax law.

There are two schools of thought regarding the building of a reserve fund. The most common and most fair way to build the replacement fund is to perform a reserve study, establishing the life expectancy of each of the common elements and associating a replacement cost with that element. Once both the replacement cost and remaining life are established, the annual assessment rate is set at an amount that would

fund a portion of the necessary funds each year so that at the end of the useful life of the element, the funds are on hand to make the replacement. By transferring funds each year, the replacement cost is fairly distributed among those owners actually using the elements.

Another approach to building reserves, although much less fair, is the use of a *special assessment* to fund the replacement of the item. A special assessment affects only the current property owner, regardless of the amount of time spent as an owner. With this method, the board's hands may be tied and very necessary repairs may go undone for lack of funds. Unfortunately, many new board members inherit a property without proper reserves and are then faced with many items in need of replacement and a severe lack of funds to use for such. This is when the board must arm itself with as much information as possible before approaching the ownership with the issue. One way to assess the overall situation in very great detail is to engage the services of a qualified property management company.

While a reserve study can help establish the cost for these items, owner involvement will ultimately get the projects approved and funded. Communicating the intent of the association to the owners and requesting feedback on the goals/plans of the board will keep both the board and the owners in tune with the pulse and desires of the association as a whole.

## **WHY HAVE A PROFESSIONAL RESERVE STUDY**

Every community association has three functions - to serve as a business, a government and a community. Community associations are generally nonprofit corporations, functioning in many ways as businesses with revenues (association dues) and expenses.

As a business, the Board needs a business plan for the maintenance of the assets of the association. Which assets or parts thereof (i.e. partial pavement replacements, phasing roofing replacements) will require repair or replacement, when will they need replacement, and at what cost are the most important questions one must ask in determining a forecast of future capital projects. When managing the contributions (assessments) of hundreds of homeowners, it is essential to provide as accurate a forecast as possible. *A Reserve Plan is the continuous 'blueprint' for the future.*

As governance, the Board has a fiduciary responsibility to the owners not dissimilar from the responsibility corporate Board members have to shareholders. They must, to the best of their ability, strengthen the value of the organization. A Reserve Plan will also reduce claims of financial mismanagement. Demonstrating sound fiscal management to the owners

will provide the owners with a high comfort level that their investment in their property is being managed properly.

Last, having a Reserve Plan is simply good business sense.

## **THE RESERVE PLAN**

Preparing the annual budget and overseeing a community association's finances are perhaps the most important responsibilities of the association's board members. It is a primary business duty of a community association to maintain and preserve market values of both the residential and common area property. To do so properly, directors must develop funding plans for future repair or replacement of major common-area components, such as swimming pools, decks, asphalt surfaces, concrete areas, fencing, monument signs, and much more. Using annual operating budgets and reserve budgets assist in reflecting the plans and goals of the association as well as in setting the level and quality of service for the community association's activities in the months and years ahead.

Community associations have several funding options, including periodic assessments over the life of the assets, special assessments at the time of the actual replacement, borrowing funds when needed, a combination of the above, or the most common practice of setting aside

funds in a special category commonly called ***reserve funds, replacement reserves, replacement funds***, or simply, ***reserves***.

Today's boards of directors must educate their membership in understanding why property owners should invest in reserves now, even though the money seemingly might only benefit future owners. Reasons to be shared with the members for creating and adequately maintaining a reserve fund should be: (1) Fulfillment of legal, fiduciary and professional requirements; (2) Deterioration/Depreciation of common assets from which current owners have benefited (3) It minimizes the need for unforeseen special assessments, especially for those on fixed incomes, (4) A replacement fund or reserve enhances resale values, and (5) Accounting standards require proper attention be paid to the reserve/replacement fund, given the depreciable nature of certain assets over time.

Typical Reserve Plans are comprised of two parts, the *Physical Analysis* and the *Financial Analysis*.

> ***Physical Analysis*** - During the physical analysis, the analyst typically performs a site inspection evaluating information about the physical status of the association and the repair/replacement cost of the major common area components. The analyst conducts an inventory of the association's assets,

renders a condition assessment, and completes a life expectancy evaluation. The component inventory should be relatively stable from year to year. In establishing the component inventory, one must review the documents and statutory requirements to determine which components are to be included in the common elements. Once common elements are established, you then must review the maintenance contracts to determine the appropriateness of including all or portions of a component for proper funding.

*Component Inventory - ABC Community Association*

Component	Quantity	Unit Cost	Replacement Cost	Estimated Useful Life	Estimated Remaining Useful Life	Annual Reserve Required
Asphalt	2500 sy	\$3.00	\$7,500	12 years	5 years	\$625
Roofing	35000 sf	\$1.00	\$35,000	20 years	6 years	\$1,750
Decking	4400 sf	\$5.00	\$22,000	12 years	7 years	\$3142
Carpeting	625 sy	\$8.00	\$5,000	7 years	5 years	\$714

**Financial Analysis** – The evaluation and analysis of the association’s reserve balance, if any, income and expenses. Community associations typically set aside a separate section of the budget for the reserve. The study is normally prepared prior to the fiscal year end for use in the budget preparation process.

The *ABC Community Association* is a community association made up of twenty-four units (24) and has a small reserve fund balance of \$6,000 at year-end 2004. Its component inventory, made up of four (4) items, indicates that each component is in the latter stages of its useful life. Proper funding today must consider the lost variable of time. That is, a greater annual contribution must be made starting in 2005 than would otherwise have to have been made if the plan was initiated in 1992.

A reasonable methodology in reviewing a reserve study for purposes of assuring informative content, both now and into the future, is to gather the following:

1. Number of Units;
2. Fund Balance, if any;
3. Component Inventory;
  - a. What are the responsibilities of the association
  - b. Year component placed in service
  - c. Component's useful life estimate
  - d. Component's remaining useful life estimate
  - e. Source utilized to obtain estimates
4. Variable Factors that affect the plan
  - a. Time
  - b. Inflation

- c. Interest Earning
- d. Taxes
- e. Funding
- f. Component's useful life

Careful planning for future repairs and replacements allows the membership to know that the board of directors is taking its fiduciary responsibility seriously and that the directors are truly being good stewards of the association's money. Reference attachment.

## **RESERVE PLAN ACCOUNTING**

Now that the Reserve Plan is complete it is the responsibility of boards of directors to annually monitor the plan. Proper accounting segregates an association's Reserve Fund from its Operating Fund. Reference attachment.