DEPARTMENT OF PROFESSIONAL AND OCCUPATIONAL REGULATION
PERIMETER CENTER
9960 MAYLAND DRIVE
RICHMOND, VIRGINIA 23233

RESERVE STUDY GUIDELINES COMMITTEE
OF THE
COMMON INTEREST COMMUNITY BOARD

Tentative **AGENDA**

THURSDAY, JUNE 20, 2019 AT 9:30 AM

2nd FLOOR, BOARD ROOM 3

I. CALL TO ORDER

II. EMERGENCY EVACUATION PROCEDURES

III. INTRODUCTION OF COMMITTEE MEMBERS

IV. APPROVAL OF AGENDA
1. Committee Agenda, June 20, 2019

V. PUBLIC COMMENT PERIOD*

VI. OVERVIEW
1. Review Purpose of Committee
    a. Relevant Legislation – HB 2030 and SB 1538

VII. RESOURCES AND INFORMATION
1. Applicable Laws and Regulations
    a. Statutes
        i. Section 55-79.83:1 of the Condominium Act
        ii. Section 55-471.1 of the Virginia Real Estate Cooperative Act
        iii. Section 55-514.1 of the Property Owners' Association Act
2. Excerpts from *Virginia Common Interest Communities* (Moss, 2018)
3. Community Associations Institute Best Practices Guides
4. Reserve Study Guidelines from Other States
    a. State of California
    b. State of Nevada

VIII. RESERVE STUDY GUIDELINES
1. Review of Draft Guidelines Document

IX. OTHER BUSINESS

X. COMPLETE CONFLICT OF INTEREST FORMS AND TRAVEL VOUCHERS

XI. ADJOURN

* Five minute public comment, per person.
Persons desiring to participate in the meeting and requiring special accommodations or interpretative services should contact the Department at (804) 367-0362 at least ten days prior to the meeting so that suitable arrangements can be made for an appropriate accommodation. The Department fully complies with the Americans with Disabilities Act.

PERIMETER CENTER CONFERENCE CENTER
EMERGENCY EVACUATION OF BOARD AND TRAINING ROOMS
(Script to be read at the beginning of each meeting.)

PLEASE LISTEN TO THE FOLLOWING INSTRUCTIONS ABOUT EXITING THE PREMISES IN THE EVENT OF AN EMERGENCY.

In the event of a fire or other emergency requiring the evacuation of the building, alarms will sound. When the alarms sound, leave the room immediately. Follow any instructions given by Security staff

Board Room 1
Exit the room using one of the doors at the back of the room. Upon exiting the room, turn **RIGHT.** Follow the corridor to the emergency exit at the end of the hall.

Upon exiting the building, proceed straight ahead through the parking lot to the fence at the end of the lot. Wait there for further instructions.

Board Room 2
Exit the room using one of the doors at the back of the room. (Point) Upon exiting the room, turn **RIGHT.** Follow the corridor to the emergency exit at the end of the hall.

Upon exiting the building, proceed straight ahead through the parking lot to the fence at the end of the lot. Wait there for further instructions.

You may also exit the room using the side door, turn **Right** out the door and make an immediate **Left**. Follow the corridor to the emergency exit at the end of the hall.

Upon exiting the building, proceed straight ahead through the parking lot to the fence at the end of the lot. Wait there for further instructions.

Board Rooms 3 and 4
Exit the room using one of the doors at the back of the room. Upon exiting the room, turn **RIGHT.** Follow the corridor to the emergency exit at the end of the hall.

Upon exiting the building, proceed straight ahead through the parking lot to the fence at the end of the lot. Wait there for further instructions.

Training Room 1
Exit the room using one of the doors at the back of the room. Upon exiting the room, turn **LEFT.** Follow the corridor to the emergency exit at the end of the hall.

Upon exiting the building, proceed straight ahead through the parking lot to the fence at the end of the lot. Wait there for further instructions.

Training Room 2
Exit the room using one of the doors at the back of the room. Upon exiting the doors, turn **LEFT.** Follow the corridor to the emergency exit at the end of the hall.

Upon exiting the building, proceed straight ahead through the parking lot to the fence at the end of the lot. Wait there for further instructions.

Common Interest Community Board Reserve Study Guidelines Committee	
Drew Mulhare, Chair	CIC Board Member, CIC Manager
Tom Burrell	CIC Board Member, Association representative
Michele Baldry	Reserve Specialist
Howard Goldklang	CPA
Eileen Greenberg	Citizen, Association Representative
Doug Greene	Reserve Specialist
Peter Miller	Reserve Specialist
Doug White	Reserve Specialist
Pia Trigiani	CIC Board Chair, Ex-officio member

PUBLIC COMMENT PERIOD

Five minute public comment, per person, with the exception of any open disciplinary or application files.

VIRGINIA ACTS OF ASSEMBLY -- 2019 SESSION

CHAPTER 33

An Act to amend and reenact §§ 55-79.83:1, 55-471.1, and 55-514.1 of the Code of Virginia, relating to common interest communities; dissemination of annual budget; reserve for capital components.

[H 2030]

Approved February 19, 2019

Be it enacted by the General Assembly of Virginia:

1. That §§ 55-79.83:1, 55-471.1, and 55-514.1 of the Code of Virginia are amended and reenacted as follows:

§ 55-79.83:1. Annual budget; reserves for capital components.

A. *Except to the extent provided in the condominium instruments, the executive organ shall, prior to the commencement of the fiscal year, make available to unit owners either (i) the annual budget of the unit owners' association or (ii) a summary of such annual budget.*

B. Except to the extent otherwise provided in the condominium instruments ~~and unless the condominium instruments impose more stringent requirements~~, the executive organ shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components *as defined in § 55-79.41*;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the executive organ deems necessary to maintain reserves, as appropriate.

~~B.~~ *C.* To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the unit owners' association budget shall include, without limitations:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components *as defined in § 55-79.41*;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside to repair, replace, or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; ~~and~~

3. A ~~general~~ statement describing the procedures used for ~~the~~ estimation and accumulation of cash reserves pursuant to this section ~~and the extent to which the unit owners' association is funding its reserve obligations consistent with the study currently in effect~~*; and*

4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

§ 55-471.1. Annual budget; reserves for capital components.

A. *Except to the extent provided in the declaration, the board of directors shall, prior to the commencement of the fiscal year, make available to lot owners either (i) the annual budget of the association or (ii) a summary of such annual budget.*

B. Except to the extent otherwise provided in the declaration ~~and unless the declaration imposes more stringent requirements~~, the executive board shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components *as defined in § 55-426*;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the executive board deems necessary to maintain reserves, as appropriate.

~~B.~~ *C.* To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the association budget shall include, without limitations:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components *as defined in § 55-426*;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside to repair, replace, or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; ~~and~~

3. A ~~general~~ statement describing the procedures used for ~~the~~ estimation and accumulation of cash reserves pursuant to this section and the extent to which the association is funding its reserve obligations consistent with the study currently in effect*; and*

4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

§ 55-514.1. Annual budget; reserves for capital components.

A. *Except to the extent provided in the declaration, the board of directors shall, prior to the commencement of the fiscal year, make available to lot owners either (i) the annual budget of the association or (ii) a summary of such annual budget.*

B. Except to the extent otherwise provided in the declaration and unless the declaration imposes more stringent requirements, the board of directors shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components *as defined in § 55-509*;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the board of directors deems necessary to maintain reserves, as appropriate.

~~B.~~ *C.* To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the association budget shall include, without limitation:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components *as defined in § 55-509*;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside to repair, replace, or restore capital components and the amount of the expected contribution to the reserve fund for that year; ~~and~~

3. A ~~general~~ statement describing the procedures used for ~~the~~ estimation and accumulation of cash reserves pursuant to this section ~~and the extent to which the association is funding its reserve obligations consistent with the study currently in effect~~*; and*

4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

2. That the Common Interest Community Board shall develop guidelines for the development of reserve studies for capital components, including a list of capital components that should be addressed in a reserve study.

VIRGINIA ACTS OF ASSEMBLY -- 2019 SESSION

CHAPTER 44

An Act to amend and reenact §§ 55-79.83:1, 55-471.1, and 55-514.1 of the Code of Virginia, relating to common interest communities; dissemination of annual budget; reserve for capital components.

[S 1538]

Approved February 19, 2019

Be it enacted by the General Assembly of Virginia:
1. That §§ 55-79.83:1, 55-471.1, and 55-514.1 of the Code of Virginia are amended and reenacted as follows:

§ 55-79.83:1. Annual budget; reserves for capital components.

A. *Except to the extent provided in the condominium instruments, the executive organ shall, prior to the commencement of the fiscal year, make available to unit owners either (i) the annual budget of the unit owners' association or (ii) a summary of such annual budget.*

B. Except to the extent otherwise provided in the condominium instruments ~~and unless the condominium instruments impose more stringent requirements~~, the executive organ shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components *as defined in § 55-79.41*;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the executive organ deems necessary to maintain reserves, as appropriate.

~~B.~~ *C.* To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the unit owners' association budget shall include, without limitations:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components *as defined in § 55-79.41*;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside, to repair, replace, or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; ~~and~~

3. A ~~general~~ statement describing the procedures used for ~~the~~ estimation and accumulation of cash reserves pursuant to this section ~~and the extent to which the unit owners' association is funding its reserve obligations consistent with the study currently in effect~~*; and*

4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

§ 55-471.1. Annual budget; reserves for capital components.

A. *Except to the extent provided in the declaration, the board of directors shall, prior to the commencement of the fiscal year, make available to lot owners either (i) the annual budget of the association or (ii) a summary of such annual budget.*

B. Except to the extent otherwise provided in the declaration ~~and unless the declaration imposes more stringent requirements~~, the executive board shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components *as defined in § 55-426*;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the executive board deems necessary to maintain reserves, as appropriate.

~~B.~~ *C.* To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the association budget shall include, without limitations:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components *as defined in § 55-426*;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside to repair, replace, or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; ~~and~~

3. A ~~general~~ statement describing the procedures used for ~~the~~ estimation and accumulation of cash reserves pursuant to this section and the extent to which the association is funding its reserve obligations consistent with the study currently in effect*; and*

4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

§ 55-514.1. Annual budget; reserves for capital components.

A. *Except to the extent provided in the declaration, the board of directors shall, prior to the commencement of the fiscal year, make available to lot owners either (i) the annual budget of the association or (ii) a summary of such annual budget.*

B. Except to the extent otherwise provided in the declaration and unless the declaration imposes more stringent requirements, the board of directors shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components *as defined in § 55-509*;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the board of directors deems necessary to maintain reserves, as appropriate.

~~B.~~ *C.* To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the association budget shall include, without limitation:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components *as defined in § 55-509*;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside, to repair, replace, or restore capital components and the amount of the expected contribution to the reserve fund for that year; and

3. A ~~general~~ statement describing the procedures used for ~~the~~ estimation and accumulation of cash reserves pursuant to this section ~~and the extent to which the association is funding its reserve obligations consistent with the study currently in effect~~*; and*

4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

2. That the Common Interest Community Board shall develop guidelines for the development of reserve studies for capital components, including a list of capital components that should be addressed in a reserve study.

Code of Virginia
Title 55. Property and Conveyances
Chapter 4.2. Condominium Act

§ 55-79.83:1. Reserves for capital components

A. Except to the extent otherwise provided in the condominium instruments and unless the condominium instruments impose more stringent requirements, the executive organ shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace and restore the capital components;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the executive organ deems necessary to maintain reserves, as appropriate.

B. To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the unit owners' association budget shall include, without limitations:

1. The current estimated replacement cost, estimated remaining life and estimated useful life of the capital components;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside, to repair, replace or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; and

3. A general statement describing the procedures used for the estimation and accumulation of cash reserves pursuant to this section and the extent to which the unit owners' association is funding its reserve obligations consistent with the study currently in effect.

2002, c. 459.

The chapters of the acts of assembly referenced in the historical citation at the end of this section may not constitute a comprehensive list of such chapters and may exclude chapters whose provisions have expired.

Code of Virginia
Title 55. Property and Conveyances
Chapter 24. Virginia Real Estate Cooperative Act

§ 55-471.1. Reserves for capital components

A. Except to the extent otherwise provided in the declaration and unless the declaration imposes more stringent requirements, the executive board shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the executive board deems necessary to maintain reserves, as appropriate.

B. To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the association budget shall include, without limitations:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside to repair, replace, or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; and

3. A general statement describing the procedures used for the estimation and accumulation of cash reserves pursuant to this section and the extent to which the association is funding its reserve obligations consistent with the study currently in effect.

2005, c. 436.

The chapters of the acts of assembly referenced in the historical citation at the end of this section may not constitute a comprehensive list of such chapters and may exclude chapters whose provisions have expired.

Code of Virginia
Title 55. Property and Conveyances
Chapter 26. Property Owners' Association Act

§ 55-514.1. Reserves for capital components

A. Except to the extent otherwise provided in the declaration and unless the declaration imposes more stringent requirements, the board of directors shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace and restore the capital components;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the board of directors deems necessary to maintain reserves, as appropriate.

B. To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the association budget shall include, without limitation:

1. The current estimated replacement cost, estimated remaining life and estimated useful life of the capital components;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside, to repair, replace or restore capital components and the amount of the expected contribution to the reserve fund for that year; and

3. A general statement describing the procedures used for the estimation and accumulation of cash reserves pursuant to this section and the extent to which the association is funding its reserve obligations consistent with the study currently in effect.

2002, c. 459.

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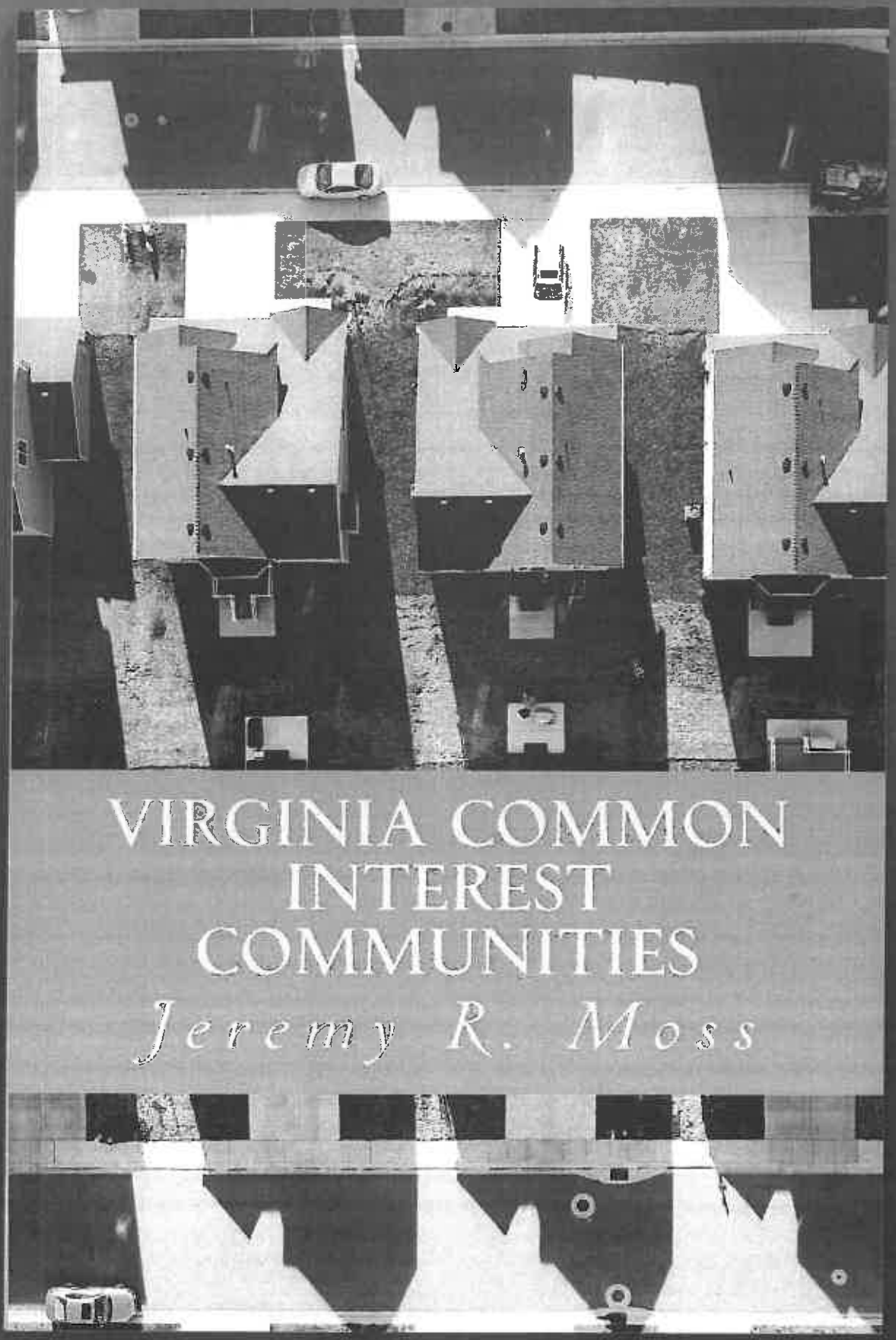

VIRGINIA COMMON INTEREST COMMUNITIES

Jeremy R. Moss

VIRGINIA
COMMON INTEREST COMMUNITIES

Second Edition
2018

VIRGINIA COMMON INTEREST COMMUNITIES

A Resource for Volunteer Leaders, Members, Managing Agents and Business Partners

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Table of Contents

CHAPTER 1

Overview of Community Interest Communities in Virginia

A. Virginia Community Interest Communities

In Virginia, "common interest community," is a generic term used to describe real estate located within the Commonwealth subject to a declaration which contains lots (at least some of which are residential or occupied for recreational purposes) and common areas to which a person, by virtue of his ownership of a lot, is a member of an association and is obligated to pay assessments provided for in a declaration.

Over the last hundred years, real estate developers have used these various land development techniques to create neighborhoods, construct and sell high-rises, comply with local zoning and proffer requirements, increase density, and to allow neighbors to establish shared services, facilities and expenses and to take advantage of economies of scale, and to enhance property values.

Virginia law recognizes three types of common interest communities – condominium unit owners associations, property owners' association, and real estate cooperative associations – used in real estate development.

For a variety of reasons, I've purposefully omitted time-share associations from most of my discussions which have many similar characteristics to common interest communities, but are less prevalent other than in ski areas of Virginia, or Virginia Beach.

Although each type of common interest community has unique features, they all share several common characteristics:

- **Governing Documents** - All common interest communities are organized and subjected to certain documents that establish the contractual relationships between the parties, and establish rights and responsibilities of individual owners, the association, authorized occupants, and the governing board.
- **Mandatory and Automatic Membership** in the Association - In all forms of Virginia common interest communities, the owner (of a lot,

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.d Automatic Membership in the
In all forms of Virginia common
ıunities, the owner (of a lot,

condominium unit, or cooperative membership interest) automatically becomes a member of the association and that membership is mandatory.

- **Mandatory Assessments** - All common interest communities in Virginia rely on assessments to fund association operations and to maintain property. The obligation to pay assessments is mandatory (through affirmative covenants running with the land or through other contractual relationships).

These mandatory obligations are said to "run with the land," imposed on the real estate by the developer through the recordation of the governing documents and binding future owners upon acceptance of their deeds for units or lots, or upon acceptance of their membership interests in cooperatives.

Despite their commonalities, the three types of common interest communities have significant distinctions that will affect the laws affecting those associations.

C. Governing Documents

Common interest communities are estab
governed by a set of documents that may be gene
referred to as the governing documents. Although t
are similarities in these governing documents fo
type of community, the desire for precision requi
analyze each community type, and their r
documents, separately.

1. Condominiums and Condominium U Owners Associations

The governing documents for a condominium a
condominium unit owners association are collec
referred to as the condominium instruments. A
although the Virginia Condominium Act requires
condominium instruments include certain cont
the developer (called the declarant) is given flexibil
many provisions.

A condominium is created by recordin
condominium instruments, that is, the declarat
bylaws, and plats and plans, in the land record
the localities in which the condominium sits.

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Declaration of Condominium

The declaration of condominium, declaration, or master deed (for condominiums created under the Virginia Horizontal Property Act) establishes the condominium. The declaration also typically describes the unit boundaries (thereby defining the common elements), establish developer rights permitted by the Virginia Condominium Act (to expand, contract or convert portions of the condominium), assigns the common element interest appurtenant to each unit, and include certain easements (to the developer, association and individual unit owners).

Bylaws

Like the declaration, the bylaws of a condominium unit owners association must be recorded in the land records. The bylaws are typically attached as an exhibit to the declaration.

But, unlike the declaration of condominium, which establishes and defines the condominium (the physical property), the bylaws define the condominium unit owners association operations and procedures.

Condominium bylaws include, for example, requirements for the number and election of directors and officers, the duties of the association executive organ (typically a board of directors), meeting requirements, the association scope of authority, use restrictions and other requirements.

Plats and Plans

The plats and plans provide a graphical (pictorial) depiction of the condominium. Plats show where the land sits (in relation to the face of the Earth) and the location (and dimensions) of improvements on the land. Plans show vertical elevations of the improvements using specific data.

Stated simply, plats show the condominium as if you are looking down on the land from space; plans show sections of the condominium as if you are looking at the condominium from adjacent land.

Articles of Incorporation (if Incorporated)

The Articles of Incorporation create the association as an incorporated entity. Because the Virginia Condominium Act provides sufficient limitations on liability for individual members

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liability for individual members

directors, and because a condominium unit owners association typically does not own real estate, condominium associations are not required to be incorporated.

Many condominium associations, however, particularly in southeastern Virginia are incorporated, the reason for which is likely more habit or practice than legal necessity.

2. Property Owners' Associations

Deed of Subdivision and Deed of Dedication

Developments governed by property owners' associations begin their lives as a single parcel or group of adjacent parcels with one, or more, land owners. With approval from the locality, these parcels are subdivided (formalized in the recordation of a deed of subdivision or site plan) into individual lots and common area, preparing those lots for eventual sale to individual lot owners.

At or near the time of subdivision, sometimes contemporaneously, a deed of dedication may be recorded that "dedicates" portions of the development for public use, transfers ownership to the locality, and

may include specific development requirements (including those in the form of restrictive covenants that may bind individual owners).

Declaration

The declaration of a property owners' association, oftentimes internally referred to as a declaration of covenants, conditions and restrictions (or CC&Rs), establish the development and establish rights and responsibilities of the association and lot owners.

Declarations also include any restrictive covenants, maintenance obligations of the association, definition of certain membership rights and responsibilities, establishing of some form of governing entity (usually an incorporated association with a functioning board of directors), a description of voting rights and classes, authority and obligations related to the payment of assessments, and the rights of access for association members.

Articles of Incorporation

The Articles of Incorporation create the association as a legal entity, describing membership classes in the association (if applicable) and voting

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Declaration

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a legal entity, describing membership
association (if applicable) and voting

rights. The Articles of Incorporation also identify the initial board of directors and provide the manner of election for future directors.

Bylaws

The bylaws of a property owners' association provide many of the procedural and administrative requirements for the property owners' association, including those related to meetings (of the membership and the board of directors), voting, engagement of a managing agent, establishment of committees, and appointment of officers (including the roles and responsibilities of officers).

Bylaws often specify members' rights and responsibilities, including many of which are merely reiterations of those required by the declaration (pay assessments, comply with rules and regulations, etc.).

Bylaws are sometimes recorded in the land records, but are not required to be. And, if possible, recordation of association bylaws should be avoided. Recordation could trigger additional requirements and impediments to amendments.

3. Real Estate Cooperative Associations

Articles of Incorporation

The articles of incorporation establish the entity that ultimately owns the cooperative building.

Bylaws

The bylaws of a real estate cooperative association establish the administration and operation of the real estate cooperative association (typically an incorporated entity) and may include limitations and other requirements for membership in the cooperative association.

Proprietary Lease

A proprietary lease, sometimes referred to as an occupancy agreement or simply as a lease, defines the terms and conditions of a member's occupancy of an apartment, including any payments required to be paid to the cooperative association.

Membership Certificate

Some real estate cooperative association utilize physical documents, membership certificates,

Estate Cooperative Associations

icles of Incorporation

; of incorporation establish the en
vns the cooperative building.

Bylaws

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Proprietary Lease

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Membership Certificate

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evidence the certificate holder's membership in the cooperative.

4. The Hierarchy of Authority (Statutes and Governing Documents)

Although each type of common interest community is different, there is a general hierarchy of authority (statutes and governing documents) that establish the order of precedence.

This hierarchy is intended to be illustrative, but should be reviewed with the understanding that facts and circumstances may dictate an alternative hierarchy. The exercise of applying legal principles to a specific set of facts is the practice of law in Virginia – legal counsel should be consulted to confirm the hierarchy of authority for a particular circumstance.

Hierarchy of Authority

Federal Law

Virginia Law and Virginia Court Decisions

Local Ordinance and Virginia Circuit Court Decisions[1]

Declaration or Proprietary Lease

Other Recorded Documents (Including Deed of Subdivision, Deed of Dedication, plats, plans and recorded Bylaws)

Articles of Incorporation

Unrecorded Bylaws

Parliamentary Authority (if specified or adopted)

Rules and Regulations

Board Resolutions and Policies

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[1] Local ordinance controls the association governing documents in limited circumstances, mostly as it relates to zoning. But, the governing documents may be, and often are, more restrictive than the local ordinances. Only a small percentage of Virginia Circuit Court opinions are "published," and even published opinions have little precedential value – they are typically considered persuasive authority, not mandatory.

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CHAPTER 2

Functions and Powers of Common Interest Communities in Virginia

Common interest communities have the preferred real estate development format in Virginia (and across the country) for approval by localities. Virginia localities have long recognized that common interest communities offer an orderly and structured development scheme, allow developers to achieve density, give localities relief from the burdens of providing traditional municipal services and maintenance obligations, all while increasing the tax base through increased property values.

For many home buyers, common interest communities make housing affordable and attractive.

According to the 2016 Community Association Fact Book for Virginia published by the Foundation for Community Association Research, Virginia is ranked 12th in the number of common interest communities.

An estimated 1,740,000 Virginians (approximately twenty-one percent) live in one of Virginia's more than 8,600 common interest

communities (governed by approximately 59,000 directors and committee volunteers).

Virginia common interest communities range in size from two dwelling units (including duplexes common near coastal areas including Virginia Beach and converted townhouses in urban centers like the Fan district in Richmond) to more than 21,000 dwelling units (the membership of Reston Association in Fairfax County is made up of approximately 60,000 residents in 21,346 residential units, making it one of the largest common interest communities in the United States).

Surprisingly (at least to me), there was little, if any, philosophical or academic justification for the early proliferation common interest communities. Aside from although the creation of condominiums may have allowed Virginians to enter the housing market earlier than if condominiums did not exist, the expansion of common interest communities was not a response to some pressing social matter.

Instead, common interest communities provided a mechanism for developers to justify a reduction in lot sizes when seeking project approvals from localities. Increases in density (through reduced lot sizes) and

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often traded with localities for the privatization of historically municipal services.

A. The Preservation of Property Values through Managing the Common Area and Community Aesthetic

Consistent with the purpose and mission provided in the governing documents of most common interest communities, the primary purpose of Virginia common interest communities is to preserve property values.

Virginia common interest communities preserve property values in two ways. The primary way common interest communities preserve property values is through the maintenance of common area.

The secondary way common interest communities preserve property values is through the preservation of the community character and appearance – the community aesthetic.

As you can see, the focus of this section is on the preservation, not the enhancement, of property values. Research related to the enhancement of property values

in common interest communities is limited in both number of studies and their scope.

And, research based on public data (i.e., real estate tax assessment valuations) does not account for artificial increases in valuation caused by transferring the value of common area or the common elements to individual dwelling units (see Chapter 4 for more details).

B. Municipal Services and the "Mini-Government" Mischaracterization

Over the last several decades, Virginia common interest communities have taken on duties and functions historically reserved strictly for municipalities.

Common interest communities throughout Virginia now provide and maintain streets, trash and snow removal services, storm water retention facilities and recreational facilities. Many common interest communities also provide other municipal services including street and common area lighting, sewer systems and treatment facilities, parks, security services, recycling pick-up, and community centers

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The provision of these municipal services may give common interest communities a "quasi-governmental" or "mini-governmental" feel, particularly for those who are unfamiliar with the legal structure of common interest communities.

Further, many Virginia common interest communities operate privately held roads that are open to public use, available to Virginia citizens other than those who are members of the associations and contribute to the funding of those roads.

The quality of those roads is in many instances the same (if not superior) quality to those maintained by the state and local governments. Determining where the privately held streets meet those operated by the Virginia Department of Transportation or a locality may be difficult or impossible to tell without a plan, map or drawing.

Other municipal-type services include not only the provision of streets, but their maintenance. They also include trash collection services, snow and ice removal from roadways and sidewalks, and salting and sanding of roadways to prevent ice build-up on roadways.

The provision of municipal services is rarely [illegible] affirmative decision of the residents within [illegible] community. Instead, the obligation of an association [illegible] provide municipal services to association residents [illegible] the public at large, in some circumstances) is imposed on an association by its developer in response to a locality-imposed proffer or development condition.

Other legal commentators have compared [illegible] regulation of common interest communities to the [illegible] government regulation of zoning. And, more popularly, the power of a common interest community to levy assessments and fees from their member has been compared to the assessment and collection of taxes by municipal governments.

The provision of locality-imposed municipal services can be very expensive. The power to assess, therefore, is critical for a common interest community board of directors to fulfill the obligations under the recorded documents governing a community.

Despite these analogies, Virginia law does not classify common interest communities as "quasi-governments" or even as "quasi-governmental."

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Virginia common interest communities are private entities and are not state actors for the purposes of U.S. Constitutional constraints (that's right, the U.S. Constitution protections against acts by Congress and other "state actors" does not apply to internal actions of private associations, like Virginia common interest communities.

Common interest communities do not receive state funding and do not enjoy the benefit of sovereign immunity, a concept that protects many Virginia localities from the liability for core functions.

C. The "Business" of Common Interest Communities

In many ways, common interest communities operate as businesses.

Common interest communities provide services for and to its members who pay assessments and fees pursuant to provisions of the governing documents. These governing documents make officers and directors responsible for a variety of business matters, including:

- Association finances (through adoption and operation of a budget);

- Real and personal property management and preservation;
- Assessment;
- Selection and maintenance of insurance; and,
- Employee hiring, firing and relations.

Virginia common interest communities manage and protect significant real and personal property assets and govern homes with a total estimated value of more than $139B (according to the *2016 Community Association Fact Book for Virginia*).

The valuation of time expended by common interest community volunteer leaders on association matters is approximately $48.5M. And the total value of community-provided housing services, including operations, asset management, repairs and replacement, capital improvements, etc. has been valued at $2.3B. That's "big" business.

D. Virginia's Contractual Framework for Common Interest Communities

Courts in Virginia have established an increasingly consistent framework in which to view the rights and responsibilities of common interest

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communities. This framework, upheld in several cases at various levels in Virginia courts, including the Virginia Supreme Court, provides that the governing documents establishing common interest communities are "contractual in nature."

Under this contractarian theory, relationships within common interest communities are governed by the written contract (the governing documents) between a common interest community, its board of directors, individual owners, residents, the declarant and, in certain instances, municipalities.

Covenants, imposed by a declarant and recorded among the land records of the county in which the real estate is situated "run with the land," binding future purchasers (all of whom are successors in title to the original developer) who agree to abide by those covenants by acceptance of a deed to a lot or unit encumbered by such covenants.

Legislation requiring the provision of information upon the sale, or resale, of a unit or lot ensures constructive knowledge of existing covenants.

The entire common interest community structure, therefore, is based on a series of overlapping binding contracts that carry certain rights, responsibilities and expectations deemed necessary to protect the owner's interest in the property. These covenants are non-discriminatory in that they are binding on all members of the community, each of whom are assumed to have entered as rational persons into the relationship.

Arguments against a purely contractarian framework are diverse, but generally unfounded. Some argue that common interest communities regulate matters too important to be shielded from government intervention and regulation. In Virginia, however, this argument fails.

Statutes governing common interest communities are clear that common interest communities, like their members and declarant, are obligated to comply with lawful provisions of the recorded governing documents and applicable provisions of those statutes.

Another criticism involves the extreme complexity involved in the contractual scheme necessary

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maintain a typical common interest community. However, despite being burdensome, the existence of a complex scheme of contractual relationships does not make the interpretation of rights and responsibilities of parties impossible to determine.

Despite its complexity, a contractarian framework further supports the existence of common interest communities and establishes a public policy in support of the existence of larger pool of associations in Virginia.

Ultimately, common interest communities provide a market of facilities and services. In light of that market, individuals could specifically choose certain communities that offered the facilities and services they desired. As part of the process of purchasing a home situated in a common interest community, individuals engage in a cost-benefit analysis when determining where to purchase. This cost-benefit analysis would balance the quality of facilities and services provided against the cost of the services (and property rights surrendered). Eventually, this process provides significant efficiency gains and greater consumer satisfaction.

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CHAPTER 4

Financing of Common Interest Communities

A. Assessment Authority

As discussed earlier, all common interest communities in Virginia rely on assessments to fund (at least in large part) association operations, maintain property and provide services to its members.

The obligation to pay assessments is mandatory when based on adequate authority (through affirmative covenants running with the land, other contractual relationships or based on statute).

The recorded governing documents of an association must outline the obligation to pay assessments and provide a basis for allocating assessments to each lot or unit.

Most governing documents provide for regular and some form of special assessment.

And, even though members are personally liable for assessments and the assessment creates an inchoate lien against the property for unpaid assessments, assessments are not always paid.

1. Regular (Annual) Assessments

Regular assessments (also referred to as annual assessments) are levied at least annually by common interest communities in accordance with an adopted budget. An association governing documents may require specific notice be provided to association members before an updated regular assessment is levied. But, even if an updated budget is not adopted annually, the prior year's regular assessment amount continues through the new fiscal year.

Most regular assessments are payable in periodic installments, either monthly or quarterly, as permitted (or provided) in the governing documents. Even when payable in installments, many governing documents allow for a regular assessment to be accelerated, with the remaining balance becoming immediately due and payable.

2. Special and Other Types of Assessments

Special assessment is a generic term for any assessment other than a regular assessment. Both the Virginia Property Owners' Association Act and Virginia

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Condominium Act provide for several types of special assessments.

Special assessments can be required when expenses cannot be covered by the regular assessment, when an unexpected expenditure arises or when the conduct of less than all members generates expense.

To encourage proper planning, the governing documents may limit the uses of special assessments or place other limitations on their imposition.

B. Declarant/Builder Assessment Issues

As part of the development process of a common interest community, the declarant enacts an assessment scheme to account for the economic realities of developing communities. Developing communities, in particular developments governed by a property owners' association, may incur operating costs that are lower than will be experienced in the projected budget at full build-out. Expenses based on consumption (utilities, community events, etc.) increase as homes are built, sold and occupied.

In many instances, declarants will subsidize the association budget by funding deficits in lieu of paying

regular assessments or pay all operating expenses (sometimes collecting assessments in normal course to create an operating contingency). Any declarant funding scheme, however, must be expressly provided for in the recorded governing documents.

The Virginia Condominium Act is clear about the declarant's obligation to pay assessments. For condominiums, Virginia policy requires that no unit may be exempted from the obligation to pay assessments by reason of the identity of the unit owner of that unit, including if that unit owner is the declarant.

If any unit owner (other than the declarant) is obligated to pay assessments, the declarant must also pay assessments on unsold units (and any other units otherwise owned by the declarant. Any attempt for a declarant to fund deficits in lieu of paying assessments would violate the Virginia Condominium Act and should be avoided.

The most commonly-used work-around for condominium declarants is to create a condominium in phases. Condominiums are built in phases as additional land is added to the condominium. A unit is

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legally created, and obligated to pay assessments, upon the recordation of the amendment adding the phase to the condominium.

Declarants are routinely accused (typically, informally) of establishing assessments at an artificially low level. This may be done for a variety of reasons, including to encourage initial sales by making the assessment more attractive or to reduce expense to the declarant in the form of declarant-owed assessments. It is a routine practice for the first owner-controlled board of directors to increase assessments in the first full year of owner-control.

C. Association Reserves

All Virginia common interest communities have significant financial responsibilities related to the establishment and keeping of reserves. Reserve funds (referred to typically as reserves) are maintained to pay association expenses related to renovations, major repairs, and planned replacements of capital components.

The obligation for common interest communities to establish and maintain reserves comes from several sources. Both the Virginia Property Owners'

Association Act and Virginia Condominium Act include provisions governing the maintenance of reserves by common interest communities. These provisions are generally supplemented by provisions of the governing documents. And, lending requirements for mortgage underwriters require reserves be established and maintained (many times at specific levels).

At a minimum, common interest communities must:

- Conduct (or have conducted) a reserve study at least once every five years to determine the necessity and amount of reserves required to repair, replace and restore the capital components for which the association is responsible;
- Review the results of that reserve study at least annually to determine if reserves are sufficient; and,
- Make any adjustments to the reserves the Board deems necessary to maintain adequate reserves.

To the extent that the reserve study for the community indicates a need to budget for reserves, the association budget must include:

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- The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components;
- As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside to repair, replace or restore capital components and the amount of the expected contribution to the reserve fund for that year; and,
- A general statement describing the procedures used for the estimation and accumulation of cash reserves pursuant to this section and the extent to which the association is funding its reserve obligations consistent with the study currently in effect.

D. Taxation Issues

1. Real Estate Taxes

For different reasons, described below, both property owners' associations and condominium unit owners association in Virginia are exempt from the payment of real estate taxes.

CHAPTER 13

Maintenance, Repair and Replacement Obligations

Questions often arises about the responsibility for cost and performance of maintenance and repairs common and individually-owned portions of a common interest community.

It is critical that a board of directors applies the maintenance regime uniformly and consistently. Failure to do so could expose a board or community to potential liability.

An analysis of maintenance, repair and replacement obligations requires consideration of both insurance coverage (discussed previously) and provisions of the governing documents.

This analysis is not always easy and conflicting provisions are routinely encountered. If you take nothing else away from this portion of the book, know that maintenance, repair and replacement obligations for common interest communities are fact-specific and vary on a case-by-case basis.

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A. Property Owners' Associations

Most issues related to maintenance, repair and replacement obligations in a property owners' association are relatively simple – the association maintains the common area and the owner maintains the lot. However, the governing documents may (but do not often) provide otherwise.

B. Condominiums

The Virginia Condominium Act establishes the general rule for allocating the responsibility for the maintenance, repair and replacement of components of the condominium between the association and individual unit owners.

Generally, unit components are the unit owner's responsibility and common elements are the association's responsibility.

The Virginia Condominium Act also provides a series of statutory rules for determining whether components of a condominium are part of the units or the common elements. For example, except as otherwise provided in the condominium instruments:

- To the extent that walls, floors and/or ceilings are designated as the boundaries of the units or of any specified units, all lath, wallboard, plasterboard, plaster, paneling, tiles, wallpaper, paint, finished flooring and any other materials constituting any part of the finished surfaces thereof, shall be deemed a part of such units, while all other portions of such walls, floors and/or ceilings shall be deemed a part of the common elements.
- If any chutes, flues, ducts, conduits, wires, bearing walls, bearing columns or any other apparatus lies partially within and partially outside of the designated boundaries of a unit, any portions thereof serving only that unit shall be deemed a part of that unit, while any portions thereof serving more than one unit, or any portion of the common elements shall be deemed a part of the common elements.
- All space, interior partitions and other fixtures and improvements within the boundaries of a unit shall be deemed a part of that unit.
- Any shutters, awnings, doors, windows, window boxes, doorsteps, porches, balconies, patios and

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any other apparatus designed to serve a single unit, but located outside the boundaries thereof, shall be deemed a limited common element appertaining to that unit exclusively; provided that if a single unit's electrical master switch is located outside the designated boundaries of the unit, the switch and its cover shall be deemed a part of the common elements.

Despite these general statutory rules, whether a component of the condominium is part of a unit or is part of the common elements is not necessarily dispositive on questions concerning the maintenance and repair responsibility for that particular component.

The condominium instruments may vary maintenance, repair and replacement responsibilities. And, that variation includes both who is responsible to perform the work and who is responsible to pay for the work (many condominium instruments include, for example, cost-shifting provisions when a unit owner's act, neglect or carelessness causes damage).

Notwithstanding general provisions of the condominium instruments relative to maintenance, repair and replacement, many condominium

instruments include a maintenance responsibilities chart (typically recorded as an exhibit to the bylaws). Maintenance responsibilities charts set out specific maintenance responsibilities for a condominium and should be carefully reviewed and considered.

best practices

REPORT #1

Reserve Studies/ Management

FOUNDATION FOR COMMUNITY ASSOCIATION research

best practices

REPORT #1

Reserve Studies/ Management

Published by
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best practices

Community Associations Institute (CAI) and the Foundation for Community Association Research are dedicated to conducting research and acting as a clearinghouse for information on innovations and best practices in community association creation and management.

What are Best Practices?

The Foundation for Community Association Research is proud to offer function-specific Best Practices Reports in the community association industry. The Foundation has developed best practices in select topic areas using a variety of sources, including, but not limited to, recommendations from industry experts and various industry-related publications. The outcomes of the Best Practices project include:

- documented criteria for function-specific best practices;
- case studies of community associations that have demonstrated success; and
- the development of a showcase on community excellence.

The benefits of benchmarking and developing best practices include: improving quality; setting high performance targets; helping to overcome the disbelief that stretched goals are possible; strengthening cost positions; developing innovative approaches to operating and managing practices; accelerating culture change by making an organization look outward rather than focusing inward; and bringing accountability to the organization because it is an ongoing process for measuring performance and ensuring improvement relative to the leaders in the field.

The Foundation's entire catalog Best Practices Reports is available at www.cairf.org as a free download and for sale in CAI's bookstore.

Overview

Community associations come in all sizes. They vary in age, amenities provided, and maintenance obligations. Careful planning for future repairs and replacements is not only in the best physical and fiscal interests of the community association, it is required by law in some states. Maintaining a reserve fund not only meets legal, fiduciary and professional requirements, it also minimizes the need for special assessments and enhances resale values.

Every community association requires a different amount of cash in reserves to complete repair or replacement projects on schedule without special assessments or loans. How does an association properly determine and compile adequate reserves to fund necessary repair and replacement costs? By conducting reserve studies.

Definition of Reserve Studies

There are two components of a reserve study—a physical analysis and a financial analysis. During the physical analysis, a reserve provider evaluates information regarding the physical status and repair/replacement cost of the association's major common area components. To do so, the provider conducts a component inventory, a condition assessment, and life and valuation estimates. A financial analysis assesses only the association's reserve balance or fund status (measured in cash or as percent funded) to determine a recommendation for an appropriate reserve contribution rate (funding plan).

Types of Reserve Studies

Reserve studies fit into one of three categories: *Full; Update, With-Site-Visit/On-Site Review;* and *Update, No-Site-Visit/Off Site Review* (listed from exhaustive to minimal).

- In a *Full* reserve study, the reserve provider conducts a component inventory, a condition assessment (based upon on-site visual observations), and life and valuation estimates to determine both a fund status and a funding plan.
- In an *Update, With-Site-Visit/On-Site Review*, the reserve provider conducts a component inventory (verification only, not quantification), a condition assessment (based on on-site visual observations), and life and valuation estimates to determine both a fund status and a funding plan.
- In an *Update, No-Site-Visit/Off Site Review*, the reserve provider conducts life and valuation estimates to determine a fund status and a funding plan.

Contents of a Reserve Study

A reserve study should include the following:

- A summary of the association, including the number of units, physical description, and the financial condition of the reserve fund.
- A projection of the reserve starting balance, recommended reserve contributions, projected reserve expenses, and the projected ending reserve fund balance for a minimum of 20 years.
- A tabular listing of the component inventory, component quantity or identifying descriptions, useful life, remaining useful life, and current replacement cost.
- A description of the methods and objectives utilized in computing the fund status and in the development of the funding plan.
- Source(s) utilized to obtain component repair or replacement cost estimates.
- A description of the level of service by which the reserve study was prepared and the fiscal year for which the reserve study was prepared.

Disclosure

Experts recommend the following items be included in a comprehensive reserve study:

- A statement disclosing other involvement(s) with the association that could result in actual or perceived conflicts of interest.
- A narrative description of the physical analysis that details how the on-site observations were performed, i.e. representative sampling vs. all common areas, destructive

testing or not, field measurements vs. drawing take-offs, etc.

- A description of the assumptions utilized for interest and inflation, tax and other outside factors for the financial analysis.
- A written explanation of the credentials (state or organizational licenses/credentials) held by the individual who prepared the reserve study or oversight.
- A report on how the current work is reliant on the validity of prior reserve studies.
- Discussion of material issues which, if not disclosed, would cause a distortion of the association's situation.
- Reliable information provided by the association's official representative regarding financial, physical, quantity or historical issues. The reserve study will be a reflection of information provided to the consultant and assembled for the association's use, not for the purpose of performing an audit, quality/forensic analyses, or background checks of historical records.
- The actual or projected reserve balance total presented in the reserve study based upon information provided.
- Accurate reserve components as determined in the *Update With-Site-Visit* and *Update With No-Site-Visit* levels of service.
- A description of reserve projects which is considered reliable. Any on-site inspection should not be considered a project audit or quality inspection.

Determining a Reserve Schedule

A reserve schedule is the financial summary of the reserve study. Its format depends on the funding method used (see "Selecting a Funding Plan" section). During the development of a reserve schedule, the association and its reserve specialist should follow the steps detailed in Figure 1 on the opposite page.

Establishing a Preventive Maintenance Schedule

Once you've determined which items are reserve components, it's time to establish a preventive maintenance schedule. Associations should establish a preventive maintenance schedule for two primary reasons:

1. If associations do not maintain the components on the reserve schedule, they will not attain their full useful life. Consequently, the components will need to be replaced earlier and the replacement cost will need to be collected over a shorter period of time. This could result in possible special assessments.
2. If associations do not maintain the components that are not included in the reserve schedule, they may require replacement whereas if they were maintained, they would not. For example, wood siding, when maintained properly, will last indefinitely. Without proper maintenance, it may need to be completely replaced in the future.

Figure 2 on the opposite page is a flowchart to assist you in developing a preventive maintenance schedule.

Selecting a Funding Plan

Once your association has established its funding goals, the association can select an

Figure 1. Flowchart for Selecting Reserve-Schedule Components

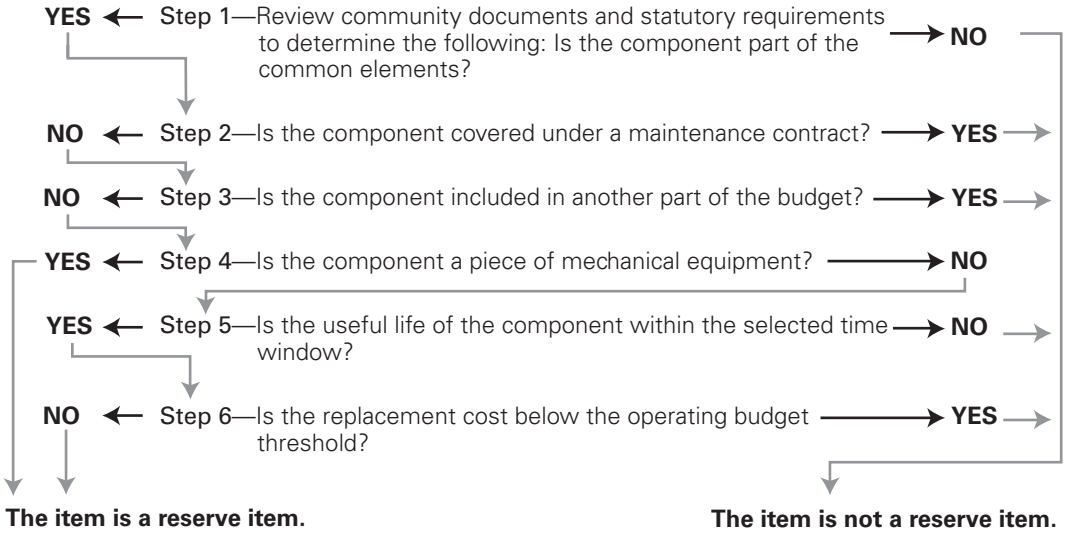
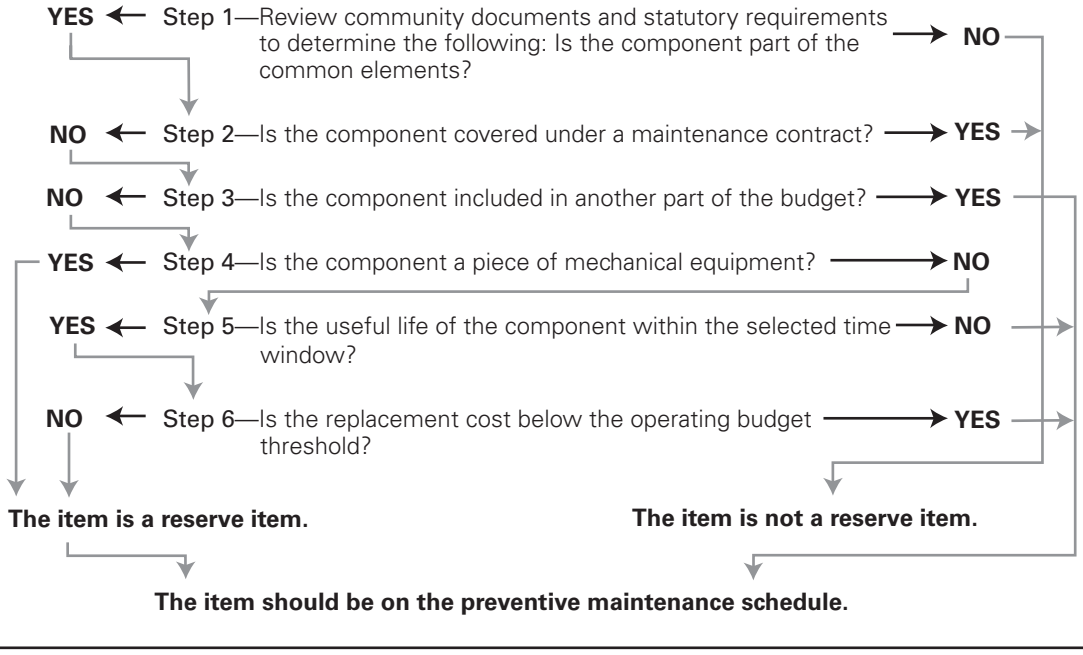


Figure 2. Flowchart for Preventive Maintenance Schedule



appropriate funding plan. There are four basic strategies from which most associations select. It is recommended that associations consult professionals to determine the best strategy or combination of plans that best suit the association's need. Additionally, associations should consult with their financial advisor to determine the tax implications of selecting a particular plan. Further, consult with the American Institute of Certified Public Accountants (AICPA) for their reporting requirements (see Financial Reporting section on page 7). The four funding plans and descriptions of each are detailed below. Associations will need to update their reserve studies more or less frequently depending on the funding strategy they select.

- **Full funding**—The goal of this funding strategy is to attain and maintain the reserves at or near 100 percent. For example, if an association has a component with a 10-year life and a $10,000 replacement cost, it should have $3,000 set aside for its replacement after three years ($10,000 divided by 10 years=$1,000 per year X 3 years=$3,000). In this case, $3,000 equals full funding.
- **Baseline funding**—The goal of this funding method is to keep the reserve cash balance above zero. This means that while each individual component may not be fully funded, the reserve balance does not drop below zero during the projected period. An association using this funding method must understand that even a minor reduction in a component's remaining useful life can result in a deficit in the reserve cash balance. Associations can implement this funding method more safely by conducting annual reserve updates that include field observations.
- **Threshold funding**—This method is based on the baseline funding concept. The minimum reserve cash balance in threshold funding, however, is set at a predetermined dollar amount.
- **Statutory funding**—This method is based on local statutes. To use it, associations set aside a specific minimum amount of reserves as required by statutes.

Developing an Investment Policy

Developing an investment policy is suggested to set a standard and procedure for investing reserve funds. It also allows boards to make consistent choices and brings structure and continuity to the decision. When developing an investment policy, the board should discuss and evaluate the following topics: general policy, goals and objectives, investment strategy, investment securities' selection criteria, and review and control policies.

Additionally, many states have laws protecting community associations from making what some would consider risky investments. It is suggested that associations review state laws related to reserves, review association documents regarding reserves, consult with service providers such as an attorney, an accountant and a community association manager, and conduct yearly reserve policy reviews.

See the sample investment policy on the opposite page.

sample investment policy

The XYZ Condominium, Rockville, Maryland

BE IT RESOLVED that the replacement reserves shall be invested in such amounts as may be authorized by the Board of Directors in accordance with the following policy:

A. No funds shall be deposited or invested except in authorized investments. Authorized investments are those that are in accordance with the Maryland Condominium Act and with the declaration and bylaws of the XYZ condominium and that are obligations of, or fully guaranteed by, the U.S. government.

B. All accounts, instruments, and other documentation of such investments shall be subject to the approval of, and may from time to time be amended by, the board of directors as appropriate, and they shall be reviewed at least annually.

C. Investments shall be guided by the following goals, listed in decreasing order of importance:

a. *Safety of principal.* The long-term goal is safety of the replacement reserves.

b. *Liquidity and accessibility.* Funds should be readily available for projected or unexpected expenditures.

c. *Minimal costs.* Investment costs (redemption fees, commissions, and other transaction costs) should be minimized.

d. *Professional management.* Funds should be invested with professional managers who have good reputations and sound credentials.

e. *Return.* Funds should be invested to seek the highest level of return that is consistent with preservation of the purchasing power of the principal and accumulated interest.

Approved by the XYZ Condominium Board of Directors, (insert date)

Financial Reporting

In the early 1990s, the AICPA developed the *AICPA Audit and Accounting Guide: Audits of Common Interest Realty Associations* (CIRA) to establish accounting standards for accountants to use when composing the financial statements for common interest realty associations. The guide outlines what needs to be included in the financial statements and has requirements for information pertaining to future repairs and replacements.

The following should be included (see the AICPA's guide for a comprehensive list):

- Requirements, if any, in state statutes or association documents to accumulate funds for future major repairs and replacements and the CIRA's compliance or lack of compliance with them.
- A description of the CIRA's funding policy, if any, and compliance with it.
- A statement that funds are accumulated based on estimated future (or current) costs, that actual expenditures may vary from these estimates and that the variations may be material.
- Amounts assessed for major repairs and replacements in the current period, if any.
- A statement indicating whether a study was conducted to estimate remaining useful lives, future major repairs and/or future replacement costs.
- Information regarding special assessments if associations fund major repairs and replacements using them.

case study #1

RR Community Association

Size: 312 units
Location: South Orange County, California

RR Community Association ("RRCA") is a condominium association located in South Orange County, California. RRCA, which was constructed from the mid- to late-1980s, consists of 312 units contained in 39 nearly identical 8-unit buildings. There are private roadways, two pool areas and extensive landscaped areas. The association's reserve components include the following:

Roadways (asphalt and concrete)
Roofs (flat and pitched composition shingle)
Paint (stucco, woodwork, and tubular steel)
Fencing, Walls and Gates
Lighting (buildings, walkways, streets and pool areas)
Two Pool Areas (each with pool, spa and restroom building)
Tot Lot
Deck Surfaces (entrance stairways and balconies)
Doors (garage and utility closets)
Landscaping (irrigation system, slopes, tree trimming)
Miscellaneous Components (awnings, rain gutters, etc.)

Steve Jackson, RS, started working with RRCA in the early-1990s. His first analyses concluded that while the association had a significant reserve fund, it was underfunded by approximately 40 percent. Based on his analyses and recommendations, the association contributed to their reserve fund to cover the normal deterioration of reserve components and also to correct their underfunded reserve position through time. With 312 units contributing to the reserve fund, the total reserve fund grew rapidly. However, everything is relative. With 312 units, the association also faced significant reserve expenditures in the future to properly maintain the community.

During the early- to mid-1990s, deterioration of the reserve components occurred at a more rapid rate than had been estimated. The association was becoming increasingly underfunded. Investigation found that the association had significant construction defects. Now, not only was the association faced with funding their reserve for normal deterioration of components and to correct their underfunded position, they also had to finance litigation against the community's developer.

During the investigation and litigation, which lasted approximately 2 years, the association's board of directors had a legal duty (according to California Civil Code) to analyze and disclose to the homeowners the association's reserve fund status on an annual basis. Contrary to the opinion of some in the legal community, this duty cannot be put on hold due to ongoing litigation. Each year, upon direction from the association's legal counsel, a reserve analysis was prepared that showed the reserve fund status *as if* the reserve components were designed and constructed properly. These analyses made it possible for the association to develop budgets based on normal circumstances with the anticipation

case study #1, continued

that additional expenses or accelerated expenses caused by defective conditions would be awarded to the association through litigation. Each year the association developed their budget based on this analysis and disclosed to the homeowners the assumptions used.

As the investigation progressed, the association's construction experts formulated a repair plan and estimated the total cost to correct construction deficiencies at roughly $3.5 million. Negotiations with the community's developer lead to a proposed settlement of $3.75 million to be paid over a one-year timeframe. Sounds great, right? Wrong. After paying accumulated legal and expert fees as well as repaying a line of credit, the association would be left with a net settlement of $3 million, resulting in a shortfall of approximately $500,000. How would the association make the necessary repairs with such a settlement?

The reconstruction, which would last approximately 18 months, called for repairs, modification or replacement of many reserve components. However, the association's board of directors had only a vague idea with regard to what the impact would be to the reserve components and subsequent changes to the reserve fund status. At this time, the association had approximately $300,000 in their reserve fund and was funding their reserves at a rate of approximately $15,000 per month.

The association's board of directors embarked on a series of analyses addressing the big picture, not just the defective conditions and proposed settlement. RRCA's property manager and legal counsel put together a panel of experts. The board of directors relied on the analyses and recommendations of their construction experts, reserve analyst, investment advisor, management firm and legal counsel. Here's what each party did:

Manager/Legal Counsel—Coordinated efforts of the experts and provided information as required.

Construction Expert—Identified most likely reconstruction schedule including cash flow requirements. Worked with reserve analyst to determine what the impact of the reconstruction plan would be to the reserve components.

Investment Advisor—Developed an investment strategy that would maximize interest income during the reconstruction period and provide necessary cash flow for reconstruction activities.

Reserve Analyst—Developed *pro forma* reserve analysis that projected the reserve fund status post reconstruction. Determined what information was critical to this analysis and collected it from management, legal counsel and the other experts. Performed analysis (described on page 10) and reported results to the board of directors.

Board of Directors—Listened to the advice of management, legal counsel and experts. The board asked the right questions and did their own due diligence to confirm what they were being told.

The experts concluded that the only way this reconstruction could be completed was if the association was willing to use not only the proposed settlement, but also the association's entire reserve fund (including reserve contributions to be made during the

case study #1, continued

reconstruction period).

The question for the reserve analyst became, "what will the impact to the membership be if the existing reserve funds are spent on the reconstruction project?" The board of directors relied on the reserve analyst to determine if the settlement would be sufficient to make the association whole again…both *physically and fiscally*. The board of directors was confident that the repair plan would make the association whole *physically*. Ultimately, the board of directors wanted to know if the existing reserve funds were spent on the reconstruction project, would the reserve contribution (and likely the assessments) need to be increased. If the reserve contribution did not require an increase after the reconstruction, the board would feel that this settlement would make them whole fiscally as well.

The reserve analyst found that the following would occur:

1. By the end of the reconstruction period, the association would spend nearly all of their reserve funds to finance the reconstruction. This would bring the reserve fund status from approximately 60 percent funded down to nearly zero.
2. Most of the major reserve components, which had been scheduled in previous reserve analyses to be addressed in the near future (i.e., flat roofs, painting, deck maintenance, etc.), would be addressed during the reconstruction period.
3. While the association's reserve fund status would be "weak" post reconstruction, the association would be able to pay for reserve expenses as they occurred and rebuild their reserve fund to a suitable level within approximately three years. After approximately five years, the association would be approaching "ideal" reserve fund status (i.e., 90% to 100% funded). All of this would be accomplished with no initial increase to the reserve fund contribution and only minimal increases through time.

During 1998, based on the analyses of their experts, the board of directors accepted the proposed settlement on behalf of the association. The reconstruction of the community was completed (ahead of schedule and within budget) during 1999. Almost the association's entire reserve fund was used to finance the reconstruction.

As of January 2000, the association's reserve fund was 22 percent funded. As planned, the 2000 fiscal year budget called for only a modest increase (consistent with the cost of living) to the reserve fund contribution. By the end of 2000, the association will be 36 percent funded. By the end of 2002, the association expects to be near 60 percent funded and by the end of 2005, they expect to be approaching an ideal reserve fund status.

Submitted by Steve Jackson, RS, Advanced Reserve Solutions, Inc.

case study #2

"ABC" Community Association

Size: 134 units
Location: Kauai, Hawaii

Located in Kauai, Hawaii, this 134-unit large resort condominium (apartment style) property was built in 1976. The association was originally designed to be a timeshare tennis club. However, that concept did not appeal to buyers and the plan was adjusted to present units in the association for sale as homes. It has experienced its share of trials through the years. The original developer took its time withdrawing from the association and turning it over to homeowner control. There were threats of converting the association to timeshare. There was the major rebuilding effort after Hurricane Iniki in September 1992. On the bright side, the community is now under a new management organization that has its roots in hotel and vacation ownership management and an appreciation for quality, cost-effective maintenance rather than a continuation of band-aid projects. Currently, there are 48 owners—47 individual owners and one large owner who operates their portfolio of units in a vacation club (timeshare) concept.

This association has had a mixture of reserve studies over the years. The first reserve study was a professional *Full* reserve study done in 1995 for fiscal year (FY) 1996. It found that the association was 17 percent funded and recommended monthly reserve contributions (MRC) of $17,700.

In 1996, the association performed a Do-It-Yourself Reserve Study Kit, in which they assembled the physical information on the property and obtained professional assistance in crunching the numbers and generating a report. In this report for FY 1997, they were found to be 29 percent funded and an effective MRC was computed to be $12,700. In 1997, a professional *No-Site-Visit Update* reserve study was done for FY 1998. That reserve study found them to be 45 percent funded and recommended a MRC of $12,600.

In 1998, the association had a professional *No-Site-Visit Update* reserve study done for FY 1999. That reserve study found them to be again 45 percent funded, and recommended a MRC of $13,000. In 1999 they also had a professional *No-Site-Visit Update* reserve study done for FY 2000, which found them to be 47 percent funded and recommended a MRC of $14,500. In 2000 they had a professional *With-Site-Visit Update* reserve study done for FY 2001. That reserve study found them to be 44 percent funded and again recommended a MRC of $14,500.

Despite starting at a weak 17 percent funded and even through the expenditures of many large repainting, asphalt resurfacing, and repair projects, the community association has increased its reserve fund strength to the 40-50 percent range over the last few years. Their expectation is continued growth in the strength of their reserve fund, judicious use of their maintenance budget, wise expenditures of reserves, and a strong reserve contribution rate. The association has never experienced a special assessment.

Submitted by Robert M. Nordlund, P.E., RS, Association Reserves, Inc.

case study #3

The Woodlands at West Orange Condominium Association

Size: 174 units
Location: West Orange, New Jersey

Since transition from developer control, the board of directors at The Woodlands at West Orange Condominium Association has funded the reserves in accordance with the recommendations in the initial capital reserve study and subsequent bi-annual updates. This strong belief in adequate reserves recently helped the association through a major roof replacement. Like many communities built in the 1980's, the roofs at The Woodlands contained fire-retardant treated (FRT) plywood that was subsequently found to be unsuitable for the construction of roofs. In 1996, within the statutory limit of ten years since construction, the association began procedures to prepare the necessary back-up to file a claim for reimbursement of replacement costs with the State of New Jersey. In 1998, the State awarded the association $254,000 toward the cost of the roof replacement project, which was anticipated to cost approximately $1.2 million including approximately $150,000 in roof-related enhancements.

The board of directors then faced the challenge of informing the unit owners that they were going to spend $1.2 million. To do so, the board president called a special meeting of all unit owners on April 30, 1998—a meeting that drew the largest attendance of any meeting ever held at The Woodlands. Under the guidance of the president and the Reserve Specialist, the project was analyzed for the owners. The association had $114,000 in available cash, of which $60,000 would be used toward the roof project. In addition, $606,000 was to be borrowed from the capital reserve fund and $78,000 was to be utilized from the escrow fund. Combined with the award from the state, the association was still facing a deficit of more than $221,000. To cover that deficit, a one-time assessment of $1,500 per unit was levied. To ease the burden, the assessment was made payable over a twelve-month period.

Luckily, the roof replacement project was completed ahead of schedule and at a cost savings of $61,000. The association was then faced with rebuilding its reserves and repaying the money borrowed from the capital reserve fund. At this time, the Reserve Specialist conducted another reserve analysis and found that a smaller contribution to the capital reserve fund would be sufficient to meet the association's needs. Prior to the roof project, the association was spending $30,000 a year in repairs. Since the new roofs were installed, that expenditure was added to the annual contribution to the reserve fund. The decision to continue to make contributions to the reserve fund at the higher rate was key to the association's ability to fully restore both the reserve fund and the escrow fund in an acceptable time frame.

Thanks to a true team effort by the association board members, the Reserve Specialist, the investment consultant, and the accountant, the association is once again fully funded—with a current reserve fund of $900,000—and the escrow fund completely restored. Moreover, the association has not had an increase in maintenance fees in seven years. This ongoing focus on reserves and quality maintenance of property has resulted in an extremely high demand for homes in The Woodlands at West Orange Condominium Association.

Submitted by Jerome M. Fien, President, The Woodlands at West Orange Condominium Association

Common Terms

For those not trained to perform reserve studies, some of the terminology may seem daunting. Here are some commonly used terms:

Cash Flow Method: A method of developing a reserve funding plan where contributions to the reserve fund are designed to offset the variable annual expenditures from the reserve fund. Different reserve funding plans are tested against the anticipated schedule of reserve expenses until the desired funding goal is achieved.

Component Inventory: The task of selecting and quantifying reserve components. This task can be accomplished through on-site visual observations, review of association design and organizational documents, a review of established association precedents, and discussion with appropriate association representative(s).

Component Method: A method of developing a reserve funding plan where the total contribution is based on the sum of contributions for individual components. See "cash-flow method."

Condition Assessment: The task of evaluating the current condition of the component based on observed or reported characteristics.

Current Replacement Cost: See "replacement cost."

Deficit: An actual or projected reserve balance less than the fully funded balance. The opposite would be a surplus.

Effective Age: The difference between useful life and remaining useful life. Not always equivalent to chronological age, since some components age irregularly. Used primarily in computations.

Financial Analysis: The portion of a reserve study where the current status of the reserves (measured as cash or percent funded) and a recommended reserve contribution rate (reserve funding plan) are derived, and the projected reserve income and expense over time is presented. The financial analysis is one of the two parts of a reserve study.

Component Full Funding: When the actual or projected cumulative reserve balance for all components is equal to the fully funded balance.

Accrued Fund Balance (AFB): The total accrued depreciation. It's an indicator against which the actual or projected reserve balance can be compared to identify the direct proportion of the "used up" life of the current repair or replacement cost. This number is calculated for each component, and then summed together for an association total. The following formula can be utilized. AFB = Current Cost X Effective Age/Useful Life

Fund Status: The status of the reserve fund as compared to an established benchmark such as percent funding.

Funding Goals: Independent of methodology utilized, the following represent the basic categories of funding plan goals:

- *Baseline Funding:* Establishing a reserve funding goal of keeping the reserve cash balance above zero.

- *Component Full Funding:* Setting a reserve funding goal of attaining and maintaining cumulative reserves at or near 100% funded.
- *Statutory Funding:* Establishing a reserve funding goal of setting aside the specific minimum amount of reserves of component required by local statues.
- *Threshold Funding:* Establishing a reserve funding goal of keeping the reserve balance above a specified dollar or percent funded amount. Depending on the threshold, this may be more or less conservative than component full funding.

Funding Plan: An association's plan to provide income to a reserve fund to offset anticipated expenditures from that fund.

Funding Principles:
- *Sufficient Funds When Required*
- *Stable Contribution Rate over the Years*
- *Evenly Distributed Contributions over the Years*
- *Fiscally Responsible*

Life and Valuation Estimates: The task of estimating useful life, remaining useful life, and repair or replacement costs for the reserve components.

Percent Funded: The ratio, at a particular point of time (typically the beginning of the fiscal year), of the actual (or projected) reserve balance to the accrued fund balance, expressed as a percentage.

Physical Analysis: The portion of the reserve study where the component inventory, condition assessment, and life and valuation estimate tasks are performed. This represents one of the two parts of the reserve study.

Remaining Useful Life (RUL): Also referred to as remaining life (RL). The estimated time, in years, that a reserve component can be expected to continue to serve its intended function. Projects anticipated to occur in the initial year have "zero" remaining useful life.

Replacement Cost: The cost of replacing, repairing, or restoring a reserve component to its original functional condition. The current replacement cost would be the cost to replace, repair, or restore the component during that particular year.

Reserve Balance: Actual or projected funds as of a particular point in time that the association has identified for use to defray the future repair or replacement of those major components which the association is obligated to maintain. Also known as reserves, reserve accounts, cash reserves. Based upon information provided and not audited.

Reserve Component: The individual line items in the reserve study developed or updated in the physical analysis. These elements form the building blocks for the reserve study. Components typically are the association responsibility, have limited useful life expectancies, have predictable remaining useful life expectancies, are above a minimum threshold cost, and are as required by local codes.

Reserve Provider: An individual that prepares reserve studies.

Special Assessment: An assessment levied on the members of an association in addition to regular assessments. Governing documents or local statutes often regulate special assessments.

Surplus: An actual or projected reserve balance greater than the fully funded balance.

Useful Life (UL): Total useful life or depreciable life is the estimated number of years that a reserve component can be expected to serve its intended function if it is properly constructed in its present application and/or installation.

Additional Resources

Books available from CAI

Accounting for Managers, by William H. Webster, 2004.

Community Association Finances, Common Sense from Common Ground: A Collection of Articles from CAI's Award-Winning Magazine, 2005.

Condos, Townhomes & Homeowners Associations: How to Make Your Investment Safer, by Patrick Hohman, 2010.

Reserve Funds: How & Why Community Associations Invest Assets, by Mitchell H. Frumkin, P.E., CGP, RS and Nico F. March, CFM, RRP, editors, 2009.

Tips for Protecting Association Finances

For more information or a CAI Press catalog, please call (888) 224-4321 (M-F, 9-6:30 ET) or visit www.caionline.org.

Best Practices Reports *(available at www.cairf.org)*:

Community Harmony & Spirit

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Financial Operations

Governance

Green Communities

Reserve Studies/Management

Strategic Planning

Transition

About the Foundation for Community Association Research

The Foundation provides authoritative research and analysis on community association trends, issues and operations. Our mission is to inspire successful and sustainable communities. We sponsor needs-driven research that informs and enlightens all community association stakeholders—community association residents, homeowner volunteer leaders, community managers and other professional service providers, legislators, regulators and the media. Our work is made possible by your tax-deductible contributions.

Your support is essential to our research. Visit www.cairf.org or e-mail foundation@caionline.org.

FOUNDATION FOR COMMUNITY ASSOCIATION research

About Community Associations Institute (CAI)

Community Associations Institute (CAI) is an international membership organization dedicated to building better communities. With more than 32,000 members, CAI works in partnership with 60 chapters, including a chapter in South Africa, as well as with housing leaders in a number of other countries, including Australia, Canada, the United Arab Emirates and the United Kingdom. CAI provides information, education and resources to the homeowner volunteers who govern communities and the professionals who support them.

CAI members include association board members and other homeowner leaders, community managers, association management firms and other professionals who provide products and services to associations. CAI serves community associations and homeowners by:

- Advancing excellence through seminars, workshops, conferences and education programs, most of which lead to professional designations for community managers and other industry professionals.
- Publishing the largest collection of resources available on community association management and governance, including website content, books, guides, *Common Ground*™ magazine and specialized newsletters.
- Advocating on behalf of common-interest communities and industry professionals before legislatures, regulatory bodies and the courts.
- Conducting research and serving as an international clearinghouse for information, innovations and best practices in community association development, governance and management.

We believe homeowner and condominium associations should strive to exceed the expectations of their residents. We work toward this goal by identifying and meeting the evolving needs of the professionals and volunteers who serve associations, by being a trusted forum for the collaborative exchange of knowledge and information, and by helping our members learn, achieve and excel. Our mission is to inspire professionalism, effective leadership and responsible citizenship—ideals reflected in associations that are preferred places to call home. Visit www.caionline.org or call (888) 224-4321.

community ASSOCIATIONS INSTITUTE

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DEVELOPING FUNCTION-SPECIFIC BEST PRACTICES in the community association industry has been a goal of Community Associations Institute and the Foundation for Community Association Research for several years. The Foundation has developed best practices in select topic areas using a variety of sources, including, but not limited to, recommendations from industry experts and various industry-related publications. The outcomes of the Best Practices project include:

- Documented criteria for function-specific best practices.
- Case studies of community associations that have demonstrated success in specific areas.
- A showcase on community excellence.

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National Reserve Study Standards

A reserve study is made up of two parts, 1) the information about the physical status and repair/replacement cost of the major common area components the association is obligated to maintain (physical analysis), and 2) the evaluation and analysis of the association's reserve balance, income, and expenses (financial analysis). The physical analysis comprises the component inventory, condition assessment, and life and valuation estimates. The component inventory should be relatively "stable" from year to year, while the condition assessment and life and valuation estimates will necessarily change from year to year. The financial analysis is made up of a finding of the client's current reserve fund status (measured in cash or as percent funded) and a recommendation for an appropriate reserve contribution rate (funding plan).

Physical analysis
- Component inventory
- Condition assessment
- Life and valuation estimates

Financial analysis
- Fund status
- Funding plan

Levels of Service

The following three categories describe the various types of reserve studies, from exhaustive to minimal.

I. Full: A reserve study in which the following five reserve study tasks are performed:
- Component inventory
- Condition assessment (based upon on-site visual observations)
- Life and valuation estimates
- Fund status
- Funding plan

II. Update, with-site-visit/on-site review: A reserve study update in which the following five reserve study tasks are performed:
- Component inventory (verification only, not quantification)
- Condition assessment (based upon on-site visual observations)
- Life and valuation estimates
- Fund status
- Funding plan

National Reserve Study Standards

III. Update, no-site-visit/off-site review: A reserve study update with no on-site visual observations in which the following three reserve study tasks are performed:

- Life and valuation estimates
- Fund status
- Funding plan

Terms and Definitions

CAI's Reserve Professionals Committee adopted the following terms and definitions to assist community association boards of directors.

Cash flow method—A method of developing a reserve funding plan in which contributions to the reserve fund offset the variable annual expenditures from it. Different reserve funding plans are tested against the anticipated schedule of reserve expenses until the desired funding goal is achieved.

Component—An individual line item in a reserve study, developed or updated in the physical analysis. Components are the building blocks on which the reserve study is built.

Component inventory—The task of selecting and quantifying reserve components. This task can be accomplished through on-site visual observations, review of association design and organizational documents, review of established association precedents, and discussion with the appropriate association representative(s).

Component method—A method of developing a reserve funding plan in which the total contribution is based on the sum of contributions for individual components. See cash flow method.

Condition assessment—The task of evaluating the current condition of the component based on observed or reported characteristics.

Current replacement cost—See replacement cost.

Deficit—An actual (or projected) reserve balance less than the fully funded balance. The opposite would be a surplus.

Effective age—The difference between useful life and remaining useful life. Not always equivalent to chronological age because some components age irregularly. Used primarily in computations.

National Reserve Study Standards

Financial analysis—The portion of a reserve study in which the current status of reserves (measured as cash or percent funded) and a recommended reserve contribution rate (reserve funding plan) are derived, and the projected reserve income and expense over time is presented. The financial analysis is one of the two parts of a reserve study.

Fully funded—100 percent funded; when the actual (or projected) reserve balance is equal to the fully funded balance.

Fully funded balance (FFB)—Total accrued depreciation; an indicator against which actual (or projected) reserve balance can be compared; the reserve balance that is in direct proportion to the fraction of "used" life of the current repair or replacement cost. This number is calculated for each component, and these sums are added together for an association total.

Funding goals—Independent of methodology utilized, the following represent the basic categories of funding plan goals:

- **Full funding**: Setting a reserve funding goal of attaining and maintaining reserves at or near 100 percent funded.
- **Baseline funding**: Establishing a reserve funding goal of keeping the reserve cash balance above zero.
- **Statutory funding**: Establishing a reserve funding goal of setting aside the specific minimum amount of reserves required by local statutes.
- **Threshold funding**: Establishing a reserve funding goal of keeping the reserve balance above a specified dollar or percent funded amount. Depending on the threshold, this may be more or less conservative than full funding.

Funding plan—An association's plan to provide income to a reserve fund to offset anticipated expenditures from that fund.

Life and valuation estimates—The task of estimating useful life, remaining useful life, and repair or replacement costs for reserve components.

Percent funded—The ratio at a particular point in time (typically the beginning of the fiscal year) of the actual (or projected) reserve balance to the fully funded balance, expressed as a percentage.

Physical analysis—The portion of the reserve study in which the component inventory, condition assessment, and life and valuation estimate tasks are performed. This represents one of the two parts of the reserve study.

National Reserve Study Standards

Remaining useful life (RUL); Remaining life (RL)—The estimated time, in years, for which a reserve component can be expected to continue to serve its intended function. Components of projects planned for the initial year have zero remaining useful life.

Replacement cost—The cost of replacing, repairing, or restoring a reserve component to its original functional condition. The current replacement cost would be the cost to replace, repair, or restore the component during that particular year.

Reserve balance—Actual (or projected) funds at a given point in time identified by the association to defray the future repair or replacement costs of those major components the association is obligated to maintain. Also known as reserves, reserve accounts, or cash reserves.

Reserve study—A budget planning tool that identifies the current status of the reserve fund and a stable and equitable funding plan to offset the anticipated future major common-area expenditures. The reserve study consist of two parts: the physical analysis and the financial analysis.

Special assessment—An assessment levied on association members in addition to regular assessments. Special assessments are often regulated by governing documents or local statutes.

Surplus—An actual (or projected) reserve balance greater than the fully-funded balance. See deficit.

Useful life (UL)—The estimated time, in years, for which a reserve component can be expected to serve its intended function if properly constructed in its present application or installation.

Professional Designation

The following is an outline of the designation application. The RS designation is intended for individuals, and is designed to demonstrate a basic level of competency within the industry. The application comprises four parts: background, experience and sample work product, references, and continuing experience. All four parts must be completed and submitted to apply for the credential via the Reserve Specialist (RS) Application.

Qualification guidelines:

1. Background:

   College bachelor level degree in construction management, architecture, or engineering; or four years prior related experience (prior to and in addition to direct reserve study experience) in a field servicing community associations (accounting, association management, construction, etc.); or trade school

diploma and two years prior related experience (prior to and in addition to direct reserve study experience).

2. Experience and sample work product:
   Must certify preparation of or be in responsible charge for preparing at least 50 reserve studies within past three calendar years and submit a list of 50 clients with application. Must submit one study of the applicant's original work using format on application including all seven tasks as described within for a "full" study. One sample work product must be submitted to demonstrate that minimum report requirements and disclosures have been met.

3. References:
   Two references from community association industry professionals. Five references from different clients.

4. Continuing experience:
   Must continue to prepare or be in responsible charge for the preparation of at least 50 reserve studies within past three calendar years and submit a list of 50 clients with application. Renewal applications, required every third year, will require documentation of this experience. (See Experience and Sample Work Product.)

Reserve Study Contents

The following is a list of the minimum contents to be included in the reserve study:

- A summary of the association's number of units, physical description, and reserve fund financial condition.
- A projection of reserve starting balance, recommended reserve contributions, projected reserve expenses, and projected ending reserve fund balance for a minimum of 20 years.
- A tabular listing of the component inventory, component quantity or identifying descriptions, useful life, remaining useful life, and current replacement cost.
- A description of methods and objectives utilized in computing the fund status and development of the funding plan.
- Source(s) utilized to obtain component repair or replacement cost estimates.
- A description of the level of service by which the reserve study was prepared.
- Fiscal year for which the reserve study is prepared.

State of California
Department of Real Estate

RESERVE STUDY GUIDELINES
for Homeowner Association Budgets

August 2010

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This independent research report was developed under contract for the California Department of Real Estate by Eva Eagle, Ph.D., and Susan Stoddard, Ph.D., AICP, Institute for the Study of Family, Work and Community and David H. Levy, M.B.A., C.P.A. Janet Andrews, MBA, was responsible for the original design, layout, and typography. The Department of Real Estate revised this publication in August 2010. It includes updates by Roy Helsing PRA, RS to insure it aligns with current California Law and the guidelines of the Association of Professional Reserve Preparers (APRA) and the Community Associations Institute (CAI).," The report does not necessarily reflect the position of the Administration of the State of California.

NOTE: Before a homeowners' association decides to prepare its own Reserve Study, it should consider seeking professional advice on that issue. There are issues concerning volunteer board member indemnification, reliance on expert advice, and other factors that should be considered in that decision. The goal of this manual is to help the reader better understand Reserve Studies. It is not the intent of this manual to define the "standard of care" for Reserve Studies or to interpret the California Civil Code.

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Preface

California's Common Interest Development Act requires that associations prepare and distribute financial information, including a plan for funding future replacement of major components (roofs, exterior paint, and so on). "Reserve Study Guidelines for Homeowners' Association Budgets" has been developed to assist boards of directors of California common interest developments (CIDs) to better understand the preparation of the reserve study portion of the association's annual *pro forma* operating budget, as this document is defined in California Civil Code Section 1365, and to assist buyers in understanding the financial implications of an association's replacement reserve funding. The term "reserves" as used in this context refers to the funds set aside to cover these replacement costs. The board of directors must make decisions about the funding goals of the association. These guidelines should enable readers to answer the following questions:

- How do reserves fit into the overall financial plan?
- What are the steps in doing a reserve study?
- What are the steps in conducting a Physical Analysis of common area major components?
- What is involved in developing a Funding Analysis?
- How do boards hire qualified professionals to perform reserve studies?
- What are the "red flags" that signal potential problems?

These guidelines were developed with the assistance of numerous industry professionals, association board members and managers and the Department of Real Estate. The approach described in these pages has been developed from examples of current reserve studies, and from the comments and suggestions of industry leaders. In following the suggestions presented here, a board should consult with the association's own attorney, accountant, or other advisors, as necessary.

1. Introduction

Common interest developments (CIDs) are defined by shared property and restrictions in the deed on use of the property. A CID is governed by a mandatory association which administers the property and enforces its restrictions. The association is responsible for repairing, replacing, or maintaining the common areas. The owner of each separate interest is responsible for maintaining that separate interest and any exclusive use common area appurtenant to the separate interest. (California Civil Code Section 1364)

Importance of Reserve Studies

A reserve study provides a current estimate of the costs of repairing and replacing major common area components (such as roofs or pavement) over the long term. Ideally, all major repair and replacement costs will be covered by funds set aside by the association as reserves, so that funds are there when needed. This requires:

- examination of the association's repair and replacement obligations;
- determination of costs and timing of replacement; and
- determination of the availability of necessary (reserve) cash resources.

Because the board has a fiduciary duty to manage association funds and property, a replacement reserve budget is very important. Not only does this information supplement the annual pro forma operating budget in providing owners with financial information; the reserve study is also an important management information tool as the association strives to balance and optimize long-term property values and costs for the membership.

For buyers, understanding the reserve study is an important part of evaluating the value of a CID property. For association members, reserve planning helps assure property values by protecting against declining property values due to deferred maintenance and inability to keep up with the aging of components.

A good reserve study shows owners and potential buyers a more accurate and complete picture of the association's financial strength and market value. The reserve study should disclose to buyers, lenders, and others the manner in which management of the association (i.e., the board and outside management, if any) is making provisions for non-annual maintenance requirements. Preparing a reserve study calls for explicit association decisions on how to provide for long-term funding, and on the extent to which the association will set aside funds on a regular basis for non-annual maintenance requirements. A good reserve study may also function as a maintenance planning tool for the association.

Content of Reserve Studies

California's Common Interest Development Act sets forth California's legal requirements for reserve study information to be included in the annual association budget. California Civil Code Section 1365 requires that homeowner associations prepare and distribute certain financial information, including a pro forma operating budget, 30-90 days prior to the start of the association's next fiscal year.

Thus, the pro forma operating budget must contain, at a minimum, the following items:

- estimated revenue and expenses on the accrual basis of accounting;
- identification of total cash reserves currently set aside;
- estimated remaining life of major components;
- estimated current replacement cost of major components;
- If applicable, the amount of any construction defect related award or settlement and the disposition of such funds;
- The total cash reserves expressed as a percentage of the current replacement cost, and the current deficiency in reserve funding on a per-unit basis;
- identification of methods of funding for future repair, replacement or additions to major components (including notification of any deferred repairs or replacements, anticipated special assessments, or certain outstanding loans to the association); and
- statement of methods used to develop estimates and funding plan.

The Civil Code requires a specific form to be used in disclosing the above items pursuant to Civil Code Section 1365.2.5.

Since the time when these requirements were established, a number of California CIDs have assembled data and produced reports in response to the law. Many CIDs, however, still have not developed required component information or funding plans. This is particularly true in smaller, self-managed associations. Even in larger associations with extensive professional support, there is often conflicting advice on what is required.

The law calls for disclosure of specific information from the "reserve study." The law does not specify the funding goal to be achieved by an association, nor does it dictate the exact form of the reserve study. While a study alone, containing the elements prescribed by Civil Code Section 1365.5, is sufficient to constitute legal compliance, an association will be stronger financially if regular assessments are collected to help assure funding of replacement requirements as they occur.

This report is the result of a project that gathered information on current reserve study practices in California, including interviews with board members and industry professionals concerning their experiences with, opinions on, and appropriate responses to the reserve study provisions of Section 1365.5. This document sets forth several decision points necessary for the board to respond to the reserve study requirements. By following the procedures set forth in this document, it should be possible for reserve studies to be produced that include the information called for in Section 1365.5 and that comply with good business practice in the management of association property.

The texts of Civil Code Sections 1365 and 1365.5 are included next as Exhibit 1.1.

Exhibit 1.1 - California Civil Code Sections 1365 and 1365.5

Section 1365

1365. Unless the governing documents impose more stringent standards, the association shall prepare and distribute to all of its members the following documents:

(a) A pro forma operating budget, which shall include all of the following:

(1) The estimated revenue and expenses on an accrual basis.

(2) A summary of the association's reserves based upon the most recent review or study conducted pursuant to Section 1365.5, based only on assets held in cash or cash equivalents, which shall be printed in boldface type and include all of the following:

(A) The current estimated replacement cost, estimated remaining life, and estimated useful life of each major component.

(B) As of the end of the fiscal year for which the study is prepared:

(i) The current estimate of the amount of cash reserves necessary to repair, replace, restore, or maintain the major components.

(ii) The current amount of accumulated cash reserves actually set aside to repair, replace, restore, or maintain major components.

(iii) If applicable, the amount of funds received from either a compensatory damage award or settlement to an association from any person or entity for injuries to property, real or personal, arising out of any construction or design defects, and the expenditure or disposition of funds, including the amounts expended for the direct and indirect costs of repair of construction or design defects. These amounts shall be reported at the end of the fiscal year for which the study is prepared as separate line items under cash reserves pursuant to clause (ii). Instead of complying with the requirements set forth in this clause, an association that is obligated to issue a review of their financial statement pursuant to subdivision (b) may include in the review a statement containing all of the information required by this clause.

(C) The percentage that the amount determined for purposes of clause (ii) of subparagraph (B) equals the amount determined for purposes of clause (i) of subparagraph (B).

(D) The current deficiency in reserve funding expressed on a per unit basis. The figure shall be calculated by subtracting the amount determined for purposes of clause (ii) of subparagraph (B) from the amount determined for purposes of clause (i) of subparagraph (B) and then dividing the result by the number of separate interests within the association, except that if assessments vary by the size or type of ownership interest, then the association shall calculate the current deficiency in a manner that reflects the variation.

(3) A statement as to all of the following:

(A) Whether the board of directors of the association has determined to defer or not undertake repairs or replacement of any major component with a remaining life

of 30 years or less, including a justification for the deferral or decision not to undertake the repairs or replacement.

(B) Whether the board of directors of the association, consistent with the reserve funding plan adopted pursuant to subdivision (e) of Section 1365.5, has determined or anticipates that the levy of one or more special assessments will be required to repair, replace, or restore any major component or to provide adequate reserves therefor.

If so, the statement shall also set out the estimated amount, commencement date, and duration of the assessment.

(C) The mechanism or mechanisms by which the board of directors will fund reserves to repair or replace major components, including assessments, borrowing, use of other assets, deferral of selected replacements or repairs, or alternative mechanisms.

(D) Whether the association has any outstanding loans with an original term of more than one year, including the payee, interest rate, amount outstanding, annual payment, and when the loan is scheduled to be retired.

(4) A general statement addressing the procedures used for the calculation and establishment of those reserves to defray the future repair, replacement, or additions to those major components that the association is obligated to maintain. The report shall include, but need not be limited to, reserve calculations made using the formula described in paragraph (4) of subdivision (b) of Section 1365.2.5, and may not assume a rate of return on cash reserves in excess of 2 percent above the discount rate published by the Federal Reserve Bank of San Francisco at the time the calculation was made.

The summary of the association's reserves disclosed pursuant to paragraph (2) shall not be admissible in evidence to show improper financial management of an association, provided that other relevant and competent evidence of the financial condition of the association is not made inadmissible by this provision.

Notwithstanding a contrary provision in the governing documents, a copy of the operating budget shall be annually distributed not less than 30 days nor more than 90 days prior to the beginning of the association's fiscal year.

(b) Commencing January 1, 2009, a summary of the reserve funding plan adopted by the board of directors of the association, as specified in paragraph (4) of subdivision (e) of Section 1365.5. The summary shall include notice to members that the full reserve study plan is available upon request, and the association shall provide the full reserve plan to any member upon request.

(c) A review of the financial statement of the association shall be prepared in accordance with generally accepted accounting principles by a licensee of the California Board of Accountancy for any fiscal year in which the gross income to the association exceeds seventy-five thousand dollars ($75,000). A copy of the review of the financial statement shall be distributed within 120 days after the close of each fiscal year.

(d) Instead of the distribution of the pro forma operating budget required by subdivision (a), the board of directors may elect to distribute a summary of the pro forma operating budget to all

of its members with a written notice that the pro forma operating budget is available at the business office of the association or at another suitable location within the boundaries of the development, and that copies will be provided upon request and at the expense of the association. If any member requests that a copy of the pro forma operating budget required by subdivision (a) be mailed to the member, the association shall provide the copy to the member by first-class United States mail at the expense of the association and delivered within five days. The written notice that is distributed to each of the association members shall be in at least 10-point boldface type on the front page of the summary of the budget.

(e) A statement describing the association's policies and practices in enforcing lien rights or other legal remedies for default in payment of its assessments against its members shall be annually delivered to the members not less than 30 days nor more than 90 days immediately preceding the beginning of the association's fiscal year.

(f) (1) A summary of the association's property, general liability, earthquake, flood, and fidelity insurance policies, which shall be distributed not less than 30 days nor more than 90 days preceding the beginning of the association's fiscal year, that includes all of the following information about each policy:

(A) The name of the insurer.

(B) The type of insurance.

(C) The policy limits of the insurance.

(D) The amount of deductibles, if any.

(2) The association shall, as soon as reasonably practicable, notify its members by first-class mail if any of the policies described in paragraph (1) have lapsed, been canceled, and are not immediately renewed, restored, or replaced, or if there is a significant change, such as a reduction in coverage or limits or an increase in the deductible, as to any of those policies. If the association receives any notice of nonrenewal of a policy described in paragraph (1), the association shall immediately notify its members if replacement coverage will not be in effect by the date the existing coverage will lapse.

(3) To the extent that any of the information required to be disclosed pursuant to paragraph (1) is specified in the insurance policy declaration page, the association may meet its obligation to disclose that information by making copies of that page and distributing it to all of its members.

(4) The summary distributed pursuant to paragraph (1) shall contain, in at least 10-point boldface type, the following statement:

"This summary of the association's policies of insurance provides only certain information, as required by subdivision (f) of Section 1365 of the Civil Code, and should not be considered a substitute for the complete policy terms and conditions contained in the actual policies of insurance. Any association member may, upon request and provision of reasonable notice, review the association's insurance policies and, upon request and payment of reasonable duplication charges, obtain copies of those policies. Although the association maintains the policies of insurance specified in this summary, the association's policies of insurance may not cover your

property, including personal property or, real property improvements to or around your dwelling, or personal injuries or other losses that occur within or around your dwelling. Even if a loss is covered, you may nevertheless be responsible for paying all or a portion of any deductible that applies. Association members should consult with their individual insurance broker or agent for appropriate additional coverage."

1365.5. (a) Unless the governing documents impose more stringent standards, the board of directors of the association shall do all of the following:

(1) Review a current reconciliation of the association's operating accounts on at least a quarterly basis.

(2) Review a current reconciliation of the association's reserve accounts on at least a quarterly basis.

(3) Review, on at least a quarterly basis, the current year's actual reserve revenues and expenses compared to the current year's budget.

(4) Review the latest account statements prepared by the financial institutions where the association has its operating and reserve accounts.

(5) Review an income and expense statement for the association's operating and reserve accounts on at least a quarterly basis.

(b) The signatures of at least two persons, who shall be members of the association's board of directors, or one officer who is not a member of the board of directors and a member of the board of directors, shall be required for the withdrawal of moneys from the association's reserve accounts.

(c) (1) The board of directors shall not expend funds designated as reserve funds for any purpose other than the repair, restoration, replacement, or maintenance of, or litigation involving the repair, restoration, replacement, or maintenance of, major components that the association is obligated to repair, restore, replace, or maintain and for which the reserve fund was established.

(2) However, the board may authorize the temporary transfer of moneys from a reserve fund to the association's general operating fund to meet short-term cashflow requirements or other expenses, if the board has provided notice of the intent to consider the transfer in a notice of meeting, which shall be provided as specified in Section 1363.05. The notice shall include the reasons the transfer is needed, some of the options for repayment, and whether a special assessment may be considered. If the board authorizes the transfer, the board shall issue a written finding, recorded in the board's minutes, explaining the reasons that the transfer is needed, and describing when and how the moneys will be repaid to the reserve fund. The transferred funds shall be restored to the reserve fund within one year of the date of the initial transfer, except that the board may, after giving the same notice required for considering a transfer, and, upon making a finding supported by documentation that a temporary delay would be in the best interests of the common interest development, temporarily delay the restoration. The board shall exercise prudent fiscal management in maintaining the integrity of the reserve account, and shall, if necessary, levy a special assessment to recover the full amount of the expended funds within the time limits required by this section. This special assessment is subject to the limitation imposed

by Section 1366. The board may, at its discretion, extend the date the payment on the special assessment is due. Any extension shall not prevent the board from pursuing any legal remedy to enforce the collection of an unpaid special assessment.

(d) When the decision is made to use reserve funds or to temporarily transfer moneys from the reserve fund to pay for litigation, the association shall notify the members of the association of that decision in the next available mailing to all members pursuant to Section 5016 of the Corporations Code, and of the availability of an accounting of those expenses. Unless the governing documents impose more stringent standards, the association shall make an accounting of expenses related to the litigation on at least a quarterly basis. The accounting shall be made available for inspection by members of the association at the association's office.

(e) At least once every three years, the board of directors shall cause to be conducted a reasonably competent and diligent visual inspection of the accessible areas of the major components that the association is obligated to repair, replace, restore, or maintain as part of a study of the reserve account requirements of the common interest development, if the current replacement value of the major components is equal to or greater than one-half of the gross budget of the association, excluding the association's reserve account for that period. The board shall review this study, or cause it to be reviewed, annually and shall consider and implement necessary adjustments to the board's analysis of the reserve account requirements as a result of that review.

The study required by this subdivision shall at a minimum include:

(1) Identification of the major components that the association is obligated to repair, replace, restore, or maintain that, as of the date of the study, have a remaining useful life of less than 30 years.

(2) Identification of the probable remaining useful life of the components identified in paragraph (1) as of the date of the study.

(3) An estimate of the cost of repair, replacement, restoration, or maintenance of the components identified in paragraph (1).

(4) An estimate of the total annual contribution necessary to defray the cost to repair, replace, restore, or maintain the components identified in paragraph (1) during and at the end of their useful life, after subtracting total reserve funds as of the date of the study.

(5) A reserve funding plan that indicates how the association plans to fund the contribution identified in paragraph (4) to meet the association's obligation for the repair and replacement of all major components with an expected remaining life of 30 years or less, not including those components that the board has determined will not be replaced or repaired. The plan shall include a schedule of the date and amount of any change in regular or special assessments that would be needed to sufficiently fund the reserve funding plan. The plan shall be adopted by the board of directors at an open meeting before the membership of the association as described in Section 1363.05. If the board of directors determines that an assessment increase is necessary to fund the reserve funding plan, any increase shall be approved in a separate action of the board that is consistent with the procedure described in Section 1366.

(f) As used in this section, "reserve accounts" means both of the following:

(1) Moneys that the association's board of directors has identified for use to defray the future repair or replacement of, or additions to, those major components that the association is obligated to maintain.

(2) The funds received, and not yet expended or disposed of, from either a compensatory damage award or settlement to an association from any person or entity for injuries to property, real or personal, arising from any construction or design defects. These funds shall be separately itemized from funds described in paragraph (1).

(g) As used in this section, "reserve account requirements" means the estimated funds that the association's board of directors has determined are required to be available at a specified point in time to repair, replace, or restore those major components that the association is obligated to maintain.

(h) This section does not apply to an association that does not have a "common area" as defined in Section 1351.

2. How Do Reserves Fit into the Overall Financial Plan?

The reserves are an important part of the association's annual pro forma operating budget. The replacement reserves relate to association budgeting in two important ways:

- The pro forma operating budget will include planned replacement reserve funding and the accrual-basis expense for the year.
- The reserve estimates depend on assumptions about the association's maintenance program, and maintenance expense is a part of the operations budget.

It is important that association members understand the difference between operations and replacement reserve activities. Boards should establish policy to distinguish between reserve expenses (funded from the replacement reserve account) and operating expenses (funded through the non-reserve operating budget).

In common interest developments, the following division of maintenance and replacement responsibility is typical, although actual items included in each category will vary according to each association's physical plan and governing documents:

- individual responsibility for maintenance;
- association responsibility for day-to-day maintenance of common area;
- association responsibility for non-annual maintenance and replacement of common area; and
- association responsibility for improvements.

Individual homeowners are usually responsible for maintenance of their own units. Certainly, this includes maintenance of interiors of the homes themselves. The carpeting, interior paint, kitchen counters, etc. are typically the separate responsibility of the unit owner. In addition, the owner may

have explicit maintenance responsibility for exclusive use common area (such as private yards, decks, front doors, etc.), or for some exterior features of the unit (such as siding, roofs, etc.).

Individual and association maintenance and replacement responsibilities can interrelate. For instance, individuals in their private units are responsible for periodic replacement of the caulking around the bathtub. Failure to replace caulking may result in moisture intrusion into walls and subflooring, and could eventually cause damage to the common area structure of the building, or another unit.

The association usually maintains the common area, which typically includes landscaping, recreation facilities, parking areas, drainage gutters, outdoor lighting, and other public or "common" property. Day-to-day maintenance for these items is the responsibility of the association, and provision for this maintenance is frequently the largest category of expense in the operating budget. Individual owners, while not directly responsible for day-to-day maintenance, do ha ve responsibility for obeying rules and regulations pertaining to the use and protection of common area property. Unfortunately, some owners do not realize their community responsibilities or the fact that damage to common area property can result in direct costs to all homeowners through assessments.

The association is responsible for the long-term maintenance and replacement of common area components as they end their useful lives. Usually, this type of replacement can be planned well in advance, based on industry information about the expected life of the various components and periodic physical inspection of wear.

Association improvements can be considered a special category of expense. If there is an addition to the common area, not planned in the original development, the association may elect to fund and make the addition. Improvements are typically onetime additions; once a part of the common area, the improvements require both day-to-day maintenance and provision for repair and replacement.

Clear distinctions must be made between the private property of individual owners in CID projects and the common areas for which the association is responsible. Ideally, association governing documents are very explicit in distinguishing that which is private property from that which is common area property maintained by the association. However, sometimes the status of component is not identified, or is identified erroneously. We have seen association governing documents that specify responsibility for components that are not in the complex (e.g., interior hallways) or that fail to define the responsibility for other important components. If the governing instruments don't allocate these responsibilities clearly, the association may wish to consider amending the documents.

3. What Are the Steps in Doing a Reserve Study?

A Reserve Study is made up of two parts: the Physical Analysis, and the Financial Analysis.

1. The Physical Analysis provides information about the physical status and repair/replacement cost of the area components the association is obligated to maintain. The Physical Analysis is comprised of the Component Inventory, Condition Evaluation, Age Adjustment [based on useful life (total) and remaining life of the components] and the Costs to Replace. The Component Inventory should remain relatively "stable" from year to year, while the

Condition Evaluation, Age Adjustment and Cost to Replace and Valuation will clearly change from year to year.

2. The Financial Analysis is the analysis of the association's Reserve income and expenses. The Financial Analysis is made up of a finding of the client's current Reserve Fund strength (measured in cash or as a Percent Funded) and a recommendation for an appropriate Reserve contribution rate (Funding Plan).

Many CID homeowners or home buyers assume that their reserve requirements have been adequately established because developers prepare a reserve budget worksheet as part of the project approval process. This worksheet is filed with the California Department of Real Estate (DRE) along with other information in order to obtain a Final Subdivision Public Report that allows the developer to begin selling homes in the project. The reserves worksheet is used to estimate the monthly reserve contribution in the association's first-year budget. Developer estimates may have been prepared one, two, or more years before the project is actually constructed. As a result, they may be dated by the time the first unit is sold, unless they have been subsequently adjusted for changes in replacement costs. More seriously, since the information was assembled at the planning stage, the reserve worksheet may not reflect the association's true liability for the project as actually constructed.

Another possible shortcoming is that the standard preprinted reserves worksheet contains only certain major components (e.g., roofing, painting, paving, etc.).

Consequently, some components may not be listed even though the association must repair and/or replace them. In addition, the estimated life shown for components may not reflect local conditions, and the costs shown may not be based on actual local prices. When associations compare the reserve worksheet to their reserve responsibilities, they may find that the worksheet needs modification.

Consequently, a new association should conduct its own reserve study before the project is more than a few years old. Exhibit 3.1 shows the major decisions an association board should make to produce reserve information.

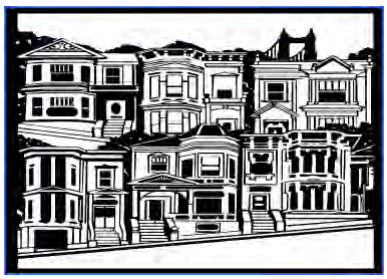
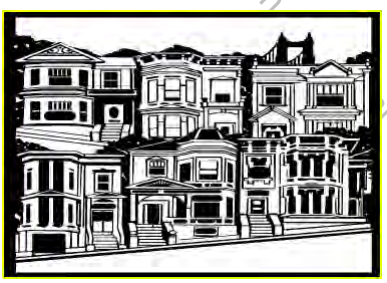
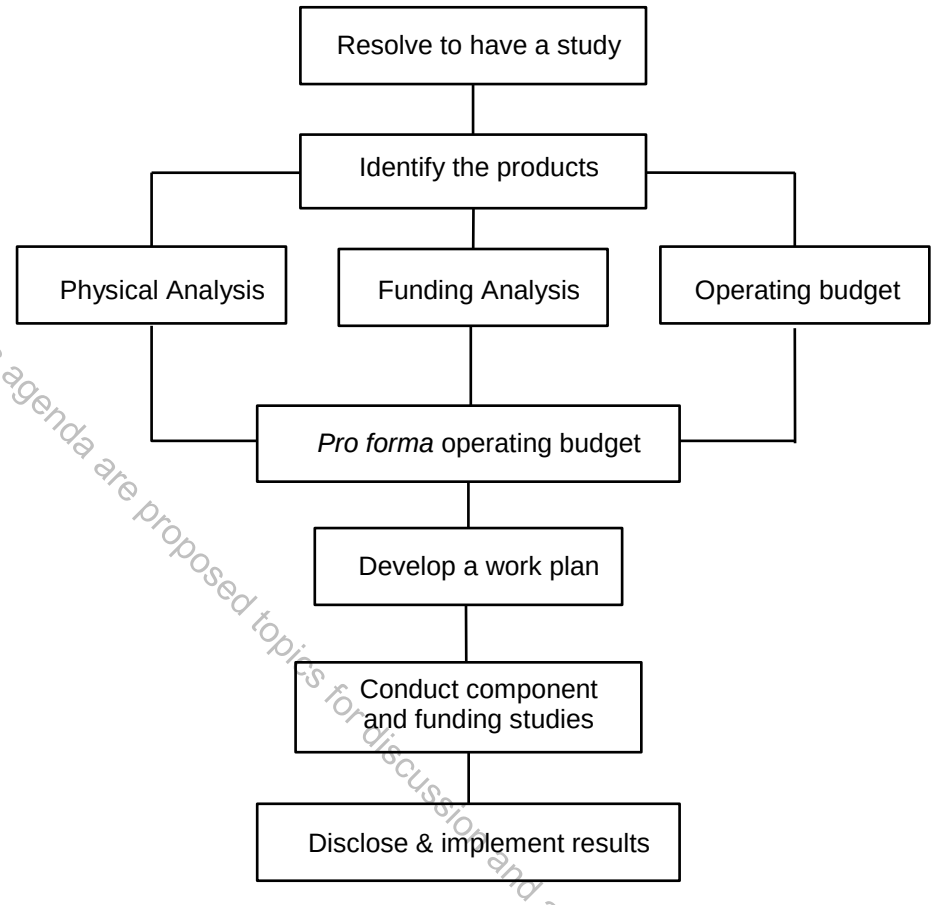




Exhibit 3.1 – Steps in Providing for Adequate Reserves



Resolve to Have a Reserve Study

The board should pass a resolution that a reserve study shall be performed and that the association is committed to taking the necessary steps. Older associations that have been operating without a reserve study, or funding plan, should initiate this process as soon as possible. New associations should have a Reserve Study done in a timely manner and certainly by the end of the first year of any significant construction, as initial budgets may not include a physical analysis of the new construction. The California Civil Code requires the Board of Directors of existing associations that have completed a study to review the study annually and consider and implement any necessary adjustments as a result of that review. For new associations it may not be possible to make that analysis without including a Physical Analysis and ensuring the Component Inventory is consistent with what was actually built. Additionally, the Civil Code requires that a Physical Analysis be conducted at least every three years. With ongoing construction, it may well be necessary to do such analysis annually in order to adjust for changes during construction. The Board of Directors should carefully consider these factors for new homeowners associations.

Identify the Work Products

The board should identify the reserve study products needed and who is to produce them. A Physical Analysis, a Financial Analysis, and the text and exhibits to be included in the reserve study portion of the annual pro forma operating budget will cover the statutory requirements and also provide sufficient detail for long-term association financial planning. As discussed in Chapter 5, the pro forma operating budget must also disclose to homeowners and potential homeowners other important information about reserve funding and obligations.

An association board may contract for the preparation of Physical Analysis, Funding Analysis, and operating budget by professionals, or it may decide to produce one or more of these products by itself. Another option is for the board to perform part of the work and hire a professional to do the rest. Chapter 6 will discuss the option of hiring professionals for some or all of the reserve study tasks.

Develop a Work Plan

Before conducting a reserve study, an association board should develop a work plan, specifying the nature of the tasks to be performed. The work plan should establish:

- the types of components to be included or excluded
- the timeframe for funding common area components
- the budget available for conducting the study

Choosing which components to include. Components can be excluded from the reserve study only if individual homeowners, not the association, are responsible for their replacement. In any association, there may be "exclusive use common areas" that individual homeowners usually maintain. Defined by California statute as common area items used exclusively by individual units (e.g., decks and patios), these areas are usually identified in the association governing documents known as the Covenants, Conditions, and Restrictions (CC&Rs). The CC&Rs should also make clear the maintenance responsibility of the association and homeowners for these items.

With the guidance of their CC&Rs, the board should make a separate list of exclusive use common area components and decide who should bear the responsibility for maintaining these items. If the association has responsibility for maintaining these items, they should be included in the list of major components and be given a line item in the reserve budget.

Whatever the board decides, the documentation of the reserves and the assumptions that are an integral part of the study should include appropriate disclosure of such specifications. Any information distributed to homeowners, or prospective homeowners, should disclose which of these items were included and which excluded.

Timeframe. Professionals do not always agree on the appropriate timeframe for a reserve study. The California Civil Code requires, as a minimum, all components with a useful remaining life of less than 30 years be included in the study. However, pursuant to Civil Code Section 1365.2.5, any components with a remaining useful life of more than 30 years that are not included must be reported in the reserve study report and the Assessment and Reserve Funding Disclosure Summary. It should be noted that a component with a long useful remaining life, that may have been excluded in earlier studies, could be included in a later study if its useful remaining life drops to within the time

parameters of a later study. A good rule of thumb is to forecast for a time period that will include the replacement year of the component with the longest estimated useful life. Professionals generally recommend that the study include all components that will fail before the building itself. "Life-of-the building" components (such as the building foundation and structure) are generally omitted from the reserve study budget. However, if there is reason to expect the item to wear out before the building does and if, due to the age of the units, the item may wear out within the time span of the reserve study, then that item (e.g., the electrical or plumbing system in a condominium) should be included as a reserve study component.

Obviously, the ability to estimate accurately is best in the near term. Estimates of costs that are 20 to 40 years away are at best an educated guess. However, a reserve study is incomplete and may be misleading unless it covers the life of the longest-lived component. Since studies should be reviewed annually as a part of the association's regular budget cycle, estimates can be updated as necessary.

Budget available for conducting the study. The third consideration will be the amount of money available to conduct the initial study. All associations required to perform a reserve study under the California Civil Code should, on an annual basis, adequately fund their budget to enable them to either conduct a study or hire outside professionals to complete the study, if need be, and/or pay for study updates at least once every three years.

Conduct the Component and Funding Studies

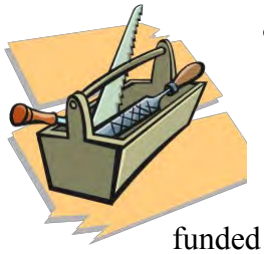
The board should identify some documents, including the CC&Rs, the most accurate existing drawings of the development, and the maintenance history of major common area components. If "as-built" drawings exist, these are the best source of information about the nature of the major components. The maintenance history obtained should include the actual dollar cost figures of that maintenance. If the association does not already do so, it may wish to create a "permanent" maintenance history file for each major component. Chapters 4 and 5 describe the conduct of the component and funding studies in detail.

Accept, Disclose, and Implement the Results

The board reviews and accepts the reserve study and incorporates a summary of the long-term funding plan, and certain other information, in the pro forma operating budget, as provided in Civil Code Section 1365.

4. What Are the Steps in Conducting a Physical Analysis?

The goals of a Physical Analysis are to:



- estimate useful and remaining life of major components; and
- estimate current replacement cost of major components.

The Physical Analysis lists and estimates replacement costs and timing for replacement of the major components whose repair or replacement is to be funded through association reserves. The study determines when such repairs or replacements will be needed and what they will cost. The major steps in conducting a Physical Analysis are shown in Exhibit 4.1.

There are a number of firms that perform these studies for community associations. This explanation of how to perform a Physical Analysis will help associations to contract for this service and to interpret the study results. For associations who cannot, or do not wish to, hire a Reserve Study preparer, this explanation will provide guidelines for board members who decide to perform their own Physical Analysis. (See Chapter 6 for additional discussion on hiring professionals.) Boards of Directors should consider the fact that they could lose the personal indemnity that comes from relying on professional advice if they choose to undertake their own study. Because of this, you should consider seeking legal advice before proceeding.

Exhibit 4.1 – Steps in the Physical Analysis Process

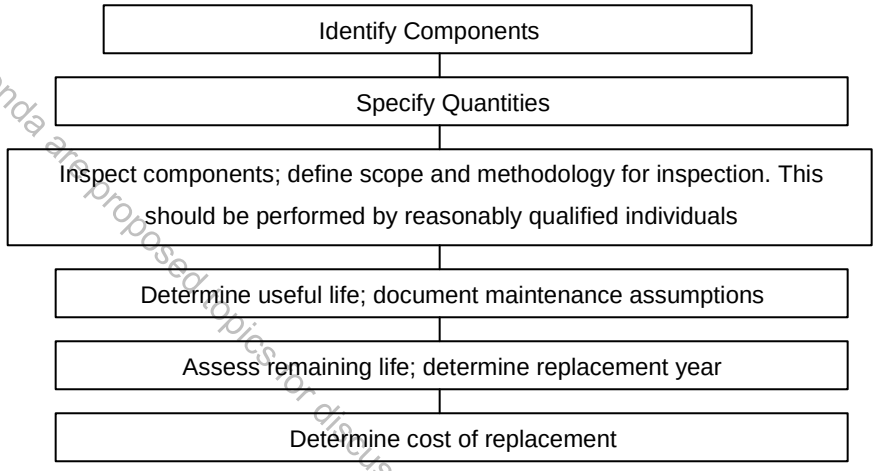


Exhibit 4.1 – Steps in the Physical Analysis Process

For each association, the exact list of major common area components is unique. Although lists from other associations or industry publications (including this one) may serve as a general guide, they are rarely usable without modifications and additions. **An inaccurate or incomplete list of components can materially distort the association's long-term funding plan.**

Criteria for Components

The board should establish criteria for determining common area major components. Many professionals suggest that items be placed on the list of components for the reserve budget if they meet all of the following criteria:

- the item is the responsibility of the association to maintain or replace, rather than the responsibility of the individual homeowners;
- the item costs over a certain amount to replace (amount to be determined by the board);[1]
- the estimated useful life of the item is greater than one year; and the estimated useful life of the item is less than thirty years at the time of the study.

[1] One possible guideline is to include items that cost 1% or more of the total annual association budget. Another possible guideline is to include items that cost over $500 or over $1000 to replace, including groups of related items (e.g., all gates in the development) that cost over $1000 to replace. The dollar amount or percentage to use as the guideline should be discussed and adopted by the board. Items costing less than this amount may be included in the annual operating budget rather than funded through the reserve budget.

Developing a Component List

Unfortunately, there is often no one document with a comprehensive list of components for a development. As a result, it is not easy to identify components accurately, although it is essential that the association develop an accurate list of all items for whose repair or replacement it must budget.

The exact list of components to include depends upon the physical characteristics of the project as well as upon the legal division of responsibility among the homeowner, the association, and the local government. Appendix A provides a list of items that might be listed as components for association reserves. This list is not exhaustive of all possible items, but does include many of those that would commonly be found.

The association's "CC&Rs" and condominium plans generally describe the common areas of the development and so can help to provide a list of components. Most CC&Rs describe what is a part of each "unit" and what is outside the unit. In a true condominium, the unit owned by the individual homeowner consists only of the air space within the common walls, although owners are generally responsible for the paint and non-structural fixtures inside, and are generally also responsible for external doors, door hardware, windows, patios, balconies, and similar items (see Civil Code Sections 1351 a nd 1634). However, in planned developments (PDs), the owners are usually responsible for some portion of the maintenance on the exterior and structure of their individual units as well. The CC&Rs usually specify the division between individual and association responsibility, and will serve as a guide to the components to be included in the reserve study.

The developers reserve budget should list components that the builder identified while planning the project. Such items as streets, roofs, exterior paint, and recreation areas are usually included in the developer's original reserve budget.

Many an association has found that, despite its existence, an item such as a sidewalk or set of balconies has not been mentioned in either the CC&Rs or the developer budget. A site analysis by knowledgeable persons should result in a comprehensive list of reserve items for which the association is, or might be, responsible. (For a list of items that are often overlooked in the CC&Rs and the developer budget, see Appendix B.)

Local governments and utility companies can often help define common area components by stating where their responsibility ends and that of the association begins. For example, the developer budget and the CC&Rs may be unclear about whether the sidewalks along the edge of a development belong to the association or the city. If the former, these sidewalks are components which, at some point in time, should be included in the reserve budget; if the latter, the association need not budget for their repair or replacement.

Specifying the Quantity of Each Component

Although existing maps and construction drawings of the development may serve as a guide to component quantities, a detailed site and building analysis is the best way to obtain an accurate count of these items. For some components (e.g., streets, roofs, fences) the square or linear footage must be measured in order to describe the quantity, while for other items (e.g., utility room doors) it may be sufficient to know the number required. "As-built" drawings are an excellent source of information for these quantities, but in their absence the items should be accurately measured. [2]

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[2] The drawings filed when the development was begun represent builder plans rather than the development as actually built. As such, they are useful but should be verified by physical inspection.

For components that are actually made up of a number of items, the nature and quantity of the constituent parts should be stated (e.g., the metal flashing for a shake roof as well as the square footage of shingles). It is common to neglect the "extra" pieces that are in fact necessary to the construction of such essential items as roofs, siding, and irrigation systems.

Once the number and constituent parts of each component are detailed, it is necessary to give some consideration to the quality and specifications of those parts. (Is the asphalt two inches thick or four inches? Is it a two-ply roof? What grade paint was used?) An accurate description of the materials is essential to proper reserves. [3] If significant in dollar amount, quantities of the same type of component existing in very different conditions should be noted separately (e.g., the square footage of siding with western or southern exposure as compared to the square footage with eastern or northern exposure).

Determining the Useful and Remaining Life of Each Component

"Useful life" is typically defined as the number of years the component is expected to serve its intended purpose if given regular and proper maintenance. If the association fails to provide proper maintenance, such as dealing effectively with the presence of wood-destroying pests or organisms as provided in Civil Code Section 1364, then it may become difficult to anticipate the "useful life" of components.

One estimate of useful life is the material manufacturer's warranty. This estimate presumes (usually in writing, in the fine print of the warranty) that the product was actually installed with the purported quality of materials and according to the manufacturer's specifications. (Some associations have found that their alleged "twenty-year roofs" were in fact installed with other materials or with inferior workmanship, making the effective useful life shorter.) When no knowledgeable inspection is made of the materials and installation, the manufacturer's warranty may not be an accurate description of the useful life of the component.

The Department of Real Estate publishes an ***Operating Cost Manual for Homeowner Associations*** which includes the average useful life for a number of major components. Some commercially available manuals also have estimates of useful life.[4] Published data may not be consistent with the location, exposure, or type of a particular component. The estimated life of a street as predicted from national data may well be lower than that of a street in the comparatively mild climate of California, but the estimated life of exterior paint as predicted from national averages may be higher than that of paint on buildings in windy or coastal areas. Similarly, paint on western or southern exposures weathers faster in sunny climates, reducing the useful life of a paint job in California and particularly reducing it for certain walls. In using published estimates, it is necessary to consider how the specific case in question may differ from the average case considered by the manual's author.

Useful life estimates vary considerably from manual to manual, so consulting more than one manual may minimize the risk of under- or over-estimating the life of a major component. In any case, the source(s) of component estimates should be identified specifically.

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3 While the association may wish to change the quality of the component at the time of replacement, this is a separate decision.

4 For example, manuals are distributed by R.S. Means Company, Inc., F.W. Dodge, Lee Saylor, Inc., and Marshall & Swift.

The remaining life is generally defined as the expected number of years the component will continue to serve its intended purpose prior to repair or replacement. If the development is new and the developer-prepared estimates are correct, the remaining life might be estimated simply by subtracting the age of the development from the useful life of each component. The older the components, the less accurate this method will be.

Some of the factors that affect the estimate of remaining life of a component are its current age, apparent physical condition, and past maintenance record (or absence of maintenance). The current age of the component may be determined from association records. The apparent current condition must be determined through physical inspection, preferably by someone familiar with the component. Records of past maintenance must be compared with recommended maintenance in order to determine whether the item has been properly maintained or may wear out sooner than expected due to inadequate care.

In determining the remaining life of a component, a certain level of continued preventive maintenance is assumed. These maintenance assumptions should be stated explicitly so that proper maintenance can be continued throughout the component's remaining life.

The remaining life of a component implicitly specifies the year in which it must be repaired or replaced. A budget timeline can be used to show the year of replacement for each component. This timeline can serve as a schedule for expected component replacements and can be updated or changed when the Physical Analysis is updated or as components last for shorter or longer periods than expected. Exhibit 4.2 shows the year of replacement for three components in a condominium complex that is five years old, as well as the information needed to determine the replacement year.

Exhibit 4.2 – Determining the Replacement Schedule

Component	*Age in Years as of 12/31/95*	*Estimated Useful Life*	*Estimated Remaining Life*	*Year to Replace*
Painting	*3*	*5*	*2*	*1998*
Paving (slurry coat)	*4*	*7*	*3*	*1999*
Roofing (wood shingle)	*11*	*15*	*4*	*2000*

Determining the Cost of Replacement

Replacement costs can be obtained from manufacturers or their representatives on some items and from local licensed contractors on others. It is important to remember that the cost of component replacement should also include the cost of removing the existing component, if appropriate.

There are a number of recognized cost estimating manuals available with pricing information that can be used (e.g., R.S. Means Company, Inc., F.W. Dodge, Lee Saylor, Inc., Marshall & Swift). Cost estimates are generally comparable among manuals intended for the same geographic area, so there is less need to consult multiple manuals for cost estimates than for estimates of useful life. However, there are some cautions to be observed in using these manuals to determine costs. The majority of professionals performing reserve studies for homeowner associations obtain their cost estimates from a data base gathered from their experience. Cost estimates derived from this data could vary significantly from estimates based on manuals alone. Therefore, it may be prudent for associations performing their own study to obtain additional supporting data for their manual cost estimates from other sources, such as contractors, suppliers, etc. This collection of data should then be considered in conjunction with the results of an inspection by a reasonably qualified person when making a final determination of replacement cost.

It is important to determine the specific geographic area for which the manual offers a cost average. If the manual has national averages, it probably underestimates the cost of labor in many parts of California. If the manual has statewide or national averages, it may underestimate the cost of labor in urban areas by a significant factor.

It is also important to determine the base year in which the manual's cost estimates were made. The current cost of replacement for association components is not the cost shown in the manual, but should be adjusted for inflation since the time the cost data were obtained.

Using Component Data to Develop the Funding Analysis

Once the charts of replacement schedule and future replacement costs are completed, the Physical Analysis is finished. The next step is to figure out how much will be spent in each year for all components, and that step is a part of the Funding Analysis.

Documenting Maintenance Assumptions

An important adjunct to determining the useful life and remaining life of a component is to document the type and schedule of maintenance that is assumed for the component to survive that life. For example, if the twenty-year life expectancy of a roof is based upon an annual cleaning of the roof and gutters, the association will be able to take action to help ensure that all the roofs will indeed last. Documentation of maintenance assumptions can lead to improved maintenance throughout the project and thus to lower costs of replacement. Ignoring maintenance assumptions, or improper maintenance, will put the replacement schedule and cost estimates in jeopardy.

Thus, a properly prepared Physical Analysis will lead to a better maintenance program for the association. Clear and concise maintenance suggestions are a useful supplement to a professionally prepared Physical Analysis. These suggestions may save more than the cost of the original study on future repairs and replacements.

Exhibit 4.3 – Physical Analysis Checklist

This checklist summarizes the major steps in developing the Physical Analysis and, under each step, suggests certain actions the Board or its designated reserve study preparer may wish to consider in performing each step.

Deciding which components to include:

__ relevant components mentioned in the developer budget have been reviewed

__ components mentioned in the CC&Rs have been reviewed

__ an on-site inspection for possible additional components has been made

__ the board has had a public discussion and has determined a policy stating its position on life-of-the-building, exclusive use, and quasi-structural components

__ the board has communicated the list to the preparer of the Physical Analysis and, in the pro forma operating budget, to the homeowners

Specifying quantities of each component:

__ as-built drawings have been consulted, if possible

__ an on-site inspection of each component and an on-site count of each type of component have been made

__ the quality of each component has been determined and expressed in terms that identify a specific grade of material

Determining the useful life of each component:

__ manufacturer warranties have been consulted whenever possible

__ environmental factors that might affect useful life have been taken into account

__ installation and materials have been determined to be consistent with each manufacturer's description; if not, an adjustment has been made to the remaining useful life estimated by the warranty or by the manuals

__ a standard manual has been consulted

__ maintenance assumptions have been documented

Assessing the remaining life of each component:

__ an on-site inspection of each component has been made

__ past maintenance has been taken into account

__ individuals with knowledge of the components have participated in the assessment of remaining life

__ the board has determined what level of maintenance is expected to achieve the remaining life estimated

Determining the cost of replacement:

__ a standard costing manual has been consulted or more than one tradesperson asked for a price for each component

__ if a manual is used, the "current" price of each component has been adjusted for the age of the data in the manual

__ if a manual is used, regional variations in price are taken into account

__ cost of replacement includes cost of removing old component, if necessary

__ adjustments have been made for grade or quality of materials or levels of maintenance of materials

5. What is Involved in Developing a Funding Analysis?

The goals of a Funding Analysis are to:

- establish funding goals
- identify annual funding requirements
- disclose limitations and assumptions

Once the components' estimated useful life, estimated remaining life, and estimated current replacement costs are identified, the association is ready to develop a plan for funding the reserve account. This funding plan specifies future reserve cash needs and planned methods for funding.

In preparing the funding plan, the association will have to make decisions about the amount of current assessments and the need for special assessments, balanced against projected liability. The law does not require the funding of projected replacement costs, only an explicit description of the plan for such funding, among other specific disclosures. Clearly, however, the financial viability of the association will depend a great deal on the ability of the association to replace components as they wear out and not to defer major maintenance items.

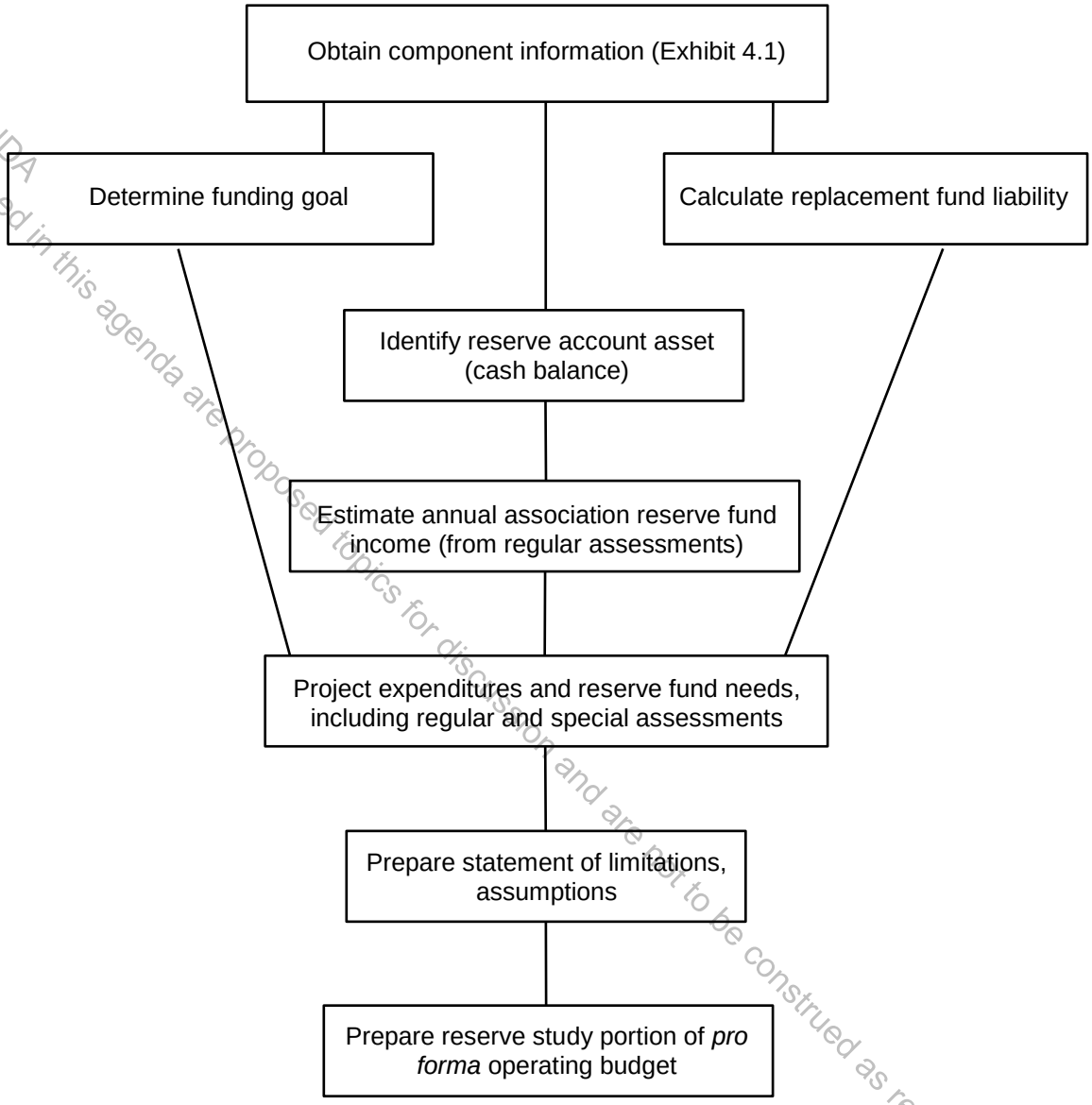
A product of the Funding Analysis process is the development of a funding plan (cash flow forecast or projection) to estimate future reserve cash receipts and disbursements. This is most easily presented in a spreadsheet format. All supporting assumptions and methodology should be carefully documented.

Exhibit 5.1 shows the major steps in the development of the funding plan and the reserve study portion of the *pro forma* operating budget. As an association completes these steps, the board will make major policy decisions. Professionals may be able to advise the board on key decisions, but it is important for the board to understand each of these decisions, since they independently affect the overall results of the funding plan. Since the amount of regular assessments and the need for any special assessments should be indicated in the plan, these decisions will affect the owners' monthly costs and property values. Because of their importance, each decision is discussed in turn, with an example showing how these decisions contribute to a long-term funding plan.

Determining the Funding Goal for Replacement Reserves

Section 1365(a)(4) of the California Civil Code calls for identification of the methods of funding used to defray future repair, replacement, or additions to major components. Revenues and expenses are to be estimated on an accrual basis. However, a specific funding goal is not indicated in the law. In preparing these guidelines, we have identified several major funding strategies followed by associations. Determination of the funding strategy, including establishment of the funding goal, is one of the most important fiscal decisions to be made by an association board. The *pro forma* operating budget should clearly indicate estimated revenues and expenses, describe the funding goal, and indicate current status in meeting the goal.

Exhibit 5.1 – Steps in the Funding Analysis Process



The funding plan should show the funds required to replace each component as it comes to the end of its useful life and indicate how the association will fund the replacements. The association should decide how much should be raised through regular assessments for the reserve account each year and how much should be raised by special assessment, if any. In addition, the association should consider how much cash will remain in the reserve account at the end of the planning period relative to the projected balance needed at that date.

Associations will have to make difficult policy choices in determining the funding goal. Many associations are currently underfunded in reserves. This is due to a lack of attention to reserve budgets in the past and underestimation of replacement costs. An ideal goal for an association is to eliminate this under funded reserves deficit or shortage. That is, to build up the reserve fund to a

level where the cash in the replacement reserve account is at least equal to the estimated value of accumulated wear of all major components. However, this goal may not be within reach of many associations in the short run, except through special assessments.

We can identify at least three basic funding goal models. Depending on current association finances and financial health, one of these models may be currently operating. The three models identified are:

- Fully Funded Model -- setting a Reserve funding goal of keeping the Reserves at or near 100% funded.
- Threshold Funded Model -- setting a Reserve funding goal of keeping the Reserve balance above some threshold. Depending on the mix of common area major components this model may be more or less conservative than the fully funded model. The only way to tell is to compare the two models closely.
- Baseline Funded Model -- "Minimum Funded Model - setting a reserve funding goal of keeping the reserve cash balance at the end of each year in the overall reserve funding projection at or above $-0-."

Each of these models depends on an analysis of cash flows into and out of the reserve fund over the next thirty years. Assessment calculations are then made sufficient to reach the Board of Director's funding goals.

Calculating the Reserve Deficit: The law establishing the reserve study requirements calls for annual disclosure of "estimated revenue and expenses" on an accrual basis. In the case of revenues, this estimate includes regular and special assessments, as well as the after-tax interest income earned on accumulated cash reserves. "Expenses" can be accrued by spreading the eventual replacement cost of each component over its total useful life or obtaining an estimate of annual component wear. After that is done, there are several methods which may be used to calculate the required estimated reserves for components and to calculate any deficit or shortage in the reserve fund, two of which are shown below.

If a component currently valued at $10,000 has a useful life of ten years, then we can estimate the annual wear, or the annual provision for the replacement fund, at $1,000. By year five, this component, then, would have accrued a liability of $5,000, assuming no inflation. (If an association is "fully funded," we would expect that this $5,000 would already be in the reserve account by the end of the fifth year.)

Exhibit 5.2 shows how to calculate a deficit in the reserve fund which can also be thought of as the current unfunded portion of the estimated value of accumulated wear of all major components. The example uses the same components shown in Exhibit 4.2. It assumes that the association, consisting of 35 units, will have an estimated $22,000 in its reserve account at the beginning of the upcoming fiscal year. Given its liability of $36,000 for the three components for which it is responsible, this association has a reserve deficit of $14,000, a total of $400 per unit.

Exhibit 5.2 – Calculating A Reserve Deficit

Desired Balance = Current Cost/Useful Life x Effective Age

The Reserve Deficit = Desired Balance - cash reserves

Component Replacement	***Current Cost***	***Useful Life***	***Effective Age***	***Desired Balance***
Painting	*$10,000*	*5*	*3*	*$6,000*
Paving	*$14,000*	*7*	*4*	*$8,000*
Roofing	*$30,000*	*15*	*11*	*$22,000*
Total Desired Balance (current)				*$36,000*
Estimated cash reserves (current)				*$22,000*
Reserve Deficit (current)				*$14,000*
Reserve Deficit per unit ($14,000 ÷ 35 units)				*$400*
Percentage of Funding				61%

The problem with the above model is that it does not take into account the impact of interest and inflation. An alternative model, which does take interest and inflation into account is as follows:

$$\text{Desired Balance} = \left(\frac{\text{Current Cost}}{\text{Useful Life}} \times \text{Effective Age}\right) + \left(\frac{\frac{\text{Current Cost}}{\text{Useful Life}} \times \text{Effective Age}}{(1+\text{Interest Rate})^{\text{Remaining Life}}}\right) - \left(\frac{\frac{\text{Current Cost}}{\text{Useful Life}} \times \text{Effective Age}}{(1+\text{Inflation Rate})^{\text{Remaining Life}}}\right)$$

While the formula looks complicated, using it for each component yields the following results (assuming 3% inflation and 5% interest after taxes):

Component Replacement	***Current Cost***	***Useful Life***	***Effective Age***	***Remaining Life***	***Desired Balance***
Painting	*$10,000*	*5*	*3*	*2*	*$5,787*
Paving	*$14,000*	*7*	*4*	*3*	*$7,590*
Roofing	*$30,000*	*15*	*11*	*4*	*$20,553*
Total Desired Balance (current)					*$33,930*
Estimated cash reserves (current)					*$22,000*
Reserve Deficit (current)					*$11,930*
Reserve Deficit per unit ($11,930 ÷ 35 units)					*$340*
Percentage of Funding					65%

While this formula takes a bit more work, assuming the interest and inflation rate estimates are accurate, it may be more reflective of the true amount of the Reserve Deficit. In most cases, the difference between the two methods is not material. However, with some mixes of common area major components the difference can be quite noticeable and failure to properly take interest and inflation into account can unfairly lead to unrealistically high calculations of the reserve deficit.

Unfunded & Special Assessment Model: This is the default model in place in many associations today. The association does not have reserve balances that will cover expected replacement costs, and the only recourse is to schedule special assessments to cover these costs when they are due. Lack of information about needed special assessments is a real problem for some common interest development owners. One-time costs impose an additional financial burden on owners who often have chosen CIDs for cost reasons. This is the riskiest of the models, and could jeopardize the financial viability of the association if assessments cannot be raised when needed.

Mixed Model: This is also a common model, with a combination of regular and planned special assessments to meet the cash needs of replacement. The degree to which an association can meet its cash needs through regular as opposed to special assessments may be an indicator of the association's fiscal stability.

Obviously, the choice of the funding goal or strategy will have a direct impact on the cash required of each individual owner. The strategy, and the degree to which the association has funded its reserves, should affect property value as well. (If an association shows a $5,000 unfunded reserve deficit per unit, this amount reasonably should be reflected in the sales price.)

California law currently does not specify one model for funding, but obviously the model that reduces or eliminates the Reserve Deficit provides the most stability and is the most conservative. Association boards should carefully consider and document the choice of a funding plan and make the details of the plan available to owners in the reserve study portion of the *pro forma* operating budget. If the information is adequate and clearly presented, owners and buyers should be in a better position to evaluate the value of the unit and the development.

Estimating Association Reserve Fund Income

The ideal funding mechanism for building the replacement reserve account is the regular (usually monthly) assessments paid by association members. A specific dollar amount of regular association payments should be earmarked for reserves, and deposited into the reserve account as they are collected. Financing of replacement reserves from regular assessments is desirable. First, it spreads the responsibility for replacements over time, rather than allocating costs to owners who happen to be in the association in the year a particular component comes due for repair or replacement. This funding mechanism provides a more equitable distribution of the costs of aging components. Second, it provides individual owners with more certainty as to the true costs of the property.

Income from regular assessments should be calculated for each year, based on the number of units and the level of assessment per unit. In associations with several rates for different types or sizes of units, the expected income should be calculated for each class of unit and then added. Assessment increases, if any, should be estimated by year.

Section 1366 of the Civil Code provides association boards with the power to increase the regular annual assessment up to 20% per year without membership approval. However, automatic

compounding at these rates would double the assessments in just four years and triple them in six. At this rate, assessments would be 32 times as large by the twentieth year! Clearly, even though automatic increases allow an association to "catch up" with reserve deficits over some period of years, the decision to increase assessments should not be an automatic one, but rather should be a careful decision by the board. Assumptions about assessment increases should be fully disclosed in the *pro forma* operating budget.

Projecting Expenditures and Reserve Funding Needs

The Physical Analysis provides the estimates for expected expenditures by year for each component. Adding these component requirements together, by year, gives the estimate of needed funds over time. We have seen how these estimates should be developed and the assumptions upon which they rely. Association members should be aware of the limitations of expenditure forecasting and of the fact that the overall funding plan is only as good as the initial estimates of replacement costs and the timing of replacement needs. Data similar to that shown in Exhibit 4.2 will be a direct input to the Funding Analysis.

An important policy issue for the board is the decision to use current costs, or estimated future costs. Use of an inflation rate will generally result in higher estimates of future costs.

If the board uses current costs, it is essential that the board revise the plan annually based upon updated current replacement costs plus currently required or anticipated expenditures. The annual cost for each component would be calculated by dividing the unfunded replacement cost by the remaining useful life. THIS APPROACH IS VALID ONLY IF REPEATED EACH YEAR.

If the board chooses to use an inflation rate, it would apply an average annual long-term cost inflation rate to all components from the time of the study until the year of replacement (based on recent average component cost data). To keep this plan current, it is important to annually review and update projected expenditures, inflation factors and other assumptions. Here also, THIS APPROACH IS VALID ONLY IF REPEATED EACH YEAR.

There are a number of ways to select an inflation rate for estimating component costs in future years. Four reliable sources of information for inflation factors in California are the following:

- the Federal Bureau of Labor Statistics
- published information from construction cost estimating companies such as R.S. Means Company, Inc.
- the State Allocation Board
- Marshall & Swift

Any of these four sources will provide a reasonable estimate that can be used to project future costs. The interest rate assumption is an important board policy decision, and should be explicitly disclosed in the Funding Analysis. Because of their affect on estimating future costs, current cost information and inflation rate assumptions should be reviewed annually, and the projections adjusted as necessary. The examples in this report use an estimated increase in the Consumer Price Index for urban United States over the year. This information is available free of charge through the Bureau of Labor Statistics' 24-hour hotlines. See Appendix C.

Exhibit 5.3 shows the calculation of future replacement costs for the same items that were listed in Exhibit 5.2, projected forward from 1996. For each item, the years of inflation shown in Exhibit 5.3 have been determined from the year of replacement shown in Exhibit 4.2. In a real situation, it may be necessary to add additional years of inflation in order to account for old pricing information. In the example shown here, it is assumed that the pricing information on all components is up-to-date.

Exhibit 5.3 – Determining the Future Cost of Replacement

Component	*Qty & Units*	*Unit Cost*	*Current Cost to Replace (1996)*	*Year to Replace*	*Future Cost to Replace*
Painting, exterior stucco	*15,875 sq. ft.*	*0.63*	*$10,000*	*1998*	*$10,941*
Paving, slurry coat	*35,000 sq. ft.*	*0.40*	*$14,000*	*1999*	*$16,022*
Roofing, wood shingle	*10,715 sq. ft.*	*2.80*	*$30,000*	*2000*	*$35,913*

(Future replacement cost was calculated with an annual 4.6% inflation rate.)

Estimating Interest Earnings of Reserve Account Over Funding Analysis Period

Reserve funds deposited in certificates of deposit or money market accounts will generate interest income to increase the reserves. For forecasting purposes, it is necessary to choose an interest rate. Obviously, a lower rate is more conservative, for planning purposes, than a higher rate. Interest rates can be pegged to current bank rates or CD rates. Income from the reserve and operating accounts is taxable to an association, even if the association is established as a non-profit organization. A board must adjust the interest rate assumption to account for applicable federal and state taxes. (The examples in this report assume a before-tax interest rate of 7.5% and an after-tax rate of 5.8%.)

While it is difficult to accurately project future component cost increases or future interest earned on reserve cash balances, it is important to use these factors for calculations in the Funding Analysis and to update them each year. This is particularly true for associations that have chosen to rely in part on special assessments.

As component replacement comes due in future years, it will draw against reserve funds. Hopefully, the initial reserve account, augmented by regular contributions from routine homeowner assessment payments, will provide enough "cushion" to pay for replacements as they are needed. In some cases, the reserve accounts will not be enough. The cash flow analysis will identify instances where expenditure projections for a given year exceed projected reserve cash balances. In these cases, additional funds from special assessments (or other sources, if any) would be needed to increase the reserve accounts to desired levels.

Some replacement expenses will be impossible to estimate. This might be due to unexpected breakage or destruction, failure in a "life-of-the-project" system, reduced useful life of a component, or other unexpected component cost. A line item in the cost estimates might be established as a contingency. This amount might be limited to 3% to 5% of the first-year budget in a new association. In a conversion, or in older associations with incomplete component documentation, larger contingency levels may be necessary. One useful way to establish estimates for contingency funding in on-going associations is to review prior year spending for contingency-type replacements or continuing repairs. For instance, if there is routine work done annually on underground utilities, then some funds for expected annual levels might be budgeted under the contingency category.

Exhibit 5.4 summarizes these income and cost concepts in a spreadsheet showing the results of the Funding Analysis, using the same components listed in Exhibits 4.2, 5.2, and 5.3. The rows in the spreadsheet show individual component costs and association income sources. The columns show the years included in the Funding Analysis. In this case, we have assumed a funding plan period of thirty years and a mixed model which uses regular and special assessments to maintain a positive cash balance. Because the model is not fully funded, inflation factors are employed based on the method described under "Determining the Funding Goal for Replacement Reserves".

Statement of Limitations and Assumptions

Limitations to the estimates, assumptions made in order to conduct the estimates, and the model used to make the estimates should all be documented in the Funding Analysis. A statement of the methods used to construct the estimates and the funding plan is a required part of the annual association *pro forma* operating budget.

Updating

Once an association has successfully produced a reserve study (both component and funding studies), the resulting information can be used in the *pro forma* operating budget, which is produced annually. How often does the reserve study need to be updated?

Annual updates of the Funding Analysis can be carried out at the same time as the preparation of the operating budget and can call for required adjustments within the original planning period. The assumptions in the reserve study (e.g., remaining life and cost of components) should be reviewed and updated as necessary. The frequency of updates of component data will depend on the soundness of the original data and estimates, the preparer's recommendations, the association's ability to maintain its components adequately, and the requirements of Civil Code Section 1365.5. Even though the methodology calls for a financial study covering a time frame of twenty years or more, annual planning and periodic reviews of the reserve study can rely on updated estimates.

Exhibit 5.4 – FUNDING STUDY: Estimated Cash Requirements by Year
(30 year plan – 3 components; values shown here for years 1-5, 15, and 30 only)

Major Component	Estimated Useful Life	Estimated Remaining Life	Estimated Current Cost to Replace	End of Year 0	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5	End of Year 15	End of Year 30
Painting	5	2	$10,000			$10,000					
Paving	7	3	$14,000				$14,000				
Roofing	15	4	$30,000					$30,000			
Total Costs			$54,000			$10,000	$14,000	$30,000	$0	$0	$0
Component cost increase factor @ 4.6% per annum					1.00	1.046	1.094	1.144	1.197	1.877	3.685
Estimated replacement cost, in scheduled year (apply cost factor to total replacement costs)					$0	$10,460	$15,318	$34,333	$0	$0	$0

Cash Flow Forecasts	End of Year 0	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5	End of Year 15	End of Year 30
Assessments, regular		$1,500	$1,800	$2,160	$2,592	$3,110	$10,906	$30,515
Assessments, special		$0	$0	$0	$30,000	$0	$0	$0
After-tax interest reserve account income, @ 5.775%		$1,271	$1,430	$1,013	$312	$229	$1,519	$6,482
Total cash receipts		$2,771	$3,230	$3,173	$32,904	$3,339	$12,426	$36,997
Major component costs (from total above)		$0	$10,460	$15,318	$34,333	$0	$0	$0
Cash receipts – cash disbursements		$2,771	($7,230)	($12,145)	($1,430)	$3,339	$12,426	$36,997
Cash balance, beginning of year		$22,000	$24,771	$17,541	$5,396	$3,967	$26,311	$112,241
Cash balance, end of year	$22,000	$24,771	$17,541	$5,396	$3,967	$7,306	$38,737	$149,238

Summary	End of Year 0	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5	End of Year 15	End of Year 30
Estimated liablility (total from next page)	$36,000	$43,932	$52,518	$50,461	$43,095	$15,026	$74,602	$154,173
Less cash balance	$22,000	$24,771	$17,541	$5,396	$3,967	$7,306	$38,737	$149,238
Estimated unfunded liability	$14,000	$19,162	$34,977	$45,065	$39,128	$7,720	$35,865	$4,935
Estimated unfunded liability per unt (35 units)	$400	$547	$999	$1,288	$1,118	$221	$1,025	$141

Exhibit 5.4 – FUNDING STUDY: Computation of Major Component Liability by Year (continued)

Major Component Replacement Liability		End of Year 0	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5	End of Year 15	End of Year 30
Painting	Useful life	5	5	5	5	5	5	5	5
	Remaining life	2	1	0	4	3	2	2	2
	Replacement cost	$10,000	$10,460	$10,941	$11,971	$11,971	$12,522	$19,632	$38,543
	Liability	$6,000	$8,368	$10,941	$2,394	$4,788	$7,513	$11,779	$23,126
Paving	Useful life	7	7	7	7	7	7	7	7
	Remaining life	3	2	1	0	6	5	2	1
	Replacement cost	$14,000	$14,644	$15,318	$16,022	$16,759	$17,530	$27,485	$53,961
	Liability	$8,000	$10,460	$13,130	$16,022	$2,394	$5,009	$19,632	$46,252
Roofing	Useful life	15	15	15	15	15	15	15	15
	Remaining life	4	3	2	1	0	14	4	4
	Replacement cost	$30,000	$31,380	$32,823	$34,333	$35,913	$37,564	$58,897	$115,630
	Liability	$22,000	$25,104	$28,447	$32,044	$35,913	$2,504	$43,191	$84,795
Total liability		$36,000	$43,932	$52,518	$50,461	$43,095	$15,026	$74,602	$154,173

Exhibit 5.5 Funding Analysis Checklist

This checklist summarizes the major steps in developing the Funding Analysis and, under each step, suggests certain actions the Board or its designated reserve study preparer may wish to consider in performing each step:

Funding goal:

__ the association's funding goal for reserve replacement is clearly specified

***Pro forma* operating budget documentation:**

__ the budget contains estimated revenue and expenses on an accrual basis

__ the budget identifies total cash reserves currently set aside

__ the budget shows funds set aside for reserves in a separate account(s)

__ the estimated remaining life of all major components is shown

__ the estimated current replacement cost of all major components is shown

__ the budget document includes identification of methods of funding for future repair, replacement or additions

__ the budget document includes a statement on methods used to develop estimates and funding plan

__ the *pro forma* operating budget is distributed 45 - 60 days prior to the start of the association's next fiscal year

Association income and expense estimates:

__ an appropriate component inflation factor has been used to estimate replacement cost in future years

__ the interest rate applied to association cash reserves is reasonable, and is an after-tax estimate

__ needed special assessments are clearly identified

__ assumptions about increases in the portion of regular assessments allocated to reserves are clearly specified

__ income and expenditures are shown annually for the plan period

Association cash balances:

__ with reserve assessments, the cash balance (assets - planned reserve expenditures) is greater than zero in every year

__ the reserve deficit is estimated for the current year

__ the model shows a stable or decreasing reserve deficit (in constant dollars) over the plan period

6. How Do Boards Hire Qualified Professionals to Perform Reserve Studies?

While the individual tasks involved in reserve studies are relatively straightforward, an association board may not have the time or the expertise to carry out the work. The estimating and accounting skills required may not be present either in the board membership or in the association's management. Most of the steps described in Chapters 4 and 5 may be performed by consultants under contract to the association. To carry out the reserve study using consultants, the following should be established by the board:

- identification of common area components, exclusive use components, quasi-structural components, and life-of-the-project components (with the assistance of association management);
- the interest rate for estimating income earned on reserve balances; and
- the funding goal of the reserve study, including the degree to which reserves are to be funded by annual assessments and the need for special assessments.

These are policy decisions, to be made by the board of directors. In addition, the board is accountable for the quality of the study itself. The board should carefully specify the work tasks and carefully review potential consultants with respect to previous experience, price, and recommendations from other associations. Some or all of the work tasks that may be performed by consultants are listed below.

Physical Analysis Products for Consultants

- quantification of components
- documentation of maintenance assumptions and recommendations
- identification of useful life and remaining life of components, and replacement year
- estimation of replacement cost in current and future dollars

Funding Analysis Products for Consultants

- spreadsheet modeling of reserve funding, and development of solution(s) meeting the funding goals of the association
- calculation of cash balance of reserve account by year
- estimation and explanation of reserve deficit
- recommendation of needed increases in reserve portion of assessment
- recommendation of needed special assessments and timing of assessments
- preparation of statement of limitations and assumptions of reserve analysis
- preparation of reserve study information for the *pro forma* operating budget

Once the work tasks have been determined, the board must select the consultants or contractors, if any, who will perform all or part of the work. Possible outcomes of this decision-making process include the following:

- hiring an independent engineering, appraisal, or construction cost-estimating firm to perform the Physical Analysis and hiring an independent accountant experienced with community associations to produce the Funding Analysis and *pro forma* operating budget;
- hiring an organization with staff expertise to perform an integrated component and Funding Analysis;

- having the board or manager prepare these studies in cooperation with independent construction contractors and accountants, as needed;
- hiring the current management company to perform both studies and incorporate the results into the *pro forma* operating budget; and
- using any of the above in conjunction with additional work tasks performed by the board.

The type of assistance that will be needed depends upon the nature of the product(s) desired, the budget, and expertise available to the association board. The board is ultimately responsible for the reserve study disclosures. In deciding whether to hire outside help or to perform the reserve study tasks internally, the board should consider potential legal liability if the study does not meet the statutory information requirements.

One possible way to find professionals to contact for performing reserve studies is through other community associations. Other sources of names are organizations of CIDs and related professionals. It is helpful to talk with people who have worked with any firm or consultant under consideration and to examine samples of related work.

It is important that the association and the contractor understand what is required of each. Exhibits 6.1 and 6.2 provide a partial list of questions the board should ask a reserve study preparer as part of the interview process and also the information the board should provide. These questions might be used in interviews with potential consultants, or used in a written Request for Proposal (RFP), along with a clear specification of the work tasks to be performed. Answers to these questions, as well as price, should help in the selection of any needed professionals. These guides treat the Physical Analysis and Funding Analysis preparers separately, so interviews of professionals offering to perform both studies could be designed by combining the two interview guides, thereby eliminating duplications.

Information the Board Should Provide

In addition to asking questions of reserve study preparers, the association must provide information on the components and the association's financial situation. Specifically, the reserve study process should start with this information from the board and/or management:

- a list and definition of the major components;
- a statement of board policy about major components for which it is not requesting an estimate of replacement costs;
- any information on condition of the major components, including maintenance records;
- directions about any desired changes or additions (new items) in the major components;
- copy of as-built construction drawings, if they exist;
- maintenance record, component warranties, or other documentation;
- estimated replacement cash balance at beginning of next (nearest) fiscal year;
- a copy of current (and/or proposed) association budget(s);
- a board estimate of long-term interest rate to be earned on reserve account cash balance;
- a copy of the final Physical Analysis report, if already prepared, and
- projected reserve expenses prior to year end.

Exhibit 6.1 Interview Guide for Physical Analysis Preparers

1. Do you have any personal or professional ties to this association? (NOTE: Such a tie does not necessarily indicate a conflict of interest, but should be disclosed and considered.)
2. Do you have any personal or professional ties to the developer? (NOTE: Such a tie does not necessarily indicate a conflict of interest, but should be disclosed and considered.)
3. If hiring an individual or sole practitioner: Do you do all the work yourself, or will you use subcontractors? (The association should approve all subcontractors.) Are you a Professional Reserve Analyst (an Association of Reserve Analysts designation) or a Reserve Specialist (a Community Associations Institute designation) or do you hold other professional designations? What is your training (formal education and workshops)?
4. If hiring a firm: Will all work be done by employees of your firm? How do you train your employees?
5. With what professional associations are you actively involved?
6. What experience have you had with performing component studies?
7. What experience have you had in this locale?
8. May we see an example of a similar product done for another association?
9. What information do you require from the association in order to start?
10. When will you begin the study?
11. Will you be measuring the components or using drawings?
12. Will you make a physical inspection of each component? What percentage of components will you inspect for fences, walls, controllers, buildings, etc.?
13. How will you determine the cost of replacement?
14. What written sources will be used?
15. How long will it be before we have the final product?
16. Will the report provide the estimated useful life of each component?
17. Will the report provide the estimated remaining life of each component?
18. Will the report provide the current costs of repair or replacement for each component?
19. Will the report provide the future costs of repair or replacement for each component and/or the inflation rate to be applied to each component?
20. Will the report provide information on proper maintenance to help assure realization of the estimated remaining life of each component? Will the report include visuals such as photographs or video?
21. Do you have liability insurance?
22. Do you have workers' compensation insurance?
23. Please provide three references (name, phone, nature of work).
24. Cost for revisions and/or updates.

Exhibit 6.2 Interview Guide for Funding Analysis Preparers

1. Do you have any personal or professional ties to this association? (NOTE: Such a tie does not necessarily indicate a conflict of interest, but should be disclosed and considered.)

2. Do you have any personal or professional ties to the developer? (NOTE: Such a tie does not necessarily indicate a conflict of interest, but should be disclosed and considered.)

3. If hiring an individual or sole practitioner: Do you do all the work yourself, or will you use subcontractors? (The association should approve all subcontractors.) Are you a Professional Reserve Analyst (an Association of Reserve Analysts designation) or a Reserve Specialist (a Community Associations Institute designation) or do you hold other professional designations? What is your training (formal education and workshops)?

4. If hiring a firm: Will all work be done by employees of your firm? How do you train your employees?

5. With what professional associations are you actively involved?

6. What experience have you had with community association budgeting?

7. May we see an example of a completed Funding Analysis?

8. What information do you require from the association in order to start?

9. When will you begin the study?

10. How long will it be before we have the final product?

11. Will the report provide current and future estimated liability computations?

12. Will the report provide current and future estimated cash balances by year?

13. Will the report provide current and future repair and replacement costs?

14. Will the report present alternative funding plans?

15. Will the report provide a description of assumptions and methodology, a narrative funding plan, and a graphic depiction for easier board and member understanding?

16. Will the report tell how much of a monthly contribution is needed for the reserves?

17. Do you have professional liability insurance?

18. Please provide three references (name, phone, nature of work).

7. What Are the Red Flags that Signal Potential Problems?

This report has explained the important elements of the reserve study portion of the *pro forma* operating budget. In reviewing an association's current status in responding to the requirements of California Civil Code Sections 1365 and 1365.5 and in performing responsibly in the management of association assets, the following indicators may suggest problems that call for remedial action. The list starts with very basic elements of the reserve study requirements and ends with "red flag" items to be identified in reserve study data when they are available.

Study Data

Reserve study data is incomplete if:

- the association has no established list of major components;
- there is no policy to distinguish reserve expenditures from operating expenses;
- there is no clear funding goal stated;
- a Physical Analysis has not been conducted;
- a Funding Analysis has not been conducted;
- information on remaining life and current replacement cost has not been prepared for all major components;
- "life of the project" components are not mentioned in assumptions, or included in the reserve budgeting;
- the *pro forma* operating budget does not contain reserve study information or assumptions;
- the association does not have a documented maintenance schedule and related assumptions for each major component;
- the list of major components in the reserve study does not include all significant common area components listed in the CC&Rs; or
- there is no separate bank account(s) for reserve funds.

Replacement Funds

Reserve study data suggest replacement funding problems if:

- the reserve deficit is staying constant or increasing over time;
- special assessments are required to fund major repairs; or
- current income from assessments does not equal or exceed dollar value of annual component wear.

Appendix A Major Common Area Components Usually Included

Awnings and other overhead coverings
Balconies (see also decks)
Benches
Boilers
Decks, pool and spa
Decks, residential
Elevator, cab
Elevator, hydraulic, traction, etc. Equipment,
cleaning and maintenance Equipment,
communication and telephone Equipment,
entertainment, music/video systems Equipment,
exercise, recreational, etc. Equipment, office
Equipment, pool, pumps, motors and filters
Fences, chain link, wood, etc.
Floor covering, carpet, tile, vinyl, etc.
Floor covering, wood replacement and refinishing
Furnishings, lobby, clubhouse, etc.
Gates, iron, wood, etc.
HVAC, air conditioning
HVAC, heating systems
Light fixtures, exterior
Light fixtures, interior
Paint and stain, exterior
Paint and stain, interior common area
Paving
Retaining wall
Roof
Siding and trim
Solar heating system, pool and spa
Solar heating system, residential
Spas
Streets and drives
Swimming pools
Tennis courts, resurfacing
Vehicles
Water heaters

Appendix B Major Common Area Components Frequently Overlooked

Alarm systems, fire and intrusion
Antennas, satellite dish and other
Asbestos encapsulation or removal
Display cases
Docks
Drainage systems
Electrical transformers
Electrical wiring and related fixtures in common area
Fans, exhaust, garage and other
Fire sprinklers and related equipment
Fountains
Garage doors and hardware
Garbage enclosures Gutters
and downspouts Irrigation
system, controllers
Irrigation system, piping, valves and sprinkler heads
Kiosks and message/communication centers
Lakes, ponds and waterways
Landscaping, replacement of major trees and plants
Mailboxes and centers
Monitoring system, carbon monoxide
Planter boxes
Plumbing fixtures, exterior
Plumbing, water piping system
Posts, deck, lamp, etc.
Pumps, lakes, ponds and waterways
Racquetball courts
Security gates, gate operator and motor
Septic tanks
Sewage ejector equipment
Skylights
Slopes
Stables and tack rooms
Stairs
Stucco, sandblasting and resurfacing
Sump pump equipment
Trellises
Ventilation systems, garage
Walkways, wood, brick, tile, etc.

Appendix C Sources for Inflation Rate Estimates

U.S. Bureau of Labor Statistics
Consumer Price Index 24-hour hotlines:
Los Angeles (310) 235-6884
San Diego (619) 557-6538
San Francisco (415) 625-2270

These hotlines provide the national U.S. Consumer Price Index (CPI). The San Francisco hotline provides information specific to the San Francisco Bay Area, while the Los Angeles and San Diego numbers provide information specific to the Greater Los Angeles Metropolitan Area. Directory assistance in other parts of California may provide additional, local hotline numbers. However, no separate CPI is calculated for other regions of California.

State Allocation Board
707 Third Street
West Sacramento, CA 95605
(916) 376-1771

RESERVE STUDY GUIDELINES

STATE OF NEVADA
DEPARTMENT OF BUSINESS AND INDUSTRY
REAL ESTATE DIVISION
OFFICE OF THE OMBUDSMAN

Prepared by
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University of Nevada, Las Vegas
College of Business
2003

Table of Contents

Introduction

The purpose of this booklet

This booklet is designed to help homeowners associations and other common-interest communities conduct reserve studies. A reserve study is a tool that allows such communities to estimate and provide for the funding necessary to repair or replace components of common areas as they wear out. Proper funding of reserve accounts help protect, maintain and enhance the value of common-interest communities, making them more desirable places in which to live. These guidelines have been developed as a collaborative effort by a number of industry professionals, as well as association board members, and Nevada Department of Real Estate managers.

This booklet contains six sections, three appendices and a glossary. Section I defines what a reserve study is, explains why one is necessary, discusses the legal requirements, and points out the advantages of a well-conducted study. Section II lays out the major steps necessary to conduct a thorough and high-quality reserve study. Sections III and IV go into further detail about the two most important components of a reserve study: the physical analysis and the funding analysis. Section V lists common deficiencies that can be addressed during the course of a reserve study. Section VI explores the option of hiring professional consultants to conduct a reserve study. The appendices list the most common components that should be included in a typical reserve study, and sources to consult for updated information on the inflation rate.

Each common-interest community includes its own unique features. Consequently, not all the suggestions in this booklet will apply to every community association. The information presented here should be used only as a guideline. We suggest that each association consult with its own attorney, accountant, or other advisors before proceeding with a reserve study.

Section I. Overview

1. Budgeting within a common-interest community

A common-interest community is a defined area of land and improvements, in which some of the property is owned in common and administered by an association composed of all the owners of individual parcels. Common-interest communities share both property and restrictions regarding use of the property.

Most of these communities are residential and are governed by *homeowners associations*, each of which is required by Nevada law to manage the property and compel observance of its rules and regulations. Each association is responsible for the maintenance of common areas, while individual owners are responsible for maintaining the structures and areas owned by them privately.

Every individual property owner within a common-interest community is a member of its homeowners association. Such an association is overseen by an elected Board of Directors. In many cases the association hires a management company to oversee most of the day-to-day operations.

Among its other duties, each Board of Directors must oversee its community's budget. Income from a typical community is derived from regular monthly assessments and special assessments. A community's shared expenses consist primarily of maintenance, repair, and replacement of facilities within the common area.

There are two principal components to the spending side of a common-interest community's budget. One of these components, the *operating budget*, is used for frequently recurring operating expenses, such as trash collection and routine maintenance of landscaping and pools. The other component, the *reserve budget*, is designated for recurring but less frequent (and often more costly) repair and replacement expenses, such as roof replacement and street resurfacing. A list of typical reserve budget components is provided in Appendix B.

For the operating budget, expenses are usually relatively level and predictable from one month to the next. Reserve expenditures, however, are more infrequent and variable. When they do occur, they can be very costly compared to normal monthly expenses. To pay these expenses, communities set up *reserve accounts* which, if properly designed, will pay for these major expenses without the need to levy costly special assessments on the individual owners.

2. Advantages of a reserve study

A periodic reserve study provides board members, owners and prospective owners with a means of anticipating upcoming major expenses and making sure that reserve accounts are adequately funded to meet such expenses. These studies permit associations to raise or lower periodic payments into the reserve

account to allow for changing circumstances within each community. *The most important goal of a reserve study is to calculate the monthly contributions required from each homeowner to provide adequate funds for reserve expenses.*

For potential buyers, understanding the reserve study is an important part of evaluating the value of property within a common-interest community. For association members, an adequately funded reserve account helps maintain property values by making funds available to replace aging components within the common areas. A good reserve study helps owners and potential buyers to form a more accurate and complete picture of a community's financial strength and market value. By requiring homeowners associations to address the long-term funding issue in detail, a reserve study also functions as a maintenance planning tool for a community.

3. Reference material

In addition to this handbook, the following documents contain information that can be useful for planning reserve studies and other activities necessary for the successful operation of community associations. They can be obtained from the issuing agencies, and in some cases are available on Internet websites.

Common Interest Communities in Nevada. State of Nevada, Research Division, Legislative Counsel Bureau, 2001.
http://www.leg.state.nv.us/lcb/research/library/CICBooklet.pdf

Common Interest Community Operating Cost Manual. State of Nevada, Department of Business and Industry, Real Estate Division, 2002 edition.

Handbook for Common-Interest Communities. State of Nevada, Department of Business and Industry, Real Estate Division, 2000 edition.

Operating Cost Manual for Homeowner Associations. State of California, Department of Real Estate, February 2000.
http://www.dre.ca.gov/pdf_docs/re8.pdf

Reserve Study Guidelines for Homeowner Association Budgets. State of California, Department of Real Estate, September 2000.
http://www.dre.ca.gov/pdf_docs/re25.pdf

Uniform Common-Interest Ownership Act. Nevada Revised Statutes, Chapter 116. http://www.leg.state.nv.us/NRS/NRS-116.html

4. Legal requirements for a reserve study

Nevada state law (NRS 116.31152) sets the legal requirements for reserve studies. This legislation, printed in its entirety below, is brief and largely self-explanatory. The "Commission" referred to in the legislation is the *Commission for Common-*

Interest Communities, which consists of five members appointed by the Governor.

Section 3 of the legislation (in italics, below) requires each association to submit the results of its reserve study to the Commission. These results should be submitted to the following address:

State of Nevada
Ombudsman for Common-Interest Communities
2501 E. Sahara Avenue, Suite 202
Las Vegas, NV 89104-4137
Telephone: (702) 486-4033

The legislation reads as follows:

1. The executive board of an association shall:

(a) Cause to be conducted at least once every 5 years, a study of the reserves required to repair, replace and restore the major components of the common elements;

(b) Review the results of that study at least annually to determine if those reserves are sufficient; and

(c) Make any adjustments it deems necessary to maintain the required reserves.

2. The study of the reserves required by subsection 1 must be conducted by a person who is qualified by training and experience to conduct such a study, including, without limitation, a member of the executive board, a unit's owner or a community manager who is so qualified. The study of the reserves must include, without limitation:

(a) A summary of an inspection of the major components of the common elements that the association is obligated to repair, replace or restore;

(b) An identification of the major components of the common elements that the association is obligated to repair, replace or restore which have a remaining useful life of less than 30 years;

(c) An estimate of the remaining useful life of each major component identified pursuant to paragraph (b);

(d) An estimate of the cost of repair, replacement or restoration of each major component identified pursuant to paragraph (b) during and at the end of its useful life; and

(e) An estimate of the total annual assessment that may be required to cover the cost of repairing, replacement or restoration of the major components identified pursuant to paragraph (b), after subtracting the reserves of the association as of the date of the study.

3. The results of the study of the reserves required by subsection 1 must be submitted to the Commission not later than 45 days after the date that the executive board of the association adopts the results of the study.

4. The Commission shall adopt by regulation the qualifications required for conducting the study of the reserves required by subsection 1.

5. If a common-interest community was developed as part of a planned unit development pursuant to chapter 278A of NRS and is subject to an agreement with a city or county to receive credit against the amount of the residential construction tax that is imposed pursuant to NRS 278.4983 and 278.4985, the association that is organized for the common-interest community may use the money from that credit for the repair, replacement or restoration of park facilities and related improvements if:

(a) The park facilities and related improvements are identified as major components of the common elements of the association; and

(b) The association is obligated to repair, replace or restore the park facilities and related improvements in accordance with the study of the reserves required by subsection 1.

Section II. Major Steps for a Reserve Study

There are five major steps involved in properly implementing a reserve study. This section will discuss how to go about each step. The two sections following this one will go into greater detail on ways to conduct two of the most important steps: a physical analysis and a funding analysis

Step 1: Identify the work products needed

Before formally proceeding with a reserve study, the association's Board of Directors should become knowledgeable regarding the elements that make up a reserve study. Board members who are unfamiliar with reserve studies will find it useful to examine studies that were previously prepared for other communities, perhaps by outside professional firms. Such studies typically include a physical analysis and a fiscal analysis, along with charts, tables, and other exhibits.

Step 2: Pass a resolution

The association's Board of Directors must next pass a resolution authorizing a reserve study. This resolution should spell out who will conduct the study; the estimated cost of the study (especially if done by an outside firm); the work that is to be performed in preparing the study; and the information that the study's final report should contain.

If the association chooses to hire an outside firm to assist in preparing the reserve study, some or all of the remaining steps will be performed by that firm.

Step 3: Develop a work plan

A work plan is a detailed "road map" of the tasks to be performed. It identifies the time frame covered by the reserve study, a budget for the money to be spent on performing the study, and the reports and other work products that should be delivered once the study has been completed.

There are varying opinions on the appropriate time frame for a reserve study. Many studies consider only items with a remaining useful life of more than one year. Nevada law requires that reserves be established for components with useful lives of 3 to 30 years. Building structures and foundations are usually not addressed in reserve studies, but included in such studies are any components that are likely to wear out before the buildings do. For example, the water in Las Vegas is extremely corrosive, and if the person preparing the reserve study sees deterioration in the pipes, he or she may recommend that these items be included.

If a community decides to hire an outside professional firm to conduct periodic reserve studies (which is preferable in most cases), the Board of Directors should budget an amount of money sufficient to fund such studies. Once the initial study

has been completed, later studies should cost less, as much of the information in the first study will be available for use in subsequent ones.

The Board of Directors may want to interview several firms before deciding which one will conduct the study. When doing so, the Board should pay particular attention to the structure and content of the reports that each company offers to provide. Such reports should be clear and understandable, and should fulfill all the legal requirements for a reserve study.

Step 4. Conduct the Physical Analysis and Funding Analysis

If good documentation is available, it will allow the study to proceed more quickly and with greater accuracy. Documents that would be helpful include the Declaration of Covenants, Conditions and Restrictions (abbreviated as CC&Rs), original drawings of the development, and a maintenance history (including cost) of common area components.

There are multiple steps to be followed for both the Physical Analysis and the Funding Analysis. These steps are detailed in the two sections that follow.

Step 5. Accept, disclose, and implement the results

Once the study has been completed to the Board's satisfaction, it should be disclosed to owners and prospective owners, and incorporated into the community's overall budget. If necessary, the monthly association assessments should be adjusted to reflect changes in the funding requirements for the reserve budget.

The results of a reserve study should be used in preparing the association's annual *pro forma* budget. This document is required to be distributed to all owners 30 to 60 days before the beginning of the association's next fiscal year. The *pro forma* budget is a planning tool that lays out projected expenses for the coming year, including long-term maintenance expenses that are intended to be paid out of the reserve account. It also reports on the current financial state of the reserve account. If the association is relying on a reserve study that was conducted in a previous year, any material changes that would affect that study's conclusions should be reflected in the current year's *pro forma* budget.

Section III. Conducting a physical analysis

1. Introduction

A physical analysis has three major objectives: to identify the major components that are the responsibility of the association (if this has not been done previously); to estimate the remaining useful life of these components; and to estimate the cost to replace them. The major steps in conducting a Physical Analysis are shown in Exhibit 3.1 at the end of this section.

Although a physical analysis can be performed by a member of the Board or a homeowner within the association, legal considerations may make it advisable to hire an outside firm to conduct this analysis. Board members can potentially be personally liable for major decisions that they make without reliance on professional advice. It is best for Board members to seek legal advice before undertaking such a project on their own.

2. Deciding which component types to include

The first step of a physical analysis is to take an inventory of the components that are the association's responsibility to maintain. If a previous reserve study has been done, the component list from that study can be used as a starting point. Even in that case, however, it is wise to verify the list from the previous study by conducting a physical inspection of the premises, especially if any significant alterations or upgrades to the common area have occurred since the previous reserve study was conducted.

If this is the community's first reserve study, further research will be necessary to make sure that it is clear which expenses are the responsibility of the association, and which are the responsibility of the individual owners. The division of these responsibilities varies from one community to another, and is usually specified in the association's CC&Rs, which are provided to each individual owner at the time of purchase.

For example, in a townhouse development, individual owners will typically be responsible for maintaining interior areas, doors, windows, patios and balconies, while associations will have responsibility for maintaining building exteriors (including periodic painting and roof repair), landscaping, sprinkler systems, swimming pools, clubhouses, and other common area amenities. In a condominium complex, the association will typically have more responsibilities and the individual owners correspondingly less than in a townhouse development. However, in planned developments containing detached homes, individual owners may be responsible for some of the exterior maintenance. Maintenance of streets and sidewalks will generally be the responsibility of either community associations or local governments.

Sometimes the CC&Rs do not fully document all the components within a community, making it unclear who is responsible for their maintenance. In such cases, the original developer's reserve budget may be able to resolve the issue by identifying the components that the builder designated as the community's responsibility when planning the project. Local governments and utility companies will usually be helpful in identifying their own areas of responsibility, which may be addressed in the plat maps on file in the County Recorder's office. If any issues still remain unresolved, the association may have to enlist help from an outside consultant or make the decisions itself.

Once an association has determined which components it is responsible for, it next must determine which of these components should be included in the reserve budget. The main criteria for such inclusion are cost and frequency of replacement. Any components with a useful life of one year or less should probably be included in the operating budget instead. At the other extreme, components not needing replacement within the next 30 years should be excluded, as it would be too early to begin saving for that purpose. In addition, components whose cost is below a certain threshold (such as $500 or 1% of the community's annual budget) might be better suited for the operating budget. The reason is that each item included in the reserve study must undergo a significant amount of analysis regarding its useful life, replacement cost, and the revenue flow necessary to meet this cost over time. Putting low-cost and frequently replaced items into the operating budget, perhaps under "miscellaneous maintenance costs," can save administrative overhead and decrease the time (and cost) of conducting the reserve study.

Appendix A provides a list of items that might be suitable for inclusion in a reserve budget. However, this list is not exhaustive, and should be used as a general guide only.

3. Specifying the Quantity of Each Component

Once the types of components have been determined, the next step is to establish the size, amount and quantity of each component that will be required. For this step, written documentation will be helpful, but (at least for the first reserve study) it must be supplemented with a careful on-site inspection.

Developer drawings can be helpful in identifying components to be included in the reserve study. However, drawings that were filed when the development was begun often do not accurately reflect the completed development, because changes to the specifications can occur as the development is being built. *As-built* drawings, if available, are more useful for this purpose.

Although existing maps and drawings of the development may serve as a guide to component quantities, a detailed site and building analysis is the best way to obtain an accurate count of these items. An on-site inspection will reveal not only the size and quantity of the components, but also their quality.

For components such as streets, roofs, and fences, the square or linear footage must be measured in order to describe the quantity. For other items, such as sprinkler system components, it might be necessary to determine both the size and the quantity.

Some components, such as roofs and siding, are made up of multiple items. For such components, the nature and quantity of the constituent parts must be documented (such as the metal flashing for a shake roof as well as the square footage of shingles).

4. Determining the remaining useful life of each component

A component's useful life is the amount of time that it is designed to serve its intended purpose. Except in new communities, a reserve study should focus on each component's *remaining useful life,* or the amount of time left before it needs to be replaced.

Two methods can be used to arrive at a rough estimate of a component's remaining useful life. One is to take the amount of time left before the manufacturer's warranty expires. Another is to research professional estimates of a component's useful life, and subtract the amount of time that the component has been in service.[1] If published estimates are used, more than one manual should be consulted to avoid over-reliance on one author's estimates.

Exhibit 3.1. Sample Format for Replacement Schedule

Component	Age in Years (as of 7/1/2003)	Estimated Useful Life	Estimated Remaining Life	Year to Replace
Painting	3	5	2	2005
Paving (slurry coat)	4	7	3	2006
Roofing (wood shingle)	11	15	4	2007

(adapted from *Reserve Study Guidelines for Homeowner Association Budgets* , California Dept. of Real Estate)

Often, other factors must also be taken into consideration. The useful life of a component can be significantly shortened if it is not given proper maintenance. (Failure to properly install or maintain a component may also void the

[1] Some commercially available manuals contain estimates of useful life. Sources for these manuals include R.S. Means Company, Inc., F.W. Dodge, Lee Saylor, Inc., and Marshall & Swift.

manufacturer's warranty.) Use of inferior materials during construction can also reduce the expected life of components.

The current condition of a component can be evaluated by physical inspection by a knowledgeable person, and by comparing the maintenance history of that component with the manufacturer's recommendations. If the component has not received proper maintenance, it is important that a maintenance schedule be immediately established, so that the component's useful life is not shortened any further.

Variations in climate can affect the amount of wear and tear a component receives over a given time period, which in turn can lengthen or shorten its useful life. In certain cases, identical components in the same structure may wear out at different rates. For example, siding with a southern exposure may age more quickly than that with a northern exposure. A reserve study should take into account the variation in cost that will result from these differences.

An on-site inspection should take into consideration not only the size and quantity of the components, but also their quality. Issues of quality include considerations such the grade of paint and the thickness of roofs and asphalt streets. A difference in quality may greatly affect a the length of a component's useful life.

5. Determining the cost of replacement

There are three frequently used sources for obtaining information on replacement costs for components: manufacturers, cost estimate manuals, and professional reserve study consultants.

Manufacturers and their sales representatives are the best source for current pricing information on components. In addition to the price of the component, however, reserve studies must also take into account the labor cost of removing old components and replacing them with new ones.

Cost estimating manuals with general pricing information can be obtained from companies such as R.S. Means Company, Inc., F.W. Dodge, Lee Saylor, Inc., and Marshall & Swift. Many of these manuals use national averages to compute their published costs, so a reserve study must take into account regional and local variations in labor costs. Also, when using these manuals as a pricing source, it is important that they be as up to date as possible. For manuals more than one year old, prices should be adjusted by the percentage increase in the consumer price index that has occurred since the manual was published.

Professional consultants who conduct reserve studies generally maintain databases with cost estimates derived from their own experience. Homeowners associations that employ such consultants for reserve studies will be able to take advantage of the knowledge that the consultants bring to the process.

Exhibit 3.2. Physical Analysis Checklist

This checklist summarizes the major steps in developing the Physical Analysis and, under each step, suggests certain actions the Board or its designated reserve study preparer may wish to consider in performing each step.

Deciding which components to include:
____ relevant components mentioned in the developer budget have been reviewed
____ components mentioned in the CC&Rs have been reviewed
____ an on-site inspection for possible additional components has been made
____ the board has had a public discussion and has determined a policy stating its position on life-of-the-building, exclusive use, and quasi-structural components
____ the board has communicated the list to the preparer of the Physical Analysis and, in the pro forma operating budget, to the homeowners

Specifying quantities of each component:
____ as-built drawings have been consulted, if possible
____ an on-site inspection of each component and an on-site count of each type of component have been made
____ the quality of each component has been determined and expressed in terms that identify a specific grade of material

Determining the useful life of each component:
____ manufacturer warranties have been consulted whenever possible
____ environmental factors that might affect useful life have been taken into account
____ installation and materials have been determined to be consistent with each manufacturer's description; if not, an adjustment has been made to the remaining useful life estimated by the warranty or by the manuals
____ a standard manual has been consulted
____ maintenance assumptions have been documented

Assessing the remaining life of each component:
____ an on-site inspection of each component has been made
____ past maintenance has been taken into account
____ individuals with knowledge of the components have participated in the assessment of remaining life
____ the board has determined what level of maintenance is expected to achieve the remaining life estimated

Determining the cost of replacement:
____ a standard costing manual has been consulted or more than one tradesperson asked for a price for each component
____ if a manual is used, the current price of each component has been adjusted for the age of the data in the manual
____ if a manual is used, regional variations in price are taken into account
____ cost of replacement includes cost of removing old component, if necessary
____ adjustments have been made for grade or quality of materials or levels of maintenance of materials

(adapted from *Reserve Study Guidelines for Homeowner Association Budgets* , California Dept. of Real Estate)

Section IV. Conducting a funding analysis

1. Introduction

A funding analysis has four major objectives: to calculate the cost for repair and replacement of major common-area components over an extended period of time (often 20 to 30 years); to develop a long-term funding plan that will generate sufficient cash flow to pay these costs as they come due; to incorporate this plan into the association's overall budget; and to document this plan in a way that is understandable to owners and potential buyers.

As with the physical analysis, a funding analysis can be performed by a member of the Board or other interested party within the association. However, legal considerations and the complexity of such an analysis may make it advisable to hire an outside firm. Board members can potentially be personally liable for major decisions that they make without reliance on professional advice. It is best for Board members to seek legal advice before undertaking such a project on their own.

2. What is involved in developing a funding analysis?

After the Board of Directors has decided on the time frame to be encompassed by the reserve study, a very rough preliminary estimate of annual contributions needed for the reserve account can be obtained by taking the total cost for that time frame and dividing it by the number of years that the study covers. For example, if $240,000 is needed over a period of 20 years, the annual contribution needed would be $12,000, or $1,000 per month.

However, many other factors enter into the picture, and these factors can substantially raise or lower the monthly contributions required by the reserve account. These include the timing of the needed maintenance, the assumed annual rate of inflation, the estimated amount of interest that can be generated by the reserve account, and the presence or absence of a contingency budget to account for unforeseen expenses. All assumptions and estimates of this type should be carefully documented by the association.

Because of the complexity of the calculations involved in reserve studies, a good funding analysis requires the aid of a computer. Spreadsheet programs can be used to prepare detailed reserve budgets with accompanying charts that are easy to understand. Spreadsheets also permit users to instantly discover how changes in assumptions can affect the budgeting process – for example, how much the monthly contribution will change if the assumed inflation rate is raised from 3% to 4%.

In addition to general-purpose spreadsheets, several companies sell custom software that generates reserve studies from information that an association enters into a form on the computer. This is similar in concept to the type of

software that people use to prepare their own taxes. However, the funding analysis that is generated by such software is only as good as the software itself and the information that is entered into its forms. Associations that employ such software should have the resulting study reviewed by a professional firm to insure that there are no major errors or omissions in either the input or the output.

Even with professional assistance, the Board of Directors must still make the ultimate decision on how to fund the association's reserve account. There are several ways to accomplish this, which will be examined below.

3. Funding methods for reserve accounts

There are two methods that a common-interest community can employ to pay for repair and replacement of major components: build up a reserve account for this purpose, or levy a special assessment on all owners within the community whenever a major maintenance expense occurs. Many communities employ a combination of these two methods. (A third alternative, deferring maintenance and continuing to use components beyond their intended lifetime, can prove more costly in the long run and can lower property values within the community.)

A well-funded reserve account has the advantage of providing money whenever it is needed to keep all community-owned assets in good repair. Conversely, a chronically underfunded reserve account will result in frequent calls for special assessments, often creating financial hardships on owners within the community. Although this alternative is clearly less attractive, it often occurs to communities that underestimate the cost of major common-area maintenance expenses, or that attempt to save money in the short run by keeping monthly assessments low.

4. Calculating needed contributions to the reserve account

The only way to keep payments to the reserve account level, and still have sufficient money to pay each expense as it comes due, is to use an *accrual* method of estimating fund contributions. This means saving for each expense at a constant rate until the money is needed. To oversimplify the concept, if it will cost $12,000 to replace a particular item in six years, then $2,000 should be added to the reserve account each year, so that by the sixth year the $12,000 will be available to replace the component.

Analyzing each component in this manner, and then adding up the total annual cost for all the components (with adjustments for interest rates and inflation, discussed below), should result in a ballpark estimate of the minimum annual contributions needed to keep the reserve account in balance. If current contributions are significantly below this amount, then the reserves are in deficit, and additional money will have to be raised sometime in the future to pay for replacement of major components.

New associations have the opportunity to avoid the need for special assessments if they practice good budgeting from the start. Older communities can also make up for lost time, but the process will be more difficult. Using the above example, if a community needs to replace the $12,000 component in two years, but has only $4,000 currently in the reserve account, adding an additional $2,000 a year will still leave a $4,000 deficit when it is time to replace the component. Thus, the association will have to either levy a one-time assessment to raise the remaining $4,000, or temporarily raise the monthly association assessments to cover the shortfall. However, the good news is that once the reserve account has been restored to solvency, monthly assessments can be stabilized (and perhaps reduced), and special assessments are less likely to be needed in the future.

It is also desirable to allocate some money in the reserve account for unexpected expenses, such as damage to common-area components or larger-than-expected cost increases. Such a contingency or "rainy-day" fund might add 5 to 10 percent to the monthly contribution to reserves. This money will make the reserve account more stable, decrease the likelihood of special assessments, and increase the attractiveness of the community to potential buyers.

Inflation and interest rates play a big role in determining whether a reserve account is able to meet its financial goals. For example, recent changes in the economic environment have adversely affected communities that anticipated their reserve accounts would earn 5% interest annually. As of this writing (2003), banks and money-market funds are paying less than 2% for short-term deposits. Consequently, many communities are faced with the need to increase their reserve account contributions to make up for the lower amount of interest being earned.

To minimize the consequences of such negative surprises, it is recommended that associations assume that inflation will be somewhat high and that interest rates will be somewhat low, and fund their reserve accounts accordingly. If these projections prove too pessimistic, a surplus will result. However, it is easier to deal with a surplus than with a deficit. Association assessments can be lowered or stabilized until the surplus disappears.

Information on inflation rates can be obtained from the sources listed in Appendix C. Information on interest rates paid on reserve accounts can be obtained from banks, savings and loans, and other financial institutions.

5. Estimating monthly contributions to the reserve account

Exhibit 4.1 shows how a computer spreadsheet can be set up to calculate the amount of money that should be assessed each year to maintain sufficient reserves to pay the necessary expenses as they come due.

For each component, the desired reserve account balance is calculated by multiplying the replacement cost by the age of the component (in years), and

then dividing this number by the component's useful life (in years). After all components have been accounted for, the desired balances for all components are added together to produce the approximate desired balance for the reserve account. (A professional firm will refine this estimate by taking projected inflation and interest rates into account.)

Next, the actual cash balance in the reserve account is subtracted from the desired balance calculated above. If the cash balance is less than the desired balance, the result of this subtraction is the reserve deficit.

Dividing the deficit by the number of units within the association gives the amount that each unit will need to pay to eliminate this deficit. This amount can be paid by means of a one-time assessment, a temporary surcharge on the monthly association assessments, or some combination of the two.

Exhibit 4.1. Calculating a Reserve Deficit

Component	Replacement Cost	Estimated Useful Life	Effective Age	Desired Balance
Painting	$10,000	5	3	$6,000
Paving	$14,000	7	4	$8,000
Roofing	$30,000	15	11	$22,000
Total Desired Balance				$36,000
Current Cash Reserves				$24,000
Current Reserve Deficit (Desired Balance minus Cash Reserves)				**$12,000**
Number of Units in Association				48
Reserve Deficit per Unit				**$250**

(adapted from *Reserve Study Guidelines for Homeowner Association Budgets* , California Dept. of Real Estate)

Once the deficit issue (if any) has been addressed, the remaining major issue is to calculate how much money needs to be added to the reserve account each month to keep it solvent. A method for accomplishing this is shown in Exhibit 4.2. Again, a professional firm will refine this estimate by taking projected inflation and interest rates into account. However, under normal economic circumstances the method shown in Exhibit 4.2 should yield a good approximation.

The Board of Directors is required by law to conduct an annual review of the financial assumptions used in the most recent reserve study. Changes in inflation and interest rates, or unusual changes in the price of components, may make it

Exhibit 4.2. Calculating Monthly Payments to the Reserve Fund

Component	Replacement Cost	Estimated Useful Life (Years)	Annual Contribution
Painting	$10,000	5	$2,000
Paving	$14,000	7	$2,000
Roofing	$30,000	15	$2,000
Total Annual Contribution			$6,000
Add 10% for Contingencies			$600
Total Annual Contribution			$6,600
Number of Units in Association			48
Annual Contribution per Unit			$138
Monthly Contribution per Unit			**$11.46**

advisable to raise or lower the monthly amount assessed to fund reserves. Such "mid-course corrections" promote the stability of the reserve account, and decrease the likelihood of major financial shocks when the next reserve study is performed.

Exhibit 4-3. Sample Reserve Account Projection Over 20-Year Period

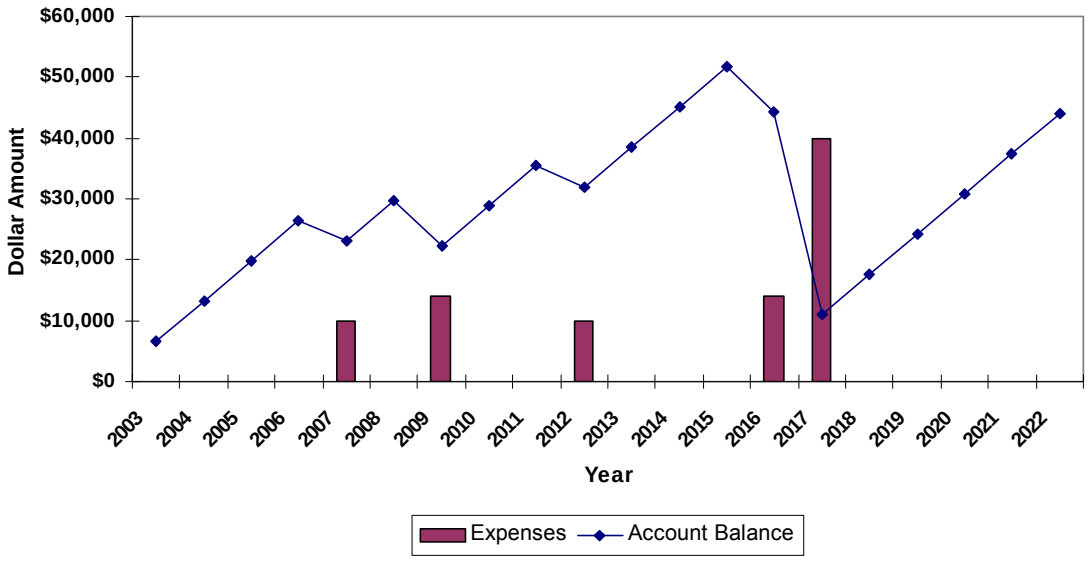

Exhibit 4.3 shows how applying this simplified model would affect reserve account balances over a 20-year period. Paving occurs in 2009 and 2016. Repainting occurs in 2007, 2012 and 2017. Roofing occurs only once, also in 2017. The balance in the reserve account fluctuates, but sufficient money is always available when scheduled maintenance is needed. In addition, the contributions added for contingencies build up over time, giving the reserve account a cushion that can be used when unexpected expenses occur.

Exhibit 4.4 – Funding Analysis Checklist

This checklist summarizes the major steps in developing the Funding Analysis and, under each step, suggests certain actions the Board or its designated reserve study preparer may wish to consider in performing each step:

Funding goal:
____ the association's funding goal for reserve replacement is clearly specified

Pro forma operating budget documentation:
____ the budget contains estimated revenue and expenses on an accrual basis
____ the budget identifies total cash reserves currently set aside
____ the budget shows funds set aside for reserves in a separate account(s)
____ the estimated remaining life of all major components is shown
____ the estimated current replacement cost of all major components is shown
____ the budget document includes identification of methods of funding for future repair, replacement or additions
____ the budget document includes a statement on methods used to develop estimates and funding plan
____ the pro forma operating budget is distributed 45 - 60 days prior to the start of the association's next fiscal year

Association income and expense estimates:
____ an appropriate component inflation factor has been used to estimate replacement cost in future years
____ the interest rate applied to association cash reserves is reasonable, and is an after-tax estimate
____ needed special assessments are clearly identified
____ assumptions about increases in the portion of regular assessments allocated to reserves are clearly specified
____ income and expenditures are shown annually for the plan period

Association cash balances:
____ with reserve assessments, the cash balance (assets minus planned reserve expenditures) is greater than zero in every year
____ the reserve deficit is estimated for the current year
____ the model shows a stable or decreasing reserve deficit (in constant dollars) over the plan period

(Source: *Reserve Study Guidelines for Homeowner Association Budgets* , California Dept. of Real Estate)

Section V. Identifying missing information

Many associations, especially if conducting a reserve study for the first time, may find that they are lacking certain information that is necessary to complete the study. If so, they will need to retrieve and document this information either before the study is begun, or during the study itself.

Here are some of the more common problems that can be addressed in the course of doing a reserve study:

1. There is no master list of major common-area components.
2. If a master list exists, it is missing some components mentioned in the CC&Rs or developer's drawings.
3. The Board lacks information on the remaining life and replacement cost of major components.
4. Major components are lacking a documented maintenance schedule.
5. No reserve funding goal has been established.
6. Reserve expenses and operating expenses are intermixed.
7. Reserve funds and operating funds are not in separate bank accounts.
8. A continuing deficit exists in the reserve account.
9. The dollar amount of component wear is greater than the amount used to replenish the reserve account.
10. Special assessments are employed to make up reserve account deficits.

Section VI. Hiring qualified professionals to conduct a reserve study

1. Overview

Members of each association's Board of Directors must decide whether to conduct a reserve study by themselves, or hire qualified outside professionals to accomplish the task. Some associations hire outside consultants to perform certain tasks, but not others.

In making this decision, the Board must consider several factors. These include:

1. The level of expertise within the Board or the community for this kind of study
2. Willingness of Board or community members to volunteer their time
3. Cost of hiring outside consultants to conduct the reserve study
4. Whether a previous reserve study is available for use as a guideline
5. Quality of existing documentation of components and replacement costs
6. The association's previous history regarding special assessments
7. The current financial state of the association's reserve account
8. The degree to which Board members can be held personally liable for a defective reserve study

If the Board wishes to have all or part of the study performed by outside professionals, the Board itself must still make certain major decisions. These include interviewing and hiring the consultants, assisting them in obtaining association data, reviewing the work product delivered by the consultants, and following up on the consultants 'recommendations for funding the reserve account.

2. Determining who should perform the work

Associations will typically be able to choose among several different types of firms that conduct reserve studies. The physical analysis is often performed by an engineering or appraisal firm, or one that does cost estimating for construction projects. The funding analysis, along with the association's pro forma operating budget, can be performed by an accounting firm that has experience with community associations.

There are also firms specializing in reserve studies that can perform both the physical analysis and the funding analysis. In some cases the association's own management company will offer this service.

The recommendations of other community associations can often be helpful in deciding which company or companies to hire for the reserve study. The Board of Directors should interview several companies and obtain samples of their work to get a sense of each company's qualifications, experience, and pricing structures.

For a partial list of questions that the association should ask these companies, see Exhibits 6.1 and 6.2.

3. Information that the association should provide

Before it can provide a cost estimate for the reserve study, a consulting firm will need general information from the Board regarding the size of the development and the scope of work. Following is a checklist of information that will be useful to consulting firms in preparing their estimates:

1. The size of the community – area and number of units
2. Types of improvements in the common area – pools, clubhouses, etc.
3. Which portions of the reserve study the consulting firm is being asked to do
4. A list and definition of major components
5. Identification of components that are not to be included in the study
6. Maintenance records, warranties, and other information regarding the condition of major components
7. Information on planned changes or additions to major components
8. A copy of any portion of the reserve study that has already been completed
9. A copy of the previous reserve study, if one was conducted
10. Construction drawings, especially as-built drawings if available
11. Current cash balance in the reserve account
12. Current and/or proposed association budget
13. Anticipated reserve expenses remaining in the current fiscal year
14. Board estimate of interest rate that the cash balance in the reserve account will earn

In certain cases, a consulting firm might need further information to make its estimate. It will save time to ascertain a company's information requirements before the actual interview takes place.

Exhibit 6.1 – Interview Guide for Physical Analysis Preparers

1. Do you have any personal or professional ties to this association? (NOTE: Such a tie does not necessarily indicate a conflict of interest, but should be disclosed and considered.)

2. Do you have any personal or professional ties to the developer? (NOTE: Such a tie does not necessarily indicate a conflict of interest, but should be disclosed and considered.)

3. If hiring an individual or sole practitioner: Do you do all the work yourself, or will you use subcontractors? (The association should approve all subcontractors.) Are you a Professional Reserve Analyst (an Association of Reserve Analysts designation) or a Reserve Specialist (a Community Associations Institute designation) or do you hold other professional designations? What is your training (formal education and workshops)?

4. If hiring a firm: Will all work be done by employees of your firm? How do you train your employees?

5. With what professional associations are you actively involved?

6. What experience have you had with performing component studies?

7. What experience have you had in this locale?

8. May we see an example of a similar product done for another association?

9. What information do you require from the association in order to start?

10. When will you begin the study?

11. Will you be measuring the components or using drawings?

12. Will you make a physical inspection of each component? What percentage of components will you inspect for fences, walls, controllers, buildings, etc.?

13. How will you determine the cost of replacement?

14. What written sources will be used?

15. How long will it be before we have the final product?

16. Will the report provide the estimated useful life of each component?

17. Will the report provide the estimated remaining life of each component?

18. Will the report provide the current costs of repair or replacement for each component?

19. Will the report provide the future costs of repair or replacement for each component and/or the inflation rate to be applied to each component?

20. Will the report provide information on proper maintenance to help assure realization of the estimated remaining life of each component? Will the report include visuals such as photographs or video?

21. Do you have liability insurance?

22. Do you have workers. compensation insurance?

23. Please provide three references (name, phone, nature of work).

24. Cost for revisions and/or updates.

(Source: *Reserve Study Guidelines for Homeowner Association Budgets* , California Dept. of Real Estate)

Exhibit 6.2 – Interview Guide for Funding Analysis Preparers

1. Do you have any personal or professional ties to this association? (NOTE: Such a tie does not necessarily indicate a conflict of interest, but should be disclosed and considered.)

2. Do you have any personal or professional ties to the developer? (NOTE: Such a tie does not necessarily indicate a conflict of interest, but should be disclosed and considered.)

3. If hiring an individual or sole practitioner: Do you do all the work yourself, or will you use subcontractors? (The association should approve all subcontractors.) Are you a Professional Reserve Analyst (an Association of Reserve Analysts designation) or a Reserve Specialist (a Community Associations Institute designation) or do you hold other professional designations? What is your training (formal education and workshops)?

4. If hiring a firm: Will all work be done by employees of your firm? How do you train your employees?

5. With what professional associations are you actively involved?

6. What experience have you had with community association budgeting?

7. May we see an example of a completed Funding Analysis?

8. What information do you require from the association in order to start?

9. When will you begin the study?

10. How long will it be before we have the final product?

11. Will the report provide current and future estimated liability computations?

12. Will the report provide current and future estimated cash balances by year?

13. Will the report provide current and future repair and replacement costs?

14. Will the report present alternative funding plans?

15. Will the report provide a description of assumptions and methodology, a narrative funding plan, and a graphic depiction for easier board and member understanding?

16. Will the report tell how much of a monthly contribution is needed for the reserves?

17. Do you have professional liability insurance?

18. Please provide three references (name, phone, nature of work).

(Source: *Reserve Study Guidelines for Homeowner Association Budgets* , California Dept. of Real Estate)

Glossary

(Note: The following definitions refer to words and phrases as they are used in reserve studies.)

Accrual method – a means of saving for an upcoming expense at a constant rate, so that all the money will be available when needed.
As-built drawings - drawings produced by the developer that show the actual characteristics of a community at the time when construction was completed. These drawings can be very useful in conducting a reserve study.
Assessment - monetary contribution required of each member of the homeowners association to meet the association's expenses. Assessments are typically due once a month.
Board of Directors - a group of people that oversees the operations of a common-interest community and enforces its rules. Typically the Board is composed of owners within the association, and its members are elected at the association's annual meetings.
Cash flow - the amount of money deposited into and withdrawn from a reserve account over a certain period of time.
Common area - the portion of a common-interest community that is owned jointly by all members of the homeowners association.
Common-interest community (CIC) - a defined area of land and improvements, in which some of the property is owned in common.
Contingency fund - the portion of reserves allocated for unanticipated expenses such as damage to components or unexpected cost increases.
Declaration of Covenants, Conditions and Restrictions (CC&Rs) - the governing documents of a common-interest community, which often provide details regarding the types, locations and quantities of community-owned components.
Deficit - the amount of money that a reserve account lacks to meet its funding obligations.
Developer drawings - drawings produced by the developer before or during construction of the community. Such drawings may or may not match the community's actual attributes. (Also see as-built drawings).
Funding analysis - the portion of a reserve study concerned with development of a funding plan to replace major community-owned components over an extended period of time.
Homeowners association - a legal entity that manages a residential common-interest community and enforces its rules. All owners within a community are members of its homeowners association.
Inflation - the rate at which the cost of components are expected to rise over time.
Interest - money earned from reserve funds deposited into an account at a financial institution.
Inventory - a list of community-owned components and their attributes, such as age, quality, manufacturer, degree of wear, and useful life.

Management company - an outside company hired by a homeowners association to perform some of the association's functions, such as landscape maintenance and collection of monthly assessments.
On-site inspection - physical inspection of one or more components to help determine their current physical state and remaining useful life.
Operating budget - the portion of a community's budget that is allocated for frequently-recurring or minor expenses.
Physical analysis - the portion of a reserve study that identifies major components, and estimates their remaining useful life and replacement costs.
Pro forma budget - a planning tool that estimates projected expenses and revenues for the coming year, including those impacting the reserve account.
Remaining useful life - the amount of time remaining before a component will need to be repaired or replaced (in other words, a component's useful life minus the time it has already been in service).
Replacement cost - the cost for replacing a component at the time such replacement is necessary. Inflation will increase this cost over time.
Reserve account - an account at a bank or other financial institution, containing funds intended solely to pay reserve expenses.
Reserve budget - the portion of a community's budget allocated for major expenses that occur infrequently (typically less than once a year), such as replacement and repair of community-owned components.
Reserve funds - the amount of money earmarked for reserves, usually placed in its own bank account known as the reserve account.
Reserve study - a periodic review of major community-owned components, designed to allow communities to estimate and provide for the funding necessary to repair or replace them as necessary.
Reserves - the amount of money set aside for a designated purpose, such as maintenance and replacement of major components within a common-interest community.
Special assessment - an amount of money beyond the normal monthly assessment, levied on all homeowners within the community to meet expenses that cannot be met using the community's budgeted funds.
Spreadsheet - computer software that can be used to calculate and document elements of reserve studies.
Useful life - the time frame for which a component is designed to operate properly before needing to be replaced or repaired.
Work product - the output from a reserve study, such as reports, tables, and charts.

Appendix A. Major Common Area Components Included in Reserve Studies

Alarm systems, fire and intrusion
Antennas, satellite dish and other
Asbestos encapsulation or removal
Awnings and other overhead coverings
Balconies (see also decks)
Benches
Boilers
Decks, pool and spa
Decks, residential
Display cases
Docks
Drainage systems
Electrical transformers
Electrical wiring and related fixtures in common area
Elevator, cab
Elevator, hydraulic, traction, etc.
Equipment, cleaning and maintenance
Equipment, communication and telephone
Equipment, entertainment, music/video systems
Equipment, exercise, recreational, etc.
Equipment, office
Equipment, pool, pumps, motors and filters
Fans, exhaust, garage and other
Fences, chain link, wood, etc.
Fire sprinklers and related equipment
Floor covering, carpet, tile, vinyl, etc.
Floor covering, wood replacement and refinishing
Fountains
Furnishings, lobby, clubhouse, etc.
Garage doors and hardware
Garbage enclosures
Gates, iron, wood, etc.
Gutters and downspouts
HVAC, air conditioning
HVAC, heating systems
Irrigation system, controllers
Irrigation system, piping, valves and sprinkler heads
Kiosks and message/communication centers
Lakes, ponds and waterways
Landscaping, replacement of major plants
Light fixtures, exterior
Light fixtures, interior
Mailboxes and centers
Monitoring system, carbon monoxide

Paint and stain, exterior
Paint and stain, interior common area
Pathways (if paved)
Paving
Planter boxes
Plumbing fixtures, exterior
Plumbing, water piping system
Posts, deck, lamp, etc.
Pumps, lakes, ponds and waterways
Racquetball courts
Retaining wall
Roof
Security gates, gate operator and motor
Septic tanks
Sewage ejector equipment
Siding and trim
Skylights
Slopes
Solar heating system, pool and spa
Solar heating system, residential
Spas
Stables and tack rooms
Stairs
Streets and drives
Stucco, sandblasting and resurfacing
Sump pump equipment
Swimming pools
Tennis courts, resurfacing
Trees
Trellises
Vehicles
Ventilation systems, garage
Walkways, wood, brick, tile, etc.
Water heaters

(Adapted from *Reserve Study Guidelines for Homeowner Association Budgets,* California Dept. of Real Estate, September 2000.)

Appendix B. Sources for Inflation Rate Estimates

The U.S. Bureau of Labor Statistics (BLS) releases monthly updates to the Consumer Price Index. Detailed current and historical statistics are available on its website, http://www.bls.gov/.

The Western BLS Information Office in San Francisco services the states of Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, and Washington. The Economic Analysis & Information staff is available for phone assistance from 9:00 AM to 11:30 AM and 1:30 PM to 4:00 PM at (415) 975-4350.

Appendix C. Preparation and Authorship of this Manual

1. Background

From the outset of common-interest communities boom in the 1960s, proponents have argued that associations should maintain reserves for replacement of capital assets, and as working capital. Some courts and legislatures consider the maintenance of reserve accounts for major, contingent future expenses as among the most important obligations of common-interest communities management. This position is based upon two ideas. First, the large amount of money needed to repair a major asset or operational problem will be difficult to raise from sources other than existing reserve funds. Members inevitably resist sudden or substantial assessment increases, some because their own incomes are fixed, some because they plan on moving out of the community before realizing the benefit of the expenditure. Also, lenders may well consider the lack of reserve funds a financial weakness of associations seeking to borrow cash urgently needed for repair, replacement or operational reasons. Second, fairness would seem to require members to pay for the association's capital assets as they "consume" them. Unlike public governments, community associations should operate on a "pay as you go" basis. Unlike public governments, which often assume a perpetually expanding tax base as a municipality grows, common-interest communities are generally constituted to preclude future growth.

The Lied Institute for Real Estate Studies (Lied Institute) at the University of Nevada, Las Vegas (UNLV) assisted the State of Nevada Department of Business and Industry, Real Estate Division to develop the "Reserve Study Guidelines for Common-Interest Communities" in compliance with NRS 116.311512.

This proposal was developed with the knowledge that the regulations promulgated must address the unique and diverse needs of Nevada 'varied common-interest communities 'needs. The Lied Institute fully understands the importance of developing relevant, concise, and compliant rules for use by Nevada's common-interest communities.

2. Methodology

We based our approach to this task upon our understanding of the scope of the project, and our collective experience working on projects of this type. We recognized that for this undertaking to be successful, we had to be certain to consider the intent of the legislation and unique needs of the Nevada's common-interest communities. As such, our approach included the legal and practical considerations of complying with the statute. We organized our efforts by focusing on the development of a deliverable product that was both legally compliant and consumer-usable. It is critical to provide research that is usable at many levels.

Our methodology included the following activities:

1. We conducted a detailed literature search of recent regulations and administrative cases on "common-interest communities.

Several other states have begun to assess the implications of reserve account legislation. Additionally, there has been a limited amount of case law developing throughout the nation on this subject. Certain states have developed regulations that carefully address both the legal implications of their respective statutes within the framework of the state's unique needs. Our initial research suggested that regulations must be developed that adequately and practically addresses the state's unique topography and statutory framework. Although other state's regulations cannot be directly imported into Nevada, they can provide information and suggestions on the regulation development and direction.

2. We surveyed the State's common-interest communities to identify and evaluate statewide needs.

As of January 1, 2001 there were 1,060 common-interest communities registered with the State of Nevada Division of Real Estate. Although 709 of these entities are located in Clark County, a significant amount of common-interest communities are located in urban northern Nevada and rural Nevada. Not surprisingly, these entities often have different concerns. To provide assurances that each region's issues would be addressed; we conducted interviews in January 2003 with common-interest communities in urban southern, urban northern, and rural Nevada. The researchers summarized their findings as follows:

> Most respondents believe that the minimum education or training requirements to conduct a reserve study should involve some sort of industry-specific training.
>
> Overwhelmingly, respondents indicated that professional or performance insurance should be required of those conducting studies. Generally, the

larger the number of units managed, the more strongly they believed that insurance should be required.

Similarly, a clear majority of respondents believed that studies should be conducted by individuals or groups independent of the common interest community organization.

The same respondents that felt strongly that persons conducting reserve studies should have industry-specific training believed that association board members should not be required to take education courses related to reserve studies.

Only 7.6% of respondents felt that reserve studies should be conducted annually. Over half (53.2%) indicated that conducting reserve studies every five years would be sufficient.

Respondents are evenly split on whether the reserve studies should have the percent funded in all years of the study.

Entities responsible for larger number of units are more likely to believe that the State should require a detailed revenue summary for all components in the reserve study. Overall, however, respondents are opposed (53.2% to 44.3%) to such a requirement.

Similarly, larger entities are more likely to believe that the State should require detailed schedules of expenses over the life of the reserve study. Overall, however, respondents were evenly split on the issue of mandatory expense schedules.

Again, larger entities were more likely to support a requirement that the reserve fund be reported annually. Overall, respondents favored this requirement gy a 53.8% to 46.2% margin.

Large and small entities alike were opposed to the formation of a State board to monitor reports by reserve specialists that board members have inappropriately managed the reserve study.

3. We drafted Guidelines that address the needs of Nevada's common interest communities.

Regulatory guidelines are most useful when they adequately analyze the concerns of the legislature and the community at large. In the development of the Reserve Study regulations, we addressed these types of concerns. We asked our subjects:

What items must be included in a reserve study?
What are the steps in conducting a reserve study?
How do reserves fit into the overall financial plan?

How do I identify and categorize components?
How do I do cost estimates?
How do I determine cost of replacement/repairs?
How do I determine a replacement schedule?
How do I project expenditures?
How do I identify qualified consultants?

After drafting the preliminary guidelines, we reviewed them for statutory compliance, completeness, and adequacy. In addition we reviewed them with individual common-interest community managers, to insure that they were easy to understand.

3. Staffing

A project of this scope required several interrelated skills. The primary skills included working knowledge of real estate, residential development and management, public finance, facilities planning, legal, financial analysis, and cost and project management.

Ms. Debra March, Executive Director of the Lied Institute for Real Estate Studies served as administrative project manager and technical advisor. Debra has extensive experience in real estate.

Dr. Robert Schmidt holds advanced degrees in economics and urban sociology, and in addition holds a J.D. in Law. Bob has appointments in the graduate schools of Management, Public Administration, and Sociology at the University of Nevada, Las Vegas (UNLV) and is also a member of the visiting faculty at the Helsinki School of Business and Economics in Finland.

Dr. Alan Schlottmann is Professor of Economics at University of Nevada, Las Vegas, and serves as Director of Research, Lied Institute for Real Estate Studies.

Professor Richard Ansson served as legal advisor. Richard holds a J.D. and L.L.M. in law. Richard currently serves as a Law Professor at the Boyd School of Law specializing in Indian Law and Land Use Planning.

Charles Barr earned Masters degrees in both Economics and Liberal Studies from University of Nevada, Las Vegas. He has extensive experience in research and writing, and served on a homeowners association Board of Directors during the 1990s.

Introductory Disclaimer

Chapters 33 and 44 of the 2019 Virginia Acts of Assembly, which resulted from the passage of House Bill 2030 and Senate Bill 1538, direct the Common Interest Community Board ("the Board") to "…develop guidelines for the development of reserve studies for capital components, including a list of capital components that should be addressed in a reserve study."

In accordance with the General Assembly's directive, this document provides guidelines for the development of reserve studies for capital components, as defined in the Code of Virginia. This document reflects the significant input and contributions of industry professionals experienced in the development of reserve studies for common interest communities, and generally reflects standard and accepted industry practice. It is intended to provide useful information and guidance to members of the public, including members of association governing boards and those who provide management services to associations, regarding developing reserves studies. It is not intended to regulate the development of or define a "standard of care" for reserve studies, and does not prescribe, or proscribe, any specific method for developing such studies.

Introduction

Throughout the United States there are various forms of real property ownership in which multiple homeowners agree to share in the common ownership of certain real property for their mutual benefit and enjoyment. Developers have employed this approach to, among other things, create neighborhoods, increase density, comply with local zoning and proffer requirements, and allow neighbors to establish shared services, facilities and expenses, take advantage of economies of scale and enhance property values (Moss, 2018).

In Virginia, developments of this type are called ***common interest communities*** (CICs), and can take one of the following forms: property owners' association, condominium, or real estate cooperative (Moss, 2018). In a CIC, individual homeowners own their residence – lot or unit – in the community and have shared ownership with their neighbors in the remaining real property, the ***common area or common elements***. CIC's have three general characteristics. First, the property is subject to ***governing documents*** that organize the community, provide for the administration of the community and common areas through an ***association***, and establish the rights and obligations of the association, individual owners, and the association's ***governing board*** (Moss, 2018). Second, by virtue of ownership in a CIC, membership in the association is mandatory and automatic (Moss, 2018). Finally, in a CIC members are required to pay ***assessments*** to fund the association and maintain the property (Moss, 2018). In a CIC, responsibility for maintenance and upkeep of the property is established by the community's governing documents. Generally, these responsibilities are divided between the association and the individual lot or unit owners. Items that the association is obligated to maintain, repair, and replace, regardless of whether such items are part of the common areas or elements, and for which the association's governing board has determined funding is necessary are called ***capital components***.

In order to ensure capital components are properly maintained, repaired, and timely replaced, many associations establish a reserve fund consisting of a budgeted portion of monies collected from assessments imposed on lot or unit owners. Funds in reserve are set aside for the dedicated purpose of paying for costs to repair and replace capital components when the need arises. In this sense, a reserve fund is like a "piggy bank." By establishing and funding a reserve, associations can lessen the potential of having to impose costly special assessments on members to pay for repairing or replacing capital components.

Toward this end, Virginia law requires the governing board of an association to periodically conduct a study, called a ***reserve study***, to determine the necessity and amount of reserves required to repair, replace and restore the capital components. (See Appendix A for applicable provisions in the Code of Virginia). The governing board must conduct the reserve study every five years, review the results of the study at least annually to determine if reserves are sufficient, and make any appropriate adjustments deemed necessary to maintain reserves. If the reserve study indicates a need for the association to budget reserves, then the governing

board must also ensure that certain information is included in the association budget (Moss, 2018).

Because an association governing board has a fiduciary duty to manage association funds and property, establishing a reserve fund and making provision in the association budget for reserves is important (California, 2010). The information provided by a reserve study aids association members in understanding the physical condition of the property, and the financial condition of the association, in order to allow for adequate planning. It can serve as an important tool for the association to balance and optimize long-term property values and costs for members, as reserve planning helps assure property values by protecting against decline in value due to deferred maintenance and inability to keep up with aging components (California, 2010). Moreover, a reserve study is beneficial to purchasers of property in a common interest community. A reserve study can aid in the evaluation of the value of the property, and show a more accurate and complete picture of the association's financial strength and market value (California, 2010).

The Basics of Reserve Studies

Components of a Reserve Study

There are two components of a reserve study: (i) a ***physical analysis*** and (ii) a ***financial analysis***. The physical analysis provides information about the physical status and the repair or ***replacement cost*** of components the association is obligated to maintain (California, 2010). This entails conducting an ***inventory*** of components, an assessment of the components' condition, and ***life and valuation estimates*** (FCAR, 2014). The financial analysis assesses the association's reserve income and expenses, by examining the reserve ***fund status***, measured in cash or ***percent funded***) and recommending an appropriate contribution for the fund (California, 2010; FACR, 2014).

Types of Reserve Studies

Reserve studies can be grouped into three types, each of which reflects differing levels of service.

1. Full Study: A full reserve study is the most exhaustive level of service. A full study involves conducting of a ***component inventory***, a ***condition assessment*** (based upon on-site visual observations), and life and valuation estimates to determine both fund status and a funding plan.
2. Update, With-Site-Visit/On-site Review: This type of study involves conducting a component inventory (verification only, not quantification), a condition assessment (based upon on-site visual observations), and life and valuation estimates to determine both a fund status and funding plan.

3. Update, No-Site-Visit/Off Site Review: This is the minimal level of service. It involves conducting life and valuation estimates to determine fund status and a funding plan.

(FACR, 2014)

Contents of a Reserve Study

A reserve study should consist of the following:

- A summary of the association, including the number of units, physical description, and the financial condition of the reserve fund;
- A projection of the reserve starting balance, recommended reserve contributions, projected reserve expenses, and the projected ending reserve fund balance for a minimum of 20 years;
- A tabular listing of the component inventory, component quantity or identifying descriptions, useful life, remaining useful life, and current replacement cost;
- A description of the methods and objectives utilized in computing the fund status in the development of the funding plan;
- Source(s) utilized to obtain component repair or replacement cost estimates; and
- A description of the level of service by which the reserve study was prepared and the fiscal year for the reserve study was prepared.

(FACR, 2014)

Governing Board Action Steps to Providing for Adequate Reserves

In order to adequately provide for reserves, an association should employ a systematic approach involving specific action steps. First, the association's governing board should **resolve to have a reserve study** by passing a resolution that a reserve study be performed and commit the association to taking action to ensure the study is conducted. Associations that have been operating without a reserve study, or funding plan, should consider undertaking this process as soon as possible (California, 2010). Keep in mind it is a statutory requirement for the governing board of an association to conduct a reserve study at least once every five years, and review the results of the study annually.

Second, the governing board should **identify the reserve study products needed**. A governing board may contract for the preparation of the physical analysis, financial analysis, and ***operating budget*** by professionals, or may elect to produce one or more of these items on its

own. The governing board may also choose to perform part of the work, and have a professional perform the rest (California, 2010).

Third, the governing board should **establish a work plan**, specifying the nature of the tasks to be performed, before conducting the study. The work plan should establish (i) the types of components to be included or excluded; (ii) the timeframe for funding common area components; and (iii) the budget available for conducting the study.

Choosing components to include. Components that the association is obligated to maintain, repair, or restore cannot be excluded from the reserve study, even if the components are not part of the common areas or elements. Components for which individual lot or unit owners are responsible can be excluded from the study. The association's governing documents establish those components that are the responsibility of the association to maintain, and those for which owners are individually responsible (California, 2010). Governing documents often contain a ***maintenance responsibility chart*** which can be useful for this purpose (Moss, 2018). (See Appendix C for a list of components that are typically addressed in reserve studies.)

Timeframe. There is not universal agreement of the appropriate timeframe for a reserve study. A good approach is to forecast for a time period that will include the replacement year of the component with the longest estimated useful life. Professionals recommend that the study include all components that will fail before the building itself. "Life-of-the-building" components such as the building foundation and structure are generally excluded from the reserve study budget. However, if there is reason to expect an item will wear out before the building does, or the item may wear out within the time span of the reserve study, then the item should be included as an item in the study (California, 2010).

Budget Available for the Study. Another consideration is the amount of money available to conduct the study. In order to comply with reserve study requirements, associations should, on an annual basis, adequately fund their budget to enable them to either conduct a study, or hire outside professionals to complete the study, once every five years (California, 2010).

Next, the governing board needs to **conduct the component and funding studies**. The governing board should identify documents, including the association's governing documents (i.e. declaration, bylaws), the most accurate drawings of the development, and the maintenance history of major common area components. If "as built" drawings exist, these would be the best source of information about the nature of the major components. The maintenance history should include the actual dollar cost figures of that maintenance. If an association has not already done so, it should consider creating a "permanent" maintenance history file for each major component (California, 2010).

Finally, once the study has been completed, the governing board needs **accept, disclose, and implement the results** of the study. The governing board reviews and accepts the results of the reserve study, and incorporates this information into the association's funding plan (California, 2010). State law specifies that to the extent a reserve study indicates a need to budget reserves, the association budget shall include, without limitation, (i) the current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components; (ii) the current amount, as of the beginning of the fiscal year for which the budget is prepared, of accumulated cash reserves set aside to repair, replace, or restore capital components and the amount of the expected contribution to the reserve fund for that fiscal year; (iii) a statement describing the procedures used for estimation and accumulation of cash reserves; and (iv) a statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves. Association governing boards are also required by state law to review the results of the reserve study at least once annually to determine if reserves are sufficient, and make any adjustments they deem necessary to maintain reserves.

Conducting a Physical Analysis

The goals of a ***physical analysis*** are to (i) estimate useful and remaining life of major components; and (ii) estimate current replacement cost of major components. The analysis lists and estimates replacement costs and timing for replacement of components whose repair or replacement is funded through association reserves. The study determines when such repairs or replacements will be needed and what they will cost (California, 2010). The major steps in conducting a physical analysis are:

1. Identify components
2. Specify quantities
3. Inspect components; define scope and methodology for inspection
4. Determine useful life; document maintenance assumptions
5. Assess remaining life; determine replacement year
6. Determine cost of replacement

(California, 2010)

There are a number of professional firms that perform reserve studies for common interest communities in Virginia. This explanation of how to perform a physical analysis will help associations to contract for this service and interpret the study results. For associations that cannot, or do not wish to, hire a professional reserve study preparer, this explanation will provide guidelines for governing board members who decide to perform their own physical analysis. Governing board members may wish to consider any potential legal consequences, including civil liability against the association, if they choose to undertake their own study; and should consider seeking legal advice before proceeding (California, 2010).

Identify Components

For each association, the exact list of major components is unique. Lists from other associations or industry publications may serve as a general guide, but are rarely usable without modifications and additions. Note that an inaccurate or incomplete list of components can materially distort an association's long-term funding plan (California, 2010). Professionals recommend that items be placed on the list of components for the reserve budget if they meet all of the following criteria:

- The item is the responsibility of the association to maintain or replace, rather than the responsibility of individual homeowners;
- The item costs over a certain amount to replace (amount to be determined by the governing board)[1]; and
- The estimated useful life of the item is greater than one year; and the estimated useful life of the item is less than 30 years at the time of the study.

(California, 2010)

There is often no one document with a comprehensive list of components for a development. Therefore, it is not easy to identify components accurately, although it is nonetheless essential that the association develop an accurate list of all items whose repair or replacement it must budget (California, 2010).

The exact list of components to include depends upon the physical characteristics of the project, as well as upon the legal division of responsibility among owners, the association, and local government. Appendix C provides a list of items that might be listed as components for association reserves. Note, however, this list is not exhaustive of all possible items (California, 2010).

An association's ***governing documents*** can help provide a list of components. Governing documents, including the declaration for the community, typically provide a general description of the common areas or common elements of the development. In a condominium, the governing documents, called condominium instruments, describe that which is part of each unit and what is outside of the unit. Governing documents usually specify the division of responsibilities between the association and individual owners, and can serve as a guide to the components to be included in a reserve study (California, 2010; Moss, 2018).

[1] One possible guideline is to include items that cost 1% or more of the total association budget. Another possible guideline is to include items that cost over $500 or $1,000 to replace, including groups of related items (e.g. gates in the development) that cost over $1,000 to replace. The dollar amount or percentage to use as a guideline should be discussed and adopted by the governing board.

The developer's reserve budget should list components the builder identified while planning the project. Such items as streets, roofs, exterior paint, and recreation areas are usually included in the developer's original reserve budget. However, note that governing documents and the developer's budget may not always account all components for which the association is responsible (California, 2010). A site analysis by knowledgeable individuals should result in a comprehensive list of items for which the association is, or might be responsible (California, 2010).

Local governments and utility companies can often help to identify capital components by stating where their responsibility for certain components ends, and that of the association begins. For instance, the governing documents or developer budget may be unclear about whether sidewalks along the edge of a development belong to the association or to the locality. If the sidewalks are an association responsibility, then they are components which should be included in the reserve budget; if not, then the budget need not account for their repair and replacement (California, 2010).

Quantifying Components

Although existing maps and construction drawings of a development may serve as a guide to component quantities, a detailed site and building analysis is the best way to obtain an accurate count of these items. For some components, such streets, roofs, and fences, the square or linear footage must be measured in order to describe the quantity; while for other items, such as utility room doors, it may be sufficient to know the number required. ***As-built drawings*** can be an excellent source of information for these quantities (California, 2010).[2]

For components that are actually made up of a number of items, the nature and quantity of the constituent parts should be stated (e.g., the metal flashing for a shake roof as well as the square footage of shingles). It is common to overlook the "extra" pieces that are in fact necessary to the construction of essential items such as roofs, siding, and irrigation systems (California, 2010).

Once the number and constituent parts of each component are detailed, it is necessary to give some consideration to the quality and specifications of those parts. For instance, is the asphalt two inches thick, or four inches thick? Is the roof a two-ply roof? What grade of paint was used? An accurate description of the materials is essential to proper reserves. If significant in dollar amount, quantities of the same type of component existing in very different conditions should be noted separately (e.g., the square footage of siding with western or southern exposure as compared to the square footage with eastern or northern exposure) (California, 2010).

[2] The drawings filed when the development was begun represent builder plans, but may not reflect the development as actually constructed. Therefore, they can be useful, but should verified by physical inspection.

Determining Useful Life and Remaining Life of Components

Useful life (UL) is typically defined as the number of years the component is expected to serve its intended purpose if given regular and proper maintenance. If the association fails to provide proper maintenance, then it may become difficult to anticipate the useful life of components (California, 2010).

One estimate of useful life is material manufacturer's warranty. This estimate presumes, usually in writing in the fine print of the warranty, that the product was installed with the purported quality of materials and according to the manufacturer's specifications. Note, though, that sometimes components may have been installed with lesser quality materials or inferior workmanship, thereby making the effective useful life shorter. When no knowledgeable inspection is made of the materials and installation, the manufacturer's warranty may not be an accurate description of the useful life of the component (California, 2010).

There are also some commercially available manuals that have estimates of useful life. [Refer to examples.] Published data may not be consistent with the location, exposure, or type of a particular component. The estimated life of a street as predicted from national data may well be lower than that of a street in a comparatively mild climate, but the estimated life of exterior paint as predicted from national averages may be higher than that of paint on buildings in windy or coastal areas. In using published estimates, it is necessary to consider how the specific case in question may differ from the average case considered by the manual's author (California, 2010). Useful life estimates may vary considerably from manual to manual, so consulting more than one manual may guard against the risk of underestimating or overestimating the life of a component. The source(s) of component useful life estimates should be identified specifically (California, 2010).

Remaining useful life (RUL) is generally defined as the expected number of years the component will continue to serve its intended purpose prior to repair or replacement. If the development is new and the developer-prepared estimates are correct, the remaining useful life might be estimated simply by subtracting the age of the development from the useful life of each component. The older the components, the less accurate this method will be (California, 2010).

Some of the factors that affect the remaining useful life of a component are its (i) current age, (ii) apparent physical condition, and (iii) past maintenance record (or absence of maintenance). The current age of the component may be determined from association records. The apparent current condition must be determined through physical inspection, preferably by someone familiar with the component. Records of past maintenance must be compared with recommended maintenance in order to determine whether the item has been properly maintained or may wear out sooner than expected due to inadequate care (California, 2010).

In determining the remaining useful life of a component, it is assumed there has been a certain level of continued preventative maintenance. These maintenance assumptions should be

explicitly stated so that proper maintenance can be continued through the component's remaining life (California, 2010).

The remaining life of a component implicitly specifies the year in which it must be repaired or replaced. A budget timeline can be used to show the replacement year for each component. This timeline can serve as a schedule for expected replacement of components and can be updated or changed when the physical analysis is updated, or as components last for shorter or longer periods than expected (California, 2010).

Sample Replacement Schedule

Component	Age in Years as of 12/31/2018	Estimated Useful Life (UL)	Estimated Remaining Useful Life (RUL)	Year to Replace
Painting	3	5	2	2021
Paving (slurry coat)	4	7	3	2022
Roofing (wood shingle)	11	15	4	2023

Determining Replacement Cost

Replacement costs can be obtained from manufacturers or their representatives for some items, and from local licensed contractors on others. It is important to remember that the cost of component replacement should also include the cost of removing the existing component, if applicable (California, 2010).

There are a number of recognized cost estimating manuals available with pricing information that can be used. [Refer to examples.] Cost estimates are generally comparable among manuals for the same geographic area, so there is less need to consult multiple manuals for replacement costs than for estimates for useful life. However, there are some considerations to factor in when using these manuals to determine costs. The majority of professionals performing reserve studies for associations obtain their cost estimates from a data base gathered from their experience. Cost estimates derived from this data may vary significantly from estimates based on manuals alone. Accordingly, associations performing their own study may want to obtain additional supporting data for their manual cost estimates from other sources, such as contractors, material suppliers, etc. This collection of data should then be considered in conjunction with the results of an inspection by a reasonably qualified person when making a final determination of replacement cost (California, 2010).

It is important to determine the specific geographic area for which the manual offers a cost average. If a manual has national averages, it may underestimate the cost of labor in certain areas, such urban areas. It is also important to determine the base year in which the manual's

cost estimates were made. The current replacement cost for components is not shown in the manual, and should be adjusted for ***inflation*** since the time cost data was obtained (California, 2010).

Documenting Maintenance Assumptions

An important adjunct to determining UL and RUL of a component is to document the type and schedule of maintenance that is assumed for the component to survive that life. For example, if the 20-year life expectancy of a roof is based upon annual cleaning of the roof and gutters, the association will be able to take action to help ensure that all the roofs will indeed last. Documentation of maintenance assumptions can lead to improved maintenance throughout the project and thereby lower replacement costs. On the other hand, ignoring maintenance assumptions, or improper maintenance, can put the replacement schedule and costs in jeopardy (California, 2010).

A properly prepared physical analysis will lead to a better maintenance program for the association. Clear and concise maintenance suggestions are a useful supplement to a professionally prepared physical analysis. These suggestions may save more than the cost of the original study on future repairs and replacements (California, 2010).

Using Component Data to Develop the Funding Analysis

Once charts of replacement schedule and future replacement costs are completed, the physical analysis is finished. The next step is to determine how much will be spent in each year for all components, and that step is part of the financial analysis (California, 2010).

Conducting a Financial Analysis

The goals of a ***financial analysis*** are to (i) establish ***funding goals***; (ii) identify annual funding requirements; and (iii) disclose limitations and assumptions. Once the estimated useful life, estimated remaining life, and estimated current replacement costs of components are identified, the association is ready to develop a plan for funding the ***reserve account*** (California, 2010).

In preparing the ***funding plan***, the association will have to make decisions about the amount of current assessments and the need for ***special assessments***, balanced against projected liability. The financial viability of the association will depend a great deal upon the ability of the association to replace components as they wear out, and not to defer major maintenance items (California, 2010).

A product of the financial analysis process is the development of a funding plan (***cash flow*** forecast or projection) to estimate future reserve cash receipts and disbursements. This is most easily presented in a spread sheet format. All supporting assumptions and methodology should be carefully documented (California, 2010).

The major steps in conducting a financial analysis are:

1. Obtain component information (from physical analysis)
2. Determine funding goal
3. Calculate replacement fund liability
4. Identify reserve account asset (cash balance)
5. Estimate annual association reserve fund income (from regular assessments)
6. Project expenditures and reserve fund needs, including regular and special assessments
7. Prepare statement of limitations and assumptions
8. Disclose reserve study information in association budget

(California, 2010)

As an association completes these steps, the board will make major policy decisions. Professionals may be able to advise the governing board on key decisions, but it is important for the governing board to understand each of these decisions, since they independently affect the overall results of the funding plan. Since the amount of regular assessments and the need for special assessments should be indicated in the plan, these decisions will affect owners' monthly costs and property values (California, 2010).

Determine Funding Goal

Determination of the funding strategy, including establishment of the funding goal, is one of the most important fiscal decisions to be made by the governing board. The association budget should clearly indicate estimated revenues and expenses, describe the funding goal, and indicate current status in meeting the goal (California, 2010).

The funding plan should show the funds required to replace each component as it comes to the end of its useful life, and indicate how the association will fund the replacements. The association should decide how much should be raised through regular assessments for the reserve account each year, and how much should be raised by special assessment, if any. In addition, the association should consider how much cash will remain in the reserve account at the end of the planning period relative to the projected balance needed at that date (California, 2010).

Associations will have to make difficult policy choices in determining the funding goal. Many associations underfund their reserves. This is due to lack of attention to reserve budgets in the past, and underestimation of replacement costs. An ideal goal for an association is to eliminate any ***deficit*** or shortage in reserve fund by building up the reserve fund to where the cash in the replacement reserve account is at least equal to the estimated value of accumulated wear of all major components. However, this goal may not be within reach of many associations in the short term, except through special assessments (California, 2010).

There are at least four basic funding goal or strategy models.

- **Full Funding Model** – The goal of this model is to attain and maintain the reserves at or near 100%. For example, if an association has a component with a 10-year life and a $10,000 replacement cost, it should have $3,000 set aside for its replacement after three years. In this case, $3,000 equals full funding
- **Baseline Funding Model** – Also called a "Minimum Funded Model," the goal of this model is to keep the reserve cash balance above zero. This means that while each individual component may not be fully funded, the ***reserve balance*** does not drop below zero during the project period. An association using this model must understand that even a minor reduction in a component's remaining useful life can result in a deficit in the reserve cash balance. Associations can implement this model more safely by conducting annual reserve updates that include field observations.
- **Threshold Funding Model** – This model is based on the baseline funding concept. However, in this model the minimum cash reserve balance is established at some predetermined dollar amount. Associations should take into consideration that depending on the mix of common area major components this model may be more or less conservative than the fully funded model.
- **Statutory Funding Model** – This model is based on local statutes. To use it, associations set aside a specific minimum amount of reserves as required by statutes.

(California, 2010; FACR, 2014)

Each of the funding goal models depends on an analysis of cash flows into and out of the reserve fund over the next 30 years. Assessment calculations are then made sufficient to reach the governing board's funding goals (California, 2010).

Calculate the Reserve Deficit

The association should employ the ***accrual method*** to estimate fund contributions and expenses. This will ensure payments to the reserve account remain level, and that sufficient funds will be available when expenses come due. With respect to revenues, this estimate includes regular and special assessments, as well as the after-tax ***interest*** income earned on accumulated cash reserves. Expenses can be accrued by spreading the eventual replacement cost of each component over its total useful life or obtaining an estimate of annual component wear (Nevada, 2003; California, 2010). For instance, if a component currently valued at $10,000 has a useful life of ten years, then one can estimate the annual wear, or the annual provision for the replacement fund, at $1,000. By year five, this component would then have accrued a liability of $5,000, assuming no inflation. (If the association fully funded its reserves, then this $5,000 would already be in the reserve account by the end of the fifth year.) (California, 2010).

After estimated revenues and expenses are established, this information can be used to calculate the required estimated reserves for components, and calculate any deficit or shortage in the reserve fund (California, 2010).

Begin by determining the ***accrued fund balance*** for each component. This can be calculated according to the following formula: Current Cost x Effective Age/Useful Life. For example, consider a roofing component with a current cost of $30,000, an effective age of 11 years, and a useful life of 15 years:

$$\frac{Current\ Cost\ (Roofing) x\ Effective\ Age}{Useful\ Life}$$

$$\frac{\$30{,}000\ x\ 11}{15} = \frac{\$330{,}000}{15} = \$22{,}000$$

Analyze each component in this manner, and then total together the accrued fund balance for components to determine the projected reserve fund balance. Then determine the reserve deficit by calculating the difference between the projected reserve fund balance and the estimated cash balance in the reserve fund. Once the reserve deficit (if any) is established, this information can be used to determine the amount of reserve deficit per lot or unit. In addition, the reserve balance funding percentage can be determined (Nevada, 2003; California, 2010; FACR, 2014).

Component Replacement	Current Cost	Useful Life (years)	Effective Age (years)	Accrued Fund Balance
Painting	$10,000	5	3	$6,000
Paving	$14,000	7	4	$8,000
Roofing	$30,000	15	11	$22,000
Total Reserve Balance (current)				$36,000
Estimated Cash Reserves (current)				$22,000
Reserve Deficit (current)				$14,000
Reserve Deficit per unit ($14,000 ÷ 35 units)				$400
Percentage of Funding				61%

Accrued Fund Balance = Current Cost x Effective Age/Useful Life

Reserve Deficit = Total Reserve Balance – Estimated Cash Reserves

Percentage Funding = Estimated Cash Reserves / Reserve Deficit x 100

Although this approach is relatively simple, there are challenges posed by the fact that it does not factor the effects of interest or of inflation. Interest rates and inflation play a significant role in whether a reserve fund can meet its goals. An alternative reserve deficit model, which does take into account interest and inflation, is as follows:

$$Desired\ Balance = \left(\frac{Current\ Cost}{Useful\ Life} \times Effective\ Age\right) + \left(\frac{\frac{Current\ Cost}{Useful\ Life} \times Effective\ Age}{1 + Interest\ Rate^{Remaining\ Life}}\right) - \left(\frac{\frac{Current\ Cost}{Useful\ Life} \times Effective\ Age}{1 + Inflation\ Rate^{Remaining\ Life}}\right)$$

Assuming an inflation rate of 3% and interest rate of 5% after taxes, the following are calculated.

Component Replacement	Current Cost	Useful Life (years)	Effective Age (years)	Desired Fund Balance
Painting	$10,000	5	3	$5,787
Paving	$14,000	7	4	$7,590
Roofing	$30,000	15	11	$22,553
Total Reserve Balance (current)				$33,930
Estimated Cash Reserves (current)				$22,000
Reserve Deficit (current)				$11,930
Reserve Deficit per unit ($11,930 ÷ 35 units)				$340
Percentage of Funding				65%

This approach, though more complicated, may be more reflective of the true amount of the reserve deficit (assuming the interest and inflation rates are accurate). In most cases, the difference between these approaches is not material; however, with some mixes of common area major components the difference can be quite noticeable and failure to properly take interest and inflation into account can unfairly lead to unrealistically high calculations of the reserve deficit (Nevada, 2003; California, 2010).

Many associations take the approach of an ***unfunded &special assessment model***. The association does not have reserve balances that will cover expected replacement costs, and the only recourse is to schedule special assessments to cover component replacement costs when they are due. Lack of information about needed special assessments can pose a problem for owners. One-time costs impose an additional financial burden on owners, and can be a considerable hardship on those with limited or fixed incomes who may be unable to pay. This approach is the riskiest, and could jeopardize the financial viability of the association if assessments cannot be raised when needed (California, 2010).

Another approach is a ***mixed model*** in which the cash needs for replacement of components are met through a combination of regular and planned special assessments. The degree to which an association can meet its cash needs through regular as opposed to special assessments may be an indicator of the association's financial viability (California, 2010).

The association's choice of the funding goal or strategy will have a direct effect on the cash required of each individual owner. The strategy, and the degree to which the association has funded its reserves, should affect property value as well. (If an association shows a $5,000 unfunded reserve deficit per unit, this amount reasonably should be reflected in the sales price.) (California, 2010).

Estimate Association Reserve Fund Income

Ideally, the replacement reserve account should be built through regular (usually monthly) assessments paid by association members. A specific dollar amount of regular association payments should be earmarked for reserves, and deposited into a reserve account as they are collected. Financing of replacement reserves from regular assessments is desirable. First, it spreads the responsibility for replacements over time, rather than allocating costs to owners who happen to be in the association in the year a particular component comes due for repair or replacement. This funding approach provides a more equitable distribution of the costs of aging components. Second, it provides individual owners with more certainty as to the true costs of the property (California, 2010).

Income from regular assessments should be calculated for each year, based on the number of lots or units, and the level assessment per lot/unit. In associations with several rates for different types or sizes of units, the expected income should be calculated for each class of unit and then added. Assessment increases, if any, should be estimated by year (California, 2010). A method for calculating the amount to contribute to the reserve account follows. Under normal economic circumstances this approach should yield a good approximation. However, associations may wish to obtain the assistance of a professional firm to fine tune estimates to take into account inflation and interest rates (Nevada, 2003).

Component	Replacement Cost	Estimated Useful Life (years)	Annual Contribution
Painting	$10,000	5	$2,000
Paving	$14,000	7	$2,000
Roofing	$30,000	15	$2,000
Total Annual Contribution			$6,000
Add 10% for Contingencies			$600
Total Annual Contribution			$6,600
Number of Units in Association			48

Annual Contribution per Unit	$138
Monthly Contribution per Unit	$11.46

State law requires associations to review reserve study results at least annually to determine if reserves are sufficient, and to make adjustments necessary to maintain reserves. Changes in interest rates or inflation rates, or unusual changes in the prices of components, may make it advisable to raise or lower the monthly amount assessed to fund reserves. These periodic "course corrections" can promote the stability of the reserve account, and decrease the likelihood of financial shocks when the next reserve study is performed (Nevada, 2003).

Project Expenditures and Reserve Funding Needs

The physical analysis provides the estimates for expected expenditures by year for each component. Adding these component requirements together, by year, gives the estimate of needed funds over time. Association members should be aware of the limitations of expenditure forecasting and of the reality that the overall funding plan is only as good as the initial estimates of replacement costs and the time of replacement needs (California, 2010).

An important policy issue for a governing board is the decision over whether to use current costs, or estimated future costs. Use of an inflation rate will generally result in higher estimates of future costs. If the governing board uses current costs, it is essential the board revise the plan annually based upon updated current replacement costs, plus currently required or anticipated expenditures. The annual cost for each component would be calculated by dividing the unfunded replacement cost by the remaining useful life. This approach is valid only if repeated each year (California, 2010).

If the board chooses to use an inflation rate, it would apply an average long-term cost inflation rate to all components from the time of the study until the year of replacement (based on recent average component cost data). To keep this plan current, it is important to annually review and update projected expenditures, inflation factors and other assumptions. As with the current cost approach, the inflation rate approach is valid only if repeated each year (California, 2010).

There are several ways to select an inflation rate for estimating component costs for future years. These include: (i) Federal Bureau of Labor Statistics; (ii) published information from construction cost estimating companies; and (iii) Marshall & Swift. The interest rate assumption is an important decision for the governing board, and should be explicitly disclosed in the financial analysis. Because of their effect on estimating future costs, current cost information and inflation rate assumptions should be reviewed annually, and the projections adjusted as necessary (California, 2010).

Following is a sample chart showing calculations for future replacement costs. In a real situation, it may be necessary to add additional years of inflation in order to account for old pricing information. The sample chart assumes the pricing information on all components is up-to-date (California, 2010).

Component	Quantity & Units	Unit Cost	Current Cost to Replace (2019)	Year to Replace	Future Cost to Replace
Painting, exterior stucco	15,875 sq. ft.	.63	$10,000	2021	$10,941
Paving, slurry coat	35,000 sq. ft.	.40	$14,000	2022	$16,022
Roofing, wood shingle	10,715 sq. ft.	2.80	$30,000	2023	$35,913
(Future replacement cost was calculated with an annual 4.6% inflation rate.)					

Estimate Interest Earnings of Reserve Account Over Financial Analysis Period

Reserve funds deposited in certificates of deposit or money market accounts will generate interest income to increase the reserves. For forecasting purposes, it is necessary to choose an interest rate. For planning purposes, a lower interest rate is more conservative than a higher one. Interest rates can be pegged to current bank rates or CD rates. Income from the reserve and operating accounts is taxable to an association, even if the association is established as a non-profit organization. A governing board should adjust the interest rate assumption to account for applicable federal and state taxes (California, 2010).

Though it may be difficult to accurately project future component cost increases or future interest earned on reserve cash balances, it is nonetheless important to use these factors for calculations in the financial analysis, and to update them each year. This is particularly true for associations that have chosen to rely in part on special assessments (California, 2010).

As component replacement comes due in future years, it will draw against reserve funds. The initial reserve account, augmented by regular contributions from routine homeowner assessment payments, should provide enough "cushion" to pay for replacements as they are needed. In some cases, though, the reserve account will not be enough. The cash flow analysis will identify instances where expenditure projections for a given year exceed projected reserve cash balances. In these cases, additional funds from special assessments (or other sources, if any) would be needed to increase the reserve accounts to desired levels (California, 2010).

Some replacement expenses will be impossible to estimate. This may be due to unexpected breakage or destruction, failure in a "life-of-the-project" system, reduced useful life of a component, or other unexpected component cost. A line item in the cost estimates might be established as a contingency. This amount might be limited to 3% to 5% of the first-year budget

in a new association. In a conversion, or older associations with incomplete documentation, larger contingency levels may be necessary. One useful way to establish estimates for contingency funding in on-going associations is to review prior year spending for contingency-type replacements or continuing repairs. For instance, if there is routine work done annually on underground utilities, then some funds for expected annual levels might be budgeted under the contingency category (California, 2010).

Appendix F contains a sample financial analysis which summarizes these income and cost concepts. The rows of the spreadsheet show individual component costs and association income sources. The columns show the years included in the financial analysis. The sample assumes a funding plan period of 30 years and mixed funding model which uses regular and special assessments to maintain a positive cash balance. Because the model is not fully funded, inflation factors are employed in determining component costs (California, 2010).

Statement of Limitations and Assumptions

The funding analysis should document (i) all limitations to the estimate, (ii) assumptions made in order to conduct the estimates, (iii) the model used to make the estimates (California, 2010).

Disclose Reserve Study Information in the Annual Budget; Updating

An association, once it has successfully completed a reserve study (both physical and financial analysis), can use the resulting information in its annual budget. Indeed, state law requires that to the extent a reserve study indicates the need for an association to budget reserves, the budget must include:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components;
2. The current amount of accumulated cash reserves set aside, to repair, replace, or restore the capital components and the amount of the expected contribution to the reserve fund for the fiscal year (as of the beginning of the fiscal year for which the budget is prepared);
3. A statement describing the procedures used for estimation and accumulation of cash reserves; and
4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

An association governing board is required to review the results of the reserve study at least annually to determine if reserves are sufficient, and make appropriate adjustments to ensure reserves are maintained. How often, though, does the reserve study need to be updated? (California, 2010).

Annual updates of the financial analysis can be carried out at the same time as preparation of the operating budget, and can call for required adjustments within the original planning period. The assumptions in the reserve study (e.g. remaining life and cost of components) should be reviewed and updated as necessary. The frequency of updates of component data will depend on the soundness of the original data and estimates, the preparer's recommendations, and the association's ability to adequately maintain its components. Even though the methodology calls for a financial study covering a time frame of twenty years or more, annual planning and periodic reviews of the reserve study can rely on updated estimates (California, 2010).

Hiring a Professional to Perform a Reserve Study

Members of an association governing board must decide whether to conduct a reserve study by themselves, or hire qualified professionals to perform the task. Some associations elect to hire outside consultants to perform certain tasks, but not others. In making this decision, a governing board should consider several factors, to include:

1. The level of expertise within the board or the community for this kind of study;
2. The willingness of board or community members to volunteer their time;
3. The cost of hiring outside consultants to conduct the reserve study;
4. Whether a previous reserve study is available for use as a guideline;
5. The quality of existing documentation of components and replacement costs;
6. The association's previous history regarding special assessments;
7. The current financial state of the association's reserve account; and
8. The degree to which board members can be held personally liable for a defective reserve study.

(Nevada, 2003)

If the governing board wishes to have all or part of the study performed by professionals, it must still make several important decisions. These include interviewing and hiring the consultants, assisting them in obtaining association data, reviewing the ***work product*** delivered by the consultants, and following up on consultants' recommendations for the reserve funding account. Should a governing board elect to use consultants, the following should be established by the board:

- Identification of common area components, exclusive use components, quasi-structural components, and life-of-the-project components (with the assistance of association management);
- The interest rate for estimating income earned on reserve balances; and
- The funding goal of the reserve study, including the degree to which reserves are to be funded by annual assessments, and the need for special assessments.

(Nevada, 2003; California, 2010)

As the governing board is accountable for quality of the study itself, it should carefully specify the work tasks and carefully review potential consultants with respect to previous experience, price, and recommendations from other associations. Following are some or all of the work tasks that may be performed by professionals (California, 2010).

Physical Analysis Products for Consultants

- Quantification of components;
- Documentation of maintenance assumptions and recommendations;
- Identification of useful life and remaining life of components, and replacement year; and
- Estimation of replacement cost in current and future dollars.

Financial Analysis Products for Consultants

- Spreadsheet modeling of reserve funding, and development of solution(s) meeting the funding goals of the association;
- Calculation of cash balance of reserve account by year;
- Estimation and explanation of reserve deficit;
- Recommendation of needed increases in reserve portion of assessment;
- Preparation of statement of limitations and assumptions of reserve analysis; and
- Preparation of reserve study information for association budget.

(California, 2010)

After determining the work tasks, the board must select the consultants or contractors, if any, who will perform all or part of the work. Possible outcomes of this decision-making process include:

- Hiring an independent engineering, appraisal, or construction cost-estimating firm to perform the physical analysis, and hiring an independent accountant experienced with community associations to produce the financial analysis and association budget;
- Hiring an organization with staff expertise to perform an integrated component and financial analysis;
- Having the board or managing agent prepare these studies in cooperation with independent construction contractors and accountants, as needed;
- Hiring the current ***management company*** to perform both analyses and incorporate the results into the association budget; and
- Using any of the above in conjunction with additional work tasks performed by the board.

(California, 2010)

The type of assistance that will be needed depends upon the nature of the product desired, the budget, and expertise available to the governing board. The governing board is ultimately responsible for the reserves study disclosures. The board should also consider its potential legal liability if the study does not meet statutory information requirements (California, 2010).

Recommendations from other community associations can often be helpful in determining which company or companies to hire for the reserve study. Organizations of common interest communities and related professionals can also be a resource to find qualified professionals. It is helpful to talk with people who have worked with any firm or consultant under consideration and to examine samples of related work (Nevada, 2003; California, 2010).

The governing board should interview several companies and obtain samples of their work in order to get a sense of each company's qualifications, experience, and pricing structures. Appendix E contains partial lists of questions a governing board may use to ask a reserve study preparer as part of the interview process. The questions may be used in interviews with potential consultants, or used a written ***request for proposal***, along with a clear specification of the work tasks to be performed. Answers to these questions, as well as price, should help in the selection of any needed professionals (California, 2010).

Information the Governing Board Should Provide

Before it can provide a cost estimate, a consulting firm will need information from the governing board regarding the community and the scope of work. The governing board should provide potential consultants with the following:

- The size of the community – area and number of lots/units;
- Types of improvements in the common area/common elements – pools, clubhouses, etc.;
- Which portions of the reserve study the consulting firm is being asked to perform;
- A list and definition of major components;
- A statement of board policy about major components for which it is not requesting an estimate of replacement costs;
- Maintenance records, warranties, and other information regarding the condition of components;
- Information on planned changes or additions to major components;
- Copy of as-built construction drawings, if they exist;
- A copy of the previous reserve study, if one was conducted;
- Estimated replacement cash balance at beginning of next (nearest) fiscal year;
- A copy of the current or proposed association budget;
- A board estimate of long-term interest rate to be earned on reserve account cash balance; and
- Anticipated reserve expenses for the remaining year.

In some cases, a consulting firm might need further information to make its estimate. It will save time to ascertain a company's information requirements before the actual interview takes place (Nevada, 2003; California, 2010).

Potential Problems

Many associations, especially if conducting a reserve study for the first time, may find they are lacking certain information that is necessary to complete the study. If so, they will need to retrieve and document this information either before the study is begun, or during the study itself. Here is a list of the more common problems that can be addressed during the course of doing a reserve study:

- The association does not have an established master list of major components;
- If a master list of components exists, it does not include all significant common area/common element components listed in the governing documents or developer's drawings;
- Information on remaining life and current replacement cost has not been prepared for all major components;
- The association does not have a documented maintenance schedule and related assumptions for each major component;
- "Life-of-the-project" components are not mentioned in assumptions, or included in reserve budgeting;
- The association budget does not contain reserve study information or assumptions;
- There is no policy to distinguish reserve expenditures from operating expenses;
- No reserve funding goal has been established;
- There is no separate bank account(s) for reserve funds;
- No previous physical analysis or financial analysis has been conducted;
- The reserve deficit is staying constant or increasing over time;
- Special assessments are required to fund major repairs; and
- Current income from assessments does not equal or exceed dollar value of annual component wear.

(Nevada, 2003; California, 2010)

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Code of Virginia
Title 55. Property and Conveyances
Chapter 4.2. Condominium Act

§ 55-79.41. Definitions

When used in this chapter:

"Capital components" means those items, whether or not a part of the common elements, for which the unit owners' association has the obligation for repair, replacement or restoration and for which the executive organ determines funding is necessary.

"Common elements" means all portions of the condominium other than the units.

"Common expenses" means all expenditures lawfully made or incurred by or on behalf of the unit owners' association, together with all funds lawfully assessed for the creation and/or maintenance of reserves pursuant to the provisions of the condominium instruments.

"Common interest community manager" means the same as that term is defined in § 54.1-2345.

"Condominium" means real property, and any incidents thereto or interests therein, lawfully submitted to this chapter by the recordation of condominium instruments pursuant to the provisions of this chapter. No project shall be deemed a condominium within the meaning of this chapter unless the undivided interests in the common elements are vested in the unit owners.

"Condominium instruments" is a collective term referring to the declaration, bylaws, and plats and plans, recorded pursuant to the provisions of this chapter. Any exhibit, schedule, or certification accompanying a condominium instrument and recorded simultaneously therewith shall be deemed an integral part of that condominium instrument. Any amendment or certification of any condominium instrument shall, from the time of the recordation of such amendment or certification, be deemed an integral part of the affected condominium instrument, so long as such amendment or certification was made in accordance with the provisions of this chapter.

"Condominium unit" means a unit together with the undivided interest in the common elements appertaining to that unit. (Cf. the definition of unit, infra.).

"Contractable condominium" means a condominium from which one or more portions of the submitted land may be withdrawn in accordance with the provisions of the declaration and of this chapter. If such withdrawal can occur only by the expiration or termination of one or more leases, then the condominium shall not be deemed a contractable condominium within the meaning of this chapter.

"Conversion condominium" means a condominium containing structures which before the recording of the declaration, were wholly or partially occupied by persons other than those who have contracted for the purchase of condominium units and those who occupy with the consent of such purchasers.

"Convertible land" means a building site; that is to say, a portion of the common elements, within which additional units and/or limited common elements may be created in accordance with the provisions of this chapter.

"Convertible space" means a portion of a structure within the condominium, which portion may be converted into one or more units and/or common elements, including but not limited to limited common elements in accordance with the provisions of this chapter. (Cf. the definition of unit, infra.).

"Declarant" means any person, or group of persons acting in concert, that (i) offers to dispose of his or its interest in a condominium unit not previously disposed of, including an institutional lender which may not have succeeded to or accepted any special declarant rights pursuant to § 55-79.74:3;(ii) reserves or succeeds to any special declarant right; or (iii) applies for registration of the condominium. However, for the purposes of clauses (i) and (iii), the term "declarant" shall not include an institutional lender which acquires title by foreclosure or deed in lieu thereof unless such lender offers to dispose of its interest in a condominium unit not previously disposed of to anyone not in the business of selling real estate for his own account, except as otherwise provided in § 55-79.74:3. The term "declarant" shall not include an individual who acquires title to a condominium unit at a foreclosure sale.

"Dispose" or "disposition" refers to any voluntary transfer of a legal or equitable interest in a condominium unit to a purchaser, but shall not include the transfer or release of security for a debt.

"Electronic transmission" means any form of communication, not directly involving the physical transmission of paper, that creates a record that may be retained, retrieved, and reviewed by a recipient thereof, and that may be directly reproduced in paper form by such a recipient through an automated process. Any term used in this definition that is defined in § 59.1-480 of the Uniform Electronic Transactions Act shall have the meaning set forth in such section.

"Executive organ" means an executive and administrative entity, by whatever name denominated, designated in the condominium instruments as the governing body of the unit owners' association.

"Expandable condominium" means a condominium to which additional land may be added in accordance with the provisions of the declaration and of this chapter.

"Financial update" means an update of the financial information referenced in subdivisions C 2 through C 7 of § 55-79.97.

"Future common expenses" means common expenses for which assessments are not yet due and payable.

"Identifying number" means one or more letters and/or numbers that identify only one unit in the condominium.

"Institutional lender" means one or more commercial or savings banks, savings and loan associations, trust companies, credit unions, industrial loan associations, insurance companies, pension funds, or business trusts including but not limited to real estate investment trusts, any other lender regularly engaged in financing the purchase, construction, or improvement of real estate, or any assignee of loans made by such a lender, or any combination of any of the foregoing entities.

"Land" is a three-dimensional concept and includes parcels with upper or lower boundaries, or both upper and lower boundaries, as well as parcels extending ab solo usque ad coelum. Parcels of airspace constitute land within the meaning of this chapter. Any requirement in this chapter

of a legally sufficient description shall be deemed to include a requirement that the upper or lower boundaries, if any, of the parcel in question be identified with reference to established datum.

"Leasehold condominium" means a condominium in all or any portion of which each unit owner owns an estate for years in his unit, or in the land within which that unit is situated, or both, with all such leasehold interests due to expire naturally at the same time. A condominium including leased land, or an interest therein, within which no units are situated or to be situated shall not be deemed a leasehold condominium within the meaning of this chapter.

"Limited common element" means a portion of the common elements reserved for the exclusive use of those entitled to the use of one or more, but less than all, of the units.

"Meeting" or "meetings" means the formal gathering of the executive organ where the business of the unit owners' association is discussed or transacted.

"Nonbinding reservation agreement" means an agreement between the declarant and a prospective purchaser which is in no way binding on the prospective purchaser and which may be canceled without penalty at the sole discretion of the prospective purchaser by written notice, hand-delivered or sent by United States mail, return receipt requested, to the declarant or to any sales agent of the declarant at any time prior to the formation of a contract for the sale or lease of a condominium unit or an interest therein. Such agreement shall not contain any provision for waiver or any other provision in derogation of the rights of the prospective purchaser as contemplated by this subsection, nor shall any such provision be a part of any ancillary agreement.

"Offer" means any inducement, solicitation, or attempt to encourage any person or persons to acquire any legal or equitable interest in a condominium unit, except as security for a debt. Nothing shall be considered an "offer" which expressly states that the condominium has not been registered with the Common Interest Community Board and that no unit in the condominium can or will be offered for sale until such time as the condominium has been so registered.

"Officer" means any member of the executive organ or official of the unit owners' association.

"Par value" means a number of dollars or points assigned to each unit by the declaration. Substantially identical units shall be assigned the same par value, but units located at substantially different heights above the ground, or having substantially different views, or having substantially different amenities or other characteristics that might result in differences in market value, may, but need not, be considered substantially identical within the meaning of this subsection. If par value is stated in terms of dollars, that statement shall not be deemed to reflect or control the sales price or fair market value of any unit, and no opinion, appraisal, or fair market transaction at a different figure shall affect the par value of any unit, or any undivided interest in the common elements, voting rights in the unit owners' association or liability for common expenses assigned on the basis thereof.

"Person" means a natural person, corporation, partnership, association, trust, or other entity capable of holding title to real property, or any combination thereof.

"Purchaser" means any person or persons, other than a declarant, who acquire by means of a voluntary transfer a legal or equitable interest in a condominium unit, other than (i) a leasehold interest, including renewal options, of less than 20 years or (ii) as security for a debt.

"Resale certificate update" means an update of the financial information referenced in subdivisions C 2 through C 9 and C 12 of § 55-79.97. The update shall include a copy of the original resale certificate.

"Settlement agent" means the same as that term is defined in § 55-525.16.

"Size" means the number of cubic feet, or the number of square feet of ground and/or floor space, within each unit as computed by reference to the plat and plans and rounded off to a whole number. Certain spaces within the units including, without limitation, attic, basement, and/or garage space may, but need not, be omitted from such calculation or partially discounted by the use of a ratio, so long as the same basis of calculation is employed for all units in the condominium, and so long as that basis is described in the declaration.

"Special declarant rights" means any right reserved for the benefit of a declarant, or of a person or group of persons that becomes a declarant, to (i) expand an expandable condominium, (ii) contract a contractable condominium, (iii) convert convertible land or convertible space or both, (iv) appoint or remove any officers of the unit owners' association or the executive organ pursuant to subsection A of § 55-79.74, (v) exercise any power or responsibility otherwise assigned by any condominium instrument or by this chapter to the unit owners' association, any officer or the executive organ, or (vi) maintain sales offices, management offices, model units and signs pursuant to § 55-79.66.

"Unit" means a portion of the condominium designed and intended for individual ownership and use. (Cf. the definition of condominium unit, supra.) For the purposes of this chapter, a convertible space shall be treated as a unit in accordance with subsection (d) of § 55-79.62.

"Unit owner" means one or more persons who own a condominium unit or, in the case of a leasehold condominium, whose leasehold interest or interests in the condominium extend for the entire balance of the unexpired term or terms. "Unit owner" includes any purchaser of a condominium unit at a foreclosure sale, regardless of whether the deed is recorded in the land records where the unit is located. "Unit owner" does not include any person or persons holding an interest in a condominium unit solely as security for a debt.

1974, c. 416; 1975, c. 415; 1981, c. 480; 1982, c. 545; 1991, c. 497; 1993, c. 667; 1996, c. 977;2001, c. 715;2002, c. 459;2003, c. 442;2008, cc. 851, 871;2015, cc. 93, 410.

The chapters of the acts of assembly referenced in the historical citation at the end of this section may not constitute a comprehensive list of such chapters and may exclude chapters whose provisions have expired.

Code of Virginia
Title 55. Property and Conveyances
Chapter 4.2. Condominium Act

§ 55-79.83:1. Reserves for capital components

A. Except to the extent otherwise provided in the condominium instruments and unless the condominium instruments impose more stringent requirements, the executive organ shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace and restore the capital components;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the executive organ deems necessary to maintain reserves, as appropriate.

B. To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the unit owners' association budget shall include, without limitations:

1. The current estimated replacement cost, estimated remaining life and estimated useful life of the capital components;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside, to repair, replace or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; and

3. A general statement describing the procedures used for the estimation and accumulation of cash reserves pursuant to this section and the extent to which the unit owners' association is funding its reserve obligations consistent with the study currently in effect.

2002, c. 459.

The chapters of the acts of assembly referenced in the historical citation at the end of this section may not constitute a comprehensive list of such chapters and may exclude chapters whose provisions have expired.

Code of Virginia
Title 55. Property and Conveyances
Chapter 24. Virginia Real Estate Cooperative Act

§ 55-426. Definitions

When used in this chapter or in the declaration and bylaws, unless specifically provided otherwise or the context requires a different meaning, the following terms shall have the meanings respectively set forth:

"Affiliate of a declarant" means any person who controls, is controlled by, or is under common control with a declarant. A person "controls" a declarant if the person (i) is a general partner, officer, director or employer of the declarant; (ii) directly or indirectly or acting in concert with one or more other persons, or through one or more subsidiaries, owns, controls, holds with power to vote, or holds proxies representing, more than 20 percent of the voting interest in the declarant; (iii) controls in any manner the election of a majority of the directors of the declarant; or (iv) has contributed more than 20 percent of the capital of the declarant. A person "is controlled by" a declarant if the declarant (i) is a general partner, officer, director or employer of the person; (ii) directly or indirectly or acting in concert with one or more persons, or through one or more subsidiaries, owns, controls, holds with power to vote, or holds proxies representing, more than 20 percent of the voting interest in the person; (iii) controls in any manner the election of a majority of the directors of the person; or (iv) has contributed more than 20 percent of the capital of the person. Control does not exist if the powers described in this paragraph are held solely as security for an obligation and are not exercised.

"Allocated interests" means the common expense liability and the ownership interest and votes in the association allocated to each cooperative interest.

"Association" or "proprietary lessees' association" means the proprietary lessees' association organized under § 55-458.

"Capital components" means those items, whether or not a part of the common elements, for which the association has the obligation for repair, replacement, or restoration and for which the executive board determines funding is necessary.

"Common elements" means all portions of a cooperative other than the units.

"Common expenses" means expenditures made by or financial liabilities of the association, together with any allocations to reserves.

"Common expense liability" means liability for common expenses allocated to each cooperative interest pursuant to § 55-444.

"Conversion building" means a building that at any time before creation of the cooperative was occupied wholly or partially by persons other than purchasers and persons who occupy with the consent of purchasers.

"Cooperative" means real estate owned by an association, each of the members of which is entitled, by virtue of his ownership interest in the association, to exclusive possession of a unit.

"Cooperative interest" means an ownership interest in the association coupled with a possessory interest in a unit under a proprietary lease. For purposes of this act, a declarant is treated as the

owner of any cooperative interests or potential cooperative interests to which allocated interests have been allocated pursuant to § 55-444 until that cooperative interest has been created and conveyed to another person.

"Declarant" means any person or group of persons acting in concert who (i) as part of a common promotional plan, offers to dispose of his or its cooperative interest not previously disposed of; (ii) reserves or succeeds to any special declarant right; or (iii) applies for registration of a cooperative under Article 5 (§ 55-496 et seq.) of this chapter.

"Declaration" means any instruments, however denominated, that create a cooperative and any amendments to those instruments.

"Development rights" means any right or combination of rights reserved by a declarant in the declaration to (i) add real estate to a cooperative; (ii) create units, common elements, or limited common elements within a cooperative; (iii) subdivide units or convert units into common elements; or (iv) withdraw real estate from a cooperative.

"Dispose" or "disposition" means a voluntary transfer to a purchaser of any legal or equitable interest in a cooperative interest, but does not include the transfer or release of a security interest.

"Executive board" means the body, regardless of name, designated in the declaration to act on behalf of the association.

"Identifying number" means a symbol or address that identifies only one unit in a cooperative.

"Leasehold cooperative" means a cooperative in which all or a portion of the real estate is subject to a lease, the expiration or termination of which will terminate the cooperative or reduce its size.

"Limited common element" means a portion of the common elements allocated by the declaration or by operation of § 55-439 paragraph 2 or 4 for the exclusive use of one or more but fewer than all of the units.

"Master association" means an organization described in § 55-456, whether or not it is also an association described in § 55-458.

"Offering" means any advertisement, inducement, solicitation or attempt to encourage any person to acquire any interest in a cooperative interest, other than as security for an obligation. An advertisement in a newspaper or other periodical of general circulation, or in any broadcast medium to the general public, of a cooperative not located in the Commonwealth, is not an offering if the advertisement states that an offering may be made only in compliance with the law of the jurisdiction in which the cooperative is located.

"Person" means a natural person, corporation, business trust, estate, trust, partnership, association, joint venture, government, governmental subdivision or agency, or any other legal or commercial entity. In the case of a land trust, however, "person" means the beneficiary of the trust rather than the trust or the trustee.

"Proprietary lease" means an agreement with the association pursuant to which a proprietary lessee has a possessory interest in a unit.

"Proprietary lessee" means a person who owns a cooperative interest, other than as security for

an obligation, and the declarant with respect to cooperative interests or potential cooperative interests to which allocated interests have been allocated pursuant to § 55-444 until that cooperative interest has been created and conveyed to another person.

"Purchaser" means any person, other than a declarant or a person in the business of selling cooperative interests for his own account, who by means of a voluntary transfer acquires or contracts to acquire a cooperative interest other than as security for an obligation.

"Real estate" means any leasehold or other estate or interest in, over or under land, including structures, fixtures, and other improvements and interests which by custom, usage or law pass with a conveyance of land though not described in the contract of sale or instrument of conveyance. "Real estate" includes parcels with or without upper or lower boundaries, and spaces that may be filled with air or water.

"Residential purposes" means use for dwelling or recreational purposes, or both.

"Security interest" means an interest in real or personal property, created by contract or conveyance, which secures payment or performance of an obligation. "Security interest" includes a mortgage, deed of trust, trust deed, security deed, contract for deed, land sales contract, lease intended as security, assignment of lease or rents intended as security, pledge of an ownership interest in an association, and any other consensual lien or title retention contract intended as security for an obligation.

"Special declarant rights" means rights reserved for the benefit of a declarant to: (i) complete improvements described in the public offering statement pursuant to subdivision A 2 of § 55-478 ;(ii) exercise any development right pursuant to § 55-446;(iii) maintain sales offices, management offices, signs advertising the cooperative, and models; (iv) use easements through the common elements for the purpose of making improvements within the cooperative or within real estate which may be added to the cooperative; (v) make the cooperative part of a larger cooperative or group of cooperatives; (vi) make the cooperative subject to a master association as specified in § 55-456;or (vii) appoint or remove any officer of the association, any master association or any executive board member during any period of declarant control.

"Time share" means a right to occupy a unit or any of several units during five or more separated time periods over a period of at least five years, including renewal options, whether or not coupled with an estate or interest in a cooperative or a specified portion thereof.

"Unit" means a physical portion of the cooperative designated for separate occupancy under a proprietary lease.

1982, c. 277; 2005, c. 436.

The chapters of the acts of assembly referenced in the historical citation at the end of this section may not constitute a comprehensive list of such chapters and may exclude chapters whose provisions have expired.

Code of Virginia
Title 55. Property and Conveyances
Chapter 24. Virginia Real Estate Cooperative Act

§ 55-471.1. Reserves for capital components

A. Except to the extent otherwise provided in the declaration and unless the declaration imposes more stringent requirements, the executive board shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the executive board deems necessary to maintain reserves, as appropriate.

B. To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the association budget shall include, without limitations:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside to repair, replace, or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; and

3. A general statement describing the procedures used for the estimation and accumulation of cash reserves pursuant to this section and the extent to which the association is funding its reserve obligations consistent with the study currently in effect.

2005, c. 436.

The chapters of the acts of assembly referenced in the historical citation at the end of this section may not constitute a comprehensive list of such chapters and may exclude chapters whose provisions have expired.

Code of Virginia
Title 55. Property and Conveyances
Chapter 26. Property Owners' Association Act

§ 55-509. Definitions

As used in this chapter, unless the context requires a different meaning:

"Act" means the Virginia Property Owners' Association Act.

"Association" means the property owners' association.

"Board of directors" means the executive body of a property owners' association, or a committee which is exercising the power of the executive body by resolution or bylaw.

"Capital components" means those items, whether or not a part of the common area, for which the association has the obligation for repair, replacement or restoration and for which the board of directors determines funding is necessary.

"Common area" means property within a development which is owned, leased or required by the declaration to be maintained or operated by a property owners' association for the use of its members and designated as common area in the declaration.

"Common interest community" means the same as that term is defined in § 55-528.

"Common interest community manager" means the same as that term is defined in § 54.1-2345.

"Declarant" means the person or entity signing the declaration and its successors or assigns who may submit property to a declaration.

"Declaration" means any instrument, however denominated, recorded among the land records of the county or city in which the development or any part thereof is located, that either (i) imposes on the association maintenance or operational responsibilities for the common area or (ii) creates the authority in the association to impose on lots, or on the owners or occupants of such lots, or on any other entity any mandatory payment of money in connection with the provision of maintenance and/or services for the benefit of some or all of the lots, the owners or occupants of the lots, or the common area. "Declaration" includes any amendment or supplement to the instruments described in this definition. "Declaration" shall not include a declaration of a condominium, real estate cooperative, time-share project or campground.

"Development" means real property located within this Commonwealth subject to a declaration which contains both lots, at least some of which are residential or are occupied for recreational purposes, and common areas with respect to which any person, by virtue of ownership of a lot, is a member of an association and is obligated to pay assessments provided for in a declaration.

"Disclosure packet update" means an update of the financial information referenced in subdivisions A 2 through A 9 of § 55-509.5. The update shall include a copy of the original disclosure packet.

"Financial update" means an update of the financial information referenced in subdivisions A 2 through A 7 of § 55-509.5.

"Lot" means (i) any plot or parcel of land designated for separate ownership or occupancy shown

on a recorded subdivision plat for a development or the boundaries of which are described in the declaration or in a recorded instrument referred to or expressly contemplated by the declaration, other than a common area, and (ii) a unit in a condominium association or a unit in a real estate cooperative if the condominium or cooperative is a part of a development.

"Lot owner" means one or more persons who own a lot, including any purchaser of a lot at a foreclosure sale, regardless of whether the deed is recorded in the land records where the lot is located. "Lot owner" does not include any person holding an interest in a lot solely as security for a debt.

"Meeting" or "meetings" means the formal gathering of the board of directors where the business of the association is discussed or transacted.

"Professionally managed" means a common interest community that has engaged (i) a common interest community manager to provide management services to the community or (ii) a person as an employee for compensation to provide management services to the community, other than a resident of the community who provides bookkeeping, billing, or recordkeeping services for that community.

"Property owners' association" or "association" means an incorporated or unincorporated entity upon which responsibilities are imposed and to which authority is granted in the declaration.

"Settlement agent" means the same as that term is defined in § 55-525.16.

1989, c. 679; 1991, c. 667; 1996, c. 618;1998, c. 623;2001, c. 715;2002, c. 459;2003, c. 422;2008, cc. 851, 871;2011, c. 334;2015, cc. 93, 410.

The chapters of the acts of assembly referenced in the historical citation at the end of this section may not constitute a comprehensive list of such chapters and may exclude chapters whose provisions have expired.

Code of Virginia
Title 55. Property and Conveyances
Chapter 26. Property Owners' Association Act

§ 55-514.1. Reserves for capital components

A. Except to the extent otherwise provided in the declaration and unless the declaration imposes more stringent requirements, the board of directors shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace and restore the capital components;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the board of directors deems necessary to maintain reserves, as appropriate.

B. To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the association budget shall include, without limitation:

1. The current estimated replacement cost, estimated remaining life and estimated useful life of the capital components;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside, to repair, replace or restore capital components and the amount of the expected contribution to the reserve fund for that year; and

3. A general statement describing the procedures used for the estimation and accumulation of cash reserves pursuant to this section and the extent to which the association is funding its reserve obligations consistent with the study currently in effect.

2002, c. 459.

The chapters of the acts of assembly referenced in the historical citation at the end of this section may not constitute a comprehensive list of such chapters and may exclude chapters whose provisions have expired.

VIRGINIA ACTS OF ASSEMBLY -- 2019 SESSION

CHAPTER 33

An Act to amend and reenact §§ 55-79.83:1, 55-471.1, and 55-514.1 of the Code of Virginia, relating to common interest communities; dissemination of annual budget; reserve for capital components.

[H 2030]

Approved February 19, 2019

Be it enacted by the General Assembly of Virginia:

1. That §§ 55-79.83:1, 55-471.1, and 55-514.1 of the Code of Virginia are amended and reenacted as follows:

§ 55-79.83:1. Annual budget; reserves for capital components.

A. *Except to the extent provided in the condominium instruments, the executive organ shall, prior to the commencement of the fiscal year, make available to unit owners either (i) the annual budget of the unit owners' association or (ii) a summary of such annual budget.*

B. Except to the extent otherwise provided in the condominium instruments ~~and unless the condominium instruments impose more stringent requirements~~, the executive organ shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components *as defined in § 55-79.41*;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the executive organ deems necessary to maintain reserves, as appropriate.

~~B.~~ *C.* To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the unit owners' association budget shall include, without limitations:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components *as defined in § 55-79.41*;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside to repair, replace, or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; ~~and~~

3. A ~~general~~ statement describing the procedures used for ~~the~~ estimation and accumulation of cash reserves pursuant to this section ~~and the extent to which the unit owners' association is funding its reserve obligations consistent with the study currently in effect~~*; and*

4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

§ 55-471.1. Annual budget; reserves for capital components.

A. *Except to the extent provided in the declaration, the board of directors shall, prior to the commencement of the fiscal year, make available to lot owners either (i) the annual budget of the association or (ii) a summary of such annual budget.*

B. Except to the extent otherwise provided in the declaration ~~and unless the declaration imposes more stringent requirements~~, the executive board shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components *as defined in § 55-426*;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the executive board deems necessary to maintain reserves, as appropriate.

~~B.~~ *C.* To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the association budget shall include, without limitations:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components *as defined in § 55-426*;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside to repair, replace, or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; ~~and~~

3. A ~~general~~ statement describing the procedures used for ~~the~~ estimation and accumulation of cash reserves pursuant to this section and the extent to which the association is funding its reserve obligations consistent with the study currently in effect*; and*

4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

§ 55-514.1. Annual budget; reserves for capital components.

A. *Except to the extent provided in the declaration, the board of directors shall, prior to the commencement of the fiscal year, make available to lot owners either (i) the annual budget of the association or (ii) a summary of such annual budget.*

B. Except to the extent otherwise provided in the declaration and unless the declaration imposes more stringent requirements, the board of directors shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components *as defined in § 55-509*;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the board of directors deems necessary to maintain reserves, as appropriate.

~~B.~~ *C.* To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the association budget shall include, without limitation:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components *as defined in § 55-509*;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside to repair, replace, or restore capital components and the amount of the expected contribution to the reserve fund for that year; ~~and~~

3. A ~~general~~ statement describing the procedures used for ~~the~~ estimation and accumulation of cash reserves pursuant to this section ~~and the extent to which the association is funding its reserve obligations consistent with the study currently in effect~~*; and*

4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

2. That the Common Interest Community Board shall develop guidelines for the development of reserve studies for capital components, including a list of capital components that should be addressed in a reserve study.

VIRGINIA ACTS OF ASSEMBLY -- 2019 SESSION

CHAPTER 44

An Act to amend and reenact §§ 55-79.83:1, 55-471.1, and 55-514.1 of the Code of Virginia, relating to common interest communities; dissemination of annual budget; reserve for capital components.

[S 1538]

Approved February 19, 2019

Be it enacted by the General Assembly of Virginia:
1. That §§ 55-79.83:1, 55-471.1, and 55-514.1 of the Code of Virginia are amended and reenacted as follows:

§ 55-79.83:1. Annual budget; reserves for capital components.

A. *Except to the extent provided in the condominium instruments, the executive organ shall, prior to the commencement of the fiscal year, make available to unit owners either (i) the annual budget of the unit owners' association or (ii) a summary of such annual budget.*

B. Except to the extent otherwise provided in the condominium instruments ~~and unless the condominium instruments impose more stringent requirements~~, the executive organ shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components *as defined in § 55-79.41*;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the executive organ deems necessary to maintain reserves, as appropriate.

~~B.~~ *C.* To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the unit owners' association budget shall include, without limitations:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components *as defined in § 55-79.41*;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside, to repair, replace, or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; ~~and~~

3. A ~~general~~ statement describing the procedures used for ~~the~~ estimation and accumulation of cash reserves pursuant to this section ~~and the extent to which the unit owners' association is funding its reserve obligations consistent with the study currently in effect~~*; and*

4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

§ 55-471.1. Annual budget; reserves for capital components.

A. *Except to the extent provided in the declaration, the board of directors shall, prior to the commencement of the fiscal year, make available to lot owners either (i) the annual budget of the association or (ii) a summary of such annual budget.*

B. Except to the extent otherwise provided in the declaration ~~and unless the declaration imposes more stringent requirements~~, the executive board shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components *as defined in § 55-426*;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the executive board deems necessary to maintain reserves, as appropriate.

~~B.~~ *C.* To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the association budget shall include, without limitations:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components *as defined in § 55-426*;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside to repair, replace, or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; ~~and~~

3. A ~~general~~ statement describing the procedures used for ~~the~~ estimation and accumulation of cash reserves pursuant to this section and the extent to which the association is funding its reserve obligations consistent with the study currently in effect*; and*

4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

§ 55-514.1. Annual budget; reserves for capital components.

A. *Except to the extent provided in the declaration, the board of directors shall, prior to the commencement of the fiscal year, make available to lot owners either (i) the annual budget of the association or (ii) a summary of such annual budget.*

B. Except to the extent otherwise provided in the declaration and unless the declaration imposes more stringent requirements, the board of directors shall:

1. Conduct at least once every five years a study to determine the necessity and amount of reserves required to repair, replace, and restore the capital components *as defined in § 55-509*;

2. Review the results of that study at least annually to determine if reserves are sufficient; and

3. Make any adjustments the board of directors deems necessary to maintain reserves, as appropriate.

~~B.~~ *C.* To the extent that the reserve study conducted in accordance with this section indicates a need to budget for reserves, the association budget shall include, without limitation:

1. The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components *as defined in § 55-509*;

2. As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside, to repair, replace, or restore capital components and the amount of the expected contribution to the reserve fund for that year; and

3. A ~~general~~ statement describing the procedures used for ~~the~~ estimation and accumulation of cash reserves pursuant to this section ~~and the extent to which the association is funding its reserve obligations consistent with the study currently in effect~~*; and*

4. A statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

2. That the Common Interest Community Board shall develop guidelines for the development of reserve studies for capital components, including a list of capital components that should be addressed in a reserve study.

GLOSSARY

The following definitions are for common terms related to common interest communities and reserves studies.

Accrual Method: A means of saving for an upcoming expense at a constant rate, so that all money will be available when needed.

Accrued Fund Balance (AFB): The total accrued depreciation. It is an indicator against which the actual or projected reserve balance can be compared to identify the direct proportion of the "used up" life of the current repair or replacement cost. This number is calculated for each component, and the summed together for the association total. The following formula can be used to determine AFB: AFB = Current Cost x Effective Age/Useful Life.

As-built Drawings: Drawings produced by the developer that show the actual characteristics of a community at the time when construction was completed.

Assessment: Monetary contribution required of each member of common interest community association to meet the association's expenses. Assessments are typically due once a month.

Association: A legal entity that manages a common interest community and enforces its governing documents. These include property owners' associations, condominium unit owners' associations, and proprietary lessees' associations in real estate cooperatives.

Capital Components or Components: Items, whether or not a part of the common area or common elements, for which an association has the obligation for repair, replacement or restoration and for which the association governing board determines funding is necessary.

Cash Flow: The amount of money deposited into and withdrawn from a reserve account over a certain period of time.

Cash Flow Method: A method of developing a reserve funding plan where contributions to the reserve fund are designed to offset the variable annual expenditures from the reserve fund. Different reserve funding plans are tested against the anticipated schedule of reserve expenses until the desired funding goal is achieved.

Common Area or Common Elements: The portion of a common interest community that is owned jointly by all members of the association. In a property owners' association this portion is called a common area. In a condominium or real estate cooperative, these are called common elements.

Common Interest Community: Means real estate located within the Commonwealth of Virginia subject to a declaration which contains lots or units, at least some of which are

residential or occupied for recreational purposes, and common areas or common elements to which a person, by virtue of his or her ownership of a lot/unit, is a member of an association and is obligated to pay assessments provided for in a declaration. Property owners' associations, condominium unit owners' associations, and proprietary lessees' associations (in real estate cooperatives) are common interest communities.

Component Full Funding: When the actual or projected cumulative reserve balance for all components is equal to the fully funded balance.

Component Inventory: The task of selecting and quantifying reserve components. This task can be accomplished through on-site visual observations, review of association design and organizational documents, a review of established association precedents, and discussion with appropriate association representatives.

Component Method: A method of developing a reserve funding plan where the total contribution is based on the sum of contributions for individual components.

Condition Assessment: The task of evaluating the current condition of the component based on observed or reported characteristics.

Contingency Fund: The portion of reserves allocated for unanticipated expenses, such as damage to components or unexpected cost increases.

Current Replacement Cost: See "replacement cost."

Deficit: An actual or projected reserve balance less than the fully funded balance.

Developer Drawings: Drawings produced by the developer before or during construction of the community. Such drawings may or may not match the community's actual attributes. (Also see "As-built Drawings.")

Effective Age: The difference between useful life and remaining useful life. Not always equivalent to chronological age, since some components age irregularly. Used primarily in comparisons.

Financial Analysis or Funding Analysis: The portion of a reserve study where the current status of the reserves (measured as cash or percent funded) and a recommended reserve contribution rate (reserve funding plan) are derived, and the projected reserve income and expense over time is presented. The financial analysis is one of the two parts of a reserve study.

Fund Status: The status of the reserve fund as compared to an established benchmark such as percent funding.

Funding Goals: Independent of methodology utilized, the following represent the basic categories of funding plan goals:

- *Baseline Funding:* Establishing a reserve funding goal of keeping reserve cash balance above zero.
- *Component Full Funding:* Setting a reserve funding goal of attaining and maintaining cumulative reserves at or near 100% funded.
- *Statutory Funding:* Establishing a reserve funding goal setting aside the specific minimum amount of reserves of component required by local statutes.
- *Threshold Funding:* Establishing a reserve funding goal of keeping the reserve balance above a specified dollar or percent funded amount. Depending on the threshold, this may be more or less conservative than component full funding.

Funding Plan: An association's plan to provide income to a reserve fund to offset anticipated expenditures from that fund.

Funding Principles:

- *Sufficient Funds When Required*
- *Stable Contribution Rate over the Years*
- *Evenly Distributed Contributions over the Years*
- *Fiscally Responsible*

Governing Board: Means the governing board of an association, including the executive board of a condominium unit owners' association, the executive board of a cooperative proprietary lessees' association, and the board of directors of a property owners' association.

Governing Documents: Legal documents that organize the common interest community, establish contractual relationships between the parties, and establish the rights and responsibilities of individual owners, the association, authorized occupants, and the governing board. Governing documents typically consist of a declaration for the community, including a legal description of the property, plat(s) of the development, plans for development structures, and bylaws for the operation of the association. Governing documents may also include rules and regulations for the community. In a condominium, the governing documents are called *condominium instruments*.

Inflation: The rate at which the cost of components are expected to rise over time.

Interest: Money earned from reserve funds deposited into an account at a financial institution.

Inventory: A list of community-owned components are their attributes, such as age, quality, manufacturer, degree of wear, and useful life.

Life and Valuation Estimates: The task of estimating useful life, remaining useful life, and repair or replacement costs for the reserve components.

Maintenance Responsibility Chart: A table or chart often included in association governing documents that details maintenance responsibilities in a common interest community between the association and individual owners.

Management Company or Common Interest Community Manager: An outside company hired by an association to perform some of the association's functions. These can include collection of assessments, and maintenance of the common area or common elements.

On-site Inspection: Physical inspection of one or more components to help determine their current physical state and remaining useful life.

Operating Budget: The portion of an association's budget that is allocated for frequently-occurring or minor expenses.

Percent Funded: The ratio, at a particular point of time (typically the beginning of the fiscal year), of the actual (or projected) reserve balance to the accrued fund balance, expressed as a percentage.

Physical Analysis: The portion of the reserve study where the component inventory, condition assessment, and life and valuation estimate tasks are performed. This represents one of the two parts of the reserve study.

Remaining Useful Life (RUL): The estimated time, in years, that a reserve component can be expected to continue to serve its intended function. Projects anticipated to occur in the initial year have "zero" remaining useful life. RUL is also referred to as remaining life (RL).

Replacement Cost: The cost of replacing, repairing, or restoring a reserve component to its original functional condition. The current replacement cost would be the cost to replace, repair, or restore the component during that particular year.

Reserve Account: An account at a bank or other financial institution containing funds intended solely to pay reserve expenses.

Reserve Balance or Reserve Funds: Actual or projected funds as of a particular point in time that the association has identified for use to defray the future repair or replacement of those major components which the association is obligated to maintain. Also known as reserves, reserve accounts, cash reserves. Based upon information provided and not audited.

Reserve Component: The individual line items in the reserve study developed or updated in the physical analysis. These elements form the building blocks for the reserve study. Components typically are the association responsibility, have limited useful life expectancies, have predictable remaining useful life expectancies, are above a minimum threshold cost, and are as required by local codes.

Reserve Provider: An individual that prepares reserve studies.

Reserve Study: A capital budget planning tool that can be used by an association to determine the physical status and repair/replacement cost of an association's capital components, and an analysis of an association's funding capacity to maintain, repair, and replace capital components.

Special Assessment: An assessment levied on the members of an association in addition to regular assessments. Governing documents or local statutes often regulate special assessments.

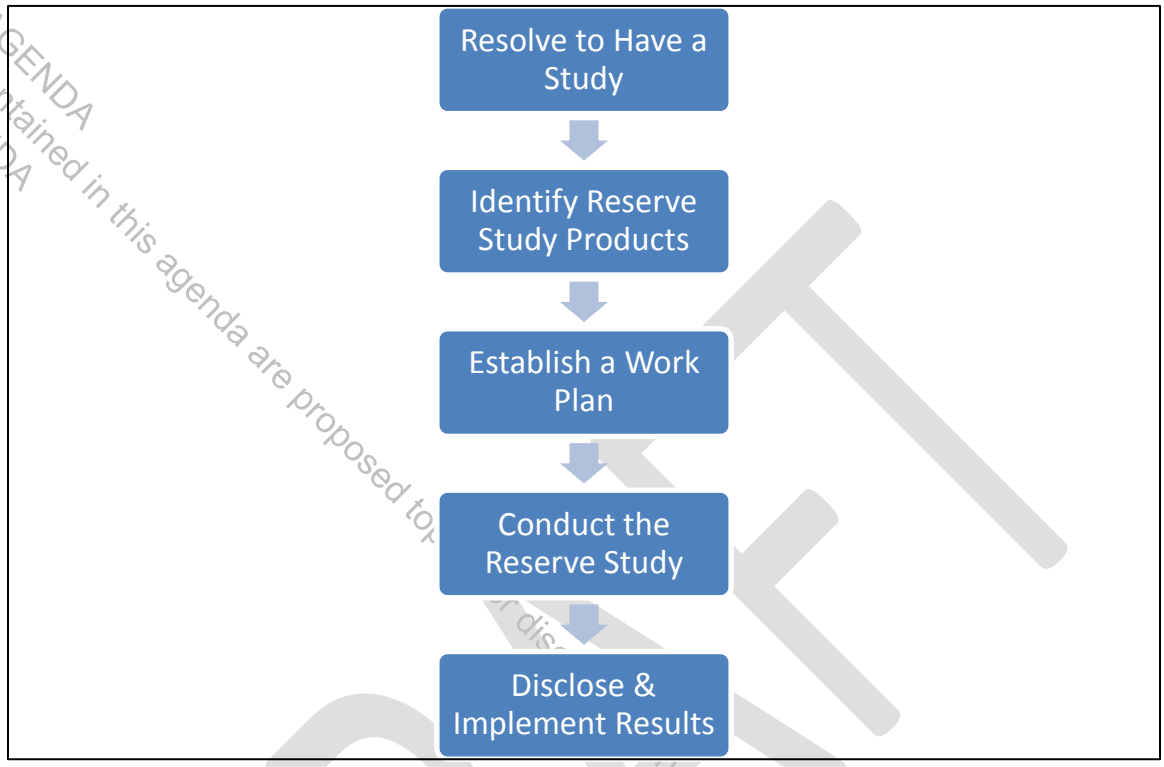
Surplus: An actual or projected reserve balance greater than the fully funded balance.

Useful Life (UL): Total useful life or depreciable life is the estimated number of years that a reserve component can be expected to serve its intended function if it is properly constructed in the present application and/or installation.

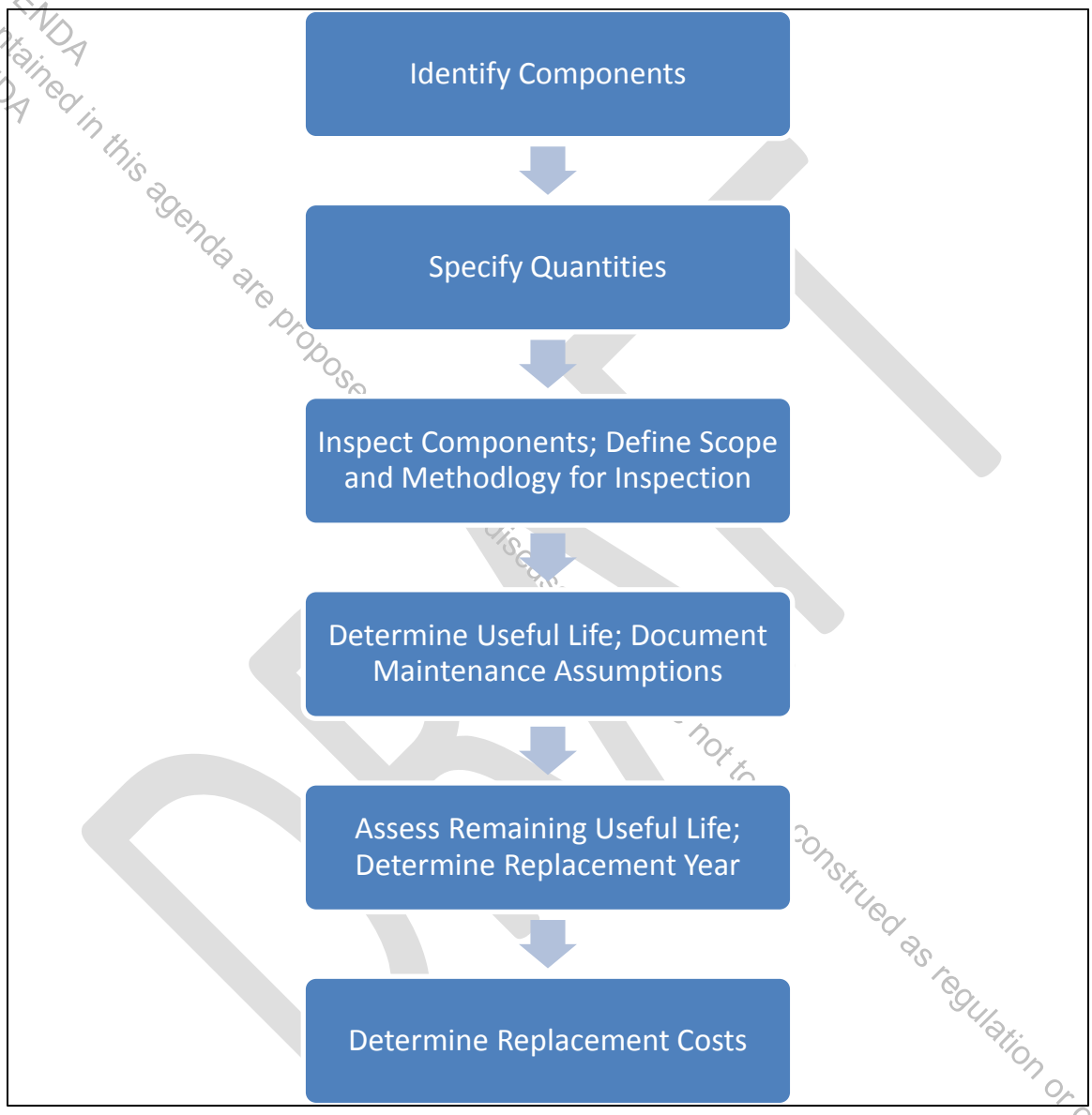
Work Product: The output from a reserve study, such as reports, tables, and charts.

Common Area/Common Elements Components	
A	**K**
Awnings and other overhead coverings	Kiosks and message/communication centers
Alarm systems, fire and intrusion	**L**
Antennas, satellite dish and other	Lakes, ponds, and waterways
Asbestos encapsulation or removal	Landscaping, replacement of major trees and plants
B	Light fixtures, exterior
Balconies (see also decks)	Light fixtures, interior
Benches	**M**
Boilers	Mailboxes and centers
D	Monitoring system, carbon monoxide
Decks, pool and spa	**P**
Decks, residential	Paint and stain, exterior
Display cases	Paint and stain, interior common area
Docks	Paving
Drainage systems	Planter boxes
E	Plumbing fixtures, exterior
Electrical transformers	Plumbing, water piping system
Electrical wiring and related fixtures in common area	Posts, deck, lamp, etc.
	Pumps, lakes, ponds and waterways
Elevator, cab	**R**
Elevator, hydraulic, traction, etc.	Racquetball courts
Equipment, cleaning and maintenance	Retaining wall
Equipment, communication and telephone	Roof
Equipment, entertainment, music/video systems	**S**
	Security gates, gate operator and motor
Equipment, exercise, recreational, etc.	Septic tanks
Equipment, office	Sewage ejector equipment
Equipment, pool, pumps, motors and filters	Siding and trim
F	Skylights
Fans, exhaust, garage, and other	Slopes
Fences, chain link, wood, etc.	Solar heating system, pool and spa
Fire sprinklers and related equipment	Solar heating system, residential
Floor covering, carpet, tile, vinyl, etc.	Spas
Floor covering, wood replacement and refinishing	Stables and tack rooms
	Stairs
Fountains	Streets and drives
Furnishings, lobby, clubhouse, etc.	Stucco, sandblasting and resurfacing
G	Sump pump equipment
Gates, iron, wood, etc.	Swimming pools
Garage doors and hardware	**T**
Garbage enclosures	Tennis courts, resurfacing
Gutters and downspouts	Trellises
H	**V**
HVAC, air conditioning	Vehicles
HVAC, heating systems	Ventilation system, garage
I	**W**
Irrigation system, controllers	Walkways, wood, brick, tile, etc.
Irrigation system, piping, valves and sprinkler heads	Water heaters

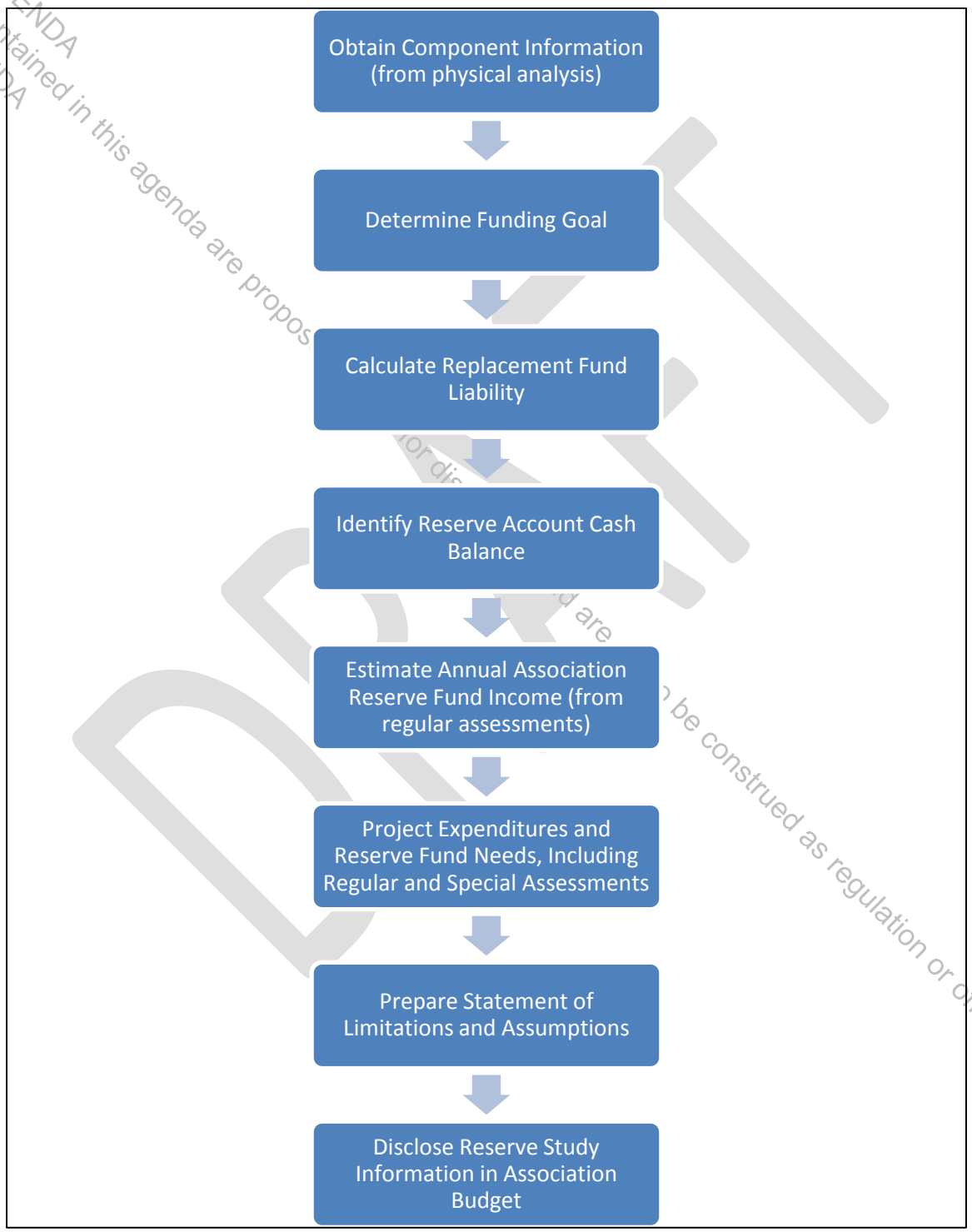
Steps to Provide for Adequate Reserves



Steps in the Physical Analysis Process



Steps in the Financial Analysis Process



Physical Analysis Checklist

Deciding which components to include:

- ☐ Relevant components mentioned in developer budget have been reviewed.
- ☐ Components mentioned in the governing documents have been reviewed.
- ☐ An on-site inspection for possible additional components has been made.
- ☐ The governing board has had a public discussion and has determined a policy stating its position on life-of-the-building, exclusive use, and quasi-structural components.
- ☐ The governing board has communicated the component list to the preparer of the physical analysis.

Specifying quantities of each component:

- ☐ As-built drawings have been consulted, if possible.
- ☐ An on-site inspection of each component and on-site count of each type of component have been made.
- ☐ The quality of each component has been determined and expressed in terms that identify a specific grade of material.

Determining the useful life (UL) of each component:

- ☐ Manufacturer warranties have been consulted whenever possible.
- ☐ Environmental factors that might affect useful life have been taken into account.
- ☐ Installation and materials have been determined to be consistent with each manufacturer's description; if not, an adjustment has been made to the remaining useful life estimated by the warranty or by the manuals.
- ☐ A standard manual has been consulted.
- ☐ Maintenance assumptions have been documented.

Assessing the remaining useful life (RUL) of each component:

- ☐ An on-site inspection of each component has been made.
- ☐ Past maintenance has been taken into account.
- ☐ Individuals with knowledge of the components have participated in the assessment of remaining life.
- ☐ The governing board has determined what level of maintenance is expected to achieve the remaining life estimated.

Determining the cost of replacement:

- ☐ A standard costing manual has been consulted or more than one tradesperson asked for a price for each component.
- ☐ If a manual is used, the "current" price of each component has been adjusted for the age of the data in the manual.
- ☐ If a manual is used, regional variations in price are taken into account.
- ☐ Cost of replacement includes cost of removing old component, if necessary.
- ☐ Adjustments have been made for grade or quality of materials or levels of maintenance of materials.

Financial Analysis Checklist

Funding goal:

- ☐ The association's funding goal for reserve replacement is clearly specified.

Budget information

- ☐ The budget contains estimated revenue and expenses on an accrual basis.
- ☐ The budget identifies total cash reserves currently set aside.
- ☐ The budget shows funds set aside for reserves in a separate account(s).
- ☐ The estimated remaining life of all major components is shown.
- ☐ The estimated current replacement cost of all major components is shown.
- ☐ The budget includes identification of methods of funding for future repair, replacement, or additions.
- ☐ The budget includes a statement on methods used to develop estimates and funding plan.

Association income and expense estimates:

- ☐ An appropriate component inflation factor has been used to estimate replacement cots in future years.
- ☐ The interest rate applied to association cash reserves is reasonable, and is an after-tax estimate.
- ☐ Needed special assessments are clearly identified.
- ☐ Assumptions about increases in the portion of regular assessments allocated to reserves are clearly specified.
- ☐ Income and expenditures are shown annually for the plan period.

Association cash balances:

- ☐ With reserve assessments, the cash balance (assets-planned reserve expenditures) is greater than zero in every year.
- ☐ The reserve deficit is estimated for the current year.
- ☐ The model shows a stable or decreasing reserve deficit (in constant dollars) over the plan period.

Physical Analysis Preparer Interview Guide

1. Do you have any personal or professional ties to this association? (Note: Such a tie does not necessarily indicate a conflict of interest, but should be disclosed and considered.)
2. Do you have any personal or professional ties to the developer? (Note: Such a tie does not necessarily indicate a conflict of interest, but should be disclosed and considered.)
3. If hiring an individual or sole practitioner: Do you do all the work yourself, or will you use subcontractors? (The association should approve all subcontractors.) Are you a Professional Reserve Analyst (an Association of Reserve Analysts designation) or a Reserve Specialist (a Community Associations Institute designation) or do you hold other professional designations? What is your training (formal education and workshops)?
4. If hiring a firm: Will work be done by employees of your firm? How do you train your employees?
5. With what professional associations are you actively involved?
6. What experience have you had with performing component studies?
7. What experience have you had in this locale?
8. May we see an example of a similar product done for another association?
9. What information do you require from the association in order to start?
10. When will you begin the study?
11. Will you be measuring the components or using drawings?
12. Will you make a physical inspection of each component? What percentage of components will you inspect for fences, walls, controllers, buildings, etc.?
13. How will you determine the cost of replacement?
14. What written sources will be used?
15. How long will it be before we have the final product?
16. Will the report provide the estimated useful life of each component?
17. Will the report provided the estimated remaining life of each component?
18. Will the report provide the current costs of repair or replacement of each component?
19. Will the report provide the future costs of repair or replacement for each component and/or the inflation rate to be applied to each component?
20. Will the report provide information on proper maintenance to help assure realization of the estimated remaining life of each component? Will the report include visuals such as photographs or video?
21. Do you have liability insurance?
22. Do you have workers' compensation insurance?
23. Please provide three references (name, phone, nature of work).
24. Cost for revisions and/or updates.

Financial Analysis Preparer Interview Guide

1. Do you have any personal or professional ties to this association? (Note: Such a tie does not necessarily indicate a conflict of interest, but should be disclosed and considered.)
2. Do you have any personal or professional ties to the developer? (Note: Such a tie does not necessarily indicate a conflict of interest, but should be disclosed and considered.)
3. If hiring an individual or sole practitioner: Do you do all the work yourself, or will you use subcontractors? (The association should approve all subcontractors.) Are you a Professional Reserve Analyst (an Association of Reserve Analysts designation) or a Reserve Specialist (a Community Associations Institute designation) or do you hold other professional designations? What is your training (formal education and workshops)?
4. If hiring a firm: Will work be done by employees of your firm? How do you train your employees?
5. With what professional associations are you actively involved?
6. What experience have you had with community association budgeting?
7. May we see an example of a completed financial analysis?
8. What information do you require from the association in order to start?
9. When will you begin the study?
10. How long will it be before we have the final product?
11. Will the report provide current and future estimated liability computations?
12. Will the report provide current and future estimated cash balances by year?
13. Will the report provide current and future repair replacement costs?
14. Will the report present alternative funding plans?
15. Will the report provide a description of assumptions and methodology, a narrative funding plan, and a graphic depiction for easier board and member understanding?
16. Will the report tell how much of a monthly contribution is needed for the reserves?
17. Do you have professional liability insurance?
18. Please provide three references (name, phone, nature of work).

Sample Financial Analysis – Estimated Cash Requirements by Year

(30 year plan – 3 components; values shown for years 1-5, 15, and 30 only)

Major Component	Estimated Useful Life	Estimated Remaining Life	Estimated Current Cost to Replace	End of Year 0	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5	End of Year 15	End of Year 30
Painting	5	2	$10,000			$10,000					
Paving	7	3	$14,000				$14,000				
Roofing	15	4	$30,000					$30,000			
Total Costs			$54,000			$10,000	$14,000	$30,000	$0	$0	$0
Component cost increase factor @ 4.6% per annum					1.00	1.046	1.094	1.144	1.197	1.877	3.685
Estimated replacement cost, in scheduled year (apply cost factor to total replacement costs)					$0	$10,460	$15,318	$34,333	$0	$0	$0

Cash Flow Forecasts	End of Year 0	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5	End of Year 15	End of Year 30
Assessments, regular		$1,500	$1,800	$2,160	$2,592	$3,110	$10,906	$30,515
Assessments, special		$0	$0	$0	$30,000	$0	$0	$0
After-tax interest reserve account income, @ 5.775%		$1,271	$1,430	$1,013	$312	$229	$1,519	$6,482
Total cash receipts		$2,771	$3,230	$3,173	$32,904	$3,339	$12,426	$36,997
Major component costs (from total above)		$0	$10,460	$15,318	$34,333	$0	$0	$0
Cash receipts – cash disbursements		$2,771	($7,230)	($12,145)	($1,430)	$3,339	$12,426	$36,997
Cash balance, beginning of year		$22,000	$24,771	$17,541	$5,396	$3,967	$26,311	$112,241
Cash balance, end of year	$22,000	$24,771	$17,541	$5,396	$3,967	$7,306	$38,737	$149,238

Summary	End of Year 0	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5	End of Year 15	End of Year 30
Estimated liablility (total from next page)	$36,000	$43,932	$52,518	$50,461	$43,095	$15,026	$74,602	$154,173
Less cash balance	$22,000	$24,771	$17,541	$5,396	$3,967	$7,306	$38,737	$149,238
Estimated unfunded liability	$14,000	$19,162	$34,977	$45,065	$39,128	$7,720	$35,865	$4,935
Estimated unfunded liability per unt (35 units)	$400	$547	$999	$1,288	$1,118	$221	$1,025	$141

Sample Financial Analysis – Computation of Major Component Liability by Year

Major Component Replacement Liability		End of Year 0	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5	End of Year 15	End of Year 30
Painting	Useful life	5	5	5	5	5	5	5	5
	Remaining life	2	1	0	4	3	2	2	2
	Replacement cost	$10,000	$10,460	$10,941	$11,971	$11,971	$12,522	$19,632	$38,543
	Liability	$6,000	$8,368	$10,941	$2,394	$4,788	$7,513	$11,779	$23,126
Paving	Useful life	7	7	7	7	7	7	7	7
	Remaining life	3	2	1	0	6	5	2	1
	Replacement cost	$14,000	$14,644	$15,318	$16,022	$16,759	$17,530	$27,485	$53,961
	Liability	$8,000	$10,460	$13,130	$16,022	$2,394	$5,009	$19,632	$46,252
Roofing	Useful life	15	15	15	15	15	15	15	15
	Remaining life	4	3	2	1	0	14	4	4
	Replacement cost	$30,000	$31,380	$32,823	$34,333	$35,913	$37,564	$58,897	$115,630
	Liability	$22,000	$25,104	$28,447	$32,044	$35,913	$2,504	$43,191	$84,795
Total liability		$36,000	$43,932	$52,518	$50,461	$43,095	$15,026	$74,602	$154,173

OTHER BUSINESS

COMPLETE CONFLICT OF INTEREST FORMS AND TRAVEL VOUCHERS

ADJOURN

Please return your document folders to Tanya Pettus.