Reserve Funding & Reserve Investment Strategies, 6th Ed. (GAP #24)

Chapter 1 (Partial)

Establishing a Reserve Fund

Adequate reserve funding means more than just providing funds for roof replacements. In the long run it can contribute to the rise or fall of property values. For instance, if an association is in debt or has no reserve fund, educated homebuyers may not want to invest in the community. The importance of this has been confirmed by the *Results of the CAI Research Foundation National Survey of Homeowner Satisfaction* conducted by the Gallop organization in 1999. This poll showed that overall community appearance, which translates directly into the property values, is the leading driver of association members' general satisfaction with their community. In addition, lenders looking for signs of financial health may hesitate to approve mortgage applications in a community with inadequate reserve funds.
Careful planning for future repairs and replacements is not only in the best physical and fiscal interests of the association, but is also required by law in some states. For instance, the Florida Condominium Act requires reserves for roads, roofs, and sidewalks. Reserves for capital expenditures and deferred maintenance can be waived from the annual budget in Florida, but only by a vote of the membership. Many other states have laws or legislation pending that addresses reserve funding requirements.

Convincing Owners of the Need

Owners are often reluctant to contribute to reserve funds because they think the funds are costing them extra money. To convince these owners of the need for reserves, the association must make them understand that a reserve fund is not an extra expense--it just spreads out association expenses more evenly. Equipment and major components must be replaced, whether the expense is planned or not.
However, some owners may still wonder why they should invest in something that may not have to be replaced for several years and would benefit future owners. To convince these owners, the association should inform them of the commonly accepted reasons for maintaining a reserve fund:

1. It meets legal, fiduciary, and professional requirements. A replacement fund may be required by:
   - Any secondary mortgage market in which the association participates (e.g., Fannie Mae, Freddie Mac, FHA, VA)
   - State statutes, regulations, or court decisions
   - The community's governing documents
2. It provides for the planned replacement of major items that must, at some point in time, be replaced.
3. Major items deteriorate during use. Although a roof will be replaced when it is 25 years old, every owner who lived under it should share its replacement costs.
4. It minimizes the need for special assessments. Owners, especially those on fixed incomes, may have limited resources. They may be unable to afford the large special assessments necessary for major replacements.
5. A replacement fund enhances resale values. Lenders and real estate agents are aware of the ramifications for new buyers if the replacement reserves are inadequate. Many states require associations to disclose the amounts in their reserve funds to prospective purchasers.
6. Accounting standards require that proper attention be paid to the replacement fund. In 1991, the American Institute of Certified Public Accountants (AICPA) released the *AICPA Audit and Accounting Guide: Common Interest Realty Associations* (the CIRA guide), which provides disclosure requirements for community association financial reporting. The CIRA guide details the information that must be disclosed in the notes to a CIRA's financial statements. It should be noted that the current version of the CIRA guide incorporates, by reference, the National Reserve Study Standards of the Community Associations Institute.

First Step: Conducting a Reserve Study

Before establishing a replacement fund, the association should discuss its financial needs with a manager, accountant, engineer, or other professional advisor. These professionals should assist the association in preparing a reserve study or recommend someone for the job. State laws do not specify the type of professional who may prepare a reserve study, although the recently established CAI

Standards do recommend minimum necessary qualifications as part of its new Reserve Specialist (RS) designation program. (See "Selecting a Reserve Provider," below.)

The reserve study consists of two parts: the physical analysis and the financial analysis. The CAI reserves designation requires that the provider prepare both parts of the study. Due to the technical details involved, each association should hire a qualified, experienced person to prepare its study.

Selecting a Reserve Provider

CAI established a special designation to help associations select a reserve provider. To earn the designation, an individual must demonstrate that he or she has met minimum qualifications in five areas: experience, background, work product, references, and continuing experience. By meeting these qualifications, designees demonstrate that they can perform both physical and financial analyses. Contact CAI at (703) 548-8600 for additional information.

In some instances board members prepare reserve studies. But a director should be aware of the risks before undertaking such a study. The most serious risk is the exposure to liability: If the board sets aside inadequate funds, members could claim that the board was negligent in its fiduciary duty. Never guess about how much to include in a reserve study. Some reserve companies offer a "do-it-yourself" reserve study kit for associations that cannot afford to hire a professional to prepare a reserve study. This kit provides the software programs and worksheets needed to complete a reserve study. However, the board will still be liable for the effect of incorrect data.

Additional Resources

CAI members—visit the Members Only section to access the Message Board, Advocacy Center, and more!

Visit our Related Links page for additional online resources.