REPLACEMENT RESERVES

FOR

COMMUNITY ASSOCIATIONS

Guidelines for Board Members

This handbook is a reprint of an article
by Douglas B. Gardner, President of DNI Properties

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Introduction

If I were asked for a single central theme to describe the objective of condominium management, I would state as follows: "Preserve and enhance property values."

We were recently involved with an Association in a 12-year-old conversion project facing major maintenance problems. Substantial water leakage was damaging basements, the parking lots needed major resurfacing, the roof needed replacement, and there were no reserves.

The magnitude of the calamity facing this Association and the owners is hard to overstate. Many owners are on fixed incomes, just meeting their expenses; others are rented with income just covering mortgage payments and Association fees. Few of these owners are capable of absorbing the assessments required to bring this property to a sound condition.

Failure to address basic physical repairs now needed will result in rapid deterioration of property values. The unit owners who might wish to sell rather than undergo the expense of rehabilitation may be unable to do so. I feel a great deal of sympathy for the owners of this project and their dilemma.

The owners of this project are not alone. In a HUD survey, approximately 25 percent of unit owners responding reported they had no reserves at all. Many who were interviewed felt that even though some reserves were available, they were woefully inadequate.

It's not difficult to forecast that major problems lie ahead of owners and Associations where reserves have not been provided. Ultimately, what follows is deterioration in property values and possible civil action against Directors or the original developers. This can all be avoided through the proper use of reserves. A proper Reserve Program will preserve and enhance property values.

Reserves are an Association's way of setting money aside for future repairs and replacements. A certain portion of assessments are collected from members and set aside to plan for the repair and replacement of common facilities to preserve property values.

This money set aside must be included in the overall budgeting process for the Association, and funds so set aside must not be used for any other purpose.

The Board of Directors, and the appointed Property Manager, have the responsibility to periodically review the reserve program. It should be done annually as part of the budget preparation process.

HOW TO START A RESERVE PROGRAM

- **Property Condition Assessment**

  Each item in the Common Area that has a finite life should be inspected periodically by a professional to determine its condition.

- **Estimate Useful Life**

  For each item in the program, an estimate should be made of the remaining life of that component. In estimating life, allowance should be made for the type of preventative maintenance that has been performed and will be budgeted.

  For example, wood siding, which has been designated for regular staining, sealing and re-nailing, will have a substantially different life from siding that has not and will not be treated or maintained.

- **Estimate Replacement Cost**

  In some cases, replacement cost is simple and straightforward, as when an identical replacement can be reasonably expected. An example of this would be resurfacing of a parking lot.

  On the other hand, replacement of a satellite dish system might involve questions of technological obsolescence in replacement. Replacement cost should be that cost which will replace the function, and may be higher or lower than the original cost.

CHECKLIST OF ITEMS FOR RESERVE STUDY

The following is a checklist of items that should be accounted for in Association reserve budgets:

- Exterior Paint (siding, trim, fences, signs)
- Roofing
- Water Heaters & Piping
- Boilers
- Central Heat and Air Conditioning
- Tennis Courts
- Hot Water Tanks
- Underground Utilities
- Outside Lighting Fixtures
- Carpets and Floors in Common Areas
- Elevators
- Private Streets and Driveways
- Swimming Pools
- Furnishings and Equipment

CUSTODY OF RESERVE ACCOUNTS

Reserve Funds should be placed in secure, interest-bearing accounts. The interest accumulating in reserve accounts can offset a portion of the cost and should be entered into the reserve fund calculation.

Prompted by the Property Manager, the Board should schedule regular reviews of the reserve accounts. Within the above prudent guidelines, funds can be switched to longer or shorter-term maturities, and to institutions bearing higher yields.

Decisions regarding investment of reserve funds is a Board responsibility and should not be delegated. The Property Manager can be asked for suggestions and recommendations and can provide the Board with options and proposals, but the final decision and responsibility lies with the Board of Managers.

An offsetting consideration is the escalation of replacement costs. For those which cannot be specifically determined, inflation factor estimates should be used.

WORKING EXAMPLE

Let's work a simple example - the roofs of a small Association.

- **Basic Facts**

There are 100 units in this Association. There is an asphalt shingle roof. The original roof was believed to have a life of 20 years. The roof is five years old. Major weathering is occurring on all southern exposures. Several contractors have inspected the roof and estimates of remaining life run from seven to ten years. The entire roof should then be replaced. Cost of the original roof was $50,000.

The existing roof reserve is $12,500, invested in a money market at eight-percent fixed interest.

Current replacement cost is $60,000 (based on professional estimates).

- **Calculations**

Assume the remaining life of the roof is seven years. Our roofing contractor tells us that the roof costs have been rising at about six percent per year.

Funds required can be determined from a calculator that has a compound interest program (such as an HP 12C).

We enter:

Present Value = $60,500
Term = 7 years (84 months)
Inflation Factor = 6 percent (0.5% per month)

The calculation solving for future value yields $91,982. Deduct the present reserve balance of $12,500 and you have $79,482 as the added amount needed in seven years.

We need to know what amount annually must be set aside to generate $79,482 in seven years.

We believe that interest rates are in a down cycle, so we will assume that our money market fund will be yielding eight percent in the next year. After that, we are not sure, but we will be examining the account again in one year.

We enter into our calculator:

Present Value Needed in Reserve = $12,500
Future Value Needed in Reserve = $91,982
Term of the Reserve = 7 years (84 months)
Interest on the Funds = 8 percent (0.67% per month)

The calculator solves for a payment of $7,507 per year or $626 per month.

The monthly assessment for roof replacement will be:

626/100 = $6.26 per month.

We have leaned on the conservative side in making our assumptions. If we have some funds remaining when the roof is replaced, few will complain.

The original monthly charge for roof replacement was based on a 20-year life, same replacement cost. This was $2.08 per month. This is a serious increase in assessment, yet failure to raise the assessment now will make the problem worse.

This example illustrates what happens if the reserve program is not reviewed annually. Note that after accumulating reserves for five years, the balance required is greater than when the project was new. It shows the effect of varying interest rates and escalating replacement costs.

Each item requiring a replacement reserve can be budgeted in this way. The sum of the individual items obviously comprises the monthly assessment for reserves.

When first assuming responsibility for budgeting and reserve provisions for an Association with inadequate prior reserve funding, some “catch up” may be necessary, as the above example illustrates.

A table can be constructed for each item on the reserve schedule indicating the actual reserves available and the reserve position required to meet the present estimate of remaining life and replacement cost. A shortfall in reserves can then be assessed, based upon a policy decision of the Board of Directors, who might take several years to fund a materials shortfall.

PROGRAM MAINTENANCE

The Reserve Program should be reviewed annually by the Board. A record of that review process with the updated reserve study on file is a demonstration of the Board's exercise of its fiduciary responsibility to preserve property values.

If the community is professionally managed, the Board should ask the Management Company to review and update the program. Annual changes in basic assumptions will be small, and the annual update is a reasonably simple process.

Some Boards, guided by their Managers, establish the Reserve Program in stages. There may not be funds to establish a fully funded program at the outset, but the main point is to get started, and to establish the goals and path.

At each annual review, the condition of the Reserve Program can be reassessed and further steps taken to strengthen the program.

CONCLUSION

No aspect of Condominium Management has more long-term significance and influence on property values than a properly established Reserve Program.

Reserves should be set aside and prudently invested so that funds will be available when required. Developers of new properties have initial responsibility to set up reserve schedules. Newly formed Associations can hardly be expected to take the initiative or understand the priorities or the mechanics of a Reserve Program.

Management of an adequate Reserve Program, accumulating appropriate reserves and authorizing expenditures within the Reserve Budget, is the very foundation of fiduciary responsibility of the Developer and Board of Directors, and central to the Property Manager's responsibility and accountability,

USE A PROPERTY MANAGEMENT COMPANY

The example in this Handbook was developed to enhance understanding of the mechanics and principles in setting up a Reserve Study.

The art and practice of Reserve Programs requires experience and know-how. It is a serious fiduciary responsibility that most Boards would not want to assign to an inexperienced person, or even worse, assign to a member of the board.

The most important step is making the decision to start a Reserve Study. Once a Board understands the mechanics and the principles, the question of who is to perform the study and complete the work becomes paramount. To avoid mistakes, errors in judgment, and possible liability, most Boards will turn to professionals. Qualified Property Management companies have both the theoretical know-how and practical experience to complete the study promptly and competently.

At DNI Properties, Reserve Programs are a way of life. Most communities under DNI's management have active reserve programs in place, many established by DNI.

If you are now a client of DNI, and do not have an actively maintained Reserve Program, your Property Manager should be asked to prepare a proposal. Normally this service is included in the Management Fee.

If you are not now a client of DNI, we invite your inquires and would be happy to make suggestions for the kind of Reserve Program which would be just right for your community.