

Condo Insights – Reserve Studies – Part 2

The importance of a reserve study for long term financial planning

The first part of this column focused on the purpose of a reserve study to identify association assets, estimating their service life and replacement cost. The second part of this column will focus on assessing an association's long term financial health including its revenues, expenses, and reserve fund balance.

An association annual operating budget includes revenue projections, expense projections and an annual contribution to its reserve fund. These reserve funds represent a portion of the owners annual condo fees accumulated over time and specifically allocated to finance repair, rehabilitation, and replacement of association assets. Reserve funds should be held in a separate bank or investment account that is specifically designated for such expenses and not co-mingled with the association's operating funds.

Once the asset schedule is compiled including expected lifespan, timing of asset replacement and cost of asset replacement, a recommended schedule of annual contributions to the reserve fund can be determined. An important part of the reserve study is this schedule of recommended annual reserve contributions spanning up to 30 years to fund these major projects. Major repair, replacement and rehabilitation projects can be very costly and require years of planning. These annual reserve contributions are based on the component asset schedules, the timing of major repair or replacement of assets and their estimated costs.

The reserve study is vital in assisting the board with funding reserves – that is, the ability to closely estimate the amount of funds that will be needed (and when they will be needed) to keep the association in good repair without having to impose special assessments or obtain outside funding.

Reserve studies enable the condo board to analyze the overall strength of its reserve fund by evaluating the actual reserve fund balances at a specific point in time compared to the projected reserve fund balances in the reserve study at that same point in time. In theory, if the actual schedule of asset repairs or replacement is in line with the schedule in the study, and if the association is following the recommended reserve funding schedule, the actual amount of cash in the association's reserve fund should be relatively close to the reserve study's forecasted reserve fund balance so long as the actual replacement costs incurred are close to the estimated replacement costs in the reserve study.

Reserve studies are critical in helping the board avoid financial emergencies. Assuming it has followed its recommended reserve contribution schedule, when it's finally time for that large repair, rehabilitation, or replacement project the association will use the reserve fund to pay for such large expenses. Ultimately, smart reserve fund planning reduces the likelihood of fewer unexpected and unfunded major repair or replacement costs in the future.

The recommended annual reserve contribution schedule is a budget planning tool that considers the current status of the replacement fund and determines a stable and equitable funding plan to offset the anticipated future major common area expenditures. The annual recommended reserve contribution is generally stable from one year to the next, over a limited time frame. Depending on the preparer, (also up to the Board) the recommended reserve contribution may be the same for a few years, usually up to but no more than five years. Other preparers may increase the annual recommended reserve contribution by a nominal fixed percentage, usually a small percentage increase every year or every few years.

If followed and regularly updated, reserve studies create equity between the current and future members of an association. For example, if the current members of an association are using the association's physical assets such as the swimming pool, elevators, or a community room, they are creating wear and tear on that asset. Eventually something will happen – i.e., elevators will need modernization, the swimming pool will need to be resurfaced, community room carpeting will need replacing or a roof leak will occur.

If there is no reserve fund – or if that fund is inadequate – the future members would then be responsible for financing all or a large portion of, wear and tear usage that they did not personally cause. Contributing to a reserve fund is the homeowners' way of paying for the long-term maintenance of the association, paying their fair share.

Some may still question whether their association needs a reserve study. The short answer is yes. Not only is it mandatory in many states (but not in New Jersey at this time), but as stated previously a reserve study also helps gauge an association's current and future financial condition. With a reserve study, an association has a reasonably good estimate of the remaining service life of its assets and the cost to replace or repair them. This will improve the likelihood that an association has adequate funds on hand to finance a project or an essential repair when the time comes. Without a reserve study, an association may fail to anticipate major repairs, replacement or rehabilitation projects and may not have funds on hand when the need for such repairs or projects arise.

How much money should an association have in reserve? The reserve study includes such a forecast. The process of how to calculate reserve contributions differs from association to association based on several factors such as association size and the nature of the association's common elements. Typically, reserves are considered fully funded if they cover 100 percent of future financial obligations (if the funding plan matches the depreciation values of the assets). Meeting this reserve funding percentage is usually difficult for many associations, though, and industry guidelines suggest an acceptable level of funding is 70 percent at the least, but each association's reserve requirements can be unique.

Reserve fund studies help the board get an accurate picture of association finances and future capital reserve projects. A reserve study includes a multi-year reserve funding plan that projects funds available now and, in the future, so board members can plan for big expenditures.

The complexity of a reserve study can often intimidate board members. Professional managers and engineers can guide board members to a better understanding of the components of a reserve study. Savvy board members realize having an up-to-date reserve study is an essential tool for managing their association.

The third part of this three-part column will focus on the relationship of a reserve study to the association financial statements, how reserve contributions and reserve studies impact the mortgage application process and how capital reserve planning can affect condo values in your association.

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