RESERVE STUDIES EXPLAINED

COMMON INTEREST DEVELOPMENTS

A Common Interest Development (CID) is defined by shared property and deed restrictions on the use of that property. **Park Imperial – North is a Common Interest Development.** CID's have distinct legal characteristics that distinguish them from other forms of ownership. One important feature is that ownership in a CID combines individual ownership, or the right of exclusive occupancy of a unit, with the shared ownership of the common area within the development. Another distinguishing trait is that owners in a CID are automatically members of an association that is responsible for the operation and maintenance of the common area and must provide for a system of self-government. To cover the costs of operating the association, CID owners are assessed dues for their equitable share of the association's expenses.

A CID is governed by a mandatory association of owners, which elect representatives to make decisions regarding its management and operation. This Board Of Directors administers the property, enforces its restrictions, and is responsible for maintaining the common areas. The Declaration, By-laws, and Articles of Incorporation are the documents used to establish the framework for the operation of the association. They form the legal basis for the "mini-government" that is created and are generally enforceable in a court of law.

RESERVES

To cover the day-to-day operating costs of the association and to build a reserve fund for future repair and replacement of major components of the common area requires the collection of assessments from all of the owners in a CID. The Board of Directors is responsible for establishing an operating budget and disbursing the funds necessary to accommodate it. In addition, ***California Civil Code requires the establishment of a reserve fund to provide for the future repairs and replacement of the major components that the association is responsible for.*** A Reserve Study focuses exclusively on those reserve funds, which are preferably collected with the regular assessments and accumulated in a separate reserve account until they are needed. Ideally, all major repair and replacement costs will be covered by funds in the reserve account.

A fundamental distinction that is important for association members to understand is the difference between operating costs and reserve expenses. Operating costs occur at least annually and are normally recurring administrative expenses or those that relate to the day-to-day maintenance of the common area. They are funded through a non-reserve or "operating" account. Some examples of typical operating costs are insurance premiums, utility bills, pool and landscape contracts, and minor repairs. Reserve expenses, on the other hand, are predictable non-annual costs for the maintenance, repair and replacement of those major common area components with a limited useful life. They are funded from the replacement reserve account. Typical reserve expenses are roof replacement, street repair, and painting of the common area. Building foundations and major infrastructure are generally not considered reserve components since they do not have limited life expectancies, nor are sprinkler heads

or other small items since their individual costs are immaterial. Flood, earthquake and other unpredictable expenses are also typically excluded from reserve analysis.

As the governing body is charged with the responsibility for maintaining and protecting the association's assets, it is important that cash reserves are available when a major repair or replacement is needed. This is most fairly accomplished by a process in which financial assets (reserve funds) are accumulated over the course of time that the physical assets (major components) deteriorate. Insufficient reserves results in either deferring the work, levying a potentially burdensome special assessment, or deferring payment by borrowing the necessary funds, which increase costs via interest expense. Deferred maintenance and the financial inability to keep up with the normal aging of the common area components can lead to a state of disrepair and declination of property values. Additionally, lending institutions may refuse to grant financing to the association, its owners, or its prospective owners if the association is inadequately reserved or financially unsound.

WHAT IS A RESERVE STUDY?

Now that we have established the importance of a healthy reserve fund we must determine how large the fund should be and how much the association should contribute to the fund on a regular basis to prevent it from being depleted by the ongoing expenses incurred by the association. This is accomplished by identifying the associations major components and subsequently anticipating and preparing for their repair and replacement by projecting the timing and related costs of those activities. This process is commonly referred to as a Reserve Study.

When determining how large the reserve fund should be (our "funding goal"), there are many methodologies and philosophies that can be applied. Some are very risky and some are more conservative. One example is Baseline or Minimum Cash Flow Funding where the goal is simply to have enough cash to cover the projected expenses over a particular period of time, usually 30 years. The logic is simple, you examine a cash flow for a given period of time and if the reserve balance never falls below zero you're adequately funded. The danger is that there is little margin for error and expenses that occur sooner than expected, those that are higher than anticipated, or those that are completely unexpected can create major problems. In addition, those expenses that fall outside of the analysis period are totally ignored.

Another method is called Threshold Funding. The association decides on a target to serve as a threshold or lower limit of the reserve fund. It can be a particular cash balance or a percent of the ideal reserve. The level of risk depends on the target selected and this method can generate erratic funding requirements

The riskier the method the higher the likelihood of deferred maintenance and special assessments. If the association has not accumulated the reserve funds to cover a necessary major repair or replacement at the time they are needed the only recourse may be to require a potentially burdensome special assessment. This scenario imposes an inequitable concentration of costs on the owners in the community at the time the repair or replacement is required and may also jeopardize the financial viability of the association if the special assessment cannot be passed and the funds raised when needed.

The funding method that we advocate is the Fully Funded Model. This is the most conservative of all models and calls for a reserve balance equal to the estimated value of accumulated component wear. In other words, the association should have cash on hand equal to the amount that has been consumed or used of each major component. We are accumulating financial assets (reserve funds) over the course of time that the physical assets (major components) deteriorate. In this model the association does not have any unfunded reserve liability in any projected year. Because the concept of unfunded liability is new to many associations, and because an understanding of the concept of Full Funding is important in distinguishing between alternative funding goals, it is explained here in more detail.

If a component currently valued at $10,000 has a useful life of ten years we can estimate the annual deterioration, or the annual provision for the replacement fund at $1,000. By the end of year five, assuming no inflation, this component has accrued a liability of $5,000. This is commonly referred to as its “Ideal Reserve”. If the association had accumulated $5,000 in the reserve account by the end of the fifth year it would be “Fully Funded” or 100% Funded to its Ideal Reserve. If however the reserve balance was only $2,500 at the end of the fifth year, the association would be 50% Funded to its Ideal Reserve. Fully Funded associations enjoy a low risk of special assessments or deferred maintenance and can absorb the inevitable bumps in the road without catastrophic impact.

Once the funding goal has been established we must calculate the amount that the association should contribute to the reserve fund on a regular basis, typically monthly, to maintain the fund at the desired level. This is called a funding plan and again there are different methods and philosophies. In principle the funding plan should provide enough cash to complete the reserve projects, present a stable contribution rate that avoids the erratic peaks and valleys inherent in reserve expenditures, evenly distribute the contributions over many years so each owner pays a fair share, and work in harmony with our funding goal.

Our analysis is primarily predicated on the Component Calculation Method to generate the funding plan. This method generates a funding plan for each component in the Reserve Study which is subsequently totaled to determine the overall funding plan for the association.

The choice of funding goals and strategies will have a direct impact on the amount of cash required of each owner as well as the timing of those requirements. Currently, California law does not specify a particular model. It is obvious however that the Fully Funded Model is the most conservative, provides the most stability, and more equitably distributes the cost of predictable repairs and replacements over time.

A well-funded reserve goes a long way toward maintaining property values within a CID. Not only does it ensure that all common area components are well maintained, it also spreads the cost of predictable repairs and replacements over time, helping to eliminate the need for special assessments. Proper reserve planning eliminates the inequitable concentration of costs on the owners at the time the repair or replacement is required.

WHY IS A RESERVE STUDY IMPORTANT?

Every homeowner association should exercise a plan to repair and replace major common area components like roofs, siding, and decks. Healthy reserves are critical to a healthy association because:

- ✓ Buyers examine the Reserves before buying
- ✓ Lenders examine the Reserves before approving a loan
- ✓ The board has a fiduciary responsibility to protect the association from financial hardship
- ✓ The costs of maintaining the property will be shared by all owners now and in the future
- ✓ It provides a predictable, manageable, contribution plan
- ✓ A healthy Reserve Fund will enhance the value of your home
- ✓ Most importantly, avoids special assessments