Is Your Reserve Budget Just an Illusion?

Adequate Reserve Funding Requires Diligence, Not Magic!

By Tyler P. Berding, Esq.

By Tyler P. Berding, Esq.

Is Your Reserve Budget Just an Illusion?

Adequate Reserve Funding Requires Diligence, Not Magic!

Law firms have seen an increase in claims for defective budgets in recent years. These claims arise when associations find out that what they thought was a solid budget turns out to be an illusion. The financial protection they expected has vanished upon closer inspection. Budget issues most often arise in conjunction with condominium conversions, but we have also seen them associated with newly built projects. Because the damage that a community association can sustain from a budget that has not been adequately prepared can be significant, we have delved into the budget process to give our readers a look at the procedures and issues that accompany reserve budget preparation.

How many of you can say that your community association's reserve budget is adequate? Think about that for a moment. Now, a show of hands. Ok, everyone who raised his or her hand, tell me this: how do you know? Have you reviewed those accounts yourself? Could you prepare one if you wanted to? What criteria would you use? Where would you get the numbers? Do you know if the figures used in that budget are based on solid facts, or did someone just wave a magic wand over them and hope for the best? We've written a lot on these pages about how many reserve budgets lack necessary funding to meet their stated goals, but here's a new one: what if your budget is fully funded but the *goals* have been underestimated?

To know the answers to those questions, and unless you are a CPA or a reserve study professional, you probably need to know a lot more about what goes into the preparation of an association reserve budget than you do now. For starters, you should know what the State of California requires. You should also know how a professional goes about creating a budget—what is typically done, and what is *not* done. Finally, you should consider how often the budget should be revised.

But first, why would a manager, board member, or member of the association need to know this stuff? Isn't that what we hire professionals for? Yes, but budget preparation requires a broad array of skills and experience—accounting, construction, cost estimating, property management, and maybe even a little law thrown in—and few individual professionals possess every one of those skills. Someone has to be sure that all the bases are covered, and that responsibility often falls to managers or board members. If you are among that group, then having a basic understanding of reserve budget preparation, and the pitfalls associated with it, is a good idea. A little time spent now in gaining an understanding of the critical issues in reserve budget preparation might make a big difference a few years down the road.

To gather material for this article, I discussed reserve issues with John D. Beatty, owner of John D. Beatty & Company, professional reserve analysts and construction managers. I also spoke with Tim Nerby, who for 17 years was an Appraiser with the California Department of Real Estate in the Subdivision Department. Among other things, Mr. Nerby's job at the Department of Real Estate was to review the submittals by developers to determine whether they met the DRE standards. He now works with John Beatty doing budget analysis and preparation for community associations.[1]

Department of Real Estate Budget Guidelines—Solid Standards or Magic Wand?

Most association reserve budgets start life with the California Department of Real Estate. Developers of new construction and condominium converters cannot sell their properties to the public without approval from the DRE. To get that approval, the developer has to submit an annual budget for the future association that meets the standards of the Department; that includes the reserve budget. The DRE guidelines for reserve budget preparation are found in the Operating Cost Manual and Reserves Worksheet published by the Department. That document provides the criteria by which the department will evaluate the developer's proposed budget. If the submitted budget meets the criteria, the budget will be approved and eventually a Final Public

1 Our thanks to John D. Beatty and Tim Nerby for the generous contribution of their time in assisting this writer to understand some of the nuances and pitfalls to be encountered in reserve budget preparation and the policies of the California Department of Real Estate.

Report will be issued, allowing the developer to market the property. This first budget is then provided by the developer to the new association.

Missing Components. This would all be fine if the DRE criteria were adequate in the first place. For various reasons they may not be. The first problem is the failure to include some components with an obvious service life. The Operating Cost Manual for Homeowner Associations lists those components that it recommends for inclusion in a reserve budget. One of the most problematic building components on any condominium or planned development project is exterior wood. This can be found in siding, balconies, entry structures, and trim. On some common interest developments, the entire exterior is wood. We all know that wood deteriorates quicker than say, stucco; so, it is very important that the association maintain all of that wood properly. Proper maintenance includes periodic painting, but also repair and eventual replacement. But that takes money, and the funds for caring for all of that wood should be found in the reserve budget. So let's look at how the California Department of Real Estate prepares an association for wood maintenance and replacement.

Look at any aging association with exterior wood and it will be clear that wood products decay and will eventually need to be replaced. We have never talked to a single architect or contractor who believes that wood siding or balcony rails or staircases will last forever, even with periodic painting. And, if you look at the typical condominium conversion that is 20–30 years old when it's converted, the wood on the building will definitely show its age and it is obvious that most, if not all, of the exterior wood is in sight of the end of its service life.

Knowing this, you would expect that the Department of Real Estate would include the replacement of exterior wood components within the scope of its Operating Cost Manual and the Reserves Worksheet. Right? Wrong. The only reference to exterior wood is in Section 301—"Painting." The cost for exterior painting is shown as $1.12 per square foot and if what is being painted is wood (whether siding, balconies, stairways, etc) you are to add an additional $0.20 per square foot. That's it. There is no suggested reserve for repair or replacement. In other words, the California Department of Real Estate believes that exterior wood will never have to be replaced if it's painted at certain intervals. There is nothing in the DRE's guidelines for the eventual replacement of any exterior wood component. Now, wood fences are given a 10-year useful life and a reserve for eventual replacement. But not wood siding or any other exterior wood component on the building.

Cost Estimates. The budget may properly include a component, but strictly following DRE guidelines may lead to underfunding in other ways. The estimated replacement costs, for example. The Operating Cost Manual identifies the cost to replace a composition shingle roof at a recently revised $2.60 per square foot in 2007. Prior to that, the number was $1.80 per square foot. Mr. Nerby advises that the actual cost of removing and replacing a composition shingle roof is closer to $4.38 per square foot, which does not include any periodic repair or maintenance costs if required by the age or condition of the roof.[2] If so, an association that strictly followed the DRE guidelines would start life with a roof reserve that, unless modified, would never accumulate enough to replace the roof.

The Department does include some cautionary notes in the manual, for example: *"The reserve section of this manual only includes components or costs for items most frequently found in common-interest subdivisions. Reserve items for your budget may not be limited to those found in this manual. Your budget should be tailored to fit your project and include necessary reserves for all appropriate items."*[3] There is apparently not, however, any enforcement or oversight of these concerns by the Department, and if the developer chooses to stay within the Department's minimum standards, its budget will be approved.

The Department also states: *"It is recommended that associations consider verification and, if necessary, correction of their major component inventory after project start-up."*[4] Even more interesting, another Department of Real Estate publication states: *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.*[5] That publication also devotes a great deal of space to other cautionary notes such as why an association should consult with multiple cost manuals or other contractors to be sure that such things as cost estimates and quantities are accurate. The publication, *Reserve Study Guidelines for Homeowner Association Budgets*, is available online at:
dre.cahwnet.gov/pdf_docs/re25.pdf

This, of course, is all well and good, but by the time a new board member has a chance to read any of these publications or cautionary notes, the budget has long been in concrete, the homes are sold, and the homeowners have purchased on the strength of the costs included in the original budget and represented to them at the time of sale. If you read "The Reserve Study Guidelines," you will see page after page of recommendations that go far beyond the minimal requirements employed in the project approval process. It is truly amazing that the DRE can devote an entire publication

2 Mr. Nerby offers the following information applicable to conversions: "It should be pointed out that the reserve factors in both of these operating cost manuals 'are based upon new building components and equipment.' Both manuals go on to say: 'Therefore, these reserve factors need to be adjusted if they are to be used for an existing development or for the conversion of an existing structure. For existing structures you would normally divide the cost of replacing the component by its remaining useful life.'"

3 California Department of Real Estate, *Operating Cost Manual for Homeowner's Associations*, Revised April, 2007.

4 *Ibid.*

5 California Department of Real Estate, *Reserve Study Guidelines for Homeowner Association Budgets*, April 2004

to what an association should do to avoid reserve budget pitfalls, while its own budget review process ignores most of those recommendations and leaves major budget decisions up to the developer promoting the project! There's something wrong with that picture.

There is little reason for a prospective homebuyer to challenge a financial plan that appears to be blessed by the State of California. This renders moot any cautionary notes issued by the DRE and leaves any underfunding to be dealt with by the association board. In other words, by the time owners read the provisions of the Operating Cost Manual or Reserve Study Guidelines, the developer is usually long gone, and it is too late to correct the developer's initial mistakes or intentional underfunding. What these various publications do tell us, however, is that the Department of Real Estate is now well aware of many of the concerns we have long been discussing. Perhaps one day it will implement enforcement.

Which Wizard Prepared Your Budget?

The accuracy of your budget will often depend upon who prepared it. A developer or converter does not want high monthly assessments as compared to comparable properties in the neighborhood. Higher assessments may make that product less marketable and fewer buyers will qualify to buy those homes. So a developer will likely push back on initial reserve calculations if they result in an assessment that is too high for the market. There are numerous ways to influence this, as we have seen. Leave out components, lower unit costs, lean toward repair rather than replace, and lengthen useful lives. Unfortunately, it is the future buyer, and not the developer, who will have to deal with any underfunding that results from these maneuvers.

The association board members, while always under pressure from owners to keep assessments from rising too fast, nevertheless are also owners of the property and will eventually want to sell their interests. Buyers are becoming increasingly more sophisticated in the financial and physical health of condominium and planned development projects, and will want to know not only the condition of the buildings but that of the budget as well. So, a gamble on reserve funding may not be the smart move in the end, and boards of directors, working with their budget professionals, have the best opportunity to correct the developer's mistakes. This is especially true early in a project's life, and the reserve study done after the developer's departure is a good place to start.

In the end, there are many things an association can do to offset the problems presented by an original budget that fails to adequately prepare the association to maintain and repair its common area. The lack of oversight by the DRE or the mistakes of a developer can be overcome with diligence and attention to better guidelines and state statutes. All associations, old and young, can get the budget back on track if they get realistic estimates and are ready to tackle the difficult political issues that come with raising assessments.

Looking Beyond the Crystal Ball—The Anatomy of a Reserve Study

As you can see, an association that continued to follow the DRE guidelines would most likely never accumulate sufficient reserves. That's not surprising since the DRE admits that its guidelines are minimal.[6] Unfortunately, too many developers have been all too happy to adopt this minimalist approach. The Legislature, however, has seen to it that if the original budget is deficient, there are ways to correct it. California Civil Code Section 1365 requires that a board state its budget annually, including any deficiencies in the reserve funding, and distribute copies to the members.

But more important, California Civil Code Section 1365.5 requires: *"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… The study required by this subdivision shall at a minimum include… identification of major components that, as of the date of the study, have a useful life of less than 30 years."* This is what is commonly known as a "reserve study," which is a legal requirement for all associations. The reserve study also includes an estimate of the cost of repair and the amount necessary to be contributed annually to insure adequate funding.

What's Behind the Budget? Good budget professionals will modify or augment the initial DRE budget in several ways. First, they will likely add more components to those in the original budget. Second, cost estimates are utilized that reflect true market prices. Professional reserve analyst John Beatty says that new associations should seriously consider having an initial reserve study done, not at the three-year point, but rather in the first year after the developer turns over the project to the association.

What else will the expert budget wizard do to assist your association in conducting a reserve study and preparing the budget? It won't be done with smoke and mirrors. Good professionals will insure that the physical inspection of the project is adequate to confirm or reject the assumptions passed on to the association by the developer. They will use that information to add to the list of building components that have an identified service life of less than 30 years.

What's Not? Inspections performed as part of a reserve study will typically *not* include inaccessible portions of a building such as wall cavities, attic spaces, and closed foundation areas, especially where portions of the building may have to be removed for access. Where a surface inspection indicates that there may have been leaks through exterior walls, the roof, or moisture accumulation under buildings, a more intrusive inspection

6 Mr. Nerby states that during his tenure with the DRE, the department considered all budget numbers in the Operating Manual to be the minimum required and looked to developers and their budget preparers for any modifications that might be necessary.

may be necessary to determine if any of this moisture may have led to rot or other deterioration in these inaccessible areas. This is especially true for older buildings. Also, reserve inspections may not include plumbing lines that may require replacement during the life of the building.[7] If your association is more than, say, twenty-five years old, or if there has been evidence of leaks, ask your reserve study professional if a more intrusive inspection into certain areas would be recommended.

The Calculations. After inspection, the reserve professional will calculate a funding plan that sets appropriate and realistic goals based on true market costs. And unlike the developer, who tries to make the budget fit a preconceived assessment in order to qualify buyers and sell units, the good budget professional will make the funding plan fit the association's real repair and replacement needs to give the board a true picture of its funding requirements. The board can then decide whether to raise assessments or not. But only with an accurate picture of its financial needs can a board of directors make informed fund-raising decisions.

Making Your Own Magic

You can improve your association's chances of surviving a reserve funding crisis by checking the following factors:

1. Double Check the List of Components. The Department of Real Estate Reserve Checklist includes 30 major components that it suggests should be included in a reserve budget. Beatty's list contains 81 components, indicating that the more modern view is to be over-inclusive to avoid surprises later on.

2. Confirm Unit Costs. Roofing is measured in square feet, or sometimes "squares" (100 square feet) and a cost to repair assigned to that unit of measurement. As we stated above, the Department of Real Estate cost manual appears to offer unit costs that in some instances are substantially below market. It is important that the cost that is applied to each unit of measurement is an accurate reflection of the true cost of repair and is periodically updated to reflect inflation.

3. Question Estimated Useful Lives. Another factor that can throw off a reserve budget is an over-estimate (or under-estimate) of the useful life of a building component. If the life of a roof is estimated at 25 years but it only lasts 15, the association will be faced with a big roofing replacement cost long before it has saved enough cash to do the work. This is not as much of a problem for new projects as it is for conversions. With new construction not only does the association have many years to correct any deficiencies, but the expected life of a new roof, or new paint, or new asphalt is reasonably predictable based on industry standards and averages. Furthermore, the Department of Real Estate lists suggested useful lives for many major building components (not wood siding, however, as mentioned above). But the remaining useful life of a 15- or 20-year-old roof, for example, on a 35- or 40-year-old converted apartment house may be difficult to estimate accurately. This is one reason why a reserve study at developer turnover and every three years after that is so important. If nothing else, it serves as a log of the condition of the building so that previous assumptions can be evaluated and corrected if later history proves them wrong.

4. Check Quantities. How do you know that the number of square feet of roofing shown in your reserve budget is an accurate calculation? Architects or engineers can calculate such things using the drawings for the project, assuming the drawings are an "as-built" set. Be sure that someone has spot-checked the quantities shown in the initial budget to be sure they are right. If the roofing or siding quantity shown in the budget is less than actually exists on the project, your funding plan will not work.

5. Repair vs. Replace. Even when a component is included in a reserve budget, different budget preparers have different views on what to do with that component. Virtually all reserve budget professionals and most contractors agree that at the end of a roof's useful life it should be completely replaced. Now, there may be instances where a partial replacement is adequate, but that's rare. However, some experts might disagree about whether you should tear off the old roof first, but most budgets you will find will call for complete replacement of a roof at the end of its useful life. Not so with other components. Take exterior wood, for example. Some experts will call for complete replacement of wood siding at the end of its estimated useful life, while others will provide only for periodic repair of a small percentage of the wood—say 5% to 25% over a 10- to 20-year period. The "repair" approach assumes that a substantial portion of the siding will never need replacement, since if you repair only 5% every 10 years you are never going to get to all of it.

With components like wood siding or other exterior wood, a decision to simply repair a small percentage every ten years, rather than to provide for complete replacement, say, 30 years into the future, will result in the association suffering a major shortfall should replacement become necessary. On the other hand, augmenting a paint budget with additional funds for "miscellaneous carpentry" every five years will allow an association to do periodic repairs in conjunction with repainting, and on some projects that might be good enough, and clearly better than what is suggested by the DRE. Budgeting for full replacement is conservative—but costs more. Providing for repair only is a gamble but can result in lower assessments. Our opinion is to take the conservative route. In the unlikely event that you find you have too much money in reserves, you can always give some back!

6. Straight Line vs. Cash Flow. This refers to two different accounting methods used to prepare a funding plan for a reserve budget. I will not pretend to understand the nuances of these two systems, but suffice to say that the advocates of each are not hesitant to defend them. The differences

7 It should be noted that the Department of Real Estate believes that plumbing will never need a reserve.

EchoJournal

Reprinted from the
October 2007
ECHO Journal

between them and their respective philosophy would offer enough material for an article on this issue alone. But let me try to explain why each might be important to an association. The "straight line" method assigns a funding goal to each component in the reserve budget without regard to the accumulation of funds for other components. It's like having an individual reserve "account" for each component—roofs, paint, asphalt, etc. The balance in one component "account" is not considered available to satisfy the funding requirements of another component. The cash in each of these separate "accounts" is compared to the funding requirements of each when determining the adequacy of the association's funding, according to David Levy, CPA.

The "cash flow" method focuses instead on the total cash available to address pending repair issues at any one moment in time. Nerby states, "…part of creating an acceptable cash flow method is to anticipate the expected expenses for many years to come (usually at least 30 years) and to annually fund enough money in reserves to cover all the annual expenses no matter in what year they occur. In addition to the annually needed reserve funds to cover expenditures, there should also be a "cushion" established that will define the lower limit (of the reserve account)." In other words, if there is sufficient cash on hand to deal with whatever obligations are maturing in the present fiscal year along with the expense projections and necessary cushion for future years, the amount in the reserve account is considered adequate.

Advocates of the straight-line method say that projecting future cash requirements for each component separately results in a more accurate funding plan when the budget is viewed as a whole—a more conservative approach that carries less risk of future underfunding for the association. Advocates of the cash flow method claim that straight line fails to project accurately the *timing* of the cash requirements of an association, resulting in cash accumulations that might not be used, which in turn would result in greater expense to the members of the association.[8]

As we have said many times, our own view is that associations should adopt whichever method is less likely to result in a funding crisis down the road. That usually means saving more money, not less; so whichever method results in more total cash being accumulated over time would be the one we would choose.

Final Comments

One obvious conclusion is that an association should not rely on most developer-prepared budgets. The developer's short-term need to sell units does not necessarily square with an association's long-term budget goals. A second is that a reserve study, conducted in the first full year of an association's operation, will help to adjust deficiencies early and allow the board the maximum amount of time to add any necessary funding. A third is to hire good professionals and make sure they rely on independently derived data in calculating your reserve requirements. Finally, you can never have too much money in reserves. Following these guidelines with diligence will insure that you don't have to rely on magic when its time to replace a major component.

Tyler Berding is a founding partner of Berding & Weil, a construction defect and homeowner association law firm and a former member and the immediate past president of the ECHO board of directors.

8 Our thanks to David Levy of Levy, Erlanger & Co, CPAs, for his valuable time and assistance in helping us understand straight-line accounting.

Feature Article

Reserve Budgets
Page 6