

## **ABC Association**

### Model Reserve Policy

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# **ABC Association**

## **Model Reserve Policy**

### **Introduction**

The Association is charged with the responsibility to maintain, repair and replace certain common area facilities, furniture and equipment. The Declaration of Conditions, Covenants, and Restrictions sets forth the Association's legal requirement for maintenance of certain real property common elements and states that the assessments shall be sufficient to, among other things, establish and maintain adequate repair and replacement reserves. In addition, the Association has determined that it shall maintain certain real property common components not identified in the declaration, as well as personal property common components that are not identified in the Declaration. The personal property common components consist of vehicles, furnishings, and equipment. The Association has established below specific guidelines regarding components. The Board of Directors has determined that all common areas should be maintained in a minimum condition rating of "good" condition.

The purpose of the reserve fund is to provide sufficient monies for major repair and replacement of common area components when necessary to maintain those components in the condition determined above. The primary goals of the reserve fund are to preserve members' property values and to effect major repairs and replacements at the lowest efficient cost.

The purpose of this policy statement is to document the policies and procedures for the orderly repair and replacement of the Association's common area components by developing a sound financial plan to spread major costs over time and avoid special assessments.

### **Reserve Study Philosophy - ICBI standards**

**Maintenance Plan** - The Association believes that timely maintenance of common area components and not allowing condition to deteriorate below a rating of "good" condition provides for the lowest cost over time. Accordingly, the Association has adopted a long term maintenance plan for repair and replacement of major components. The maintenance plan encompasses both "day-to-day" maintenance activities and long term maintenance activities.

Day-to-day maintenance activities are a crucial part of the maintenance plan, as failure to perform regular maintenance activities can impact both the timing and cost of long term, major repair and replacement projects that are the subject of the reserve maintenance plan.

Delay of long term reserve expenditures for common area maintenance can also result in worse than anticipated deterioration of components that results in higher long term maintenance costs. Of particular concern are those components such as roofing, siding, windows, and doors that, if not properly installed and maintained, could allow water intrusion that would result in structural of interior damage that would otherwise not exist.

The maintenance plan serves as the basis for the reserve study, which is the financial reflection of the physical maintenance plan. The reserve study is the long term budget that provides the funding to pay for future major repair and replacement expenditures.

**Reserve Study Standards** - The Association has determined that its reserve maintenance plan will comply with Generally Accepted Reserve Study Principals as adopted by the International Capital Budgeting Institute (ICBI). These are the highest standards for reserve studies and reflect the conceptual framework and philosophy under which the Association operates. Reserve study engagements shall be performed, and reserve study reports prepared, in accordance with ICBI Generally Accepted Reserve Study Standards.

### **External considerations**

**Statutory requirements** - There are no specific requirements in the state in which the Association is located that require preparation of a reserve study.

Statutory reserve study requirements exist for California, Delaware, Florida, Nevada, Utah, and Washington associations. Insert appropriate statutory requirements for those states.

**Regulatory requirements** - FHA requires specific annual funding for reserves for associations desiring to qualify under FHA regulations. The Financial Accounting Standards Board (FASB) requires disclosures of reserve study information to accompany audited, reviewed, or compiled financial statements. The Association's reserve maintenance plan includes compliance with FHA funding requirements and FASB disclosure requirements.

### **Reserve Study Plan and Procedures**

**Overview** - The Association's reserve study shall be conducted as a reserve management plan as defined by ICBI, and not as an independent reserve study. Association staff will set the scope of the reserve study and outside consultants retained shall provide advice and prepare reports in accordance with ICBI Generally Accepted Reserve Study Standards. Reserve studies performed by outside consultants shall be performed in accordance with ICBI Generally Accepted Reserve Study Standards.

Since the Association is more than 10 years old, an independent, on-site analysis shall be performed by an outside consultant no less than every three years. For any year in which an on-site analysis is not performed, an updated reserve study report shall be prepared without an on-site analysis. This report may be prepared by Association staff or management, or by an outside consultant. In either case, the updated report shall be prepared using ICBI certified software licensed by the Association.

Reserve transactions occur on a regular basis for contributions to reserves, and on an irregular basis for reserve expenditures. It is the Association's policy to update the reserve transactions to their licensed software on at least an annual basis. This provides the Association with accurate, up-to-date reserve information. The Association shall update component cost information as it becomes aware of any significant changes in cost.

**Site Analysis Guidelines** - At least once every three years, a formal reserve study report shall be prepared that is based upon an on-site analysis performed by an outside consultant. The reserve study services and reserve study report shall be performed and prepared in accordance with ICBI Generally Accepted Reserve Study Standards. The reserve study engagement shall be a reserve management plan service level as defined by ICBI standards. The first such study performed by a reserve study company shall be performed as a Type 1 engagement. Subsequent on site engagements performed by the same company may be performed as a Type 2 engagements. If a different reserve study company is engaged for any subsequent on site analysis engagement, that engagement shall be performed as a Type 1 engagement.

The standard of care for the on-site analysis shall that of a reasonably competent and diligent visual observation, performed by a qualified, experienced, outside consultant holding a designation as a PRC, RS, or PRA. The Association recognizes that, while certain Association members may be technically qualified to perform the site analysis, they may lack the time, software, experience, or resources relating to determining future cost, to adequately complete the study. Further, reliance on volunteer members may actually hinder the transference of information accumulated in the reserve study process. Accordingly, the Board of Directors believes that it is more prudent to rely upon an outside, independent consultant that has experience in performing reserve studies.

**Annual Updates without a Site Analysis** - On intervening, or non-site analysis years, the Association shall perform an annual update of the reserve study report without a site analysis. This report may be prepared by Association staff or management, or by an outside consultant. In either case, the updated report shall be prepared using ICBI certified software licensed by the Association.

In conducting the Association's annual update for non-site analysis years, the Board should avoid making any changes in methodology, or in classes or categories of components included or excluded from the reserve study. Changes should generally be limited to recognizing events that have occurred since the last study, such as:

- (a) Components which have been replaced (delete old, add new);
- (b) Additions of new items to a class of components already included;
- (c) Changes to interest and/or inflation rates are clearly inappropriate without professional advice;
- (d) Changes in conditions that would affect the useful life of a component.

It is not considered necessary to re-challenge future replacement costs for all components during an annual update. The report shall be issued in accordance with ICBI Generally Accepted Reserve Study Standards.

### **Components**

The Association, in consultation with the independent, outside reserve consultant, shall determine what components shall be included from the reserve study, and those components that shall be excluded. The Association shall also determine the scope, or materiality level at which components shall be included in the reserve study, and the maintenance standards which shall be applied. As such, this policy provides a consistent method and criteria for determining the Association's components that are required to be included in the study of reserve account

requirements and a method of funding for these components. Identification of components shall be in accordance with ICBI Generally Accepted Reserve Study Principals.

The reserve study shall include all components identified in the governing documents or that are required by state statutes. The reserve study shall include all components for which the Association has determined it has maintenance responsibility that have an estimated replacement cost in excess of \$1,000 (set scope / materiality accordingly) individually or in the aggregate, except for those exclusions identified below. In addition, the Association has determined that the reserve fund shall include allowances for estimated significant, future, non-annual maintenance expenditures where neither exact costs nor exact time periods can be determined. These are partial major repairs or replacements of such components as landscaping and concrete block walls, which might normally be considered as lifetime components.

Components for which the Association has maintenance responsibility that are excluded from the reserve study as being considered lifetime components or by board decision are:

- Building structural components
- In wall, under slab, and underground utilities
- Road base
- Hardscape such as sidewalks and concrete gutters
- Storm drainage systems

### **Funding Plan**

**Funding Goals** – The Association has set a desired goal of reaching, and remaining at, or near, 100% funded. While the Board of Directors realizes this means that significant reserve balances may be held on hand at any given time, priority is given to fairly spreading reserve contributions over both current and future owners. This is achieved by a reserve funding plan that maintains reserve balances at, or near 100% funded, as this matches reserve contributions to the estimated deterioration of the physical common area components.

**Reserve Calculation Methods** – The Association shall comply with the ICBI Generally Accepted Reserve Study Standards and use the cash flow method of calculating reserve funding. If percent funded calculations are made, they shall be made using the inflation adjusted method.

**Interest and inflation assumptions** – The future inflation shall be estimated and used in the calculation of future reserve expenditures.

Interest income shall be estimated and assumed to be retained in the reserve fund. Income taxes shall be paid from the operating fund. (Alternate position – Interest income earned by accumulated reserve funds shall be transferred to the operating fund. As a result of this decision, reserve contributions will be increased by the amount of estimated interest earnings, and operating assessments will be decreased by the same amount.)

**Regular and Special Assessments** – Every effort shall be made to avoid special assessments by establishing adequate regular assessments to achieve the desired 100% funding level. Unanticipated events may occur, in addition to the normal changes in estimates that will occur due

to changes in estimated replacement costs or timing of repair or replacement activities. Significant events could lead to special assessments.

The Board's decision to not include in wall, under slab and underground utilities may also lead to a special assessment. These components normally have an estimated life to 40 to 60 years, and could have costs ranging from \$10,000 to \$40,000 per unit. Based upon a member survey, and the fact that these components were not included in the reserve study for the first twenty years of the Association's existence, the members voted overwhelmingly to exclude funding for this component. Funding for the cost of this single component was estimated at \$83 per member, per month, for the next 30 years (\$30,000 per unit with a remaining life of 30 years).

### **Reporting on Reserves**

Reserve study reports shall be prepared in accordance with ICBI Generally Accepted Reserve Study Standards.

The Association will also require supplemental exhibits that report:

- Expenditures by year
- Expenditures by component for future years within the funding plan period (30 years)
- Component full detail report with photos
- Components by location
- Components by unit (timeshare only)

### **Reserve Fund Cash Management**

**Budget** - As the elected body of the Association, the Board of Directors is responsible for ensuring its sound management and operation. One of the primary duties of the Board of Directors is to review and approve the annual budget. The annual budget process must address two areas: Operating Funds and Reserve Funds, and may address a third area, Capital Improvements/

***The purpose of the operating budget*** is to provide funds for the Association's day-to-day operations, including maintenance of common area facilities. Establishing an ongoing maintenance plan is also an essential part of determining the reserve maintenance plan. For instance, failure to maintain asphalt surfaces with annual crack sealing may result in much faster deterioration of the asphalt surfaces requiring major revisions to the planned reserve activities.

***The purpose of the reserve budget*** is to provide funds for the Association's long-term maintenance of existing Association common areas and facilities. The reserve budget is based upon a long-range forecast for the major repair or replacement of Association common areas. The actual maintenance activities required, and the timing of those activities is dependent on, to a certain extent, the timing and nature of operating maintenance activities performed on a regular basis. It is recognized that the maintenance plan may change over time.

***The purpose of the capital improvements budget*** is to provide funds for new additions to the Association's common areas and facilities. Capital improvements are distinguished from reserves in that capital improvements represent purchase or construction of new components, whereas the reserves budget deals only with existing components.

**Financial accounts** – The Association maintains separate bank and investment accounts for the accumulation of reserve funds.

**Assessment transfers** – Member assessments consist of two components; the operating assessment, and the reserve assessments. These are received as a single payment from each member, and are deposited into the operating bank account. A transfer of the reserve portion of assessments is made monthly by the 15<sup>th</sup> of each month to the reserve checking account.

**Authorization for expenditures** – Since reserve expenditures are usually irregular in timing and of significant amount, it is Association policy that expenditures from the reserve fund must be authorized by two board members, or one board member and an officer who is not a board member. Expenditures shall be for components that have been included in the reserve study. In the event that an expenditure is required for an item that was not previously identified as a reserve component, the reserve study should be revised to include the component, and the expenditure made from reserve funds. Withdrawals from the reserve fund may only be used for restoration, repair and replacement of existing capital improvements, not for new Capital Improvements of facilities or additions.

**No transfers to operating fund** – Reserve funds are designated by the Board of Directors for future major repairs and replacement only. No transfers shall be made to the operating fund other than for reimbursement of reserve expenditures that were disbursed from the operating account. An exception is that temporary loans may be made from the reserve fund to the operating fund only if there is an established repayment plan that repays the loan within twelve months.

**Investment policy** – The Association has adopted an investment policy, and all investment of reserve funds shall be made in accordance with that policy.

### **Capitalization Policy**

The Association has adopted a capitalization policy that coordinates with the reserve component materiality limit established above.

### **Income Tax Considerations**

The Board believes it is generally beneficial to avoid the risk of adverse tax consequences by filing Form 1120-H as a qualifying homeowners association.

However, the Board also recognizes that under certain circumstances it may be beneficial to file Form 1120 as a nonexempt membership organization. Accordingly, the Association wishes to avoid any adverse federal income tax consequences on reserve assessments set aside and held in reserve for repair and replacement of improvements to the common areas by following the IRS guidance for contributions to the capital of a corporation.