# Reserve allocation: A significant part of the budget

*by Robert J. Petrisin*

California Civil Code Section 1365 requires community associations to prepare and distribute to all its members certain financial information, including a pro forma operating budget, 45 to 60 days prior to the start of the association's next fiscal year. A significant part of this budget is the reserve allocation.

Developers typically establish the initial reserve allocation for an association's first-year budget by filing Department of Real Estate form 623 with the California Department of Real Estate along with other information in order to obtain a "Final Subdivision Public Report." The original form 623 should not be used as the foundation for reserve fund planning. Developer estimates may have been prepared several years in advance of project construction and are frequently obsolete by the time the first unit closes escrow. This early planning may not accurately reflect the association's true liability for the project as actually built. Other possible shortcomings are as follows.

1) The form contains only limited major components.

2) The estimated life shown may not reflect local conditions.

3) The estimated cost shown may not reflect actual local prices.

4) The reserve allocation may lack annual inflationary adjustments.

Therefore, it is imperative for a newer association to conduct a reserve study immediately after it has taken over control of the association from the developer, so the new board of directors can independently determine the long-term funding requirements. Older associations that have been operating without a reserve study should conduct one as soon as possible to protect themselves against financial instabilities that may result in special assessments or deferred maintenance. California Civil Codes require the association to conduct a reserve study at least every three years.

The reserve study provides a long-term funding plan necessary to maintain, repair, replace or restore major common area components (such as asphalt pavement, exterior paint/stain and roofs) in the future. Ideally, all future reserve item expenditures will be covered by those funds currently set aside by association management as reserves. The plan involves a component study and a funding study.

The component study is a compilation of physical and financial estimates of the major common area components of the association. An inaccurate or incomplete list of components can cause havoc to the association's long-term funding plan. For each component listed, the current maintenance or replacement cost, useful life and remaining life are identified. Maintenance and replacement responsibility must be determined for exclusive-use common areas (e.g. balcony decks, entry doors, garage doors, etc.); if responsibilities are not clearly defined in the governing documents, the association should consider amending these documents. All components that will fail before the building itself should be included. Life-of-the-project components (e.g. building foundation, structure, etc.) are usually omitted, unless there is reason to expect the item to wear out before the building does. Supplemental information should be provided in the form of a "field report" that assesses the present condition and indicates the type of annual preventive maintenance program that should be implemented to ensure/extend the items' useful life expectancy.

The funding study is a financial analysis that utilizes the component study to determine reserve allocation, reserve funding level or percent funded (reserve strength indicator) and reserve analysis (cash-flow forecast or projection). Although California law currently does not specify a specific method to determine reserve allocation, the method that reduces or eliminates any unfunded liability (increases reserve strength) provides the most stability and is the most conservative (i.e. the "fully funded" method). Association management should strive to obtain a reserve funding level (or percent funded) of at least 70 percent. Reserves at or above this level normally indicate that reserves are strong and can be expected to fund future reserve item expenditures with low risk of financial instabilities that may result in special assessments or deferred maintenance. The time frame of the reserve analysis should be at least 20 years and is normally presented in a spreadsheet format. Caution must be exercised when using an inflation rate in the reserve analysis because the rate will generally result in higher estimated future costs.

A properly prepared reserve study allows association management to utilize the resulting information in the pro forma operating budget. Because the reserve allocation is a significant part of the budget, annual financial updates (no site visit) — performed at the same time as the preparation of the operating budget — should be accomplished for up to two years following the completion of a reserve study. A reserve study (with site visit) must be accomplished at least every third year to access component condition, to update the component study, to update the funding study and to ensure compliance with state law requirements. Proposals should be requested several months prior to the association's fiscal year budget preparation to allow for unanticipated lead-time problems.

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