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--RESERVES AND ASSOCIATION OBLIGATIONS--
--COLLECTION OF ASSESSMENTS--

A continuing source of concern to associations is reserves and the association's obligation for reserves. Reserves are the way of setting money aside to meet anticipated and unanticipated short-term repairs and replacements and to fund future replacements. Reserves must be included in the association budget and are part of the obligations imposed upon an association, its board and upon any corporation. It is necessary to include reserves in planning, budgeting and assessing. The more detailed and accurate the association is in evaluating the reserve obligation, the better managed and operated the association will be considered.

Types of Reserves

There are two basic categories of reserves. One category is generally identified as replacement reserves. The second category is generally identified as operating or contingency reserves.

Contingency Reserves

Contingency reserves are funds to cover shortages in the association's current operating budget during the next 12 months. This should be a line item in the association budget. Its function is to address unanticipated increases in costs such as increases in snow removal, plumbing, heating, air conditioning, electricity and other expenses which are incurred during the course of a year. Such costs are relatively fixed but can vary from year to year depending on weather conditions and the age and mainte-nance of the buildings and property. The Federal Housing Administration (FHA) has a guideline for this kind of reserve. The FHA recommends a contingency amount of 3% of assessment income in a new association. This can be increased or decreased depending upon the age of the association and its experiences.

Operating Reserve

The operating reserve represents an unallocated pool of funds to be used for significant, unforeseen expenses. An operating reserve generally is considered to be a stable amount and should remain equal to 2% - 3% of the operating budget. Operating reserves are not budget commitments; although, they are identified in a budget. The association is not committing to spending those reserves, only to maintaining them for purposes of meeting extraordinary expenses. The expenses to be covered from these kinds of reserves are sudden increases in budgeted items that are in excess of the contingency reserves. For example, the association receives a 20% increase in insurance for the coming year. That increase can be funded from the operating reserve. The association anticipates a repair next year, but due to severe deterioration finds it necessary to repair this year. The difference between the capital reserve amount for the repair and replacement and that which is available in the current year for the repair can be funded by the operating reserve.

Capital Reserve

Capital reserves differ from contingency reserves and operating reserves. Capital reserves are intended for projected repairs and replacements to the association's physical premises and equipment in future years. There are numerous theories and approaches for determining what is required and how to calculate capital reserves. The one

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constant in all of the theories and approaches is that capital reserves should be established and funded. The failure to establish and reasonably fund capital reserves can have serious short-term and long-term impact upon associations. The board and the association can be held accountable for failing to establish and maintain capital reserves.

The Condominium Property Act, at Section 9, addresses reserves. Section 9(c)(2) states: "(2) All budgets adopted by a board of managers on or after July 1, 1990 shall provide for reasonable reserves for capital expenditures and deferred maintenance for repair or replacement of the common elements. To determine the amount of reserves appropriate for an association, the board of managers shall take into consideration the following: (i) the repair and replacement cost, and the estimated useful life, of the property which the association is obligated to maintain, including but not limited to structural and mechanical components, surfaces of the buildings and common elements, and energy systems and equipment; (ii) the current and anticipated return on investment of association funds; (iii) any independent professional reserve study which the association may obtain; (iv) the financial impact on unit owners, and the market value of the condominium units, of any assessment increase needed to fund reserves; and (v) the ability of the association to obtain financing or refinancing."

Subparagraph (3) establishes a method to waive reserves. Two-thirds of the total vote of the association is necessary to waive some or all of the reserves. If the association is successful in securing the waiver, it must then put everyone on notice of the waive in accordance with the provisions in subparagraph (4).

The word "shall" is used extensively in subparagraph (2). "Shall" is a mandatory term. That is, it does not allow for choice. When the word "shall" is used, legally what is directed must be done. Consequently, the board is obligated to have a budget that provides for <u>reasonable reserves</u> for capital expenditures and deferred maintenance for repair or replacement of the common elements. It is obligated to take into consideration the factors identified in ascertaining what constitutes reasonable reserves. In the opinion of most attorneys, given the wording of the Section, the association is obligated to secure a repair and replacement analysis. Most attorneys believe that an independent professional reserve study is also mandated for the association to meet its obligations.

Reasonable Capital Reserves

Most attorneys and accountants are uncomfortable with attempting to identify what is or might be considered sufficient or adequate reasonable reserves. Most are comfortable with explaining what is conservative, would be acceptable and would meet all of the association's obligations and fiduciary requirements from a business perspective. Those business factors may not include all of the considerations set forth in the Condominium Property Act. The most conservative approach is often termed by accountants and by commercial property managers as a component depreciation analysis and reserve determination.

Component Depreciation Analysis

In component depreciation analysis, every item at the property that wears and/or must be replaced and maintained in a scheduled fashion is identified. Its useful remaining life before repair or replacement is determined. The cost for repair or replacement at the end of its useful life is determined. The amount of money which must be accumulated (reserved) each year in order to accumulate the amount needed for repair and replacement of that component is then determined. That amount is added to the budget as the year's reserve for the component. Each component is evaluated in the same fashion. All of the component amounts on a yearly basis are then added, and the total amount is the total annual capital reserve.

All components of the property and all personal property are included in this evaluation. This would include concrete and asphalt areas, landscaping areas, retention ponds, grading, storm and sanitary sewers, plumbing lines and fixtures, electrical lines and fixtures, heating and air conditioning equipment and facilities and building components including foundations, walls, windows and roofs (this list is not meant to be all inclusive). It would extend not only to replacement but to periodic maintenance such as tuckpointing, roof replacement and caulking. It extends to personal property such as snow blowers, plows, trucks, automobiles, maintenance and even to office equipment such as desks, typewriters and computers. All items should be listed, their useful life determined and the cost of repair or replacement during and at the end of their useful life computed. If the association follows the component analysis process for all of its facilities and equipment, it will establish reserves which are generally considered adequate for all repair and replacement on an ongoing basis, unless costs or expenses change dramatically or unless the analysis of useful life is incorrect. To offset that prospect, the association should reevaluate that reserve and the reserve analysis on a regular basis.

Collection of Assessments

The end of each year is a good time to review the records of the association and determine which owner accounts need to be brought up-to-date. If accounts are not current, you should start the collection process. Remember you can use eviction suits if an owner is not current with assessments. You may be awarded your attorney fees, assessments, late charges and fines, and possession of the unit. Call us for details.

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