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An Unanticipated Expense - Can it be Covered by Reserve Funds? Take the Test!

An association Reserve Study consists of both a physical and financial analysis of an association's assets. The study is an excellent tool for board members to use when making decisions regarding the maintenance of the common elements of a community and developing a sound and reasonable annual budget. A well-prepared study contains the following three elements:



- A list of the common components that the association is responsible for
- An estimate of the useful life of components
- A recommended schedule for repair or replacement of each item over the next 30-40 years

You can count yourself lucky if you are serving on a board where prior board members have consistently approved budgets that meet the short- and long-term needs of the association, and followed the recommendations outlined by the association's reserve specialist. Boards that have taken these steps have gone a long way toward ensuring that the association will remain in good physical and financial health, not only for current members, but for owners who purchase in the community for decades to come.

But what happens if, even with careful planning, a common area component that was not included in the reserve study fails? What if a dilapidated perimeter fence that was always thought to belong to a neighboring property turns out to be just over the property line of your association? It was there all along – but no one knew that it belonged to your community.

What if torrential rain storms have caused a common area steep slope to give way which, if left unchecked, may present a serious liability to the association and cause damage to individual homes?

In both situations, there's no need for the board to panic. The National Reserve Study Standards (NRSS), originally published in 1998, provide board members with a four-question test to help determine what does and does not qualify as a common reserve component. The test can help board members determine if an item which was left out of the reserve study can be added and funded by reserves.

To qualify as a reserve component, the Board, with the consultation of experts in the field, will need to answer “Yes” to all four of the following test questions:

1. *Is the component a common area maintenance responsibility?* Perhaps it was listed in the governing documents as a common element and was overlooked at the time of the study. Or the board may be able to argue that there are well-established precedents that allow the item to be defined as a reserve component.
2. *Does the component have a limited useful life?* Nothing lasts forever, but any component, whether it be a roof, an entrance monument or a retaining wall, has a life expectancy that can be estimated by a professional contractor or engineer.
3. *Does the component have a predictable remaining useful life?* Can an engineer or other expert determine how much longer the component will last based on its current condition?
4. *Is the scope of work over a maximum cost threshold?* Depending on the size and budget of your association, the threshold may vary. If the item is going to cost more than the operating budget can absorb, the board should set a threshold amount for items that must be funded in another manner. If the item passes the NRSS test, it may be added as a reserve component and paid for using reserve

funds. If it doesn't pass the test, the board may need to consider a special assessment or a loan to repair or replace the item.

Let's take a look at the two examples above.

Dilapidated Perimeter Fence - For years, maybe decades, the association believed that the fence was on the grounds of an adjacent lot. Now homeowners are complaining about its dilapidated condition, and the board has been told that the fence may be on the association's property. The board hires a surveyor, and sure enough, the fence is on the common grounds of the association. Even though it was not listed in the governing documents and was not included in your last reserve study, it passes the NRSS test – It is an association maintenance responsibility, it has a limited useful life, the remaining useful life can be estimated, and the replacement cost is likely to be over the monetary threshold established by the board for items that can be paid for out of the regular operating budget. The fence can be considered a reserve component and can be paid for using reserve funds.

Common Area Steep Slope Significantly Erodes -- Torrential rains have caused a common area steeply-sloped green space to fail. The slope is now unstable and if nothing is done to correct the issue, homes located at the base of the slope may be directly impacted by water runoff, dirt and debris. An engineer determines that a retaining wall must be built to stabilize the ground and prevent further damage to the common property, and to stop erosion from damaging private property. Is the component a common area maintenance responsibility? Yes, the failing common slope is the association's responsibility to maintain, and if a retaining wall must be constructed to stop further damage, it is the association's responsibility to erect and maintain it. Does the component have a limited useful life? The slope has a useful life, but it will be limited if the retaining wall isn't erected. The new retaining wall will also have its own useful life. The Board can predict that the remaining useful life of the slope is limited and that the new wall will extend the life of this component. The engineer can easily estimate the remaining useful life of the newly constructed wall. In a case such as this, it is very likely that the cost to construct a retaining wall is going to surpass even the most carefully planned operating budget. This wall is therefore eligible to be added as a reserve component.

It's important for board members to seek professional advice from their reserve advisor when dealing with complex issues such as the two listed

above. Keep in mind that each time a new component is added to your reserve item list, your reserve study should be updated. The addition of the new component may alter the original reserve study schedule for repair and replacement, and will require a recalculation of the funds recommended to contribute each year to maintain all of the association's common components. This additional financial obligation will need to be examined and incorporated into future association budgets.

Saving for future repair and replacement is never an easy task. But Boards that seek professional reserve study counseling can make this task more manageable and more palatable for homeowners when it comes time to justify any increase in assessment fees.

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