RESERVE PLANNING –The importance of a good reserve funding strategy is critical to the long-term fiscal stability of every homeowner association. In the absence of adequate reserves the HOA is unlikely to have the money it needs to pay for major repairs and replacement of common area improvements, resulting in the need for special assessments as the facilities under the control of the HOA begin to age.

The future expenditures established by a reserve study represent a long term liability for the HOA. This liability is offset by the accumulation of reserve funds in a sequestered account that is earmarked only for expenses identified in the reserve study as reserve expenses. The extent to which these future, or *forward* obligations, exceeds the amount of money in the Association's reserve fund at any point in time is the *unfunded* portion of the liability represented by the future reserve spending obligations.

Using the formula for allocation of common area expenses that is established by the Association's governing documents it is possible to determine the exact amount of the unfunded reserve liability each owner is responsible for. When an HOA fails to accumulate adequate reserves during the early years of its existence, it is shifting the burden of funding the reserves to future generations of owners.

Later generations of buyers should have a right to know what the future reserve spending liability may be and what their allocated share of the unfunded liability will become if they purchase a home in the HOA. Having this information before finalizing an offer allows the buyer to consider the overall financial impact of owning a home in the HOA where the home is located. This information may then be used to determine whether the purchase price is a fair one, given the unfunded reserve liability they are acquiring by purchasing the home.

A weak reserve funding plan may also result in deferred maintenance of common area improvements when money is not available to pay for needed maintenance and repairs. In general, deferred maintenance of common areas has an adverse impact on the value of the homes within the community. Eventually every buyer becomes a seller. If you are a seller in a community with visible levels of deferred maintenance, the negative impact on the value of your home could be substantial.

For this reason it is imperative that the HOA you are buying into is one that takes the reserve planning process seriously and is financially able to maintain the property without having to defer major maintenance and repair work. This is particularly true of condominiums, but it is also the case with large planned developments in which the Association is responsible for significant common area improvements and amenities.

Every HOA should conduct a reserve study and should fund a reserve account based on the recommendations of a competent reserve study provider. The reserve study should be updated each year prior to the beginning of the new budget year. For most HOAs this date is January 1st. At the present time there are only seven states that require some form of reserve study to be completed, but the laws vary from state to state. Arguably none of them are adequate in terms of establishing the guidelines for conducting a reserve study or the qualifications of the practitioners who are allowed to prepare reserve studies. Virtually all of the statutes in place at this time lack any meaningful enforcement language. There are no fines or penalties for non-compliance other than the threat of the Association being sued by a disgruntled HOA member.

Effective reserve planning requires that the reserve study be updated at least once a year for the same reasons that any financial reporting process is revisited periodically. The reserve study may be compared to a balance sheet or an income statement in terms of the importance of updating the study. A balance sheet or income statement that is two years old may offer some historical insight into the operation of the HOA but it is of little value as far as assessing the current financial condition of the organization. The same may be said for an outdated reserve study.

The reserve planning process is not well understood by most people, including the average board member and a significant percentage of the association managers who work in the industry. The discipline is so arcane that there are even some reserve study providers that do not fully grasp some of the more significant nuances of the reserve planning exercise.

To ensure the financial stability and success of the HOA over an extended period of time the Association must establish policies that transcend the term of any one Board of Directors. These policies should clearly set forth the goal of creating a financial sustainable community beyond thirty years through a systematic and deliberate reserve planning process.