Carnahan Crest HOA 2020 Reserve Study Executive Summary

(Prepared by Gary A. Teale, Treasurer, Carnahan Crest HOA)

INTRODUCTION

Homeowner associations generally have two major accounts: the operating fund and the reserve fund. The operating fund – as its name states – is used for keeping up with day-to-day expenses and ongoing maintenance of the association's assets. This is where the most transactions take place. The reserve fund is essentially a savings account. It is where the HOA saves money for major repairs and replacement of its capital assets (roads, major landscaping upgrades/repairs, fencing, etc.)

Unfortunately, many associations have underfunded reserves. They don't have enough money put aside to cover estimated expenses in the future. Washington State law requires HOA's to have a professional reserve study conducted at least every few years. A reserve study evaluates the condition of major assets and amenities, estimates when they will need to be repaired or replaced, and how much that will cost.

Ideally, an association wants to have a 100% funded reserve, meaning that it has enough money to cover all anticipated costs. However, having at least 70% is a good start. Less than that and the HOA runs the risk of having to implement special assessments or raise association fees to cover costs. This can be a burden on homeowners who must come up with this money on short notice.

Here are a few things to keep in mind when it comes to an association's reserve funds:

- Hire a professional to conduct the reserve study. They know exactly what they are looking for and can guide the HOA in determining how much to save.
- If funding is coming up short, look for ways to readjust the budget and allocate a higher percentage of association fees to the reserve fund. Typically between 25% and 40% of annual fees should be put toward the reserve fund. *(We currently allocate only 10% of our fees towards funding the Capital Reserve.)*
- Be transparent with homeowners about the status of the reserve fund and options for improving funding. This may require a larger increase in dues upfront, or smaller increases each year.
- Stay on top of preventive maintenance to keep assets in good working condition and prolong their lifespan. Repairs and replacement are inevitable, but proper maintenance can help protect against unexpected damages.
- Monitor the wear and tear on assets and amenities to anticipate repairs or replacements and be better able to plan for them when possible.

Note: The above section was taken from an article published by the Kuester Management Group, a homeowner's association consulting firm.

RATIONALE FOR INCREASING FUNDING OF THE CAPITAL RESERVE

An important aspect of living in a common area development such as a Homeowner's Association is the community's ownership and commitment to maintain its common areas.

Association members have a vested interest in maintaining and preserving their investment. To meet these interests, and its legal obligations, the Association should prudently prepare for the future by conducting a Capital Reserve Study, and then "contribute, on a regular and periodic basis, funds into a reserve account. Periodic contributions provide the freedom to gradually accumulate funds for anticipated expenditures while eliminating the need to raise large sums of money through alternative means, such as special assessments." *(RSG Reserve Study, page 10.)*

Homeowners in a HOA should be aware of the benefits of accumulating reserve funds in advance through periodic contributions. These benefits include:

- ✓ Having assurance that funds for major repairs and replacements will be available when needed;
- ✓ Development of an equitable method of charging both current and future owners for the ongoing use of community assets;
- ✓ Preservation of the market value of individual units; and
- ✓ Compliance with governing documents, statutes, mortgages and other similar requirements.

In almost all cases, the preferable mode of funding a capital reserve is through smaller, monthly (or quarterly) contributions, rather than facing large, unanticipated special assessments. In addition, a reserve study conducted by a licensed professional (as required by Washington State Law), provides a HOA with access to information and materials that will assist them in making timely and informed decisions about their reserve fund and contributions.

METHODOLOGY

A reserve study was conducted by the Reserve Study Group (a licensed, professional reserve study company based in Seattle) in August of 2019 for the Carnahan Crest HOA. This reserve study report consisted of two parts: a physical analysis and a financial analysis.

The physical analysis was a result of an on-site collection and review of data specific to the property's major community components (road, fencing, etc.) and common areas (grounds/landscaping). From the on-site inspection and the use of source materials (original costs, property plans, etc.), the reserve study quantified and established the reserve components inventory and assessed the physical condition of the HOA's reserve components. Data from this physical analysis was used to define the scope and timing of future anticipated capital expenses.

The financial analysis evaluated the current status of the HOA's reserve funds in relation to its income and anticipated expenses. It appraised the adequacy of the reserve fund, and associated member contributions, against the current and projected capital expenditures of the Association. As accurately as possible, the study forecasted these expenditures over a 30 year period, based on original costs and projected costs and taking into account anticipated inflation and interest rates. Recommendations were then provided to establish a reserve fund that adequately addresses anticipated capital expenses, without having to resort to special assessments.

FINANCIAL ANALYSIS SUMMARY

1. **Where we are now:**
    - Current Capital Reserve Fund Balance as of November 15, 2019 **= $21,694 (36% of a fully funded Capital Reserve)**
    - Current annual Capital Reserve funding level from homeowner dues = **$4,200 per year (10% of total annual homeowner's fees)**

2. **Where we need to be as per the Reserve Study:**
    - Ideal Capital Reserve Fund Balance = **$59,615**
    - Ideal annual Capital Reserve funding level needed to achieve full funding over a reasonable period of time **= $8,080 per year***

*This amount takes into account both income into and expenditures from the Capital Reserve Fund anticipated over the next 30 years (2020-2050) as adjusted for inflation and interest earned.

Note: A full copy of the Reserve Study may be obtained by asking the HOA treasurer (Gary Teale) for a copy.

OPTIONS TO BE CONSIDERED REGARDING THE CAPITAL RESERVE FUNDING RECOMMENDATIONS

At the present time, the HOA assesses each homeowner dues of $750.00/quarter, with $675.00 going towards funding annual HOA operating expenses, and $75.00 being put into the Capital Reserve fund. This has been a prudent start to establishing our Capital Reserve Fund, which currently stands at $21,694, or 36% of the Ideal Capital Reserve Fund balance of $59,615 as recommended by the RSG Capital Reserve Study. However, it should be noted that our current level of funding for the Capital Reserve is significantly below industry standards.

To achieve the full funding recommendation of the reserve study (from $4,200 to $8,080/year) would require an additional $70.00 per quarter ($280.00/year) per homeowner unit to be put into the capital reserve fund.

The following three options are ones that the board would like to present to the entire association for consideration:

<u>Option 1: Full Funding (100%) of the Capital Reserve as recommended by the Reserve Study</u>

$675/quarter *For Annual Budgeted Operations*	$145/quarter *For Capital Reserve*

$820/quarter per homeowner unit

Benefits:

- Ensures adequate funding for annual operating expenses and capital assets maintenance
- Less likely to require special assessments in the future
- Distributes Capital Reserve funding proportionally among past, current and future homeowners
- Increases the Capital Reserve Fund at the recommended rate

Costs:

- Increases quarterly homeowner's dues by **$70.00/quarter** (an increase of 9.3%)

<u>Option 2: Partial Funding (75%) of the Capital Reserve</u>

$675/quarter *For Annual Budgeted Operations*	$110/quarter *For Capital Reserve*

$785/quarter per homeowner unit

Benefits:

- Maintains adequate funding for annual operating expenses
- Increases funding for the Capital Reserve (but at a lower level than the recommended rate)

Costs:

- Could a require special assessments in the future in addition to regular dues
- When a Capital Reserve is not fully funded it places the responsibility for capital asset maintenance costs disproportionally on current and future homeowners (i.e., past homeowners did not share equally in the cost of using and maintaining the capital assets)
- Increases quarterly Homeowner's dues by **$35/quarter** (an increase of 4.6%)

Option 3: No Change to Current Capital Reserve Funding

$675/quarter *For Annual Budgeted Operations*	$75/quarter *For Capital Reserve*

$750/quarter per homeowner unit

Benefits:

- Keeps homeowner's quarterly dues at current level

Costs:

- Keeps the Capital Reserve funding at a level significantly below industry standards
- May require maintenance for capital assets to be funded from the annual operating budget
- Makes the need for special assessments in the future more likely
- Disproportionally favors past owners over current and future owners
- Could negatively impact future market value of homeowner's units

BOARD TREASURER'S RECOMMENDATION:

While it will mean a 9.3% increase in our total homeowner's dues (regular and capital reserve combined) for next year, I strongly favor Option # 1. This option ensures that we will have adequate funding for our ongoing annual operating expenses, and achieve the full funding of the Capital Reserve as recommended by the Reserve Study.

The last time our homeowner dues were raised was in 2017, by a total of $300/year, an increase of 11.1%. So, an increase of $280/year at this time would not be out of line given our need to more adequately fund the Capital Reserve.

Regardless of the option chosen, I project that because of rising costs due to inflation, we will still require a moderate 3-5% increase each year in the homeowner's annual dues over the next several years to maintain the HOA's financial stability.