

October 2019

Community Associations Newsletter

Keeping up with your Reserve

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The recent Virginia legislative session contained some changes to the provisions of § 55.1-1826 (formerly § 55-514.1) of the Virginia Property Owners' Association Act and § 55.1-1965 (formerly § 55-79.83:1) of the Virginia Condominium Act, both of which went into effect on July 1, 2019. A review of the more recent Virginia Common Interest Community Ombudsman decisions confirms that there has been a focus upon the need to bolster and clarify the budgeting and reserve disclosures for owners and prospective purchasers of property within common interest communities.

This trend in Virginia is also consistent with trends in Maryland and D.C. where there have been articles in local newspapers about communities in dire financial situations due to chronic deferred maintenance and improper budgeting.

Since our [Virginia Legislative Update](#) was issued to our Virginia clients in June of 2019, the response has been consistent and considerable from the management companies and Boards that we do business with, which has been to request practical guidance on how the laws impacting required budget disclosures will impact each community's 2020 budget processes.

First, the terms of the governing documents must always be examined and read in conjunction with the requirements set forth in the applicable state statutes in Virginia, D.C., and Maryland. For many clients, the timing and appropriate format for disclosures will be affected by both sources of authority. For instance, Maryland Condominiums are required to provide the annual proposed Condominium budget to their membership at least thirty days prior to any formal vote to enact the annual budget.

A summary of the Virginia statutory requirements related to the budgeting process and reserve disclosures are below:

- 1) Unless the governing documents provide otherwise, associations must provide the annual budget or a summary of the budget before the commencement of the fiscal year.

- 2) Unless the governing documents provide more stringent requirements, associations must conduct a reserve study every 5 years, annually review the study to determine adequate reserve funding, and make adjustments to maintain reserves as appropriate.
- 3) If the study indicates a need to reserve, the budget must include (with an appendix or otherwise): a) The current estimated replacement cost, estimated remaining life, and estimated useful life of the capital components as defined in §55.1-1900 or § 55.1-1800; b) As of the beginning of the fiscal year for which the budget is prepared, the current amount of accumulated cash reserves set aside, to repair, replace, or restore the capital components and the amount of the expected contribution to the reserve fund for that fiscal year; c) A statement describing the procedures used for estimation and accumulation of cash reserves pursuant to this section; and d) statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves.

Regarding Number 1, the budget or summary of the budget disclosure, this is a new requirement of the Virginia statute, but not one that should pose a considerable impact to most associations, which typically have a disclosure requirement related to the budget (before assessments can go into effect) built into their governing documents. Depending upon the timing of the fiscal year or the annual meeting, associations may benefit from the distribution of the budget with the annual meeting notice, if possible. The clear intent of this requirement is to ensure that associations effectively communicate the budget to all members, as this is at the core of associations' fiduciary obligations.

Concerning Number 2, the reserve study preparation, review and budgeting adjustment requirements, these are not new additions to the law. The 5-year reserve rule in Virginia is well-known in common interest community circles and the statute clearly intends to ensure that boards are considering those studies as they budget every year, not just obtaining the studies and then discarding them to the filing cabinet. In order to comply with appropriate budgeting and maintenance of reserves, to avoid special assessments budget deficits, and related claims boards need to be carefully evaluating the reports and adjusting reserve, repair and maintenance planning accordingly. This does not mandate repairs when they are not needed or mean that any deviations from the last study's funding recommendations are an automatic violation of law, a thought we have heard quite a bit. Boards must instead evaluate their budgets and studies with a holistic eye towards all competing conditions and circumstances, including practical budgeting realities, market conditions, unexpected losses, or financial surpluses, as well as the clear requirements of the law and the governing documents. That being said, a total disregard from the study with a lack of long-term planning is a recipe for financial chaos and claims. The 5-year reserve rule is also a best practice recommended by the Community Associations Institute, but

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there is no mandate in Maryland or D.C. that requires Maryland and D.C. Condominiums and HOAs to obtain a new reserve study every five years.

Regarding Number 3, the required reserve disclosures in the budget, the only **wholly** new requirement is the inclusion in the budget for our Virginia clients of a “statement of the amount of reserves recommended in the study and the amount of current cash for replacement reserves. “

Nearly all of the requirements of this part of the Virginia statute can be met by including the following in the budget package: 1) the reserve study, 2) the reserve contribution (expense); 3) the balance sheet figure for the current reserve funding at the beginning of the fiscal year, and 4) a general statement about the reserve funding process (which can be drafted with the assistance of legal counsel and used with minor tweaks from year to year).

It is clear that the requirements of the statute can't be achieved by looking at a simple and higher level two-page financial document. Instead, we have seen our manager counterparts successfully use exhibits to their budgets to satisfy the required disclosures in a way that does not overcomplicate the financial document.

For our clients in Maryland, the applicable statutes require that the budget include a line item for reserves. For Condominium resales a statement must also be included with a summary of the most current reserve study report as well as a statement of “the status and amount of any reserve or replacement fund, or a statement that there is no reserve fund.” Md. Code, Real Property, Section 11-135(a)(4)(vi). The resale requirements for Maryland are similar, but not as detailed as the Virginia budgetary disclosures.

We have seen community managers utilize summaries of reserve funding requirements, which are taken from audit reports, or sections of the community's the reserve studies to meet the budget or resale disclosure requirements to detail the community's reserve funding requirements and status.

This approach works well to meet the requirements of the law and allow the managers preparing the disclosures to rely upon the precise guidance documents prepared by the reserve and financial professionals guiding the Board's budgeting decisions.

We have also been asked if the new Virginia budgeting disclosure law requires any sort of calculations, projections, or adjustments from the reserve studies by the manager, to explain current useful life left (if a report is mid cycle from the next one). For our clients in Maryland, D.C., and Virginia, we do not recommend that the managers undertake any extrapolations or projections related to the capital components and their estimated useful life. What we statutes do

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require are basic explanations of deviations from the report recommendations, i.e. deferred maintenance. If the budget exhibit appropriately identifies the date of the last study, and any assumptions included in the study as well as anticipated expenditures, this is sufficient to explain that the data provided is a snapshot from a certain point in the association's history.

We do recommend that each association carefully review their applicable state and local laws to ensure that the community's budget and reserve methodology and disclosures comply with applicable law and the published best practices of the Community Associations Institute. Legal counsel together with the community manager can effectively work with the Board to prepare a basic disclosure which addresses the specifics of the reserve funding which may deviate in any way from the recommendations of the last report, or even to prepare a basic narrative disclosure and disclaimer to aid the party viewing the budget and its exhibits, in understanding the reserve requirements and approach, as well as meeting the statutory requirements.

For our Virginia clients, an annual review of the new budget exhibit or disclosure is appropriate to satisfy the requirements of the law because appropriate reserve funding is a moving target. Additionally, as this is a new requirement, we anticipate further interpretations as to the adequacy of the budget exhibit or disclosure.

The Virginia Common Interest Community Board ("CICB") also recently published guidance on preparation and budgetary disclosures related to reserve studies, which is available via the link below:

<http://www.dpor.virginia.gov/uploadedFiles/MainSite/Content/Boards/CIC/Guidelines%20for%20the%20Development%20of%20Reserve%20Studies%20for%20Capital%20Components.pdf>

For all our clients, we wish you a happy budgeting season and are here to assist when called upon!

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