



## Policy FIN-05

### REPLACEMENT RESERVE ACCOUNT

#### 1.0 REFERENCE(S)

- CC&R, Article III, Section 3.05.02.
- Board Motion 2005-024.
- Revised Code of Washington (RCW) 64.38.065 through 64.38.090

#### 2.0 BACKGROUND AND PURPOSE

**Background.** Based on a 2004 internal reserve study, ISHOA started funding a replacement reserve account. The first “full” Reserve Study commissioned by the Board in 2005 included 25 components.

Effective January 1, 2012 Washington State law was significantly revised to delineate several key features relative to Reserve Accounts and Reserve Studies (see RCW reference above). This policy was rewritten in 2020 to reflect current state law and best practices.

**Purpose.** The Replacement Reserve Account was created with the goal of assuring that the major maintenance, repair and replacement of all Association assets, as identified in the annual Reserve Study, will be funded with the goal to not have special assessments. The Replacement Reserve Account is supplemental to the ISHOA’s operating budget and includes funding for items whose infrequent and significant nature make them impractical to be included in the annual operating budget.

#### 3.0 DEFINITIONS

**3.1 “Baseline Funding Level”** shall mean establishing a reserve funding goal of maintaining a reserve account balance above zero dollars throughout the thirty-year study period described under RCW 64.38.065. Using this approach the reserve contribution amount is as low as possible without the Replacement Reserve Account dropping below a zero balance. This is the most risky method with the least contributed to the Reserve Account. If an expense arrives early, or is unexpected, there is a significant chance of needing a special assessment or loan.

**3.2 “Full Funding Level”** shall mean setting a reserve funding goal of achieving one hundred percent fully funded reserves by the end of the thirty-year study period described under RCW 64.38.065, in which the Replacement Reserve Account balance equals the sum of the deteriorated portion of all reserve components. It requires the largest contribution to the Reserve Account, but is also the least risky.

**3.3 “Level II Study”** shall mean an update of the prior reserve study with a visual site inspection. The report updates both the physical and financial analyses of an existing reserve study. An on-site visual inspection is conducted to verify and / or make adjustments to the existing component list, condition assessments, useful life and component valuation

estimates.

**3.4 “Level III Study”** shall mean an update of the prior reserve study without a visual site inspection. The report updates only the financial analysis of an existing reserve study. A Level III Study is recommended to review, adjust, and verify that the existing funding plan is accurate and suitable for current economic conditions.

**3.5 “Remaining Useful Life”** shall mean the estimated time, in years, that a reserve component can be expected to continue to serve its intended function.

**3.6 “Useful Life”** shall mean the estimated time, in years, that a reserve component can be expected to serve its intended function if properly constructed in its present application or installation.

#### **4.0 POLICY**

**41** The Board will annually authorize preparation of a reserve study with the assistance of a reserve study professional. A “Level II Study” will be performed every three (3) years. A “Level III Study” will be performed in other years. The most recent “Level II Study” was prepared in 2019 for use in 2020.

4.1.1 The Board, in collaboration with the Treasurer and Finance Committee, will review and agree on key assumptions utilized in the reserve study.

4.1.2 The Board, in collaboration with the Treasurer and Finance Committee, will provide input on new components to be added to the reserve study based on expenditures approved since the preceding study.

4.1.3 The Board, in collaboration with the Treasurer and Finance Committee, will review and approve the final version of the annual reserve study.

**42** In addition to funding operating expenses, the Annual Budget for ISHOA will provide funding for the Replacement Reserve Account at the “Full Funding Level” as specified in the latest approved reserve study.

4.2.1 Since the monthly dues payments by residents include the Replacement Reserve Account funding, a monthly cash transfer in the amount of 1/12<sup>th</sup> of the annual amount will occur between the Operations checking account and the Replacement Reserve money market account.

4.2.2 In extraordinary circumstances the Board may authorize a temporary funding reduction to the “Baseline Funding Level”.

**43** Expenditures funded by the Replacement Reserve Account shall be made in accordance with **Addendum A: Guidelines for Reserve Account Expenditures**.

**44** The decision to pay for maintenance and repair from either the Operations Budget or the Replacement Reserve Account oftentimes becomes a matter of judgment. The decision to fund an activity through the Reserve Account will in

all instances be made by the Board or its delegated officers prior to commencing the project or activity.

- 4.4.1 Proposed reserve projects or activities that are included and approved as part of the annual budget process receive the authorization of the Board to proceed upon ratification of the annual budget.
- 4.4.2 Any proposed reserve project or activity that was not included in the annual budget process must be reviewed and approved by the Board before it can commence.
- 4.4.3 In cases of great urgency, reserve funded activities can be authorized through joint agreement of the Board President and the Treasurer.
- 4.4.4 In all instances, the Board must authorize the transfer of funds from the Replacement Reserve Account to pay the final expenses incurred by each project or activity.

**45** As provided in Policy FIN-07 Reserve Account Investment, the Board will engage a Professional Investment Manager. Transfers to or from the account with the Professional Investment Manager shall only occur after said transfers are approved by the Board.

- 4.5.1 Effective with the 2021 budget process, the Board, in collaboration with the Treasurer and Finance Committee, shall prepare and specifically approve a one-year Cash Flow Plan related to the Replacement Reserve Account. The Cash Flow Plan will specify the timing of approved withdrawals for Reserve projects or activities funded by the Replacement Reserve Account, as well as the timing for investment of any excess funds.
- 4.5.2 To assist the Professional Investment Manager with long-term portfolio management, the Treasurer should annually provide longer term cash flow information as derived from the Reserve Study's 30-year expenditure plan, the most recently approved ISHOA budget and any board-approved long range plans.
- 4.5.3 Additional transfers, not specifically included in the approved Cash Flow Plan, shall be separately reviewed and approved by the Board prior to the transfer to or from the Replacement Reserve Account.
- 4.5.4 All transfers will occur via electronic means with the signatures of two (2) Board Officers required on any documentation.

**46** Investment income derived from the Reserve Account shall only be allocated to the Replacement Reserves, not to operations.

**47** While not encouraged, RCW 64.38.075 provides that an association may withdraw funds from its reserve account to pay for unforeseen or unbudgeted

costs that are unrelated to maintenance, repair or replacement of reserve components. In such cases, the Board shall record any such withdrawal the Board approves in the minute books, cause notice of such withdrawal to be sent prepaid by first-class U.S. mail to the designated mailing address of each owner and adopt a repayment schedule not to exceed twenty-four (24) months.

## **5.0 RESPONSIBILITY FOR POLICY**

The Board, in collaboration with the Treasurer and Finance Committee, is responsible for enforcing, maintaining and keeping this policy current and to obtain Board approval of changes, as necessary.

## **6.0 EFFECTIVE DATE AND RECORD OF AMENDMENTS**

**05/19/2005**, Original Policy 2005-010, per Board Motion 2005-024.

**03/19/2015**, Reformatted and renumbered policy to FIN-05 (per new policy ADM-01, Policy Numbering and Format), Board Motion 2015-011.

**08/19/19**, Amended Policy by Board Motion 2019-039, Clarified Reserve Study purpose, Effective September 16, 2019.

**10/19/20**, Amended Policy by Board Motion 2020-075; incorporating language regarding responsibilities of the Finance Committee.

## **Addendum A: Guidelines for Reserve Account Expenditures**

RCW 64.38.065 encourages homeowner associations to establish a Reserve Account with a financial institution to fund major maintenance, repair, and replacement of common elements owned by the association. The Reserve Account is supplemental to the association's operating and maintenance budget; and it is funded in accordance with the projections generated through a reserve study that estimates the anticipated major maintenance, repair, and replacement costs of the HOA's reserve components over a 30-year period. Per RCW 64.38.010, a "reserve component" means a common element whose cost of maintenance, repair, or replacement is infrequent, significant, and impractical to include in an annual budget.

As specified under State law, the Reserve Account is established for the purpose of funding major maintenance, repair, and replacement of reserve components (HOA assets). The Reserve Account cannot be used to acquire new assets or to replace assets without regard to their remaining useful life; additionally it is not intended to be used to pay for repairs or maintenance that are a routine in nature and can be reasonably estimated and paid as part of the annual Operations Budget.

It is important to remember that the Reserve Study is a planning tool. Just because the Reserve Study indicates that a specific component's useful life will expire in the coming year doesn't mean that the component is automatically replaced. The Board should carefully assess the condition of each component before authorizing its replacement when the remaining useful life is zero.

Maintenance and repair of the HOA's assets are activities whose costs are recognized as appropriate in both the annual Operations Budget and the Reserve Account. The purpose of the Operations Budget is to pay the Association's day-to-day expenses that arise throughout the year. There are many general maintenance and repair costs that can be considered routine, ordinary, and/or fairly predictable and reasonably similar in cost from year to year. These costs belong in the annual Operations Budget.

The Reserve Account, on the other hand, is intended to be accessed for maintenance and repairs that are infrequent, often unpredictable, and of significant cost beyond amounts normally planned in the Operations Budget. Such expenses would normally be impractical to be included in an annual budget because of their magnitude and/or fluctuating occurrence. In addition to repairs and maintenance, the cost to replace an asset can be charged wholly to the Reserve Account when an asset has reached the end of its estimated remaining useful life (RUL) or when it has been determined that it is more cost effective to replace rather than repair such an asset.

### Operations/Maintenance Budget:

- All costs of the Association that are not specifically approved to be charged to the Reserve Account, i.e., any cost not directly related to major maintenance, repair or replacement of an HOA asset identified as a reserve component.

- Costs of routine maintenance of an asset performed to keep it working properly during the year. The maintenance might be scheduled annually or it might be estimated to be needed on reasonably predictable timeframes
- Costs of a wide variety of asset repairs that are known or reasonably expected to occur on a fairly regular basis throughout the year
- Costs of acquisition of any new HOA asset that is not a replacement of a current asset
- Costs related to replacing a current reserve component (asset) for reasons unrelated to its current functionality or remaining useful life (costs shared Operations/Reserve based on RUL)

Reserve Account:

- Costs that are directly related to major maintenance, repair or replacement of an HOA asset that is included in the most recent Reserve Study
- Costs of asset maintenance that occurs less often than annually and has a substantial cost that can't be programmed into the annual Operations Budget
- Costs of repairs beyond those normally anticipated and funded in the Operations Budget which restore the asset to its fully operational status
- Costs to replace an asset that has reached the end of its scheduled remaining useful life
- Costs to replace a worn out or broken asset with a new asset of equal capability and quality. Any extra costs associated with a replacement asset that has a more appealing appearance or upgraded capabilities would normally be shared with the Operations Budget.