CID Major Repair & Replacement Obligations

Under Recognized, Underfunded, Under Disclosed

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The central finance question in Common Interest Developments (CIDs) is: **Who pays—when, why, and for what?** And the most challenging financial and political issue within that question is the periodic (non-annual) Major Repair & Replacement (MRR) maintenance obligations—commonly and erroneously referred to as reserves. A conversation for another day.

My contention is, after over 40 years rummaging around in the CID finance forest, that these MRR obligations are underestimated, hidden in "back of the book" disclosures, vastly underfunded (like billions of dollars), and under disclosed to HOA stakeholders (once a year in small print at the back of the budget).

Why should you care about this issue?

My assumption is that the reader is a community manager, leader, or advisor with a duty to counsel unaware board members, owners, and other stakeholders about the range and domain of this problem in their community. This issue is like climate change. Filled with deniers, disputers, distractors, and delayers. Time for industry professionals to ring the bell, champion change, and influence outcomes.

Hopefully, this deposit to the pool of knowledge resonates with the reader, stimulates a deeper dive into the subject, and moves the needle on the recognition, funding, and disclosure continuum.

Why does this problem exist and persist?

I submit for your consideration:

1. **A general lack of financial literacy in the CID world.**
2. **Willful blindness (a conscious avoidance of the truth) by CID leadership & advisors.**
3. **Conflict avoidance—an unwillingness and inability to engage stakeholders in productive conflict about harsh realities.**
4. **Faulty theory, bad data, poor analytic techniques, and lack of agreed upon standards.**
5. **The incorrect, illegal, and institutionalized belief that the primary financial function of CID boards of directors is to minimize regular assessment increases.**
6. **Indecipherable, definitionally deficient, and computationally challenged finger-in-the-dike legislative interventions.**
7. **Governing document and statutory constraints that prevent responsible CID leadership from acting when indicated. Consider the Champlain Towers condominium building collapse. The directors knew the problem's nature and the $15 million cost to cure. The governing documents and state law prevented the Board from acting. Ninety-eight people died.**
8. **The lack of an effective, well-funded enforcement mechanism. Think a regulatory body like the California Manufactured Home Division of the Housing and Community Development Department.**

What follows is a plain language summary of:

1. **Existing law or standards.**
2. **Existing state of play—under recognized, underfunded, under disclosed.**
3. **What should be done.**
4. **What will be done.**

With that preamble, let's get to it.

1. Existing California Law:

a. **Civil Code §5600.** Duty to Levy Assessments. "(a) Except as provided in Section 5605, the association shall levy regular and special assessments sufficient to perform its obligations under the governing documents and this act."

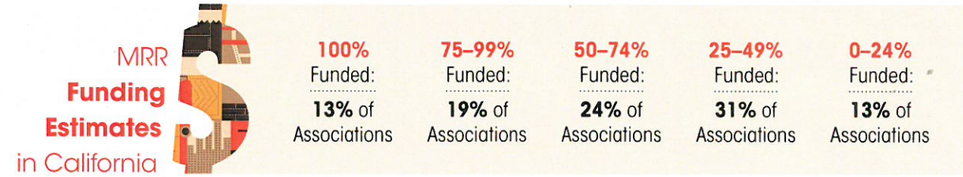
b. **The 1981 California Supreme Court Raven's Cove Decision** requires Associations "... to assess each unit for an adequate reserve fund..." Note: no legislative or case law further defines "adequate."

c. **Governing Documents.** A Covenants, Conditions, and Restrictions (CCR) example: "14.8 An adequate reserve fund for replacement of improvements in the Common Area must be established and must be funded by regular monthly payments rather than by special assessments." Other typical current CCRs will have variations of this requirement.

d. **Governing Documents.** A maintenance standard of care example: "... assessments levied ... shall be used exclusively ... for the improvement and maintenance in a first-class condition and in a good state of repair of the Project, services and facilities devoted to this purpose ..." Other typical current California CCRs will have variations of this ascertainable standard of care.

e. **Civil Code §5550.** Reserve Study Requirements. "(a) At least once every three years, the board shall cause to be conducted a reasonably competent and diligent visual inspection of the accessible areas of the major components that the association is obligated to repair, replace, restore, or maintain ... The board shall review this study, or cause it to be reviewed, annually and shall consider and implement necessary adjustments to the board's analysis of the reserve account requirements as a result of that review."

f. **Civil Code §5570.** Reserve Funding Disclosure Form. A one-page funding status and future assessment disclosure to be included in the annual budget package.



Source: www.ch-pm.com/media/images/pages/ReserveFundingPercentages.pdf

Based upon existing law and governing document agreements, rational law-abiding aliens from another planet would conclude that future CID major repair & replacement obligations would be adequately estimated, funded, and disclosed. They would be wrong.

2. Existing State of Play:

a. Under Recognized. There are three classes of accounting events: recognized, disclosed, disregarded. There are extensive Accounting Standards Code (ASC) principles, rules, and guidelines that sort accounting situations and events into those three buckets, which we will not explore here. Over the last 40-plus years there has been raging controversy about the accounting nature of CID MRR obligations. Our firm deems these obligations "Probable & Reasonably Estimable," records them on the balance sheet, and places an underfunding "Warning Label" on the first page. Thereby, clearly disclosing to the readers the difference between the "accrued obligation," the current funding position, and future funding cures. Based upon 1991 guidance, most accountants disclose these obligations in "Supplemental" information at the back of the financial reports in secret code and do not estimate or connect the dots between the should-be obligation and the actual funding position.

b. **Underfunded.** Since there is no generally accepted definition for "adequately funded" established by California law or the replacement study profession, it is hard to know what the underfunding dollars are. Moreover, there is no data gathering mechanism that would disclose the statewide funding deficit. Therefore, we are left with anecdotal evidence from replacement study professionals, community managers, bankers, and accountants. That anecdotal evidence suggests a vast underfunding exists. Probably, billions of dollars in California alone.

c. **Under Disclosed.** California is one of the few states that require MRR studies and annual updates. It also requires an annual "percent funded" calculation and possible special assessment disclosures as part of the annual budget production process (CC 5570). Neither of which passes the clear, credible, consistent tests. Three MRR study specialists will produce three wildly different results on the same property.

A percent funded calculation requires a denominator. There is no statutory definition of a major component or what major components should be included in the denominator. And, we have not even considered the other variables—typical lives, remaining lives, current cost to replace, inflation assumptions, and investment yield assumptions.

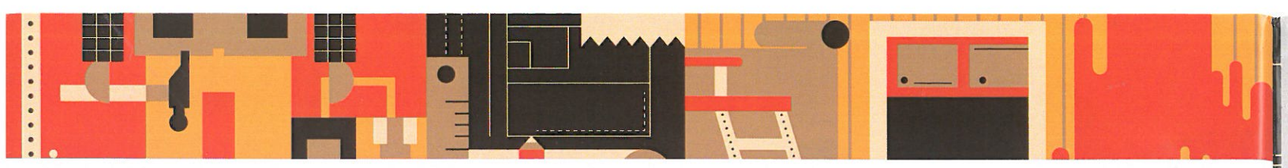
When CID Boards of Directors do not like the MRR study outcome, they will direct the MRR study specialist to adjust the numbers until they get an answer they want. The study specialists cannot push back against such demands because they have no standards, rules, or consequences that protect them from opinion shopping. They cannot say, "In our opinion the denominator should be X, but the client wants it to be Y."

Bottom line: Ask the CID owners the Goldilocks question—is the current funding level for future major repairs and replacements too much, too little, or just right? With rare exceptions, the answer will be "I don't know." Until you can get clear, consistent, credible studies, agreed upon computational standards and rules, and the correct answer from most owners, the situation is under disclosed.

3. What Should be Done:

a. **Financial Reporting.** While we can argue about and develop the rules and methods of doing so, the annual audits and reviews as well as internal monthly interim financial reports must include a reasonable estimate of these MRR obligations. The "modified accrual" and "contract liability" methods must go away as options. They are misleading and fail to reflect the CID's economic reality.

A good "warning label" on title pages disclosing or pointing to where the recognition and funding gap information is located. A belt and suspenders standard.



b. **Legislative Restatement.** This under recognized, underfunded, under disclosed problem should be assigned to the California Law Review Commission (CLRC). Its mission is to assist "... the Legislature and Governor by examining California law and recommending needed reforms." This commission handled the 2014 Davis-Stirling Act restatement. If ever there was a time for legislative reform, and a consumer protection regulatory body, it is now. This problem-resolution process needs to be taken out of the lobbyists' and legislators' hands.

c. **Replacement Study Revisions.** Current MRR studies lack generally accepted nationwide standards, codes, methods, reports, opinions, and enforcement mechanisms. Replacement study practitioners working in concert with other professions and stakeholders should develop and implement those professional elements. The harsh reality is that they do not have the resources or intent to do so. Therefore, state legislative bodies and industry special interests will act. Resulting in misguided, inconsistent, irrational finger-in-the-dike, legislative interventions across the country. It won't be pretty, and the compliance cost to CIDs won't be trivial.

d. **Regulatory Oversight & Enforcement.** In my opinion, the case for a well-funded CID regulatory body to oversee and enforce laws in the CID world is clear and compelling. There will be great resistance to this concept by CID industry professionals. Yet, most will privately admit that the CID governance model is simply incapable of self-regulation, dispute resolution, and statutory funding compliance.

e. **Stakeholder Communications.** The operative words here are "over communicate." We tend to underestimate how many times the message needs to be delivered to obtain the "Aha" moment. The goal: No CID stakeholder can ever assert they did not know and understand who pays—**when, why, and for what?**

"Time for industry professionals to ring the bell, champion change, and influence outcomes."

4. What Will be Done:

Without a "we cannot ever let this happen again" crisis event, not much. Initiating change in the California CID world is crisis driven, reactive, underfunded, logically impaired, and incremental. As our CID attorneys frequently conclude, outdated governing documents cannot be amended. They need to be restated. Such is the case here. However, change makers are generally busy volunteers and legislators without the time, talent, or treasury to develop a more robust, rational, responsible restatement, which is why the CLRC should assume this assignment.

So, there you have it. My contribution to the conversation.
I wish you well.

*While **Donald Haney** is no longer active in the day-to-day company operations, he provides his expertise and guidance to the company's CEO and its leadership team. As the company's founding member, he was the principal architect of the firm's technology environment, its business model, its operating procedures, its core values, and its leadership culture. He continues to coach and train staff and clients on a variety of CID operational and organizational development subjects. He writes articles for publication for CID trade journals. He obsesses about work product quality, process improvement, organizational health, and the client experience. He questions the status quo and disrupts conventional wisdom.*

Mr. Haney is the principal shareholder in Haney Accountants, Inc., a California CPA licensed corporation and the Managing Member of the CID Consortium, LLC, a CID Community Management Company. His firms have been providing virtual controllership, management, and leadership coaching services to CIDs for over 45 years. He can be reached at 888.786.6000 x325 or dw@haneyinc.com. Email him your questions, and he will get to as many as he can. If you have ideas about future commentary on this subject or others, contact him.