RESERVE FUND STRENGTH (% FUNDED)

A Guide to Help Managers & Board Members Understand an Association’s Reserve Fund Strength
Robert M. Nordlund, PE, RS is the Founder/CEO of Association Reserves, Inc. Established in 1986, Association Reserves is a professional Reserve Study company serving Association-governed communities of all shapes and sizes. Robert’s organization performs approximately 3,000 Reserve Studies each year, with a staff of 19 Reserve Specialists™ in 11 regional offices throughout the United States.
 Reserve Fund Strength

This pyramid represents the relationship of the three key elements of a Reserve Study.

- The **Component List** serves as the foundation by spelling out the scope & schedule of all necessary repairs & replacements.

- “Reserve Fund Strength” is a calculated ratio that compares the actual amount in Reserves to the current value of Reserve Component deterioration.

- The **Funding Plan** is a calculated plan of regular monthly assessments and/or special assessments necessary to perform the repairs & replacements in a timely manner.
SECTION 1:

HOW MUCH IS ENOUGH?
Instinctively, we all know that large associations with many common area amenities should have a high Reserve Fund balance.

Similarly, small associations with only a few common area amenities can get by with a much lower Reserve Fund balance.

“But every association has different Reserve requirements depending on the scope and schedule of their Reserve projects.”
Let’s try a simple exercise.

An acquaintance tells you he’s the Treasurer of his homeowner’s association, and he’s just been reviewing the current financial statements. His association has $500,000 in their Reserve account, so he thinks they can probably cut next year’s Reserve Funding Plan. After all, they’ve got half a million in the bank, right?

**Dollar balances don’t tell the whole story!**

You know nothing but what he’s told you. If the treasurer lived in a fairly new condo building with one pool and a tennis court, you’d probably figure they’re in great shape.

But what if he represents an aging 200-home community with crumbling roads, dilapidated amenities, and a 3,000 square foot clubhouse that needs a new roof and a paint job? How would that change your perception of things?
HOW MUCH IS ENOUGH?

*It Depends!*

It requires a comparison of the size of the Reserve Fund to some kind of benchmark.

National Reserve Study Standards (NRSS) define this benchmark as the “Fully Funded Balance”.

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SECTION 2:

FULLY FUNDED BALANCE 101
National Reserve Study Standards (NRSS) were established in 1998 by the Community Associations Institute.

(NRSS introduced standardized industry terminology, so a term that appears in one Reserve Study will have the same meaning in another Reserve Study.)

Computed terms, like “Fully Funded Balance” and “% Funded” are clearly defined.

Because of National Reserve Study Standards, there is one “right way” to prepare a Reserve Study!

A Reserve Specialist™ is a professional who has earned recognition in reserve planning by meeting rigorous qualification requirements in the areas of education, experience, work product and professional references.
**FULLY FUNDED BALANCE (FFB)**

**Definition:** The value (in dollars) of Reserve Component deterioration, as of a specific date

Deterioration is normal & inevitable!

The physical deterioration of a building starts the moment new construction is completed and starts afresh after each cycle of common area repairs & replacements.

Component deterioration can be “quantified”.

*Calculation:

\[
 FF B (\$) = \text{Current Cost (\$)} \times \frac{\text{Effective Age (years)}}{\text{Useful Life (years)}}
\]

* This calculation is made separately for each component then summed together to arrive at the total FFB for the Association.
The data needed to calculate Fully Funded Balance (FFB) is found in a Reserve Study’s “Component List”. Remember, the Component List details the Schedule & Scope of every Reserve project, where:

**Effective Age** = Useful Life (UL) – Remaining Useful Life (RUL)

We’ll use Component #101- Composition Shingle Roofing (shown in red) on the Component List above in the “Roof Only” Fully Funded Balance (FFB) example that follows.
FULLY FUNDED BALANCE (FFB)
“Roof Only” example

• It’s the first day of the Association’s Fiscal Year
• The roof of the Association was replaced 5 years ago
• Life expectancy of the roof is 20 years.
• Current cost to replace the roof is $100,000

How much money should the Association have already saved to be “on pace” with the roof’s deterioration?

\[
\text{FFB} (\$) = \frac{\$100,000 \times (20 - 15) \text{ years}}{20 \text{ years}}
\]

Answer: $25,000

The roof has “used up” 25% of its Useful Life, so it makes sense that the Association should have 25% of the $100,000 replacement cost on hand as of today.

But remember, this calculation is actually made for each component then summed together to arrive at the Total FFB for the Association.
ASSOCIATION RESERVES
LOYALTY UPDATE PLAN

Makes sure your Reserve Study is never out-of-date with a 3-year series of “Flat Fee” engagements.

✓ Lock in a fixed price
✓ Stabilize the budget
✓ Save time & energy
✓ Maintain continuity through Board transitions

Learn More
SECTION 3:

% FUNDED: WHAT IT MEANS & HOW TO CALCULATE IT
Saving is a very fine thing, especially if your parents have done it for you!

- Winston Churchill

Now that we understand that the total Fully Funded Balance measures total deterioration, we can take the process a step further.

We are able to calculate in real terms exactly how well the total Reserve Fund has “kept pace” with deterioration.

An Association’s Reserve Fund “strength” can only be measured using % Funded!
% FUNDED CALCULATIONS
Typically calculated & reported as of the first day of the Association’s Fiscal Year

It is IDEAL to have \( \% \text{ Funded} = 100 \% \)

(This would mean your Reserve Fund Balance is equal to your Fully Funded Balance)

To get this number, simply tally the amounts indicated on bank or investment account statements.

Click here to learn more!
% FUNDED CALCULATION

Going back to our earlier “Roof Only” example...

If the Association has $25,000 in reserves for the roof and the roof’s Fully Funded Balance is $25,000, what is the roof’s % Funded?

\[
\text{% Funded} = \frac{\text{Reserve} \times \text{Age}}{\text{FFB}} = \frac{25,000 \times 20}{25,000} = 100\%
\]

Answer: 100% Funded

Remember, roof % Funded measures how well the roof Reserves have kept pace with roof deterioration, and 100% Funded means perfectly “on pace” throughout the life of the roof!

<table>
<thead>
<tr>
<th>Year</th>
<th>UL</th>
<th>RUL</th>
<th>Eff Age</th>
<th>Reserve $</th>
<th>FFB $</th>
<th>% Funded</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>20</td>
<td>20</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>100%</td>
</tr>
<tr>
<td>5</td>
<td>20</td>
<td>15</td>
<td>5</td>
<td>$25,000</td>
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<td>10</td>
<td>20</td>
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<td>10</td>
<td>$50,000</td>
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<td>100%</td>
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<tr>
<td>15</td>
<td>20</td>
<td>5</td>
<td>15</td>
<td>$75,000</td>
<td>$75,000</td>
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<tr>
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<td>0</td>
<td>20</td>
<td>$100,000</td>
<td>$100,000</td>
<td>100%</td>
</tr>
</tbody>
</table>
If the Association has a total of $250,000 in Reserves and the Association’s total Fully Funded Balance (for all components) is $250,000, what is the Association’s % Funded?

\[
\text{% Funded} = \frac{\text{$250,000$}}{\text{$250,000$}}
\]

Answer: 100% Funded

Remember, % Funded measures how well total Reserves have kept pace with total deterioration, and 100% Funded means perfectly “on pace” throughout the life of the Association.
Now let’s say that instead of $250,000, the Association only has $50,000 in their reserve account at the start of their fiscal year...

\[
\text{% Funded} = \frac{50,000}{250,000} \times 100 = 20\%
\]

Answer: 20% Funded

A “% Funded” of 20% means being substantially “behind pace” compared to common area deterioration.

“Underfunded”
Associations face a high risk of needing a Special Assessment to perform repairs & replacements in a timely manner.
But what if instead of $250,000, the Association has $300,000 in their reserve account...

\[
\% \text{ Funded} = \frac{300,000}{250,000} = 120\%
\]

Answer: 120% Funded

A “% Funded” of 120% means being substantially “ahead of pace” compared to common area deterioration.

“Overfunded”
Associations face a low risk of ever needing a Special Assessment to perform timely repairs & replacements.
Underfunding Reserves

Click the PHOTO below to learn more!
SECTION 4:

WHY % FUNDED MATTERS
Now that you understand “% Funded” and how it is calculated, you might be wondering why it is so important...

TWO REASONS

1. It is an independent and meaningful measure of Reserve Fund Strength

2. It is a reliable predictor of the need for a Special Assessment to perform timely repairs & replacements
Independent & Meaningful Measure of Reserve Fund Strength

Going back to that Treasurer acquaintance...

He knows the amount of the Reserve Fund is $500,000, but does he really know if the Reserve Fund has “kept pace” with the actual common area deterioration?

- Can he assure the homeowners that the Association is in a position to perform timely repairs & replacements without requiring a Special Assessment?
- Is he prepared to have prospective buyers rely on his layman’s assessment of the situation to make an informed purchase decision?

“% Funded” is the only independent & meaningful measure of whether an Association is underfunded, overfunded, or perfectly on pace.
Reserve Fund Strength

Reserve Fund < Deterioration

Underfunded

Reserve Fund = Deterioration

100% Funded

Reserve Fund > Deterioration

Overfunded
Special Assessments are necessary to compensate for the deficit created by years of “underfunding” reserves...

and % Funded is a reliable predictor of “Special Assessment Risk”!
The risk of needing a Special Assessment to perform timely repairs & replacements can be predicted based on the “strength” of the Reserve Fund.

Reserve Fund Strength

Data provided by Association Reserves, Inc
www.reservestudy.com
As a general rule...

0 - 30% Funded → Reserve Fund is considered “Weak”.
High risk of special assessments and deferred maintenance

40 - 60% Funded → Reserve Fund is considered “Fair”.
Some risk of special assessments and deferred maintenance

70 - 130% Funded → Reserve Fund is considered “Strong”.
Low risk of special assessments and deferred maintenance
An Association with a Strong Reserve Fund

[ 70 – 130% Funded ]

is able to perform timely repairs & replacements without needing a Special Assessment.

A well funded Association is also in a position to absorb minor surprises, like a roof that fails a year earlier than expected or a re-painting project that cost more than predicted.
Underfunded Associations

who can’t pass a Special Assessment to offset their reserve funding deficit face many other challenges...

Deferred maintenance
Mortgage eligibility

Decline in property values
Boardmember liability
Our eBook series includes three publications:

- Reserve Component Lists
- Reserve Fund Strength (% Funded)
- Funding Plans

Click here to download our “Reserve Component Lists” EBook