RESERVE STUDY TIPS THAT MAKE A DIFFERENCE: WEBINAR OUTLINE

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What's the Difference between the Operating Budget & the Reserve Budget?

The Operating Budget is for the daily/weekly/monthly expenses at the association, while the Reserve Budget is for the major common area repair & replacement expenses.

Which Components should be funded through Reserves?

See below for the four-part test found in National Reserve Study Standards, which defines which projects should be funded through Reserves (there is no master list of "appropriate components", just this four-part test)

RESERVE COMPONENT "FOUR-PART TEST"

What do you look for in a completed Reserve Study?

Reserve Studies prepared according to National Reserve Study Standards will have three results:

RESERVE STUDY RESULTS

Every Reserve Study is based on the "foundation" of the Reserve Component List (with components selected according to the National Reserve Study Standard four-part test). The Component List defines the scope and schedule of all your Reserve projects (expenses). Your Reserve Fund Strength is typically measured by a term called Percent Funded (which compares your actual Reserve Balance to the deterioration at the association). This tells you if you have "enough". The Recommended Funding Plan is the third result. This Funding Plan (typically consisting of monthly contributions) is the amount the association needs to set aside in order to offset ongoing deterioration.

<u>How do we calculate Reserve Fund Strength?</u>

It is a comparison of current Reserve Component Deterioration (the Fully Funded Balance) to Reserve Cash Balance, typically as-of the first day of each Fiscal Year. When they are in balance, the association is 100% Funded. If deterioration has outpaced Reserve contributions, the association is underfunded.

How is it computed?

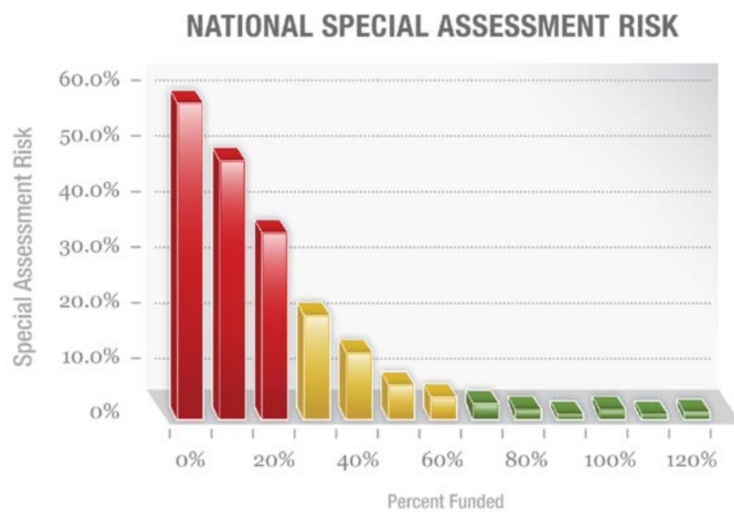
Percent Funded = Actual Reserve Balance / Fully Funded Balance (typically reported as-of the first day of the fiscal year

Note: **Fully Funded Balance** = (Fractional Age) X Current Cost

Where Fractional Age typically is calculated as (UL – RUL) / UL

Why is Reserve Fund Strength significant?

Associations can predict their risk of special assessments and deferred maintenance based on their Percent Funded. The lower the Percent Funded, the higher an association's risk of insufficient funds to perform their Reserve projects in a timely manner.



Bottom line: "enough" is not measured by a cash balance in Reserves. "Enough" is measured by comparing your Reserve Balance to the needs of your association (the value of deterioration of your common area components). The lower your strength (Percent Funded), the more likely your association is to need a special assessment in order to accomplish your anticipated Reserve projects in a timely manner.

How much do we need to contribute to Reserves?

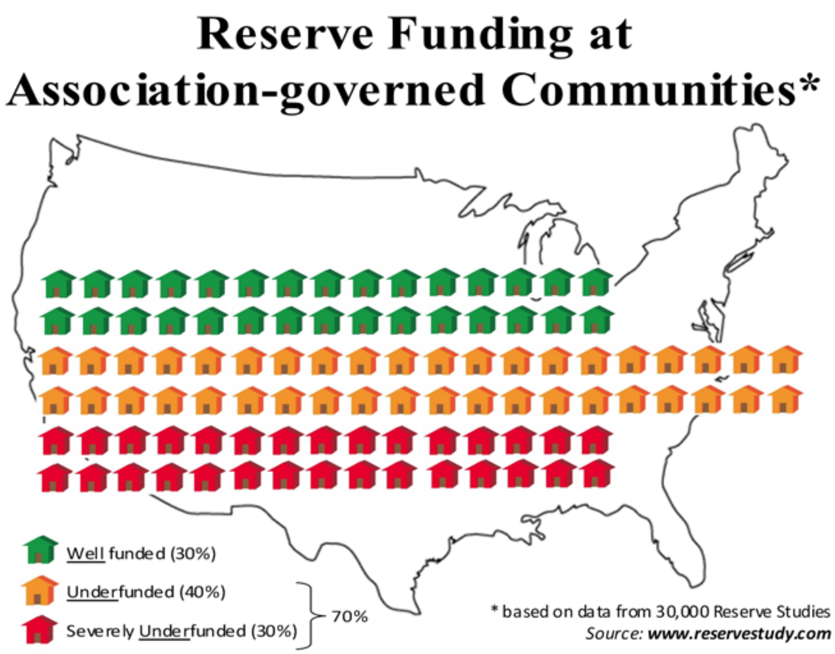
Again, that's a number found in your Reserve Study. Without it, you're forced to guess! Your Reserve Study will recommend a budgeted set-aside to Reserves that will offset ongoing deterioration at your association, providing sufficient cash to perform your anticipated Reserve projects in a timely manner. Often this is in the range of 15-40% of an association's total budget.

Note: that 15-40% is well above the 10% of total budget minimum requirement established by the FHA. In other words, adequate Reserve contributions are typically much higher than 10% of an association's annual budget.

Isn't that an unrealistic objective?

No, for two reasons:

One: Approximately 30% of associations in the country have a "strong" Reserve Fund (their Reserves are 70-130% Funded). That's a healthy fraction, proving that responsibly offsetting ongoing deterioration with appropriately-sized contributions is not unrealistic. See the graphic below for the fraction of associations in the well funded, moderately underfunded, and severely underfunded ranges.



Two: Adequate Reserve contributions for the average condo association are typically in the range of a premium coffee per day, per unit. That's not a lot of money.

What's the best strategy for making the "sale" for raising our contributions in order to adequately fund our Reserves?

- Avoid surprises
- Maximize Property Values (Reserve contributions become roof repairs, paint, asphalt resurfacing, etc.), a great investment in your own home!
- Focus on the "here and now" of everyone paying their fair share during the time they are a member of the association. Totally avoid discussing Reserves in terms of "future" issues, that people tend to discount and ignore.

Can we borrow from Reserves (for an Operating Budget shortfall, or surprise)?

Yes, but make sure it is only borrowing. The Reserve funds were collected for a specific purpose. Spending those funds will create or exaggerate your Reserve shortfall.

Can we legitimately spend Reserve $ on a project not listed in our Reserve Study?

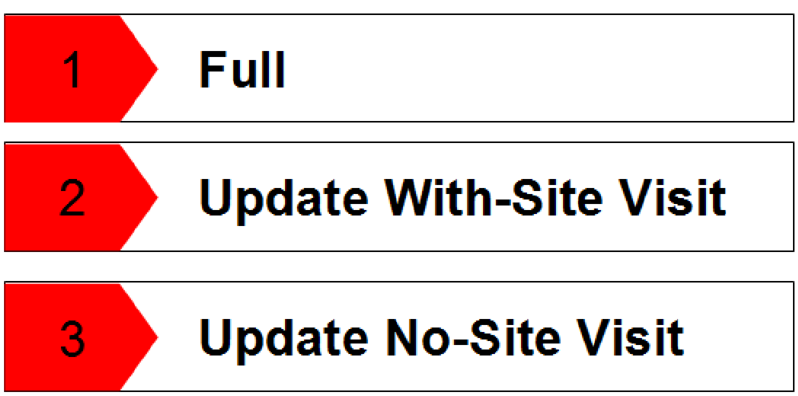
Yes – if it passes the National Reserve Study Standard four-part test. If due to human error or true surprise it doesn't appear in your Reserve Component List, spend the $ from Reserves, and include the new expenditure in your next Reserve Study update, so you'll be prepared next time around.

Aren't Reserve Studies kind of expensive?

The stereotype of being expensive doesn't hold true. In the field of Reserve Studies, there are three Levels of Service:

- Full (do once)
- Update With-Site-Visit (typically over 50% of the cost of a "Full" Reserve Study)
- Update No-Site-Visit (typically well under 50% of the cost of a "Full" Reserve Study)

So the first Reserve Study, your "Full," will be your most expensive. After that, your updates will be <u>significantly</u> less expensive.



Audience Questions after the session

Q: How often should a Reserve Study be updated?

A: The Reserve contribution rate is so large (typically 15-40% of the association's total budget) that it is one of your association's largest budget line items. As such, it deserves annual attention. The condition of your assets change each year, the expected repair or replacement costs change each year, your Reserve Balance changes each year, so after one year it all needs to be updated and re-balanced.

Q: Why should we do a Reserve Study if it's not required in our state?

A: A Reserve Study provides owners with an annual report on the status of the association's major physical and financial assets. In addition, it provides a roadmap to the future, showing the Board and the owners the contributions needed to care for the common area assets. You prepare a Reserve Study update because such information is valuable to the association, not because it's required by State Law.

Q: Where can I find National Reserve Study Standards?

A: The easiest place to find them is on the Association Reserves website, www.ReserveStudy.com, in our "Learning Center. Click here to view.

Q: Why update your Reserve Study annually if your major projects are many years away?

A: Because major projects take years of financial preparation. If a roof project is 10 years away, you'll need all 10 years to prepare. You don't want to wait 5 years and find out that your Reserve interest has been lower than you expected, or you didn't make all your planned Reserve contributions, and labor and material costs have changed enough that you are way off on your cost expectations. You want to be making progress towards your goal each of those 10 years, not spending any of those years drifting away from your objective of getting prepared.

Q: What happens to the money if you don't do a scheduled Reserve project?

A: Those funds remain available for that project or any other Reserve project, strengthening the Reserve Fund. Adjust the Remaining Useful Life as appropriate. If the project needs to be done, keep the Remaining Useful life at zero. Otherwise, adjust the

Remaining Useful Life accordingly. All just a normal part of the annual Reserve Study update process!

Q: Can you address the difference between "Straight Line" and "Cash Flow"?

A: Both are funding methods. Both provide funds for the exact same set of expenses at the association. In a side-by-side comparison where both methods are used to achieve a Full Funding objective, the resulting straight line contributions are typically 10-15% higher because Reserve funds are used more efficiently in the Cash Flow method because they are not restricted to use on a particular component. That means contributions calculated using the Cash Flow methodology, even with the same funding objective and component list, are slightly more favorable to the association.

Q: What is a good threshold to use to decide between a minor operating expense and a Reserve expense… what cost is too small for Reserve designation?

A: Typically operational expenses are under the Mgr/boardmember signature authority limit. In the absence of that criteria, a threshold in the range of .5 to 1% of the annual budget is often typical.

Q: Is it possible to use an ongoing allowance for a project instead of a total replacement cost?

A: Yes. In situations where total replacement is not expected, but partial replacements or partial repairs are to be expected (sidewalk repairs, plumbing replacements, fence repairs, etc.). These types of projects still meet the National Standard 4-part test.

Q: If I find out something new, or if something changes, should I update my Reserve Study mid-year?

A: No. A Reserve Study is an annual document, prepared for owner disclosure and board budget preparation purposes. We recommend keeping a file of Reserve expenditures and suggested changes (additions or deletions) through the year. Such a file would be used in the process of updating the Reserve Study for the next year.

Q: Is Percent Funded calculated based on current or future costs?

A: Current Costs, as Percent Funded is a measure of the current financial status of the association. The Funding Plan, on the other hand, is developed based on future costs since it deals with future events.

Q: If underfunded, how many years is acceptable to improve from Severely Underfunded to Well Funded?

A: With an eye on the cash flow needs of the association, and desiring to not place too high of a "deficit reduction" burden on current owners, often a 5-15 yr timeframe is typical.

Q: What are the remedies for dealing with an owner who refuses to pay any increased monthly assessment and/or special assessment?

A: Proceed with billing that owner their normal, designated share of common area expenses, and handle the delinquency similar to any other delinquency at the association.

Q: What do we do if we didn't make all our budgeted Reserve contributions during the year?

A: Adjust your Operating Budget so that it provides sufficient funds for the needs of the association (so Reserve contributions do not continue to subsidize a fictional Operating budget!), and update your Reserve Study to find how your Reserve contributions need to be adjusted in future years to accommodate the lower projected starting Reserve balance. Typically this results in higher homeowner assessments, as the true cost of operating the association is addressed.

Q: What is meant by a "30-yr Funding Plan"?

A: While the Reserve contributions recommendation is for the initial budget year, that initial year forms the foundation for a smooth, 30-yr plan to offset the ongoing deterioration at the association. The result is sufficient funds for all those irregularly spaced Reserve projects that occur through the years. Typically a Reserve Study will have a one-page "30-yr Funding Plan" summary table, showing columns for: years, starting Reserve Balance, the calculated Fully Funded Balance, the resulting Percent Funded (all as-of the first day of the fiscal year), and expected Reserve contributions, any loan or special assessment income, interest earnings, and Reserve expenses through the year.

Q: I have difficulty in understanding the "30-Year Funding Plan" table in our Reserve Study.

A: In most Reserve Studies, there is a page showing a 20 or 30-yr summary of Reserve Balance, projected income (Reserve contributions, interest, special assessments & loans), and expenses. This documents the association's multi-yr plan to anticipate and prepare for the major common area repair and replacement projects at the association. It helps boardmembers and managers see the multi-yr plan of contributions, and it helps all to see major expenditures years in advance.

Q: Can Reserve Funds be used for Capital Improvements (additional lighting, a new tot lot, etc.)?

A: No. Reserve Funds are for projects that meet the National Reserve Study Standard four-part test. Capital Improvements fail test #1, as they are not yet assets that are the maintenance responsibility of the association. After Capital Improvements have been installed, remember to add repair or replacement of that new asset to the Reserve Study.

Q: What is the best way to inform the members of the Reserve Budget & its purpose?

A: Distribute the Reserve Study so members can see what their Reserve contributions are going towards, and reinforce at budget time (newsletter, budget meeting, etc.) that the purpose of Reserve contributions are to offset ongoing deterioration, save money by avoiding deferred maintenance, maximize home values, and fairly spread out the contribution burden over those who own homes in the association while those assets are deteriorating. In addition, please encourage them to visit our online Library of resources, or have them view this webinar or others on our webinars page.

Q: How do Reserve professionals estimate replacement costs if that project has not yet occurred at the association?

A: In other words, how do we know how much to estimate for a roof replacement at a new association where the roof has never been replaced? Fortunately, we have experience with a large number of associations, with a wide variety of assets. This gives us familiarity with similar project costs actually executed among our clients. So we are able to use that cost experience. Other resources available to us are the recommendations of trusted association vendors, and national cost-estimating resources.

Q: Who pays the deductible for an insurance claim? Do you budget for it through Reserves?

A: In general, if the damage can be traced to an individual's willful actions (running into the entry gate), the individual responsible should pay the deductible. If it is a true common area accident, the association pays the deductible. But since insurance is for unknown, unpredictable events, insurance deductibles fail Reserve Component tests #2 and #3, and budgeting for such is inappropriate through Reserves.

Q: It's not clear to me why we should be Fully Funded, so long as we have a plan that keeps us well ahead of known requirements for decades into the future?

A: Fully Funded means you have funds on hand, in your Reserve Fund, equivalent to the deterioration at your association. Anything less than that means your success at being able to pay for major Reserve projects will rely on those major projects being spread over a number of years (not all occurring in one year or in back-to-back years), so your Reserve Fund can recuperate from one expense before it is ready to handle another expense. A plan showing you have sufficient cash flow is good, but the future is unpredictable, and it is fiscally responsible to show you are offsetting deterioration with cash.

Q: Why isn't "ramp-up rate" (steeply increasing Reserve contributions) discussed as a financial planning option?

A: An underfunded association doesn't need to take the entire leap towards an appropriate rate of Reserve contributions all at once... they can do it in a number of stages, over some years. Our encouragement is that they start with a step of improvement, do it again, and do it again, for as many years as necessary until they are adequately funding their Reserves. This could also be called a "ramped" multi-yr Reserve funding plan – working themselves over the course of a number of years to the point where their contributions offset ongoing deterioration.

Q: If we change Reserve Companies, do we have to start all over with Full Study or can the new company Update our existing Reserve Study?

A: If the prior Reserve Study was prepared according to National Reserve Study Standards (meaning it includes all the required component information and disclosures), it can be easily updated by another Reserve Study firm without starting all over again with another "Full" Reserve Study.

Q: Can homeowner dues decrease as the reserve gets stronger?

A: That's a very insightful question. Reserve contributions actually go down as the Reserve Fund grows in strength, because as an association approaches being Fully Funded, their "deficit reduction" Reserve contributions go to zero, and their Reserve contributions will truly only need to match ongoing deterioration. No more catch-up means lower Reserve contributions!

Q: Does the reserve balance fluctuate through the years?

A: Absolutely. A Reserve Fund will go up and down through the years, since expenditures are usually spaced irregularly through the years. The Reserve Fund will grow in size through “low expense” years as the association approaches a large expense year (roofing!), and the Reserve Fund will drop after one or more large expense years. That’s why it’s important to measure Reserve Fund strength in terms of Percent Funded, so you can get a more accurate picture of Reserve Fund strength, and do it in light of the association’s multi-yr plan (so you don’t think the sky is falling after a large expenditure year).

Q: Is a loan an option instead of a special assessment?

A: Absolutely. But it’s an expensive option, as the association will be paying interest on top of principal. The cost of borrowing is not insignificant.

Q: Can Reserve funds be collected for semi annual projects such as 2x a year tree trimming or other scheduled maintenance projects?

A: Yes, but multiple-time-per-year projects look more like Operating Expenses. Reserve projects typically occur once a year or less frequently. Remember the National Reserve Study Standard four-part test. If the project can be budgeted effectively through the annual Operating budget, it fails test #4 (being above a threshold cost of significance).