ASSOCIATION RESERVES™
Planning For The Inevitable™

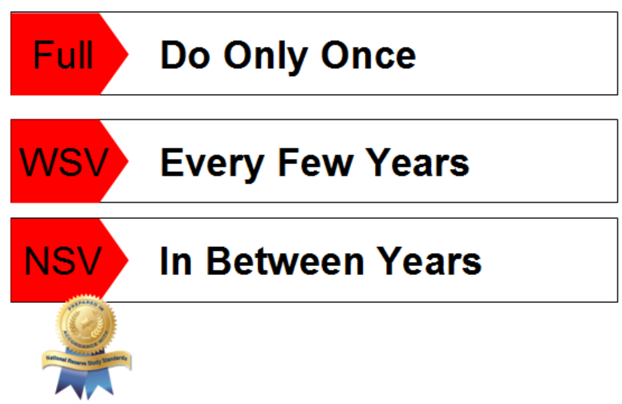
ANSWERS TO YOUR RESERVE STUDY QUESTIONS!

A Q&A session with Robert M. Nordlund, PE, RS   www.reservestudy.com   Aug 27, 2014

Note: So many questions were submitted before the session (thank you!) that not all questions were able to be answered during the session. Fortunately, many questions were similar, so often I was able to answer many questions with one answer. The answers below come primarily from National Reserve Study Standards, and secondarily from Association Reserves experience applying those standards to the preparation of over 30,000 Reserve Studies.

What's the Difference between Reserve Study types & when do you do them?

National Reserve Study Standards (released in 1998) define three types of Reserve Studies: Full, Update With-Site-Visit, and Update No-Site-Visit. 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. A "Full" Reserve Study is the most exhaustive type of Reserve Study, typically only prepared <u>once</u> for an association. After the components have been measured and defined in a "Full" Reserve Study, associations typically alternate between either the Update With-Site-Visit or the Update No-Site-Visit Reserve Study in future years.



What are the "Reserve Rules" that you've mentioned before?

The "Four Reserve Rules" which we've learned from 27 years in this business, are:

1. Expenses always occur
2. The Board is responsible for dealing with those expenses
3. Those expenses regularly only get larger when delayed or ignored
4. Homeowners always get stuck paying the bill.

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, as there is no master list of "appropriate components", just this four-part test.

RESERVE COMPONENT "FOUR-PART TEST"

Useful Life and Remaining Useful Life values are measured in whole years (not year fractions), and it is important to note that under National Reserve Study Standards, Reserve Components may include annual projects (Useful Life = 1) and distant (but predictable projects) in excess of the 20 or 30-yr limit mentioned by some other firms. Note that the typical minimum threshold cost is often in the range of .5% to 1% of an association's annual budget. Bottom line: if it is the association's maintenance responsibility, if it has a predictable, limited life, and if it is big enough to disrupt your Operating Budget, it should be a Reserve component. This means dredging a private lake, resurfacing asphalt, trimming trees, replanting entryway landscape, building painting, and a host of other projects often qualify as appropriate Reserve projects.

What is in a completed Reserve Study?

Reserve Studies prepared according to National Reserve Study Standards will have three results (see figure at right).

The Component List and Reserve Fund Strength are disclosures (helping the board communicate the physical and financial status of the association to its members), while the Funding Plan is a recommendation (so the Board will know an appropriate Reserve contribution rate). The Reserve Fund Strength and Funding Plan are computed on the basis of the Component List, which forms the foundation for every Reserve Study.

RESERVE STUDY RESULTS

How is Reserve Fund Strength Calculated?

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.

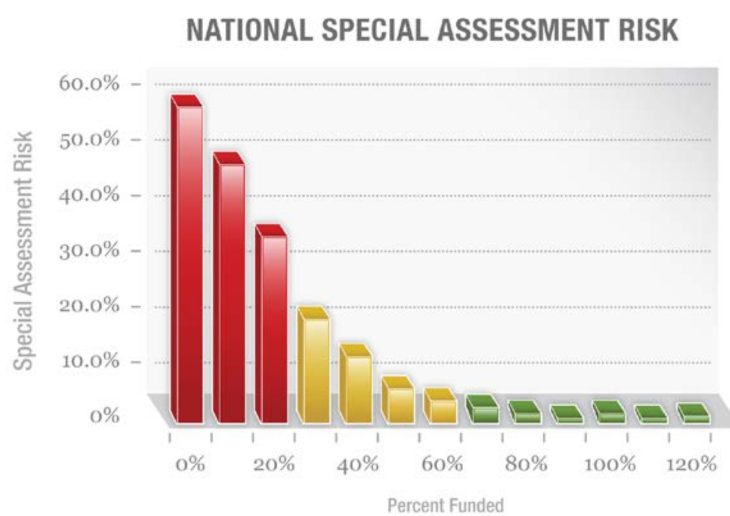
What is the Formula?

Percent Funded = Actual Reserve Balance / Fully Funded Balance (typically reported as-of the first day of the fiscal year), expressed as a percentage.

Note: **Fully Funded Balance** = (Fractional Age) X Current Cost, summed for each component

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 the cash balance in your Reserve fund. "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?

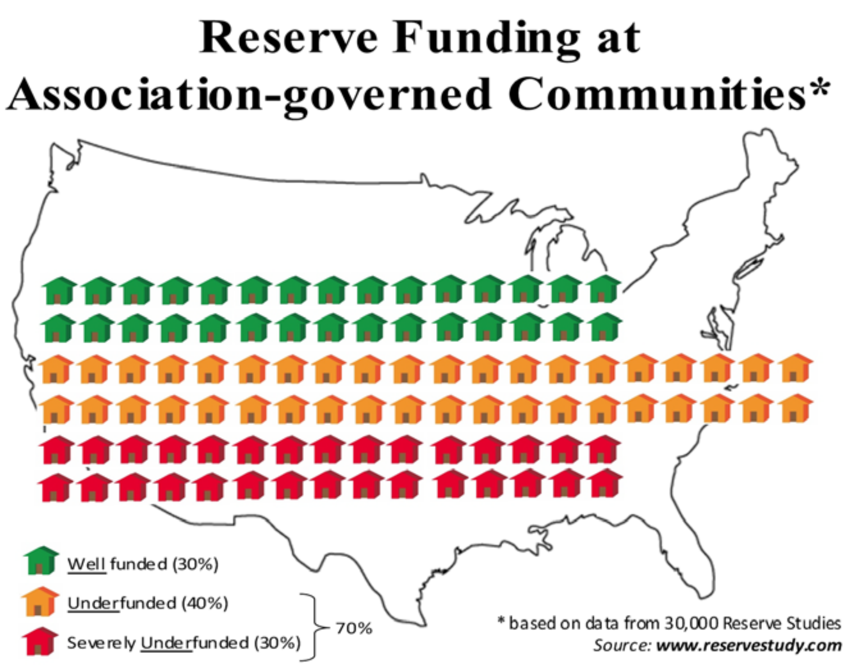
Again, that's a number found in your Reserve Study. Without it, you're forced to guess! Your Reserve Study will recommend a budgeted set-aside to Reserves that will offset ongoing deterioration at your association, providing sufficient cash to perform your anticipated Reserve projects in a timely manner. Often Reserve contributions are in the range of 15-40% of an association's total budget. Reserve contributions are designed to provide a steady, smooth income stream to the Reserve Fund sufficient to offset the irregular expenses scattered through the years, so each owner pays their fair share over time and the association will have sufficient funds in Reserves to maintain the association's major common area assets (preserving owner enjoyment and property values!).

Note: that the above "15-40% of total budget" figure 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 adequately Funding Reserves an unrealistic expectation?

No, for two reasons:

<u>One</u>: 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 <u>not</u> 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. Besides, going back to the "Four Reserve Rules", typically when an association underfunds their Reserves, they end up paying those same Reserve $ (or more!) in the form of special assessments rather than as budgeted contributions. There's no avoiding those expenses!

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

- Focus on the "here and now" of everyone paying their fair share during the time they are a member of the association. Use phrases like "Reserve contributions offset ongoing deterioration", not "Reserve contributions are for future expenses". Bottom line: totally avoid discussing Reserve contributions in terms of "future" issues that people tend to discount and ignore. It's hard for an owner to argue against the fact that they should pay their fair share of ongoing deterioration.
- Stress the benefits of avoiding surprises (unplanned special assessments).
- Remind everyone that Reserve contributions maximize Property Values (Reserve contributions allow for timely roof repairs, paint, asphalt resurfacing, etc.), a great investment in your own home!

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 and it doesn't appear in your current Reserve Component List, spend the $ from Reserves, and include the new expenditure/component 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, your first Reserve Study (your "Full" Reserve Study) will be the most expensive. After that, updates will be significantly less expensive.

What do we do if we are severely underfunded?

It's likely that it took years to get into your current underfunded situation. It is not unreasonable to take years to get out. One successful strategy, called "The $10

Solution", is to increase your Reserve contributions $10/owner/month this year, and do it again for two, three, four, or five years. You'll soon be making appropriately sized contributions, leaving your association's history of special assessments and deferred maintenance in the rear-view mirror!

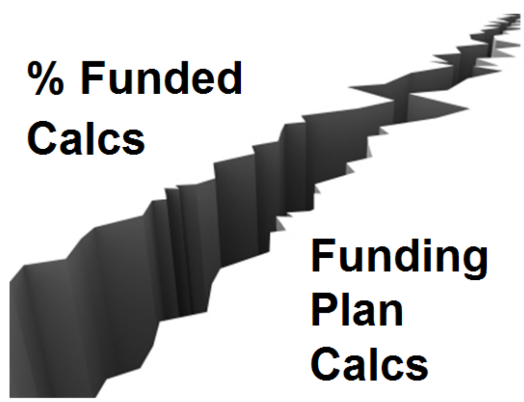
What's the difference between pooling and straight line contributions?

Pooling and Straight Line (or Cash Flow and Component methods, as they are known by their "National Reserve Study Standard" names) are just contribution calculation methods. They both calculate the contributions necessary to provide for the timely repair or replacement of exactly the same set of components (expenses), and those calculations are unrelated to Reserve Fund Strength calculations. So with no difference in the expenses, the income (contribution) side cannot be too different.

Cash Flow contributions are typically lower because they handle the scarce resource (cash) more efficiently, using it wherever it is needed because the cash is not restricted for use with a particular component (roof $, paint $, asphalt $, etc.). In addition, be aware of different Funding Objectives that might be in play. Cash Flow contributions for a Baseline Funding scenario (just barely keeping the Reserve Fund cash-positive) will always be 10-15% lower than Cash Flow contributions for a Full Funding scenario (where the Reserve Balance is designed to offset the value of Reserve deterioration at the association). Component Method contributions (which always yield a Full Funding Objective) will always be higher than Cash Flow contributions for the same Full Funding Objective, because Component Method contributions by nature tend to be front loaded (higher in the first few years then would be stable for the long term). Cash Flow contributions, on the other hand, can be more fairly distributed over the years.

Do you use Current Costs or Future Costs?

Both! Current Costs are used in Reserve Fund Strength (Percent Funded) calculations, because those calculations report the current Reserve Fund strength of the association. Interest and Inflation are real effects, and they are utilized in developing the Funding Plan (the income and expenses) in future years. So there are two different sets of calculations. One uses current costs, one uses future (inflated) costs.



Who can (should?) prepare the Reserve Study?

Only Nevada has a specific licensing requirement for the field of Reserve Studies. Otherwise, look for someone with competence in the necessary skill areas (component evaluation & pricing, Reserve Fund status evaluation, and Reserve Funding calculations). Independent, credentialed (RS or PRA) Reserve professionals offer wisdom and counsel based on their experience and expertise, hopefully providing value to the association well above their professional fees. Remember that you are seeking professional counsel, so be wary of low-cost providers (what weaknesses do their low prices reveal)? Some professionals (architects, Professional Engineers, contractors, etc.) may have impressive credentials, but what do they know about the specific field of Reserve Studies? Volunteer boardmembers may have plenty of time, but do they have the knowledge to do all the calculations accurately, the perspective to see things clearly, and the credibility to effect a budget change? Your manager may have familiarity with the property, but managers typically are weak in the area of Reserve Study knowledge, lack of independence, and divided loyalty (their ongoing employment is much more important than the difficult truth that might need to be delivered).

Can an association add or delete a component from the Reserve Study?

A great Reserve Study is built on the input, insights, and experience from the Reserve Study professional, the manager, and homeowners (as represented by Boardmembers). Hopefully this is a joint effort, but whomever notes a component that does or does not meet the earlier mentioned four-part test, should press for addition of that component or removal of that component. Accuracy should trump pride.

What's wrong with paying for Reserve projects with a loan?

Nothing is wrong with taking out a loan to pay for Reserve projects. It is just a very expensive option! For a $250,000 loan, an association will end up paying the bank approximately $320,000 (7% interest for 7 years, plus origination fees). If the Board had set the budget so that homeowner contributions were collected over time, even earning just 1% interest, the owners would have contributed only about $232,000. Since Boardmembers didn't collect appropriate Reserves on an ongoing basis, that $250,000 project is going to cost homeowners about $90k more with a loan than with budgeted contributions over time.

How does a loan affect your association's Percent Funded (Reserve Fund Strength)?

Percent Funded measures Reserve cash compared to deterioration at the association, expressed as a percentage. A loan is "water under the bridge". A loan perhaps allows the association to execute Reserve projects, lowering the deterioration at the association, increasing the resulting Percent Funded. But remember that loan payments need to be made in addition to ongoing Reserve contributions! So while after a loan your Percent Funded may be a bit higher, your total Reserve contributions (budgeted contributions + loan payments) will likely be significantly higher.

I thought we couldn't Reserve for painting due to IRS rules. Please explain.

IRS rules guide tax preparation. National Reserve Study Standards guide Reserve Study preparation. Don't follow IRS rules in preparing your Reserve Study. Click here for more information.

What's the problem with waiving Reserve contributions (FL)? Can you explain simply?

As stated in the "Four Reserve Rules", Reserve expenses don't stop or go away when they are ignored. They just pile up. Reserve deterioration is ongoing. Reserve contributions that are ignored just weaken the financial position of the association (causing mortgage lenders to look skeptically at the association, negatively affecting home values), and they create a larger and unfair financial burden for future owners. Click here to see a short 3-minute video on this subject.

Follow-up Resources:

Many questions are answered in our large online Library of resources, or in other webinars (and their outlines) on our webinars page.

Audience Questions not answered during 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 still 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: 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: 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 year 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: 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, so 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 conveniently (not bunching up into a few year time-period) 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. Perhaps most importantly, statistics clearly show that associations with a lower Percent Funded have an increasingly high risk of special assessments, no matter what the numbers on their Reserve Study say!

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 (see “The $10 Solution” mentioned above). 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 a 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: Do 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: 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).