FUNDING PLANS

Funding for timely repairs and replacements

A Publication of ASSOCIATION RESERVES™ Planning For The Inevitable™

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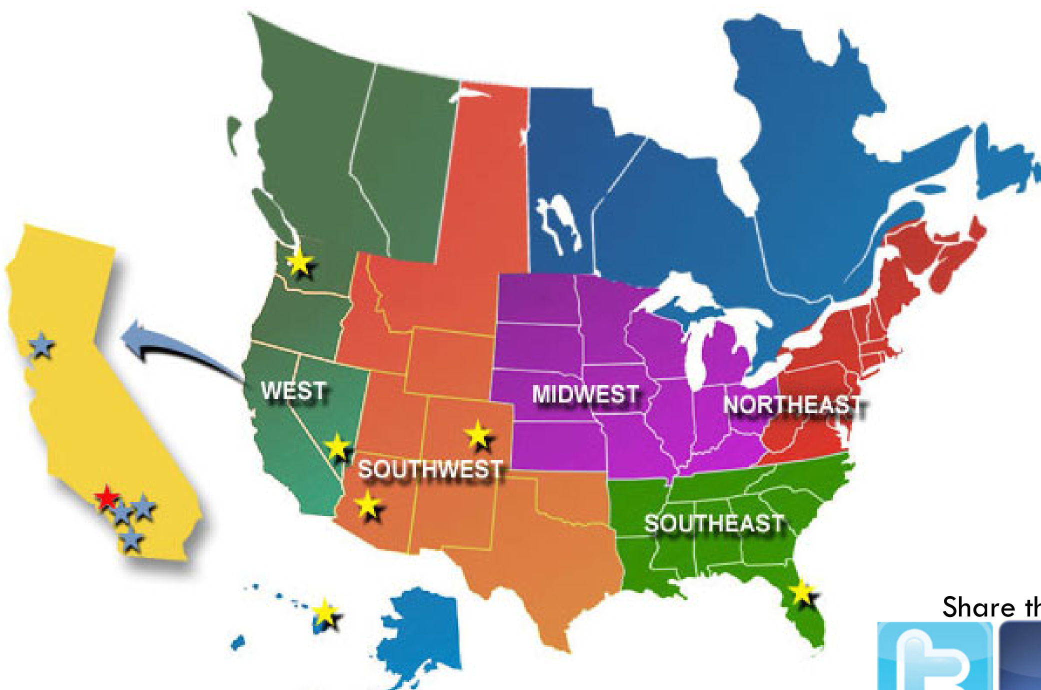

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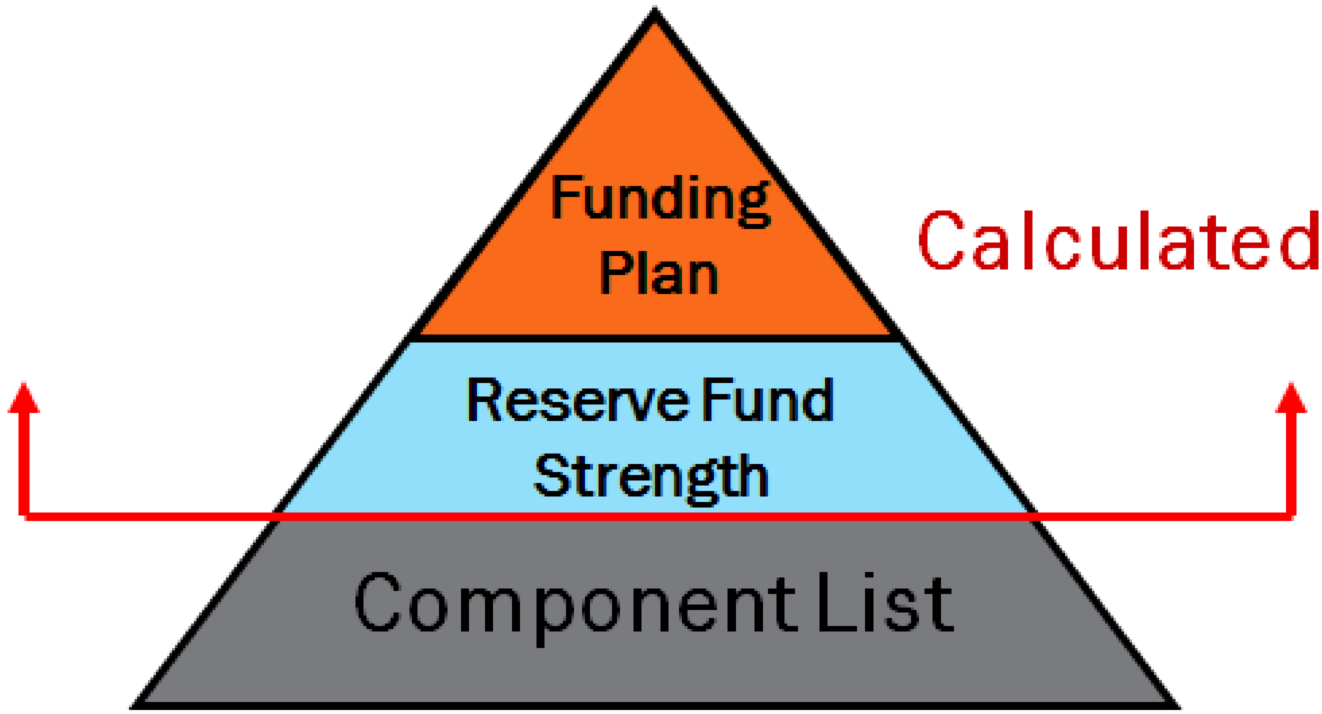
This pyramid represents the relationship of the three key elements of a Reserve Study.



- 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:

FUNDING PLANS AND RULES

> “The best way to predict the future is the create it.”
>
> -Peter Drucker

WHAT IS A FUNDING PLAN?

The Funding Plan is the *recommended action plan* by which the association provides income to the Reserve Fund to offset anticipated Reserve expenses. This “action plan” is developed to take the Reserve Fund from its current condition to the Funding Objective.

The recommendation is typically either for a conservative “Full Funding” contribution rate or an aggressive “Baseline Funding” contribution rate.

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The Funding Plan is created based on 4 distinct principles (rules) determined by National Reserve Study Standards:

$ ADEQUATE RESERVES WHEN REQUIRED

Fundamentally the Reserve Funding Plan must provide adequate funds when they are expected to be required at a future point in time. If $100,000 is needed in five years for a new roof, the Funding Plan should yield a Reserve Balance of at least $100,000 in that year.

$ BUDGET STABILITY

It is important that the budget be designed for year to year stability. Large assessment changes from year to year indicate instability, and homeowners deserve a degree of stability in order to plan their own budgets.

FAIR DISTRIBUTION OF CONTRIBUTIONS

It is fundamentally unfair (and potentially irresponsible) to burden one set of owners with the cost of replacing a Reserve component that deteriorated over a period of many years. This means that in addition to spreading the Reserve contributions fairly among the present unit owners, it is important to spread the Reserve contributions fairly among current and future owners.

FISCAL RESPONSIBILITY

Since Boardmembers are "fiduciaries" (caring for the assets of others), they have to act in a fiscally responsible manner, making "sound, business judgment decisions". Boardmembers must act as corporate officers of multi-million dollar Real Estate corporations should act, making responsible, informed plans as they fulfill their job to "maintain, protect, and enhance" the assets of the corporation.

SECTION 2:

FUNDING OBJECTIVES

FUNDING OBJECTIVES

Baseline and Full Funding are the two most common Funding Objectives.

BASELINE FUNDING

Baseline Funding means establishing a Funding Objective of keeping the Reserve cash balance above zero. Due to having little or no "margin for error" this Funding Objective exposes associations to the highest risk of special assessments.

VS.

FULL FUNDING

Full Funding is a conservative Funding Objective due to having the goal of reaching and maintaining the Reserve Fund at or near the 100% Funded level.

Both plan to provide for all anticipated Reserve expenses. They only differ in how much margin the association retains in Reserves to minimize their chance of special assessments or deferred maintenance.

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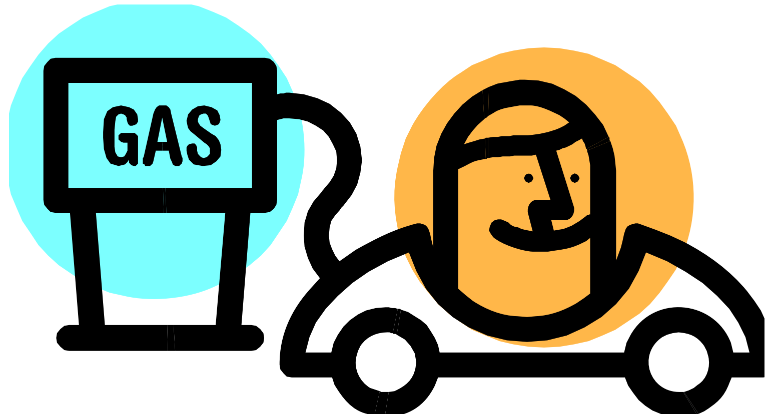
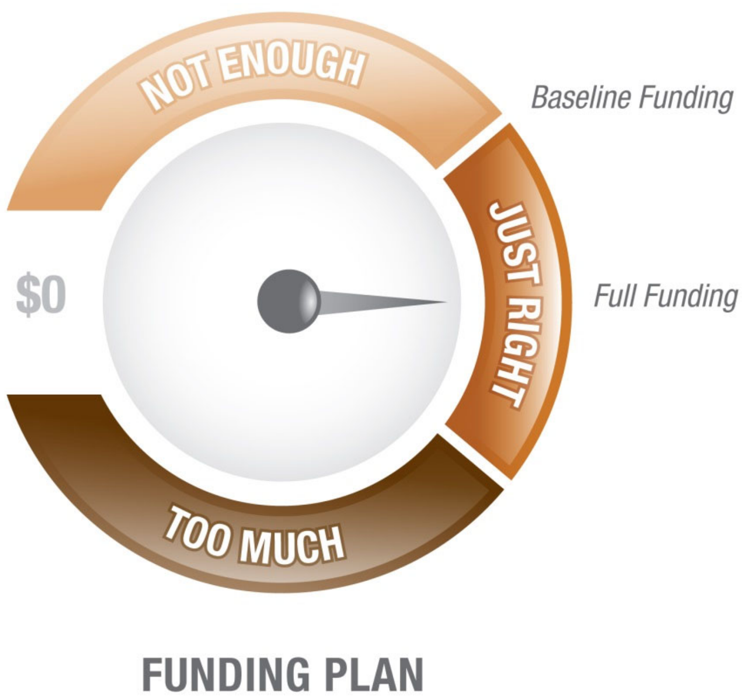
Think of it this way…



It will take many tanks of gas to drive across the country. Whether you allow the tank to just about hit fumes before you fill up and never fill the tank more than halfway (**Baseline "Fueling"**), or whether you conservatively fill up any time you get down to a ¼ tank and end up at the other coast proudly with almost a full tank (Full "Fueling"), you'll purchase just about the same amount of gas along the way.



The only difference between the two will be the half tank (or so) that one car has at the end, compared to the many tanks purchased along the way.

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ADDITIONAL FUNDING OPTION

THRESHOLD FUNDING

Threshold Funding is the third most popular Funding Objective. Threshold Funding means keeping the Reserve Fund above a pre-determined dollar or Percent Funded amount.

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SECTION 3:

INTEREST & INFLATION

WHY ARE INTEREST AND INFLATION IMPORTANT?

Interest earnings bring income to the association that inflation takes away.

DO THEY OFFSET EACH OTHER??

Interest earnings are income the bank shares with you from profits they have made with the money you deposited in their institution.

More interest earnings are good, as they mean less owner contributions are needed to pay bills. But inflation is far more significant to an association than interest, because inflation works its effect on the entire value of all your Reserve components. Interest is only earned on the much smaller amount of Reserve cash actually on deposit in the bank.

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COMMON MISTAKES TO AVOID

- INGORING THEM BOTH

  In this case, you are effectively assuming interest and inflation are both zero. This will lead to continually being underfunded and chasing after higher and high expenses, as your costs increase each year and your income needs to be raised in an attempt to regain lost ground.

- COUNTING ON INTEREST TO OFFSET INFLATION

  Because inflation works on the entire "value" of your Reserve expenses, inflation has its full effect every year. Interest is only earned on the fractional amount of Reserve expense cash that you actually have set aside in the bank.

Reserve Studies 102:
The Financial Analysis

Click the video to
learn more!

SECTION 4:

SPECIAL ASSESSMENTS VS. ONGOING CONTRIBUTIONS

SPECIAL ASSESSMENTS

Why not just special assess for Reserve expenses when the expenses occur?

It fundamentally boils down to fairness and responsible corporate planning. Reserve expenses occur unevenly through the years. It is unfair for owners to be subject to "good luck" or "bad luck" with respect to what Reserve expenses "come due" during the years they own a unit at an association.

Some owners in this scenario pay much more than their fair share, and some owners pay much less than their fair share.

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Governing Documents of most Associations specifically require an "**adequate**" amount of Reserves to be set aside on an ongoing basis to offset anticipated Reserve expenses.

Special assessments are designed as the solution for **EMERGENCIES**, not predictable common area expenses.

Planning to fund predicted Reserve expenses through Special Assessments goes against **National Reserve Study Standards**!

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ONGOING CONTRIBUTIONS

Governing Documents typically require assessments to be appropriately distributed over the membership years. In this way, every owner pays their fair share of the deterioration of the common area components for the amount of time they owned a unit at the association, and there is no chance of Boardmembers being accused of “self-dealing” by keeping the assessments low during their tenure for their own personal benefit.

There is no guarantee that the Board can pass a special assessment and collect the funds in sufficient time to meet a pressing Reserve expense. The association needs to make progress, on an even and fair basis, spread through the years, towards meeting its projected Reserve obligations.

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SECTION 5:

RESERVE CONTRIBUTIONS

HOW MUCH SHOULD YOU RESERVE?

Typically, most associations should be setting aside 15%-40% of their assessments towards Reserves.

Every association has its own unique list of common area assets it is responsible to maintain. Some may have a longer list that force higher Reserve contributions, some may have shorter lists of amenities or more cost-efficient exterior finishes.

Table 2: Reserve Component List Detail **9999-0L**

#	Component	Quantity	Useful Life	Rem. Useful Life	Best Cost	Current Worst Cost
	General Common Areas					
103	Concrete Deck/Walk - Repair	Extensive GSF	2	0	$4,000	$7,000
104	Balcony Deck - Resurface	Approx 5750 GSF	20	10	$57,500	$74,800
105	Balcony - Reseal	Approx 5750 GSF	5	1	$14,400	$20,100
109	Trex Decks - Repair	(113) decks, (4) outlooks	4	0	$11,700	$17,600
110	Trex Decks - Replace	(113) decks, (4) outlooks	20	10	$275,000	$316,000
201	Asphalt - Remove/Replace	Approx 121,200 GSF	30	6	$303,000	$424,200
202	Asphalt - Seal/Repair	Approx 121,200 GSF	3	0	$18,200	$24,200
206	Stamped Concrete - Partial Repair	Approx 53,100 GSF	10	0	$25,000	$35,000
320	Pole Lights - Replace	Approx (126) fixtures	20	15	$113,000	$151,000
322	Bollard Lights - Replace	Approx (74) fixtures	20	15	$33,300	$48,100
324	Wall Lights - Replace	Approx 919 fixtures	20	10	$91,900	$124,000
401	Awnings - Replace	(161) 4 ft x 5 ft canvas	8	1	$48,300	$64,400
403	Mailboxes - 25% Replace	(161) Individual boxes	5	1	$2,200	$2,600

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3 IMPORTANT INFLUENCES TO YOUR RESERVE CONTRIBUTIONS

Economic assumptions for interest and inflation

On average, every percent increase in interest requires a 13% increase in contribution size!

Your current "starting point"

Associations with a weak Percent Funded will have higher Reserve contributions than associations that find themselves in a strong position (70-130% Funded).

Your Objective

Full Funding is a higher objective, so associations Fully Funding their Reserves have higher Reserve contributions than those with a Baseline Funding Objective.

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MINIMIZE YOUR CONTRIBUTIONS!

Why put more money into your Reserve Fund than necessary? You don't want to make Reserve contributions that err on the side of being too little, but you shouldn't put away too much either. Here are six ideas how to responsibly minimize your Reserve contributions:

1 **Make sure your Reserve Study provider uses the "cash flow" method of calculating your recommended Reserve contribution.**

The alternative "straight line" calculation method point your Association towards Full (100%) Funding in a relatively short number of years. But there's no reason to be that aggressive. By using the "cash flow" method, your association will get to Full Funding, but more smoothly, and over a few more years.

2 **Allow an outside organization to pay part of your contributions.**

It's called Reserve interest, and you get it from the institution that holds your Reserve Funds! It adds up to a surprisingly significant amount over the years as it gradually compounds.

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3

Perform timely ongoing maintenance.
A touchup paint project, paid for through the operating budget on the high-exposure surfaces that get the most weathering, may allow you to extend the Useful Life of a repainting project from 5 years to 6 years. This same principle can be applied to other components, Including roof maintenance, gutter cleaning, carpet cleaning, and asphalt cleaning & sealing.

4

Review your actual replacement needs.
Don't execute a Reserve project just because your Reserve Study indicates it has a Remaining Useful Life of 0 years. If a fence is still standing and strong, don't replace it prematurely. This is another way to "extend" the Useful Life of your Reserve components. It's also a good reason to update your Reserve Study every year because extending the useful life of your Reserve components generally translates to a lower Reserve contribution.

5 Review your Operating Budget to verify that you are not "double-budgeting".

Double-budgeting happens when a Reserve project is funded both in Operating and Reserves. If you are successfully repainting 1/5 of the buildings every year in the Operating Budget, you don't need to include a repainting component in your Reserve Study! You only need one replacement budget for a component, not two.

6 Avoid these three common mistakes that will make Reserve Expenses higher:

1) <u>Deferring a repair or replacement project</u> "just because" is a bad idea. Deferred projects tend to get a more expensive due to deterioration of underlying materials. By deferring, you're doing the Association a financial disservice!
2) Thinking 50% Funded means making 50% of your Full Funding contributions. Thinking you can cut your Full Funding contributions in half typically leads to running out of Reserve Funds in just a few years.
3) Head in the Sand. Thinking that asphalt will never need resurfacing, or that a roof or elevator is a "lifetime component" are both critical mistakes. Ignoring that reality will only commit your Association and future homeowners to an unstable financial future.

WAYS TO PAY FOR RESERVE EXPENSES

Reserve expenses are inevitable, because deterioration is inevitable. The only question is how well prepared the association will be, and how the association chooses to deal with those expenses. There are four ways to pay for your Reserve expenses:

- The way to pay the least amount of money for your Reserve expenses is accomplished by making regular deposits into an interest bearing account.
- Special assess when the funds are required.
- Acquire a loan. You pay for the privilege of borrow money, which will end up costing you more in the long run.
- Do absolutely nothing. Unfortunately, doing nothing is by far the most costly. Undone Reserve projects don't go away, they just get bigger.

Request a Reserve Study Proposal Now!

Make sure your Funding Plan and Reserve Study is up-to-date. Visit our website or call our office to request a proposal!

Association Reserves
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Our eBook series includes three publications:

- ✓ Reserve Component Lists
- ✓ Reserve Fund Strength (% Funded)
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