ASSOCIATION RESERVES™

Planning For The Inevitable™

"WHAT DO YOU DO WITH YOUR COMPLETED RESERVE STUDY?": WEBINAR OUTLINE

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Review your Reserve Study for Accuracy and Completeness

1) Review the Reserve Component List

Walk around your association and look around – check to make sure the major items expected to deteriorate over time are included in the Reserve Component List. Such items should pass the following National Reserve Study Standards four-part test, that they:

- Are a common area maintenance responsibility
- Are Life limited
- Have a predictable Remaining Useful Life
- Are above a minimum threshold cost of significance (typically .5% - 1% of the association's annual budget

Check quantities to make sure nothing obvious was missed (the 5th elevator, the second boiler…). Finally, check Useful Life, Remaining Useful Life, and Current Replacement Cost for sensibility.

2) Check the Projected Starting Reserve Balance

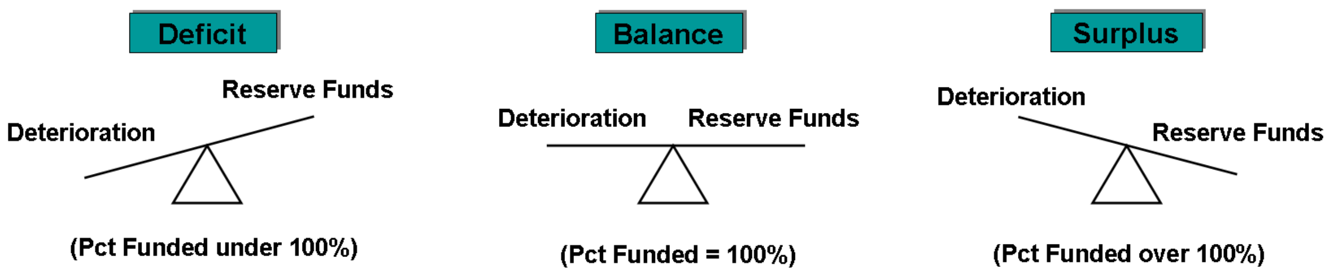
Most Reserve Studies are prepared in advance of the association's Fiscal Year End (FYE). So by nature, the starting Reserve Balance for the year is typically a projection a few months away. So by the time you (the client) get the report, check to make sure that your most recent documented Reserve Balance, plus expected contributions, minus planned expenses, is a pretty close match to the starting Reserve Balance projected in the Reserve Study.

Find the Three Results

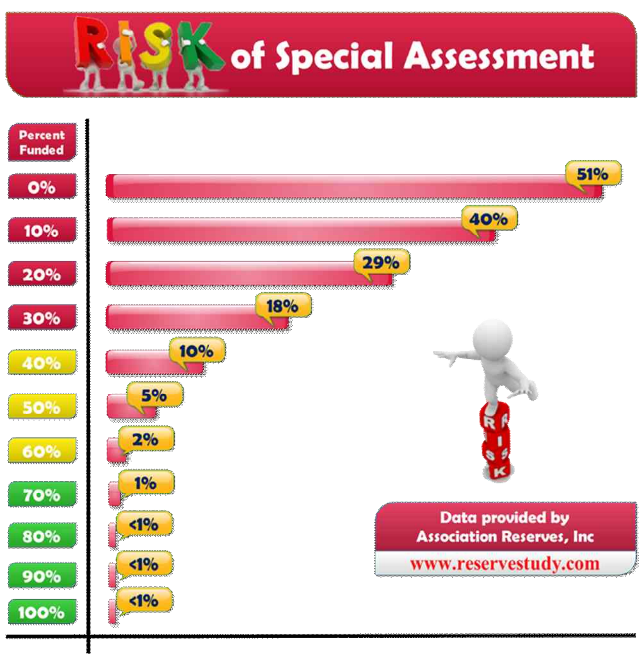
There are three results contained in every Reserve Study. Your Reserve Study may be a thick document, but it boils down to getting a grasp on these three results:

1) The Reserve Component List – a table containing a listing of Reserve Components, their description/quantity, Useful Life, Remaining Useful Life, and Current Replacement Cost (which hopefully you reviewed for accuracy). This important table contains the information which defines the Scope and Schedule of your upcoming Reserve Projects

2) The evaluation of Reserve Fund Strength (typically reported in terms of Percent Funded). This calculation reveals if you are on-pace, behind-pace, or ahead-of-pace with respect to having enough Reserves set aside to keep up with the always-advancing Reserve deterioration at the association. The three scenarios are as follows:



Knowing your current-yr Percent Funded is important, because it is a primary indicator of upcoming Special Assessments:



3) The recommended Reserve Contribution Rate – the first year of the multi-yr Reserve Funding Plan

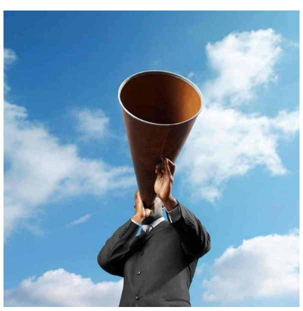
For most associations, the recommended Reserve Contribution Rate typically takes the form of a monthly recommended Reserve contribution. Read, or check, to see what the objective is of that recommendation. Typically it is either Full Funding (where the Reserve balance is designed to keep pace with ongoing deterioration), Baseline Funding (where the Reserve balance is designed to just barely keep cash-positive).

Either way, they both provide for the timely repair and replacement of your scheduled Reserve projects without planned reliance on special assessments. Because they both provide for the same Reserve expenses, there is often not too much difference between the size of Full Funding and Baseline Funding contributions. The only difference is in the amount of margin for uncertainties provided with Full Funding. Without any margin for error, special assessments are often the outcome of maintaining a minimal Reserve balance (such as when pursuing a Baseline Funding objective), so any temporary savings due to lower contributions often completely disappear.

Finally - Do two Things with it!

1) Incorporate the recommended Reserve Contribution Rate into your Budget-planning process. Remember, your Reserve assets keep deteriorating every day whether you set aside adequate Reserve contributions or not, so don't get behind pace! It only leaves unfair catch-up for future years when everyone isn't paying their fair share. Remind them that Reserve contributions are not "for future expenses", they are designed to offset the ongoing deterioration going on day-by-day while they own a home in the association.

2) Disclose important plans and findings to your homeowners



Minimize surprises and misinformation at your association! Let the homeowners know the schedule of upcoming repairs and replacements, and their exposure to future special assessments. Consider making the Reserve Study available for their review, or distribute an "Executive Summary" as part of their annual information package.

Reserve Study – What do you Do With It? – Audience Questions after the session

Q - What are National Reserve Study Standards, and where can I find them?

A – Through a multi-yr process, a group of Reserve Study providers established some national standards for terminology, disclosures, and basic contents of a Reserve Study, that were embraced and endorsed by CAI in 1998. Along with the Standards were the creation of a national credential, the Reserve Specialist (RS). A similar set of standards exist, published independently of CAI by the same group of Reserve Study providers under their own non-profit, the Association of Professional Reserve Analysts, or APRA. Their credential is called the Professional Reserve Analyst, or PRA. Both sets of standards, and the credential, are similar. You can find the national standards on CAI's or APRA's website, but probably easiest is on our website, Reserve Study.com, under our Learning Center tab.

Q – Are there different types of Reserve Studies? What did I get?

A – There are three types of professional Reserve Studies. A "Full" RS is one created from scratch, where everything is measured during the site inspection, and typically only has to be done once. Then there are two update products, an update with site visit and an update no-site-visit. Those are the types of Reserve Studies most commonly performed in the country nowadays, as associations update their Reserve Study either on the basis of a site inspection or without. The type of Reserve Study is to be disclosed clearly within the Reserve Study per NRSS. In our reports, it is on the cover.

Q – How often should you get a Reserve Study?

A – Since Reserve contributions are so significant, ranging from 15-40% of the budget, it is typically one of an association's largest budget line items. And since the Reserve Balance, condition of the Reserve Components, and estimated repair/replacement cost of the Reserve components changes every year, we believe it is appropriate to update your Reserve Study annually. In some states, like CA, an annual update is required.

Q – Aren't there special Reserve Study disclosure forms?

A – In CA and WA there are special one-page disclosure forms, designed to summarize the findings in the Reserve Study, that are to be distributed to the owners annually.

Q – What do you do if the actual cost is different from projected in the Reserve Study – do you have it revised?

A – If the actual cost represents a true-market cost, note it, and make sure that gets incorporated into the next Reserve Study update. If the cost was low for a unique reason, or high for a unique reason, those are exceptions that should not be incorporated in the next Reserve Study update.

Q – In the component list, did you say show current cost? But won't that change for the future?

A – Current costs should be shown in the Component List. The funding plan will work with inflated costs (based on the "current costs" shown in the Component List), but there needs to be a clear display of current cost estimates for all to see in the Component List.

Q – Do you have a recommendation of pooled funding vs straight line?

A – Pooled (cash flow) and straight line (component) are both methods of calculating the multi-yr funding plan. Because the pooled method is much more flexible, and allows us to customize the funding plan within the restraints of the association's financial situation, and allows us to craft that funding plan towards any of the NRSS funding objectives, we use and recommend the cash-flow (pooled) method.

Q – should you add a "contingency" line item in your Reserve component list?.

A - Only components that pass the National Reserve Study Standard four-part test should appear in your Reserve Study. That four-part test is:

1) the asset is a common area maintenance responsibility
2) the asset is life limited
3) the asset has a predictable remaining useful life
4) the asset's repair/replacement cost is above a minimum threshold.

So "contingency" does not meet National Reserve Study Standards.

Q – Is dry rot evidence, or a consequence of not painting on schedule?

A - Yes, dry rot is often the consequence of delaying a painting project. Often it would have been much less expensive to simply paint a component on schedule than face dry-rot repair expenses!

Q - Can we eliminate components, reduce prices, or extend RUL to lower Reserve contributions?

A – Hopefully an independent, credentialed Reserve Study professional wouldn't do that, but a Board certainly could. But it defeats the entire purpose of a Reserve Study, which is to prepare an association for its inevitable repair and replacement costs and serve as a reliable disclosure to association members of the state of their association's major components and the strength of the Reserve Fund.. The purpose of a Reserve Study is not to minimize Reserve contributions. One "wins" when one has enough cash in Reserves to perform the required repair/replacement projects, not when one has low Reserve contributions.

Q - What if a component costs more than budgeted in the Reserve Study?

A – A Reserve Study is based on estimates. Some projects will cost more than anticipated, some will cost less. Hopefully a few projects will come in under budget to offset the project that went over-budget. Spend the money and take care of the association. Projects that come in under or over-budget are good examples of why the Reserve Study needs to be updated each year. If your association is still calculating contributions using the "straight line" method, an over-budget expense may force a re-allocation of funds among Reserve components in the Reserve Study update (something that happens on an ongoing, automatic basis when calculating contributions using the cash-flow or "pooled" methodology).

Q - Can you borrow from Reserves to pay a shortfall in the Operating Budget?

A- It is the association's money, so you can legally spend it for an association expense, but it is unwise. Reserve funds are collected to offset Reserve component deterioration. Those funds are already "spoken for". It is <u>inappropriate</u> to spend those funds for Operating Budget expenses, and doing so may trigger some significant accounting adjustments or homeowner disclosures. Doing so regularly may actually taint the tax-free nature of Reserve contributions. Some states (CA, WA) even require funds borrowed from Reserves be repaid within a certain number of months.

Q - Should you expect to replace siding all at once, or a little bit at a time?

A – You should expect some ongoing maintenance expenses for major components prior to replacement. Often some timely maintenance will extend the life of the component. So some maintenance/replacement should be expected on an ongoing basis to siding, trim, roofing, etc., but in most cases eventual replacement of the entire asset should be anticipated.

Q - Do we have a legal obligation to spend funds to upgrade/modernize?

A – An association's Board has a legal obligation to care for the association's physical assets by collecting "adequate" funds from association members. Often an upgrade is appropriate, due to technological or aesthetic changes (some old components, materials, or styles are no longer available). While an upgrade is often appropriate, I do not believe the Board has a mandate to upgrade before the component has reached the end of its design or economic life. Sometimes it may be wise to replace a component "early" if the new component (boiler, chiller, etc.) offers significant energy savings such that the early upgrade will "pay for itself" in Operating Budget savings.

Q - Is it wrong to invest Reserves in multi-yr investments, making them inaccessible?

A – It is wise to attempt to maximize Reserve interest earnings, which often means making multi-yr investments. It must be done in light of expenses anticipated in the Reserve Study. For example, it would be unwise to lock up investments in a multi-yr investment when the Reserve Study projects they will be needed. Accomplishing projects "on schedule", preventing a deteriorated appearance or deferred maintenance, is typically of more value to the association than a little bit more interest.

Q - How much do we save if we only want to be 50% or 70% Funded?

A – It requires significant Reserve contributions just to have the cash necessary to perform the anticipated Reserve projects on schedule (0% Funded, or "Baseline Funding"). So the contribution change necessary to jump from 0% funded to 50%, 70%, or 100% Funded is surprisingly small. Typically there is less than a 10% difference between contributions to achieve 50% Funding and those designed to achieve 100% Funding.

Q - Does being 100% Funded tell you that everything is in good condition?

A – No. Being 100% Funded means you have the funds set aside equal to Reserve component deterioration. So being 100% Funded means you could have a major component be 25% deteriorated, with 25% of the replacement cost set aside in Reserves. That means you are 100% Funded (cash = deterioration). So in an extreme, you could be 100% Funded with your roof completely failed, if you have the full replacement cost sitting in Reserves ready to pay the roofing company (cash = deterioration).

Q - Wouldn't it be a good idea to have a contingency amount for the unexpected?

A – Not really. Not only does a contingency expense not fit the definition for a Reserve project (see above), depending on the size of that contingency it could significantly alter the association's Percent Funded rating, an important measure of Reserve Fund strength. Keep a strong Reserve fund, and by definition the fund will be large enough to withstand some degree of unexpected Reserve expenses.