STATE OF HI

HOW STRONG IS YOUR RESERVE FUND?

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Reserve studies are required by Hawaii State Law, HRS 514A and HRS514B-148 for Condominiums and Time Share property under HRS 514E-10.3. Reserve studies provide a tool to manage timely replacement of the major physical assets of the association.

In addition to recommending a Funding Plan to collect enough money to repair or replace these assets at the end of their useful life (without reliance on loans or special assessments), every Reserve Study should contain an evaluation of the strength of the Reserve Fund.

A Reserve Study prepared according to National Reserve Study Standards contains three results:

- **Reserve Component List:** a clear description of the major assets maintained by the association with limited, predictable life expectancies.
- **Current Reserve Fund Status:** a statement or measurement of the current size and strength of the Reserve Fund as-of the first day of the fiscal year, typically reported as "Percent Funded"
- **Recommended multi-yr Funding Plan:** the association's plan to provide income to a Reserve fund to offset anticipated Reserve expenses (typically taking the form of a recommended Reserve contribution rate for that year).

As one of the three results of a Reserve Study, the current **Percent Funded** indicates the strength of the reserve fund. A **Percent Funded between 70% and 130% is considered strong** because the association has Reserve cash on-hand roughly equivalent to the deterioration of its Reserve components, with the result that Reserve cash flow problems (special assessments and deferred maintenance) are extremely rare in this range. A **Percent Funded between 30% and 70% is considered fair,** as there is typically enough Reserve cash on hand in this range to manage the necessary Reserve projects without running into a cash flow problem when projects inevitably happen earlier or more expensive than anticipated. A **Percent Funded below 30% is**

considered weak because Reserve cash flow problems are common due to little to no margin for the association to manage projects that happen earlier or that are more expensive than anticipated. Note: when all goes according to plan, there are no problems. But because reality rarely goes exactly according to plan, associations need some "margin" to avoid cash flow problems.

Here are some helpful definitions, excerpted straight from National Reserve Study Standards:

<u>Percent Funded</u> is the ratio, at the beginning of the Fiscal Year), of the *actual (or projected)* Reserve Balance to the *Fully Funded Balance*, expressed as a percentage.

<u>Fully Funded Balance (FFB)</u> is the Reserve balance that is in direct proportion to the fraction of life "used up" of the current Repair or Replacement cost. FFB is calculated as follows:

FFB = Current Cost X Effective Age / Useful Life

<u>Current Replacement Cost</u> is the cost of replacing, repairing, or restoring a Reserve Component to its original functional condition.

<u>Effective Age</u> is the difference between Useful Life and Remaining Useful Life (not always equivalent to chronological age, since some components age irregularly).

<u>Useful Life (UL)</u> is the estimated time, in years, that a reserve component can be expected to serve its intended function if properly constructed, in its present application or installation.

Percent Funded is <u>not</u> a comparison of current Reserve cash to the total replacement cost of all Reserve assets. Percent Funded is also <u>not</u> the same as "100% Replacement Reserve contributions" for the current year. Percent Funded, according to National Reserve Study Standards, reports the size of association's Reserve Fund on the first day of the fiscal year **no matter what the association's chosen funding objective** (the Hawaii "Percent Funded Method", the Hawaii "50% Percent Funded Method" or the Hawaii "Cash Flow Method"). These Hawaii methods are statements of the association's funding objective. Regardless of funding objective, each year associations can and should reliably measure and report the strength of their Reserve Fund in terms of Percent Funded.

Summary: Current Reserve Fund balance strength can be measured. **Percent Funded** is a National Standard term indicating the association's Reserve Fund strength as-of the first day of the fiscal year. Calculations independent of funding objectives will determine if the current Reserve Fund balance is strong, fair or weak. Having a strong Reserve Fund means you have some margin for future unpredicted events. A weak Reserve Fund exposes current and future owners to Special Assessments, loans, or deferred maintenance, all of which result in loss of property market value. So it is worth caring about your Reserve Fund strength!