

A RESERVE STUDY PROFESSIONAL'S PERSPECTIVE

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(This article is in response to Samantha Hamilton's article, "A Condominium Resident's Perspective.")

Samantha's article illustrates the purpose and function of a Reserve Study as well as some common objections. Let's dissect a few of her statements to try to bring clarity to these issues faced by nearly all associations. They are highlighted below for emphasis.

"...and fully funding the recommendations put forth in the study by an independent professional"

Before crafting a reserve funding plan, the reserve study provider must identify the common and limited common components for which the association has the responsibility to maintain, repair and replace. Based upon the process of inspection and research and the providers experience, a judgment is made regarding how often those projects are likely to occur and how much they are likely to cost. The final step is to recommend a funding plan to offset those expenses while adhering to the four **¹National Reserve Study Standards Funding Principles**:

1. Sufficient funds when required
2. Stable reserve contribution rate over the years
3. Evenly distributed contribution over the years
4. Financially responsible.

The minimum reserve funding contribution going forward that can still follow these principles is called **Baseline Funding**. A baseline reserve contribution will allow the reserve balance to fall close to zero, but not below zero. This is obviously the plan that puts the community most at risk of special assessment and/or deferred maintenance (putting off projects that need to be done). **Threshold Funding** is an objective other than Baseline or Full Funding. The 60% funded level has

received a lot of attention lately due to FHA's requirement that condominium associations be a minimum of 60% funded, new condominium conversions 100% funded. The higher the threshold number, the lower the risk. **Full Funding** is the ideal where the reserve fund is at a level equal to the physical deterioration that has occurred. In other words, each year to Fully Fund reserves you would set aside 1/10 of the project costs that occur every 10 years, 1/5 of the project costs that occur every 5 years, and so on. The level of reserve funding you choose is up to you based upon your tolerance for risk of special assessment and deferred maintenance and now the importance to your community of FHA financing eligibility.

...study by an independent professional" The first condominium was recorded in King County in 1964 – the 45 year track record of leaving this important disclosure and segment of the budget process to developers and owners has been largely unsuccessful by any business metric.

Your reserve study is budget and cash flow model that should show you the Full Funding contribution as well as the Baseline Contribution and / or provide you with software to test this on your own. **You must understand the nature of a cash flow model to answer one of the typical objections:** **"...this is ridiculous to think about 30 years in the future..."** The 30-year reporting period standard was developed as a measure to help ensure inclusion of some of the components that are typically the largest reserve expenses an association will face over time: Roofs, Decks, Windows, Asphalt, Siding (depending upon a variety of factors these can last more or less than 30 years). Ok, so let's say you have a reserve study with only two funded items: a roof that is projected to need to be replaced every 30 years and decks that need to be top coated every 5 years. For this simple example, let's forget interest and inflation calculations. Your 5 year deck project is anticipated to cost \$10,000 every 5 years and your roof replacement \$90,000 every 30 years. If you were Fully Funding, you would be setting aside 1/5th (\$2,000) for the decks each year and 1/30th (\$3,000) for the roofs each year. If you chose to fund at a 50% threshold level you would set aside \$2,500 each year and therefore have \$12,500 in year 5; enough to complete the deck project but ultimately some ground to make up on the long-term roof replacement cost. If you chose to fund at a 20% level (\$1,000) each year you would have \$5,000 in year 5, not enough to pay for the \$10,000 deck project. Your ending reserve balance in that year will show -\$5,000 in the study, not -\$20,000 which includes the money you would have been ideally saving for the roof. The cash flow model compares your actual cash on hand with your expense needs. This is hard for many to wrap their minds around, so many associations pick some arbitrary funding level in frustration. One of the requirements for the reserve study law in Washington is the plan must include a projected reserve account balance for thirty years and a funding plan to pay for projected costs from those reserves without reliance on future unplanned special assessments. Most condominium associations we serve in Washington are in a high-risk low percent funded position with significant cash flow needs in the next 5 to 10 years. **Focusing on the next 5 to 10 years of your reserve plan with your members is a key strategy to move forward with your funding levels.** In summary, having completed over 19,000 reserve studies since 1986, we would consider it a great step forward if associations simply

contributed to reserves the amount necessary to be cash positive over the study period – many associations do not even fund reserves at that level.

When you or the community owners have questions or objections about the study, I recommend you contact your reserve study provider so that independent professional can help with the education process, explain how the study works and take the heat from what are often emotional reactions to a study of this nature. Time with your attorney to clearly understand what common and limited common elements the association is responsible to maintain, repair and replace is also wise. Choose an experienced reserve study provider and work with them closely to refine your plan and minimize your risk.

In conclusion, I could not have said it any better than Samantha: “My reasons for condominium association compliancy are simple: less stress for all resident/owners by avoiding unnecessary assessments and loss of property values.”

¹(see:http://www.caionline.org/career/designations/Documents/rs_application.pdf)