ASSOCIATION RESERVES™
Planning For The Inevitable™

May 21, 2019

Reserve Studies 102 – The Financial Analysis

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Miss the webinar? Watch it here.

Our job is to help your association prepare for *inevitable* future expenses. This webinar revealed what the numbers in a Reserve Study tell you about your Reserve Fund strength and what size contributions will be necessary so you can make wise, informed decisions to care for the assets of the association. Reserve Studies *minimize the surprises in your future* by accurately identifying the association's major, predictable common area repair and replacement projects, allowing the association to build Reserves over the years to offset ongoing deterioration so you can accomplish those projects in a timely manner and maximize property values.

RESERVE STUDY RESULTS

So… do you have "enough" in Reserves, and how much should you be setting aside to prepare for these inevitable expenses? These "Financial Analysis" answers, based on National Reserve Study Standards (NRSS) principles, are covered in this webinar.

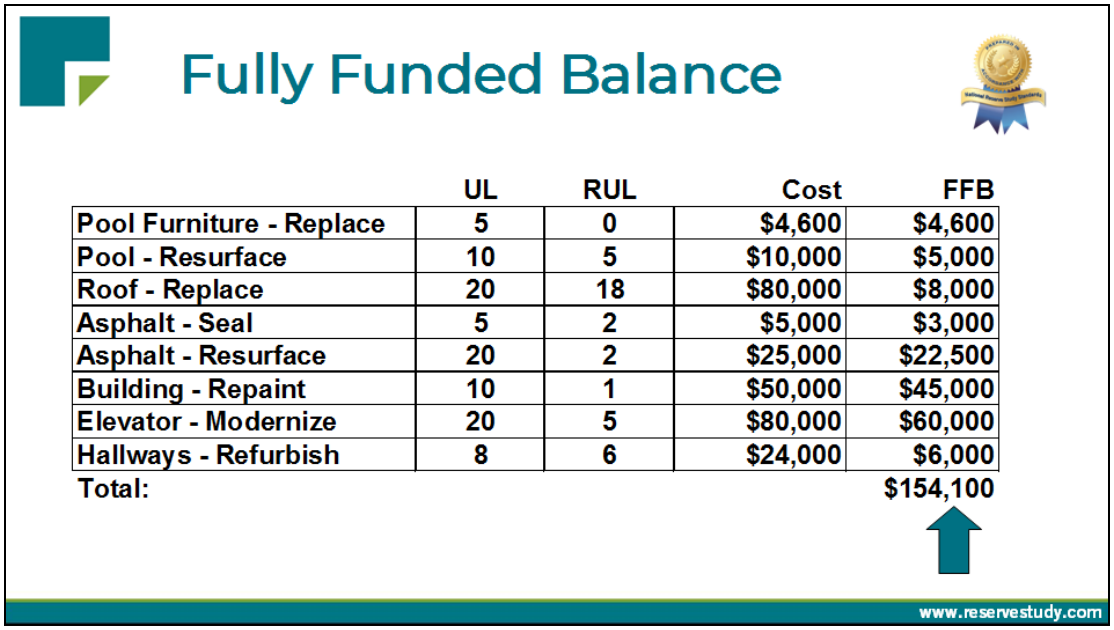
To calculate Reserve Fund Strength, one first calculates the deteriorated value of the association's Reserve Components (called the Fully Funded Balance), which defines the current Reserve "needs" of the association.

Fully Funded Balance

Fractional Age X Current Cost

(Summed for all components)

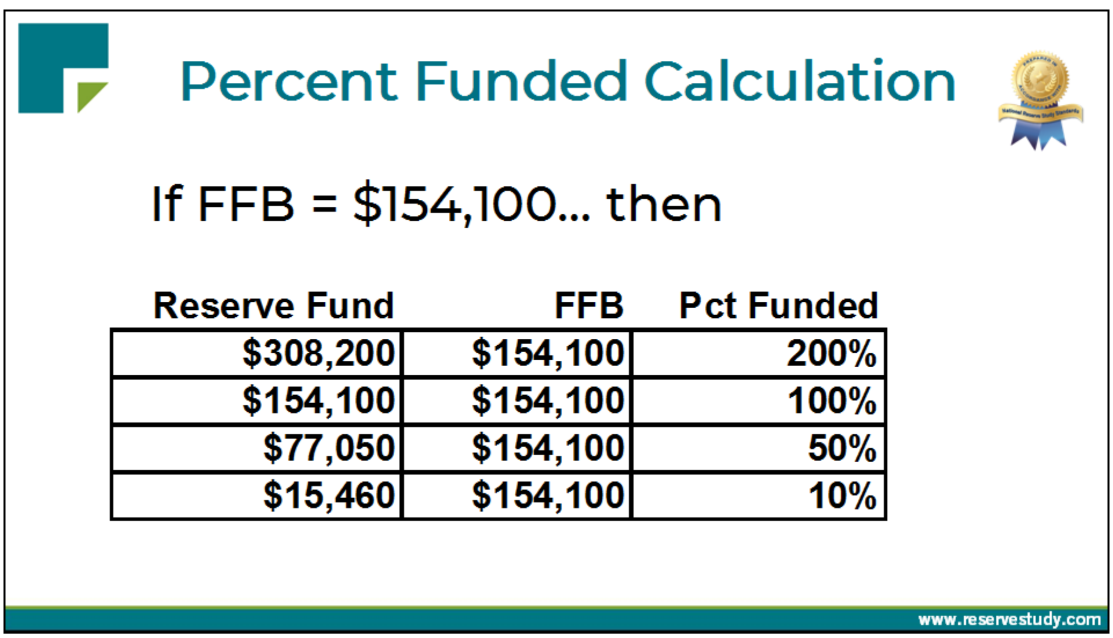
The result looks like this:



Fully Funded Balance

	UL	RUL	Cost	FFB
Pool Furniture - Replace	5	0	$4,600	$4,600
Pool - Resurface	10	5	$10,000	$5,000
Roof - Replace	20	18	$80,000	$8,000
Asphalt - Seal	5	2	$5,000	$3,000
Asphalt - Resurface	20	2	$25,000	$22,500
Building - Repaint	10	1	$50,000	$45,000
Elevator - Modernize	20	5	$80,000	$60,000
Hallways - Refurbish	8	6	$24,000	$6,000
Total:				$154,100

One then compares the association's <u>actual</u> Reserve Fund balance to the Fully Funded Balance figure to gain meaning and understanding!

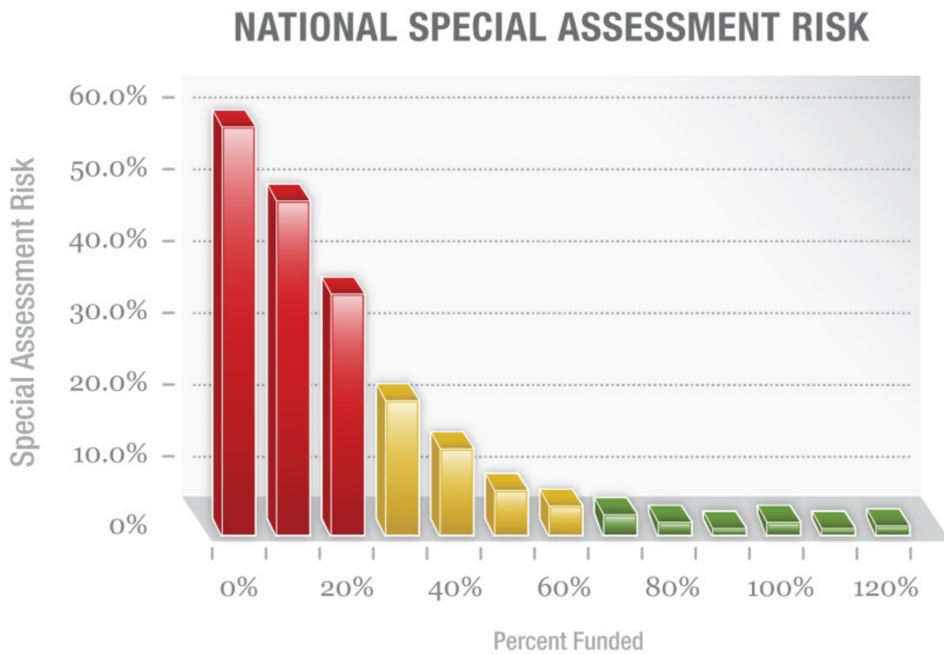


Percent Funded Calculation

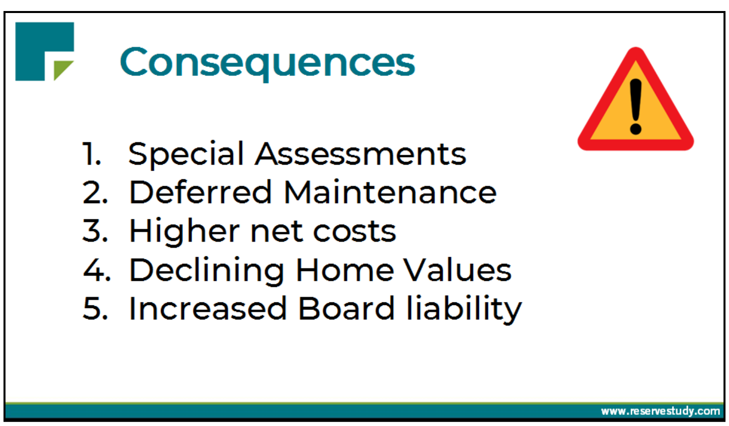
If FFB = $154,100… then

Reserve Fund	FFB	Pct Funded
$308,200	$154,100	200%
$154,100	$154,100	100%
$77,050	$154,100	50%
$15,460	$154,100	10%

The association's resulting "Percent Funded" is a key predictor of special assessments. To no one's surprise, there is a high risk of special assessments when the Reserve Fund is in the weak 0-30% range, medium-low risk when the Reserve Fund is in the middle 40-70% Funded range, and low risk of special assessments when the association has a strong Reserve Fund (70-130% Funded).

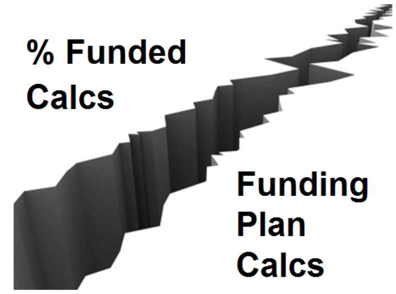


Of course, special assessments are just one of the consequences of being underfunded:



Across the country, about 30% of associations are in the 0-30% "weak" range, 40% (the largest grouping) are in the "fair" 30-70% range, and the final 30% are in the over 70% Funded "strong" range.

Now that you know how (in)adequate your existing Reserve fund is at providing for the needs of the association, and your resulting special assessment risk, what do you do about it?



Reserve Fund strength calculations focus on the size of the Reserve Fund. After that is done, Reserve contributions (the rate at which you'll need to put money into Reserves) are calculated. The size of your Reserve contributions will affect your Reserve Fund strength in future years, either strengthening it or weakening it.

In the webinar we discuss the "deterioration rate" – the smooth and predictable rate at which your Reserve components are deteriorating. This "ongoing cost of deterioration" is as real as any other bill your association faces! That deterioration rate is the Component's Current Cost divided by its Useful Life, revealing a $/yr rate "cost of deterioration".

If your association is contributing more than your ongoing cost of deterioration, you'll *strengthen* your Reserve Fund over the years. If your association is contributing less than your ongoing cost of deterioration, your Reserve Fund will *weaken* over the years.

The Cost of Deterioration

Component	UL	Cost	Cost/yr
Pool Furniture - Replace	5	$4,600	$920
Pool - Resurface	10	$10,000	$1,000
Roof - Replace	20	$80,000	$4,000
Asphalt - Seal	5	$5,000	$1,000
Asphalt - Resurface	20	$25,000	$1,250
Building - Repaint	10	$50,000	$5,000
Elevator - Modernize	20	$80,000	$4,000
Hallways - Refurbish	8	$24,000	$3,000
			$20,170

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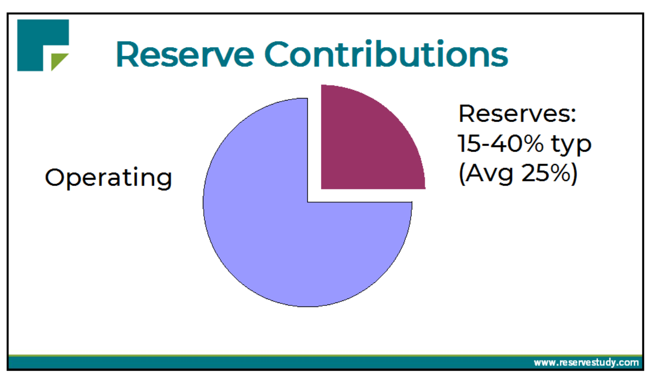
The well-being (adequacy) of your Reserve Fund is a combination of your starting point (your Percent Funded), and responsibly sized contributions. A Reserve Study prepared according to NRSS should identify your starting Reserve Fund strength and contain a custom Funding Plan to provide "just the right amount" of Reserve contributions so all your owners pay their fair share of the "deterioration bill" so the association can perform its Reserve projects in a timely manner, allowing the board to fulfill their responsibility to maintain the common areas.

Reserve contributions sufficient to offset ongoing deterioration are typically between 15% and 40% of an association's total budget. We find that Reserve contributions requirements in the range of 25% of total budget are very common.



NRSS Funding Methodologies such as the Component Method (aka "Straight Line") and Cash Flow (aka "Pooled") are different tools used to calculate Reserve contribution rates in light of the timing of upcoming expenses.

NRSS Funding Goals such as Full Funding, Baseline Funding, and Threshold Funding describe the amount of margin built into the multi-yr Reserve Funding plan, above expenses, to minimize the association's exposure to special assessments.

Reserve Funding Methodologies and Goals are covered in detail in our Reserve Studies 103 webinar curriculum. See the latest recording of this webinar here, or sign up to watch an upcoming version live.

Free eBooks on Reserve Fund Strength and Reserve Funding Plans are available for free download on this page (search for eBooks):

Get an expert on your side to provide you the information you need to make the wise decisions that guide you and your association towards an improved future. We can help by preparing your Reserve Study update, ensuring your Reserve Fund Strength is calculated correctly and a Funding Plan is custom-prepared for your association. Enlist the support of a team who has prepared over 45,000 Reserve Studies for clients in all 50 states over the last 32 years! Launch a free online proposal request by clicking here.

Looking for local expertise? Click here to see our network of offices across the country (serving clients in all 50 states!).

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****Note: This course is approved for continuing education credit by:**

- **The Community Association Managers International Certification Board (CAMICB) to fulfill one CE credit for the CMCA® certification,**

- **the State of Florida Department of Business and Professional Regulation for licensed Community Association Managers for one CE credit related to the CAM certification, and**

- **the State of Colorado Division of Real Estate for licensed Community Association Managers for one CE credit related to the CAM certification.**

Webinar Questions Asked by 2019 Attendees

Q: Why use current costs in the percent funded calculation instead of future costs? Our reserves earn 0.15% interest – so we are falling behind every year. Besides, our homeowners are paranoid about increases in the Regular Assessment, and would prefer a more or less permanent Special Assessment.

A: Per National Reserve Study Standards, the current year Percent Funded is calculated using current costs. The Funding Plan, on the other hand, because it projects the cash flow into future years to offset inflated costs and the reality of interest earnings on Reserves on-deposit, incorporates the effects of interest and inflation. This is exactly for the reason you suggest… if you ignore the two, you'll gradually be falling behind. See this article on this subject appearing on our website.

Your second question is a bit more complicated.

First, National Reserve Study Standards require that we create a Funding Plan that has as one of its four principles "Equitable Distribution of Contributions through the years". This means in an inflationary economic environment, Reserve contributions should gradually float upward to reflect the reality of inflation on gradually growing Reserve expenses. Second, it is just plain good business practice in an inflationary economic environment to "train" the homeowners to expect nominal annual increases. This is where the board needs to lead in the best interests of the association. The board is in the best position to provide funds for the ever-increasing expenses of the association if they are gradually collecting more income each year from the homeowners. And finally, the word-smithing between "basic" assessments and supplemental "special assessments" can get silly. So our recommendation, and that of many prominent voices in the industry, are to leave special assessments for the truly unexpected, and set your budget to offset the anticipated ongoing expenses.

Q: I understood your explanation of current replacement cost but if you have elevator that are 1/3 way through 30 year life; the cost of replacing the elevator will be significantly higher in 20 years.

A: Agreed. Future expenses are expected to be higher than current expenses. That's why we calculate this year's Percent Funded using the Current Cost, while we calculate the Reserve Funding Plan using assumptions for interest and inflation.

Q: Can you address again what adequate Reserves really look like?

A: Sure… please see this article. Having Adequate Reserves means you can demonstrate with your current fund balance and your steady plan to collect Reserves in the future that you will have sufficient funds to provide for all your anticipated Reserve expenditures, without reliance on future loans or special assessments. The result is having the cash on hand to do your scheduled Reserve projects on hand, fulfilling the board's job and maximizing property values in the process!

Q: How precisely do you calculate % Funded numerator and denominator, and at what point in time? Is there a standard and if so what is it? Also how do you calculate for future years?

A: We typically are provided the Reserve cash balance down to the pennies, but we typically calculate Fully Funded Balance to round dollars. We report Percent Funded to no more than one decimal place. Generally Fully Funded Balance and Percent Funded are calculated and reported as-of the first day of your Fiscal Year. For future year calculations, use a projection of Reserve cash balance and a projection of Fully Funded Balance (using shortened Remaining Useful Life values and inflated expected replacement costs).

Q: LA City has a directive to retrofit our buildings to protect against a future earthquake. How do you recommend we fund that $500,000 project?

A: Since such a retrofit project is not repeatable (it does not have a "Useful Life"), it fails the National Reserve Study Standard four-part test to be funded through Reserves. Besides, likely your Reserve funds are already designated towards existing Reserve projects (so that cash is not readily available to be spent on such a project). Thus "code change" projects like you describe are usually handled via a special assessment or loan.

Q: If you were in the midst of a construction defects law suite with arbitration set for later this year would you delay updating the Reserve Study until the law suit is settled? Some of the defects are in the Reserve Component list. Once the case is settled we will set up a Construction Defects Reserve Fund to deal with the corrective actions.

A: Since most of your components are not affected by Construction Defect litigation, it is advisable to update your Reserve Study this year. Make your best assumptions about the financial outcome of the litigation and the timing of when those projects will get accomplished. Your homeowners deserve to know what you are anticipating will be done with their money, and you don't want to miss an entire year of Reserve contribution adjustments.

Q: How do you take into consideration ongoing maintenance/repair which extends the useful life? Ex Fence - rolling annual maintenance keeps the fence as current as possible, but obviously it begins to age and the need for maintenance increases. How do you project that?

A: We ask and observe what kind of maintenance is being done around the property. Effective, timely maintenance is typically accomplished from the Operational Budget, and is typically very cost-effective. For instance, some minor maintenance and touchup paint can result in a major savings like extending the life expectancy of a wood fence from 15 years to 20 years.

Q: In a Master Community (with multiple sub-associations under it), how the cost of the Common Areas components connecting each community be allocated in the RS?

A: Look in the Governing Documents. Whichever association is responsible for maintaining the asset should be funding for its repair and replacement through the Reserve budget. If financial responsibility is "shared" between two entities (for example 80/20), then the component is listed in the Reserve Study for both associations, with 80% of cost in one and 20% of the cost in the other.

Q: Would there ever be a situation where an association would budget for a special assessment in a reserve plan?

A: The only time a special assessment should appear in a Reserve Study is for the initial year (or in a series of smaller special assessments beginning with the initial year), when a project needs to be done "now" or in the very near future and there is not enough time to collect funds through "normally sized" ongoing Reserve contributions. The NRSS Funding Principles dictate that Reserve funding be equitable, which means not delaying Reserve contributions (in the form of a special assessment) onto the shoulders of future owners. Everyone should pay their fair share of ongoing deterioration.

Q: How often should you update your Reserve Study? Every three years?

A: For two reasons we believe Reserve planning should be done annually. First, it is responsible to revisit a budget line item annually that is as huge as Reserve contributions (typically comprising 15-40% of your entire budget). Second, the data shows that special assessments are markedly lower among associations that update their Reserve Study annually, as it prevents their association from "drifting" off course financially.

Q: Does it show an inadequacy in our reserve studies (updated every other year) if we repeatedly find the need to accelerate renovations. As an example: sidewalks are scheduled for 2022, but we need to replace walks now or townhome siding is scheduled for 2024 and we need to do now?

A: If your Reserve Study is regularly optimistic about the Remaining Useful Life of your assets, your first step should be to bring that to the attention of your Reserve Study provider. They may need a "reality adjustment". If they fail to see the difference between their projections and reality, it may be time to shift to a different Reserve Study provider.

Q: How do you figure useful life of a component on the Reserve Study?

A: We establish the Useful Life estimate primarily based on our experience with the component (in your type of environment and application) and the association's history with component, adjusted by material quality, perceived maintenance, and in some cases by a conversation with your service provider.

Q: Do you think special assessments can shed the negative connotation they have?

A: No. They have a negative connotation for a good reason. If implemented for a Reserve underfunding, they unfairly burden "current" owners with the cost of replacing an asset that prior owners failed to provide for financially and they reveal a board of directors who believed in their own fantasy that major assets weren't deteriorating. The bottom line is they are unwanted and unsettling. Boards should do all they can to avoid them.

Q: Do you ever fund for plumbing? I manage two "older" communities, and both need to replace pipes and there is nothing in the reserves for it.

A: Yes, when we can gather enough information to satisfy the NRSS four-part test that projects must meet to be funded through Reserves. Often plumbing doesn't appear in a Reserve Study because the timing or cost is unknown. Reserves are for predictable projects, not "surprises". When the project becomes known (or reasonably foreseeable), that's when it should appear in your Reserve Study. See more here.

WEBINAR QUESTIONS ASKED BY PRIOR YR ATTENDEES

Q: How often do you calculate Fully Funded Balance and Percent Funded?

A: Once a year, in advance of your Fiscal Year End, with information as-of the first day of the Fiscal Year, as part of the budget planning process for the upcoming year.

Q: If a Reserve Study says an item should last 10 years, does the board HAVE to replace it at 10 years or can they postpone it? Are there consequences to postponing?

A: The board doesn't have to replace components as projected in the Reserve Study. A Reserve Study helps you prepare for anticipated expenses, it does not require that expenses be done on that schedule. There are different ways components can reach the end of their Useful Life. Click here for an article on Reserve Study failure modes. For some benign components, the association may enjoy a year (or more) of extra service life before being replaced.

Q: What is the best answer to community members who cannot (or don't want to) understand that a healthy Reserve % Funded number doesn't mean the association is charging the members too much (and that they should get a reduction in their assessments)?

A: Explain that 100% Funded means the association is "in balance", or "on pace", meaning the Reserve Fund is equal to the value of common area deterioration. When that is the case, every owner has paid their fair share of the deterioration that occurred while they owned a home in the association. Associations that underfund Reserves suffer many consequences in addition to special assessments (the great equalizer!) outlined in this 3-minute video. The board's job is to protect, maintain, and enhance the assets of the association. They do that by setting a budget that provides for major repair and replacement obligations of the association, which is in everyone's best interests.

Q: Does the % Funded calculation method apply to the cash flow method of calculating annual Reserve contributions?

A: Yes. Percent Funded calculations measure size of the Reserve Fund. The Cash Flow method calculates contributions, a different thing entirely. One can choose and use any Reserve contribution methodology, because it has nothing to do with the way Reserve Fund strength is calculated.

Q: Explain how you can calculate Percent Funded using straight line calculations, but contributions using the cash flow method!

A: You've actually almost answered the question yourself. Percent Funded is a calculation of current Reserve Fund strength. Get the answer, then start calculating the contributions (using the Cash Flow method or Component method) needed to offset ongoing deterioration and provide funds in time for upcoming expenses.

Q: So if you have a $5000 component that lasts 5 years, its deterioration is $1000. If you are contributing $800 (80% of $1000), are you 80% Funding your Reserves?

A: No. Percent Funded is a measure of Reserve Fund size compared to Reserve needs (deterioration). Percent Funded is not a measure of contribution size.

Q: Why do your calculations ignore interest and inflation when those factors become very important 20 to 30 years out?

A: <u>Current</u> costs are used in <u>current</u> year Reserve Fund <u>strength</u> calculations. To communicate key concepts in the limited time of this webinar, interest and inflation were ignored in my illustration of <u>contribution</u> calculations (inherently associated with future years). Interest and inflation are very real factors, as you suggest. We address those powerful influences in our Reserve Studies 103 webinar (see it here) when we discuss the funding plan, which with interest, prepares the association for those inflated expenses 10, 20, 30 years and even farther out into the future.

Q: Do you inflate the estimated cost of a Component Item in your Reserve Funding Plan calculations?

A: See above. Absolutely. Inflation is an economic reality in our world today, and should be factored in when computing the association's Reserve Funding Plan.

Q: What inflation rate should be used and where can it be found?

A: We believe the best indication of what will happen in the future is what has happened in the past. In looking backwards, inflation has averaged around 3% for the last few decades, so that is the value we use in our Reserve Studies.

Q: What inflation percentage do you assume for, say, a 10-year build-up to a roof replacement?

A: Since a Reserve Study is a plan that looks forward 20-30 years, we use a stable inflation value that will sometimes be higher than the "current rate" and sometimes lower than the "current rate". See the above question. We are currently using values in the 2.5% - 3.0% range.

Q: I noticed that last year tree trimming was budgeted in Reserves for $8000. The association spent $16,000. In addition, the Board spent $ on another project that wasn't a Reserve component at all. Are these types of expenses allowed, or are they considered "borrowing" from Reserves?

A: Hard to answer that one. It could be as simple as last year they were just making up for not doing a prior tree trimming. Remember that Reserve Studies are based on cost <u>estimates</u>. If the estimate is low, that should be fixed in the next Reserve Study update. On your second question, a legitimate Reserve Component meets the NRSS four-part test (whether it appears in your Reserve Component list or not). If it is a legitimate Reserve expense, that component should be included in the next Reserve Study update. If not, the Reserve fund should be reimbursed for that expense.

Q: Our Association's Reserves are in a Money Market Account. The bank charges $20 for each transaction, plus other fees. Bank charges should be an operating expense and not Reserve expense, right? I am under the impression that only Reserve expenses can be paid from Reserves.

A: Reserve-project related fees are generally considered Reserve expenses. But it sounds like it is time to shop for a new bank.

Q: We have a large roofing project due now, and we are 55% funded. How do we handle this? We have a BOD member who feels we should never have to raise dues - just minimize spending and barely maintain the complex. What are the risks for not doing what we need to do to fix the roofs?

A: Fortunately, board actions need not be unanimous. Move forward with the roof project acknowledging your responsibility to protect, maintain, and enhance the assets of the association. Set the dues (income) to what it needs to be to maintain the property. It's the right thing to do, and it minimizes your liability exposure. Click here to read the outline from our "Underfunding Reserves and the Business Judgment Rule" webinar.

Q: Is it true in the state of California that an HOA is not required to have funds in reserve but instead can levy special assessments as issues arise? If so, how does that affect Board liability?

A: Just because you can do something doesn't mean it is wise. It is true that in CA, the law does not require associations to collect Reserves on an ongoing basis. But Boards are required to maintain the physical and financial assets of the association. In addition to special assessments being inherently unfair, if there is any doubt the special assessments can be collected in a timely manner *year in and year out*, board members will increase their liability exposure.

Q: Why do some states allow the Board to "waive" their responsibility and let the Community "vote" to fund Reserves or not?

A: I believe such legislation is troublesome. People are elected to govern, and they need to have that power and use that power. Our government would get nothing done if it was continually having to ask permission of those who vote.

Q: Should unspent reserve funds for a given component in the year of replacement be carried forward or applied to other components?

A: Unspent Reserves should remain in the Reserve Fund, available to be re-allocated as necessary to the Reserve needs of the association.

Q: If reserve study estimate is much higher or lower than bids received, should we ask our Reserve Study professional to make an adjustment?

A: It is good practice to keep a file of actual Reserve expenses, so actual cost experience information can be communicated to your Reserve Study professional when the Reserve Study is updated, so those cost estimates can be adjusted.

Q: We do not have enough cash for a project and need to put a special assessment to the vote of the owners. I doubt it will pass!

A: That is unfortunate! Property values will suffer as deferred maintenance takes hold and curb-appeal drops. Property values will drop far more than the Reserve contributions (or special assessment) that would have prevented the problem. That is unfortunately a great example to others of the value of ongoing, adequate Reserve contributions so your major repair and replacement projects can be accomplished in a timely manner.

Q: Our HOA approves the reserve study prior to starting the next year's annual budget. Should they both be reviewed and approved together?

A: Reserve contributions are a large, integral part of the budget. Reserve contributions need to be established before the overall budget can be finalized. Whether the members review them separately or together is your choice.

Q: Should you show reserve expenses separately on a profit and loss or budget report?

A: Showing individual Reserve expenses is not a necessary part of regular budget reports.

Q: Is infrastructure replacement/repair a reserve item? i.e. water lines, electrical

A: Remember that Reserve components are defined by the NRSS four-part test… that it be a Common Area Maintenance Responsibility, that it have a limited Useful Life, that it have a predictable Remaining Useful Life, and that it be above a minimum threshold of significance (size). Typically, infrastructure projects fail test #2 and #3 in that their Useful Life and Remaining Useful Life are generally below a level of certainty on which a budget can be based.

Q: Would you consider carports to be a valid reserve item?

A: It doesn't matter what I think. A valid component meets the NRSS four-part test: that it is a common area maintenance responsibility, has a Useful Life limit, a predictable Remaining Useful Life, and is above a threshold cost of significance. Many associations correctly have carport components (roofing, painting, etc.) in their Reserve Studies.

Q: If we are less than 100% Funded, should we use our Operating Fund surplus to pay for Reserve expenses rather than levy a special assessment?

A: Many associations function successfully without special assessments while less than 100% Funded. Use Reserve Funds to pay for Reserve expenses if at all possible. Just because your association is under 100% Funded doesn't mean you'll need supplemental cash to pay for a Reserve project.

Q: What are the most common Reserve Funding mistakes?

A: The most common is presuming that last year's Reserve Study, or one a few years prior, is still "valid". Reserve Studies are one–year documents. They go out of date and fail to provide fresh/accurate guidance in subsequent years. The next is the mindset that Reserve contributions are for the future. They're not. Reserve contributions offset ongoing daily deterioration. And if you take care of offsetting ongoing deterioration on an ongoing basis, the future will take care of itself.

Q: How can an association that is 0% Funded not have a special assessment?

A: Think about a new association, one or two years old, with no money in Reserves. They are 0% Funded. Most of its components are relatively new, no significant Reserve projects on the horizon. But they have years to collect Reserves through budgeted contributions before major Reserve expenses occur. So they can be 0% Funded, and have enough time to collect enough Reserves through regular contributions to avoid a special assessment.

Q: Can you show an example of Straight Line and Cash Flow funding?

A: Glad to hear you are interested. We'll have time to do that in our Reserve Studies 103 webinar. See a recording here.

Q: Does delaying a project help your Percent Funded or Reserve contributions very much?

A: Not very much. The most difference occurs when a Reserve Component is added or removed. Just delaying it only makes a minor difference – the cost still exists and needs to be funded. Delaying a project and crossing your fingers is a bad idea for most components, and it usually doesn't make much of an improvement in your Financial Analysis numbers.

Q: Does it make much difference if you consider a 15-yr, 20-yr, or 30-yr window for funding?

A: Absolutely! NRSS require a minimum presentation of 20 years of income and expense projections, and most Reserve professionals include significant components outside that time frame. An association dangerously ignores some significant predictable expenses when they set a short window of only 15 or 20 years.

Q: How do National Reserve Study Standards compare to various State Law requirements, notably like in CA, WA, or FL?

A: To our knowledge, there are over 25 states now with legislation affecting or requiring Reserve Studies. NRSS provide a framework for Reserve Study professionals to serve associations across the country with consistent calculations, disclosures, terminology, and professionalism. Many states may have minimum requirements, like setting aside a minimum of x% of the budget towards Reserves, or performing a With-Site-Visit Update at least every y years. Florida requires an association to disclose if they use Cash Flow or Straight Line Funding, and in Hawaii an association needs to disclose if they are Baseline Funding or Threshold Funding their Reserves. NRSS provide us all with an ability to meet those state requirements, clearly and consistently.

Q: Can you spend Reserve Funds on a new capital asset (a cabana, or a shade structure by our swimming pool)?

A: You can, but you shouldn't. It is inappropriate to spend Reserves, collected for the purpose of repairing or replacing existing assets, to create new assets (Capital Improvements).

Q: Why have I heard the difference between Baseline Funding and Full Funding is so big?

A: Good question, but another topic we'll cover in the upcoming Reserve Studies 103 webinar (see a recording here). It takes so much money to provide for the anticipated needs of the association, that the difference between having no margin (Baseline Funding) and having some margin (Full Funding) is not large when considered over a multi-yr timeframe.

Q: What's wrong with setting contributions to cover half the cost of your items, and special assessing for the other half?

A: It's unfair and unsettling. Special assessments are inherently unfair, penalizing those few owners who happen to own at the time of the expense. Unsettling, because then your expenses come in big chunks. Deterioration is predictable and steadily moving forward each day. Ideally everyone should pay their fair share along the way, paying their "deterioration bill" just like the electric bill and the landscaper's bill.

Q: Does Percent Funded typically vary depending on the size of the HOA?

A: No. We've found that the Percent Funded profile of small associations is similar to those among large associations. Associations are run by volunteer board members, and they make the same type of budget decisions whether the association is large or small.

Q: Is there a more advanced Reserve Study you could recommend for a community that is preparing to turn over from Developer control to Homeowner control? How far in advance would you recommend that happen?

A: No "advanced Reserve Study", but there is a different type of report useful in this situation called a Transition Report. This is in addition to a Reserve Study, which reveals if the association is being turned over to the homeowners with adequate Reserves and with appropriate Reserve contributions. A Transition Report evaluates construction quality, completion status, and the "finish" of building components. A Reserve Study should be done for the Fiscal Year beginning in which the transition is to occur, and a Transition Report should be done approximately six months prior to the projected transition.

Q: In new communities, how soon should you get a Reserve Study and start collecting Reserve contributions?

A: Immediately. Deterioration starts when the property is built. Appropriately sized contributions towards Reserves to offset that deterioration should start as soon as possible (the first year). Hopefully an independent Reserve Study is prepared the year prior to the homeowners taking control of the board.

Q: When preparing a Reserve Study, would accounting for code upgrades, engineering, permits, disposal, installation, designer, and all "extras" be considered a capital improvement or is that part of the Reserve expense?

A: According to NRSS, estimated expenses for Reserve components should be all-inclusive. This means Reserve Component cost estimate should include all related costs. So if it is a $100,000 component that will cost $75,000 to install, your Reserve Study should list the project's replacement cost as $175,000.

Q: Please comment on Reserve Funding when the association is relatively small, under 50 units.

A: Expenses occur at all associations, whether large or small. Costs per unit are generally higher in smaller associations due to lack of substantial "economies of scale", so Reserve contributions are usually slightly higher on a "per unit" basis for smaller associations.

Q: Should we be making contributions for our pipes which are 40+ years old? They are original to the building, and have only had minor repairs. How does anyone figure out how to Reserve responsibly?

A: We have seen many associations performing major re-piping projects, so we have some "norms" of expectations based on building types and plumbing layout. It is very helpful to interview the plumbing company which has been performing the minor repairs, as they tend to know if re-piping the building is necessary, when it is needed, and how expensive the project will be.

Q: Is it legal to reserve for components that the Association is maintaining but doesn't own?

A: I can't think of a reason for an association to spend funds maintaining or replacing assets they don't own, but if maintenance for a component is the association's responsibility per their governing documents, making contributions is appropriate and actual ownership is irrelevant.

Q: Should we put money in reserve for complete replacement of our irrigation system down the road?

A: We often see irrigation systems being replaced a little bit at a time, usually through the ongoing operating budget. If replacements appear necessary in large projects or in its entirety, irrigation system replacement could very possibly qualify as an appropriate Reserve component.

Q: From the chart, it looks like there is slightly a higher risk of special assessment for associations right about at the 100% Fully Funded point. What is driving this?

A: What we report on that chart is the rate of special assessments among our clients. In general, the chart shows that special assessments are very rare among associations above 70% Funded. Yet even well-funded associations may have a special assessment for a non-reserve project like a capital improvement or to pay an insurance deductable, and that's why you see a tiny blip near the 100% point. The point is that special assessments for Reserve projects are essentially non-existent when an association is above 70% Funded.

Q: If an association replaces a component during the year and asks the Reserve Specialist to re-characterize the component as "new" in the Reserve Study, does the Reserve Specialist need to see evidence of the actual cost of the replacement?

A: No, you don't need to provide evidence. National Reserve Study Standards allow us to take the word of our client without "auditing" their expenses or Reserve balance. It is great to get cost and timing information from clients on their Reserve projects so we will know which projects have been accomplished, and in order to tune our cost estimates.

Q: Our association is SEVERELY underfunded, and the homeowners cause recalls and havoc if the assessments are raised by even $20 a month (Assessments are now $600/mo after a $20 mo increase last year), but we need more $ to get the reserves up to even a 50% level. What should we do?

A: Your job as a board member is to protect, maintain, and enhance the assets of the association. Clearly communicate the expenses, and the need for additional funds to pay those expenses. Don't be distracted by a vocal minority group. You have a job to do. Run the association in a fiscally responsible manner.

Q: I have an association that is not contributing to reserves. The reserve study is calling for significant monthly contributions, but the board and owners don't want to increase dues. What do I do?

A: When you discuss the issue, characterize Reserve contributions as "paying the deterioration bill", making them sound like any other bill the association is responsible to pay. Remind the board that their obligation is to provide for the needs of the association, and that if owners can't afford the cost of living in the association, they are free to move. And make sure to document what you've said and done for the record!

Q: I manage a very rural community and many of our roads are not yet paved. We don't pave until the street is almost built out to keep from having to repair the road. What's the best way to represent this new construction in a reserve study?

A: I presume the Developer or the new owners are funding roadway paving. As soon as a section of roadway is paved, make sure that section is added to your Reserve Component List (likely multiple line items such as Asphalt Phase I, Phase II, Phase III, etc.), so funds can begin accumulating for eventual resurfacing.

Q: When would it be beneficial to use Component Method to calculate a Reserve Funding Plan over the Cash Flow method?

A: That's another topic we'll cover in the upcoming Reserve Studies 103 webinar (see a recording here). Other than providing a simple and preliminary analysis, I can't think of a time calculating a Funding Plan using the Component Method is more advantageous than the Cash Flow methodology.

Q: How should reserve deficiencies be recorded in financial statements, and what information should be disclosed?

A: Many states require that the Fiscal Year start Reserve balance be disclosed, and the Reserves Percent Funded on that date. Some states even require disclosure of the Reserve contribution rate recommended in the Reserve Study compared to the association's *actual* Reserve contributions. Check with local statutes and your accounting professional. You are generally well covered if you annually disclose Reserve Fund cash balance, and the meaning of that cash balance (Percent Funded).

Q: Our state requires HOAs with our amount of income to have an annual audit done by a CPA. Our board refuses saying it's too expensive. But they also claim they can't get anyone to even do an inexpensive review. What can be done?

A: Right is right. Do the annual audit, and increase homeowner assessments in order to afford to comply with the law in performing that required professional expense.

Q: Fannie Mae & FHA guidelines require 10% of income be allocated towards Reserves. Is that in addition or instead of other Reserve contributions?

A: Reserve contributions are Reserve contributions, whether guided by government standards or the recommendation in your Reserve Study. We find that Reserve contributions typically need to be 15-40% of an association's total budget, so the 10% required for FHA compliance is usually a lower standard than the practical needs of the association.

Q: In CA, when I received our association's annual budget & policy disclosure, it did not include what I understand is the required Civil Code §5570 disclosure. Someone from the management company stated this form was not required.

A: I'm not an attorney, but it is pretty clear to me that CA Civil Code 5570 states this is an annual disclosure. I've not heard an association attorney say anything to the contrary. You can see the list of annual Reserve disclosure requirements in California Civil Code §5300.b.7 here.

Q: Why do Reserve Studies include painting as a Reserve item when the IRS does not allow deductions to be taken as capital per IRS 263?

A: Prepare your taxes according to IRS regulations, and prepare your Reserve Study to provide for the needs of the association according to NRSS. Painting projects regularly qualify under NRSS as a Reserve Component. Your tax preparer can make any adjustments necessary during their tax preparation process.

Q: I live in a mountain community of where units are generally second homes. Someone said Reserves should be funded at 30% for any 5 or 10 yr expense. Care to comment?

A: In our experience preparing over 45,000 Reserve Studies, the evidence shows that special assessment risk is low when the Reserves are above 70% Funded, no matter the type of association.

Q: What's the best way to communicate the wisdom of making Reserve contributions?

A: Characterize Reserve contributions as a present obligation… offsetting ongoing deterioration. That makes Reserve contributions sound like any other bill the association is obligated to pay. You use electricity through the month, but only pay the bill at the end of the month. Similarly, your roof is deteriorating over the course of 20 yrs, but you only pay the bill at the 20-yr point. Set the budget so you are collecting funds from the owners in order to pay all your bills.

Q: Do we listen to the developer who wants to delay having a Reserve Study prepared until a certain % of homes have been sold to individual owners?

A: It depends what your governing documents say. Most governing documents state that the developer retains control of the association until a certain threshold of homes have been sold. Even though what they do may not be wise, as long as the developer is in control, the developer gets their way.

Q: If Reserve deterioration is constant and ongoing, then doesn't it become an Operating Budget item?

A: No. Breaking down a 20-yr roof project into 240 months is just a way to personalize and make the expense more "real" to current owners, so they can appreciate they are using-up a share of the roof life. Projects that meet the NRSS four-part test are still Reserve projects, funded with Reserve contributions.

Q: We have a quarterly maintenance service contract for our roof that guarantees no leaks. How do you handle that in the Reserve Study?

A: Timely maintenance will extend the life of the roof. Tell your Reserve Study preparer, and they'll likely extend their Useful Life estimate for the roof. While the maintenance contract guarantees no leaks, like life insurance it will get prohibitively more expensive or not be available as the roof approaches the end of its life. So continue to plan for roof replacement, on an extended life cycle, in your Reserve Study.

Q: How do you accurately determine what the replacement cost is going to be?

A: We are fortunate to have a large enough volume that our primary source of costs is the "actual" costs experienced by other similar, adjacent associations. To supplement that information, we interview the association's vendors, compare to prior costs at the association, or refer to reconstruction cost guides.

Q: When I want to extend the Useful Life of a component (like from 5 yrs to 8 yrs), do I just make the change or is good practice to make a notation somewhere?

A: Any change should be noted. That way the person preparing the next year's update won't change that Useful Life back to 5 thinking it was a typographical error.

Q: You stated that a Reserve Study is typically a 20 or 30-yr plan, with ongoing contributions. Are those like long-term mortgage payments?

A: A Reserve Study is not a long-term plan like a mortgage contract. A Reserve Study is a series of one-year updated plans based on estimates of expenses far into the future. By nature it is best to revisit that plan annually and make adjustments as necessary.

Q: If we're 100% Funded now and if we make the recommended contributions, are we for sure 100% Funded next year?

A: No. Your Percent Funded rating is a measure of current Reserve balance compared to the calculated needs (deterioration) of the association's Reserve components. If cost estimates fluctuate more than anticipated, if components last longer or shorter than estimated, if the bank lowers its interest payments, or if the association misses a contribution, you'll likely still be well funded, but not 100%. Your Percent Funded needs to be recalculated every year based on the condition of the components, their estimated current costs, and the current Reserve balance, all of which are subject to change over the course of a year.

Q: Why update the Reserve Study if it was well prepared. Doesn't interest offset inflation and keep the plan "on course"?

A: See above. All factors involved in a Reserve Study are in a continuous state of change, necessitating that it be updated. In addition, as contributions are typically 15-40% of your total budget, it is one of your most significant budget line items, deserving annual scrutiny. Evidence shows that special assessments are measurably rarer among associations that update their Reserve Study annually rather than every third or fifth year, because staying "on course" requires regular adjustments!

Q: What do you recommend we do if we are 175% Funded?

A: We recommend a strategy of purposefully underfunding your Reserves (contributing less than your "deterioration rate") to gradually and in a controlled manner reduce the strength of your Reserve Fund, down closer to the 100% range. This keeps all homeowners in the habit of making Reserve contributions, and continues to spread out the contribution burden relatively fairly over the years.

Q: Can you recommend some software that will give us the kind of calculation results (NRSS compliant) that you describe?

A: Certainly. Go to QuickReserves.com, and create a free online account for your association.

Q: How do you evaluate the life of an asphalt road? Is it the same in N Dakota as in Phoenix? Is it the same on a busy road as in a residential association?

A: Asphalt life depends on its environmental exposure (heat, moisture, freeze/thaw cycles, etc.), the amount of traffic, the quality of the structural base, how well it sheds water (standing water is destructive!), and how well it is maintained (rejuvenated or sealed). It is evaluated on the basis of its age and observed condition.

Q: How often should the association make Reserve transfers?

A: Regularly, at every budget cycle. If the association operates on a monthly basis, that means every month. If the association collects from its homeowners quarterly, then quarter.

Q: What is the simplest way to explain to a Board that spending reserve funds on a needed item will not result in the reserve being underfunded?

A: Reserve fund strength is measured as cash compared to needs. So when the needs are high (a project needs to be done), you should have sufficient cash on hand. When the project is accomplished, the association's Reserve needs drop. So spending on a needed project does not create a funding deficit. Remember the pool resurface example in the webinar.

Q: Can you use reserve funds to purchase backup equipment, like a backup pump for boiler, even though it is for 'backup' and not a scheduled reserve replacement?

A: Yes. You could consider that a premature replacement, minimizing “down time” when the primary asset eventually fails.

Q: The Reserve Study done for our HOA shows net reserve funds growing to over $1 million in 30 years. This seriously affected the Board's ability to sell the Reserve plan. Can this be right?

A: Don’t focus on the balance in 30 years. With 3% inflation, those dollars are equivalent to about $400,000 today, which may seem much more “sensible”. Besides, it is always best to look at the association’s Percent Funded, which compares the Reserve cash against Reserve needs. If your Fully Funded Balance is $400k today and your association only has $200k, you are 50% funded and for sure $1M sounds like an unreasonably high target. But it may be what the association needs in 30 years.

Q: Has a homeowner ever sued board members individually for underfunding reserves that resulted in a special assessment?

A: Yes. I don’t have a specific example, but that was a question covered in our webinar on D&O insurance (find it on our webinars page). Special assessments generally reveal poor budget choices made by board members. And when homeowners are upset enough, they sue.