



“Understanding Reserves” Book Launch

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Miss the webinar? Watch it [here](#).

“Understanding Reserves” is a book based on over 30 years of experience serving thousands of associations of all shapes, types, and sizes.

In 25 chapters, we take the reader through four sections:

- Reserve Fund Basics
- Reserve Study Basics
- Understanding a Reserve Study
- General Reserve Concepts

While we go into much more depth on particular topics in our [webinar curriculum](#) and individual [articles](#) and eBooks on our website, this book compiles basic Reserve knowledge into a digestible, desktop reference. The book’s 25 chapters provide the reader with a working knowledge of Reserves and plenty of “aha” moments. If you are a board member, manager, or industry professional that wants or needs to know how to make decisions today that lead to an improved future tomorrow, this book is for you. We want your association to thrive. This book is yet one more tool to stack the odds of success in your favor.

And if you’re eager for our help preparing a Reserve Study for your association, applying all these concepts, get a proposal by clicking [here](#).



Webinar Questions about the Book

Q: Can you show the Table of Contents?

A: Yes – please see the Appendix in this Outline.

Q: Does the book address the question of changed assumptions or changed strategies to reserve funding? (Our current board made some funding policy changes)

A: The book addresses Funding Goals (Full, Threshold, Baseline), but not the effects of changing from one to another from one year to the next. Having a consistent Funding Goal is the first step towards attaining that goal. Establishing a multi-yr Reserve Funding Policy (see sample [here](#)) that doesn't change with the whims of individual board members will be a great first step.

Q: Does the book address the reserve requirements for Fannie Mae, Freddie Mac, and FHA when it comes to Condominiums?

A: On pg 97 we discuss these requirements in an example of an association that is “selling out”, and not focusing on providing for the needs of the association (which has the nice benefit of maximizing home values for the owners). But we don't go into these requirements in detail.

Q: We are in Florida and under Florida Statute 617 which means we must be non profit and unable to build up reserves. Does the book address this?

A: No, the book does not go into the nuances of individual state laws. We encourage readers to seek the opinion of local accounting and legal counsel on such matters. Please note that the IRS does not consider Reserves “profit”. Reserves are funds set aside to offset deterioration. Being “non-profit” does prevent the association from preparing for its own future.

Q: How did you describe the content in Section 4 of the book?

A: Section 4 is “General Reserve Topics”, which include Borrowing from Reserves, making decisions that differ from what is presented in your Reserve Study (made possible with the Association Reserves online calculator called [uPlanIt](#)), and an overview of laws and legislation affecting community associations and their boards (Business Judgment Rule, etc.).

Q: Is the book audience national or state-specific?

A: National.

Q: Does the price of the book include updates based on new laws?

A: No. The book is the 2021 version. Since specific laws are not identified in the book, it is not instantly outdated when a new law is passed in a particular state. That said, we currently anticipate updating the book with a new version approximately every two years.

Non-Book Questions

Q: Could you talk about how a Reserve Study can impact a condo association... not just in terms of budgeting, but more in terms of how the association is perceived by banks, realtors, etc. looking to determine IF the association is financially viable?

A: A Reserve Study is how a board finds the balance between ongoing deterioration of their common area assets and the size and growth of the Reserve Fund to provide for the inevitable expenses related to that deterioration. More buyers and Real Estate agents are looking for “adequate” or “strong” Reserves, indicating the association is on a financially sustainable trajectory. Banks are still generally looking for at least 10% of budget going towards Reserves (even though [15-40%](#) is typically necessary).

Q: Do your Reserve Studies take into account increased Cost of Compliance/newer building codes?

A: Yes. Every Component “replacement” cost should include the full cost of the project, which may include disposal, permits, shipping, and code-related upgrades. New codes are often the cause of significant price estimate increases, another reason to regularly update your Reserve Study.

Q: What is considered an average funded reserve study? What can happen if you are over funded (ex. 150%)?

A: Please see [this](#) article, showing that most associations are in the “fair” range of 30-70% Funded. If the association is significantly “surplus” funded (over 130% Funded), our recommendation is to gradually, and in a controlled manner, “under-Reserve” for a few years to bring the Reserve Fund down closer to 100% Funded.

Q: Most reserve studies list item lifespan and cost, but no history of last replacement time and cost. Why isn't this listed in the study output?

A: That is unfortunate. Component history is not a disclosure required by [National Reserve Study Standards](#). We can't answer for our competitors, but the component's "history" is typically disclosed in an Association Reserves report.

Q: What is impact (on P&L, taxes, etc) of over reserving?

A: Over-Reserving (creating a Reserve Fund well over 130% Funded) can draw the attention of the IRS, who may begin to consider some of those funds (taxable) "profit".

Q: What is the correct way to account for replacement of components that are unlikely to need complete replacement as a single unit, e.g., a fence (that is unlikely to deteriorate as a single unit) or roadway culverts. We have 60 culverts; do we identify each individually on our component list?

A: It is best practice to identify components separately that have different Useful Life or Replacement Useful Life estimates. I would doubt that you have 60 different Remaining Useful Life estimates for 60 different locations of the same asset. Group the ones together that have the same Useful Life and Remaining Useful Life (Culvert Replacements I, Culvert Replacements II, Culvert Replacements III, etc.).

Q: Our residents have to pay both for the operating needs and the reserve needs. I haven't seen anyone looking at the combined requirements when determining what the total assessment requirements are. Comments?

A: Every owner should pay the ongoing cost of maintaining the association, which consists of Operational expenses and Reserve expenses. Total assessments are the combination of the two. Our job is to help the board clearly see and appreciate the size of Reserve contributions, often [15-40%](#) of the total assessment.

Q: What percentage funded is optimal for 30 years old building?

A: It is optimal for any building to be 100% Funded. That is when the cash in Reserves is (roughly) equal to the \$ value of Reserve component deterioration at the association. Both are small numbers for a new association, both can be large numbers for an older association. 100% Funded associations are on-track to being prepared for all their upcoming Reserve expenses, and statistics show they have a very low risk of special assessments.

Q: Why are HOAs deteriorating?

A: Exposure to wear and tear (usage, the weather, ...), and short-sighted board decisions.

Q: What does the R.E. abbreviation stand for, and can HOA funds be co-mingled amongst components?

A: R.E. typically stands for Real Estate, the field of buying, selling, and owning land or improvements to that land. In all associations, *Reserve Funds* should not be comingled with *non-Reserve (Operational)* funds. With respect to components, Reserve Funds are typically not designated towards specific components (with the exception of some associations in FL). The FL exception is for associations still calculating Reserve contributions using the Component (straight line) Method. In addition to not being favorable to the owners (see more [here](#)), the Component Method requires more accounting overhead (dispersing cash into all those different “accounts” and then tracking the cash balance in those different “accounts” throughout the year, even those funds are regularly redistributed at the end of the year). FL associations still using the Component Method should shift to Cash Flow at their earliest opportunity. The Cash Flow Method is a more effective and fairer way to prepare for exactly the same expenses.

Comments about the Book

1. I have participated in most of AR webinar presentations and have expressed my opinion that all Board members should listen. I have been advised I have more time on my hands than they. I purchased the book immediately upon notice. It is at my side, just like the 12th Edition of Robert's Rules. I am hopeful it will help me express the importance more than I have been able to do so thus far. Thank you for your tremendous efforts to educate us for the benefit of our Associations!
2. I have skim-read the book and your Chapters 22 through the Conclusion is primary and appreciated! Mahalo

Thank you! (from Robert & Kevin)

APPENDIX

UNDERSTANDING RESERVES

**A GUIDE TO YOUR ASSOCIATION'S
RESERVE FUND & RESERVE STUDY**



KEVIN LEONARD, RS
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**CONCEPTS
STANDARDS
PRINCIPLES
FUNDAMENTALS**

TABLE OF CONTENTS

Introduction	1
Part I: Reserve Fund Basics	4
Chapter 1: Why Reserve Funds?	6
Chapter 2: How Much Is Enough?	12
Part II: Reserve Study Basics	18
Chapter 3: What Is a Reserve Study?	19
Chapter 4: Who Should Perform a Reserve Study?	22
Chapter 5: How Is a Reserve Study Conducted?	25
Chapter 6: The Three Types of Reserve Studies	31
Chapter 7: Reserve Study Timeline	35
Chapter 8: Reserve Studies for Home Buyers and Real Estate Professionals	37
Part III: Understanding a Reserve Study	40
<i>Key Result #1: The Component List</i>	41
Chapter 9: What Is a Component List?	42
Chapter 10: What Is and Is Not a Reserve Component	46
Chapter 11: Component List Concerns	60
<i>Key Result #2: The Evaluation of Reserve Fund Strength</i>	66
Chapter 12: Percent-Funded and the Fully Funded Balance	68
Chapter 13: How Does Your Association Compare?	75
Chapter 14: Strong Percent-Funded = Strong Home Values	77
<i>Key Result #3: The Recommended Reserve Funding Plan</i>	80
Chapter 15: The Four Reserve Funding Principles	82

Chapter 16: Reserve Funding Goals	87
Chapter 17: Calculating Reserve Funding Plans	91
Chapter 18: Selling Out, Settling, Succeeding	95
Chapter 19: The \$10 Solution	101
Chapter 20: Six Ways to Minimize Reserve Contributions	103
Chapter 21: Interest and Inflation	108
Chapter 22: Cash-Flow vs Component Method	112
Part IV: General Reserve Topics	117
Chapter 23: Borrowing from Reserves	118
Chapter 24: uPlanIt	120
Chapter 25: Reserve Study Laws and Legislation	122
Conclusion	130
Terms and Definitions	131

INTRODUCTION

On October 9, 2007, the Dow Jones Industrial Average closed at its, then, all-time high of 14,164.53. On the surface, everything appeared fine. The economy was flourishing on the back of a seemingly stable housing market. Little did anyone know that this was all built on a house of cards. Sub-prime mortgages defaulted and major financial institutions only survived because of a bailout by the federal government. Nineteen months after October 2007, on March 6, 2009, the Dow Jones reached its, then, lowest level of 6,443.27.

The whole country was hit hard by the financial crisis—big banks, small businesses, and homeowners alike. Our clients desperately needed guidance during this difficult time. One particular association, a 100-unit townhome community in Southern California, came to us asking “What should we do about our reserves?”

They were 28% funded, contributing half as much to their reserves as the amount we had recommended, and they were facing close to \$800,000 worth of shingle roof replacements.

An \$8,000-per-unit special assessment was not something their owners could afford and they were reluctant to take out yet another loan (they had recently financed their latest asphalt project). We immediately got to work.

Their first course of action was to raise the monthly contribution rate as close to our recommendation as

possible. This did not provide significant assistance in the short term, but it was necessary to get them on the right track. Based on what they currently had in their reserves, we calculated that if they were able to phase out the roofing project over four years and defer other less significant projects, they might be able to squeeze by without requiring supplemental funding.

Instead of an \$800,000 roofing project that year, they replaced the critical roofs and repaired others, delaying less immediate replacements over the following three years. This evened out to about \$200,000 over four years. Their community room remodel was put on hold, and we extended the project cycle for wrought iron and wood painting from every four years to every five. The ten-foot-tall pole lights throughout the community would need to last a few more years than anticipated, and the pool/spa surfaces were destined to accumulate a few more cracks and chips before they would have the funds to resurface.

Four long years later, all building roofs had been replaced without the need for a special assessment. The board could finally let out a sigh of relief and focus on how to never let their association get into such a vulnerable position again.

Today, we are happy to report that they are currently 38% funded (not ideal, but considerably better than where they started) and they are making appropriately sized reserve contributions. Moving forward, the funding plan will ensure that enough funds will be available to

maintain and eventually replace their major common area components on schedule.

Successful reserve planning begins by acknowledging that most major components will not last forever. The plan is executed when the board performs their duty to protect, maintain, and enhance the common areas of their association by providing sufficient funds. This is possible when communication is clear and everyone involved, board members and managers alike, have a complete understanding of their reserve fund and reserve study.

Part I

RESERVE FUND BASICS

“Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pound ought and six, result misery.”
– Charles Dickens

Living in an HOA or CID (common-interest development) certainly has its pros and cons. The dues may be higher than you would like and you might not be able to choose the style of your own garage door, but there are benefits, too. You can have the security of living in a gated neighborhood with a community pool, tennis courts, bocce ball, golf course, or enjoy city life in a high-rise with a fitness center and coffee bar to satisfy your daily habit. The association handles all common area maintenance with “economies of scale,” minimizing owner costs and responsibilities!

These shared benefits may be too expensive for a single homeowner to own and maintain, but with expenses divided among hundreds (or sometimes thousands) of community members, the benefits far outweigh the cost that an individual owner pays on a monthly basis. The key for community associations, since common area expenses are shared among all owners (both current and future), is to ensure that everyone pays *their fair share* along the way.

In addition to being the fairest option to pay for significant expenses, the following chapter will also address the fact that reserve funds are the least expensive option as well. An equitable distribution of the reserve burden across all owners of an association and using reserve funds as efficiently as possible are two issues that drive the need for accurate budget planning.

Chapter 1

WHY RESERVE FUNDS?

Reserve funding is multi-faceted and brings to mind a famous Arnold Palmer quote: “Golf is deceptively simple and endlessly complicated.” We want to help you understand the “complicated” part of reserves, but the concepts can be very simple.

There are some things that never change:

- Reserve expenses are inevitable
- The association board is responsible for ensuring those expenses are paid
- Delays usually get expensive
- Homeowners always get stuck paying the bill

The overall concept of a reserve study is to identify an association’s predictable expenses and put together a responsible funding plan so that homeowners pay their fair share—no more, no less.

Expenses an association will incur over time can generally be split into two types: Operating and Reserves.

Operating Account

Funds used to pay for day-to-day functions of the association.

Reserve Account

Funds set aside for the replacement of major components the association is responsible to maintain.

On one hand, there will be routine costs paid for on a daily, weekly, or monthly basis (eg, management fees, insurance payments, and routine maintenance). These types of operating expenses do not vary greatly from year to year, which makes them simple to plan for in the annual operating budget.

Alternatively, reserves are commonly used for large, infrequent projects such as painting building exteriors or replacing perimeter fencing. It is money that an association saves over a long period of time to replace roads, roofs, or the rusted twenty-year-old boiler that has been making a strange groaning sound for the last three months.

Reserves are treated differently than operating funds because these expenses do not occur on a regular basis. Most operating budgets would not be able to absorb a \$100,000 expense that pops up. This is why saving money over time is the ideal method for funding infrequent reserve projects.

Not only does it make sense to set aside reserve funds from a budgeting perspective, it is also the most equitable approach for any community. Remember, the key for community associations is that all owners (both current and future) pay their fair share of expenses. Over time, homeowners will come and go. Some will stay at their home for thirty years, others three years, but the common area components will be there indefinitely. Without adequately funded reserves and advance planning, only the owners living in the community at the time the roof

inevitably fails would be responsible for the total cost. This is inherently unfair. The roof had lasted twenty years, so each owner who benefitted from the roof over those twenty years should be responsible to pay his or her fair share.

The good news is that, while infrequent, reserve projects are very predictable. Reserve expenses do not pop up “randomly,” they gradually deteriorate and fail on a predictable schedule. The useful life of the roof in this example is twenty years. As soon as the roof is installed, it begins to steadily deteriorate, shingle by shingle. As the roof ages, the reserve fund should grow proportionally so that, after twenty years, the association has enough money to pay for a new roof.

Let’s say the roof replacement costs \$200,000. Ideally, the association should collect and set aside approximately \$10,000/year (\$200,000 divided by twenty years). Done this way, after twenty years, when the roof’s useful life has been “used up,” they will have the money to pay for the full replacement. A steady contribution rate would ensure that all owners pay their fair share.

If homeowners in years one through ten do not foresee the need for the eventual replacement and do not set aside any money (granted, it is hard to see anything when their heads are buried in the sand), then homeowners in years eleven through twenty would only have ten years to collect enough money for replacement. They would need \$20,000 per year—double their fair share!

In addition to being the most equitable way to fund capital replacement projects, making regular reserve contributions is the least expensive as well. Let us explain.

There are essentially four ways to pay for a reserve expense. First, associations can make regular budgeted contributions. This money is put into an interest-earning account until the time comes to replace the component. With the supplemental interest income, this method will cost the association less than the total replacement amount. Any dollar that can be contributed by an outside organization, such as a bank, means one less dollar the homeowners will have to pay.

The second way is when the board is forced to pass a special assessment for the total amount of the roof. This method ends up costing the association the exact amount for the replacement but is unfair to the current owners.

Special Assessment

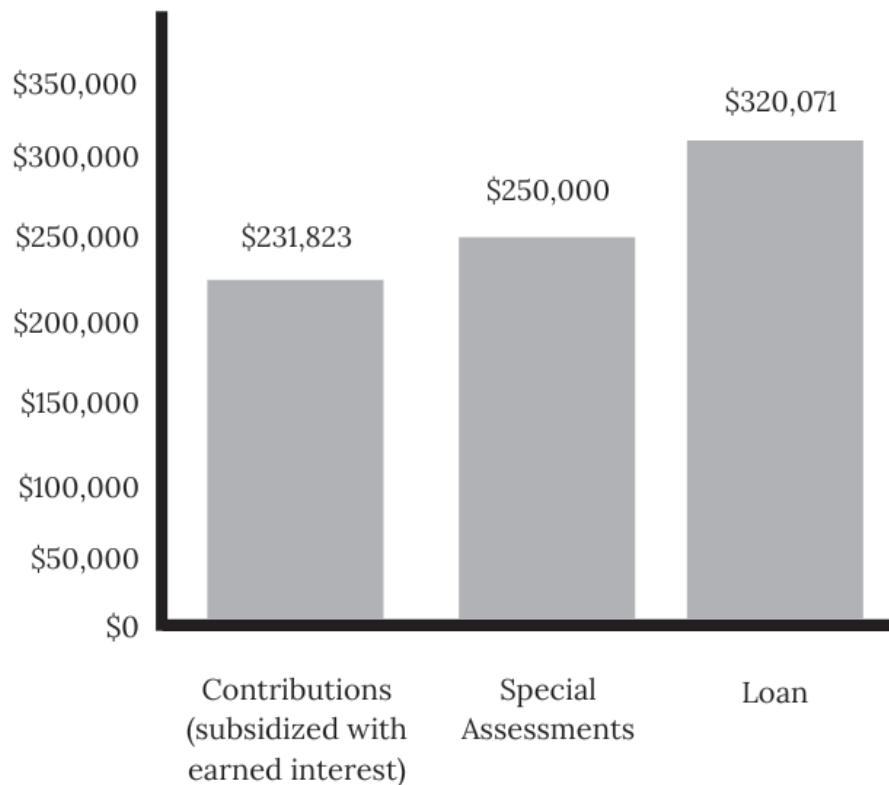
"A temporary assessment levied on the members of an association in addition to regular assessments. Note that special assessments are often regulated by governing documents or local statutes."

- National Reserve Study Standards

In some cases, the board may not be able to pass a special assessment and they need to apply for a loan (paying interest to the bank, the opposite of the bank paying interest to the association). These second and third methods show a lack of foresight that hurts the association financially.

And lastly, the fourth way to “pay” for this roofing expense is to defer the replacement. This is possibly the most expensive option. It saves money in the short term, but damage due to deferred maintenance makes the project more costly, and the need to replace the roof never goes away. The community will eventually begin to look run-down with poor curbside appeal, leading to lower property values.

Why Not Special Assess or Loan? Cost of \$250,000, 15 year roof



Boards have governing documents that define their responsibilities to preserve, maintain and enhance the common areas of the association. They also have the authority to collect funds to perform these duties. The only choice they have is how to pay for long-term, significant expenses. This decision affects when payments are made, how much is paid at a time, who pays, and additions or offsets to the cost.

A loan is paid on a regular basis in the future, it is paid over a certain term, it affects current and future owners, and interest will add to the cost.

A special assessment is paid today, it is paid in a lump sum, it affects only the current owners, and there is no addition or offset to the cost.

Regular contributions are paid on a regular basis, it is paid a little at a time, it affects all owners, and earned interest offsets some of the cost, making this option the fairest and lowest cost for an association.

Why reserve funds? Because expenses are inevitable and predictable. The board is responsible to maintain the common areas. Delaying major projects will usually compound expenses, and the homeowners always get stuck paying the bill. So, reserving funds on a regular basis is not only the most equitable approach for community associations, it is the most financially sound option as well.