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Reserve Studies 102 – The Financial Analysis

by Robert M. Nordlund, PE, RS and Bryan Farley, RS www.ReserveStudy.com

Miss the webinar? Watch it here.

Our job is to help your association prepare for *inevitable* future expenses. This webinar helps you understand if your Reserve Fund is strong, weak, or somewhere in-between. We also explain what drives your Reserve funding requirements… what makes them higher or lower than seemingly similar associations. It all starts with understanding that deterioration is inevitable. It never takes a day off, and deterioration is a formidable, expensive opponent.

So – how do you know if your association is prepared (or not)? First, your Reserve Study provider calculates the target amount of deterioration at your association at this time. That number is called your Fully Funded Balance. Shown below, it is the fractional age of every component multiplied by its current cost. That reveals the "value" of its life "used up".

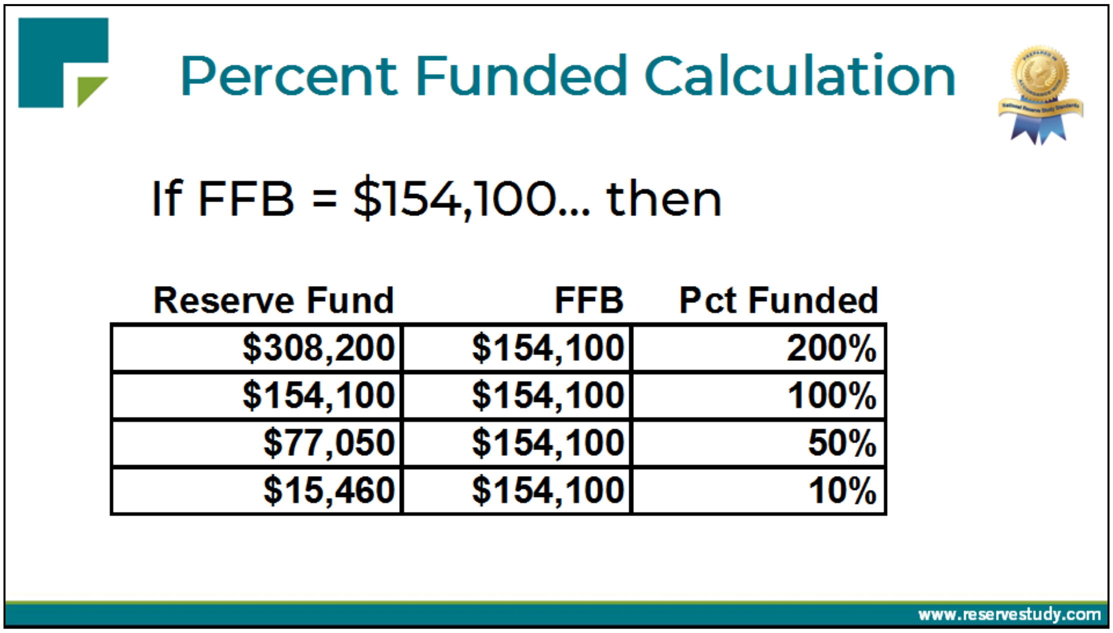
Fully Funded Balance

Fractional Age X Current Cost

(Summed for all components)

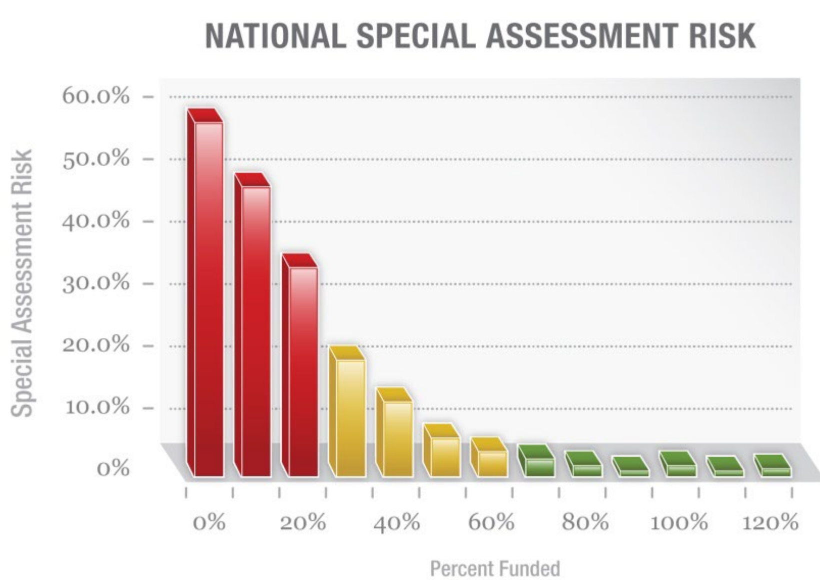
Then, your Reserve Study provider compares how much Reserves you actually have on deposit to this target value. That's when you begin to learn if you should feel good or bad about how much boards and owners have set aside in prior years to offset ongoing deterioration, resulting in today's balance.

The result of that comparison looks like this – your association's calculated Percent Funded.

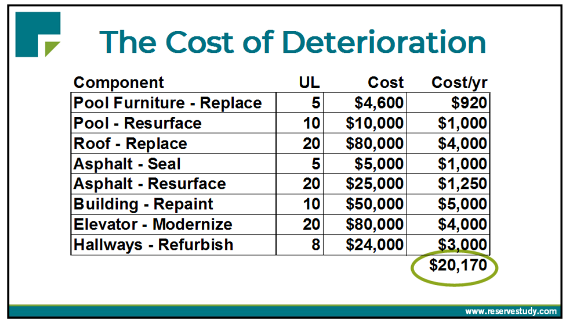


Reserve Fund	FFB	Pct Funded
$308,200	$154,100	200%
$154,100	$154,100	100%
$77,050	$154,100	50%
$15,460	$154,100	10%

And now you should be wondering… what does this tell me, and what does this mean? Your association's resulting "Percent Funded" is a strong indicator of special assessment risk. It is not an absolute correlation, but there is a <u>high risk</u> of special assessments when the Reserve Fund is in the weak 0-30% range, medium risk when the Reserve Fund is in the middle 40-70% Funded range, and <u>low risk</u> of special assessments when the association has a strong Reserve Fund (over 70 Funded).



Okay – now that you know your starting point, let's talk about your Reserve funding needs. 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! Your Reserve Study provider calculates your "deterioration rate" by dividing each Current Cost by its Useful Life, revealing a $/yr rate". This is the "pace line" of what you're up against at your association, based on the components identified in your Reserve Study. This is the ongoing cost of deterioration that you fight with ongoing Reserve funding.



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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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 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.

Note that Reserve contributions sufficient to offset ongoing deterioration are typically in the range of 15 – 40% of an association's total budget.

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. The Component Method regularly calculates very high near term Reserve funding obligations, and for that reason is rarely utilized outside of Florida.

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.

These Reserve Funding Methodologies and Goals are covered in detail in our Reserve Studies 103 webinar curriculum. See the last version of this webinar on our website here, or join us the next time we present this webinar live.

Free eBooks on Reserve Fund Strength and Reserve Funding Plans are available here.

See an explanation and examples of National Reserve Study Standards here.

Get an expert on your side to provide you the information you need to navigate 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 60,000 Reserve Studies for clients in all 50 states over the last 30+ years! Launch a free online proposal request by clicking here. Or 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.**

Webinar Questions Asked By 2022 Attendees

General Reserve Study Questions:

Q: How often should the reserve study be updated?

A: Industry Best Practice is a With-Site-Visit update at least every three years, with inexpensive No-Site-Visit updates in the in-between years. Reserve Funding is regularly 15-40% of an association's overall budget, so annual updating is in the best interests of the association.

Q: Our Reserve requirement is limited by a percentage in the Governing Docs. Costs are increasing. Do you have any suggestion on how to handle?

A: Revise your Governing Docs (which also require you to take care of the property!).

Q: Isn't it better to develop the annual budget based on operating costs and the annual reserve contributions without the bias of "the assessment MUST be increased?"

A: The objective is to provide for the needs of the association. Given that all operating costs and Reserve costs are increasing, the net effect is your homeowners should be expecting annual increases because they have been receiving annual increases.

Reserve Funding Questions:

Q: When the reserve study is funded at 100%, for how many years is the study fully funded?

A: One year. As Bryan explained, everything is always deteriorating. Costs are fluctuating, and your Reserve Balance fluctuates (maybe not all funding was accomplished, maybe some projects occurred over or under budget…). So expect that your Reserve Study is a one-year document, and expect funding to be adjusted annually.

Q: What funding sources are there other than monthly budgeting, special assessment, and bank loan?

A: A special fee at time of home sale (I've seen two months of association assessments charged and going 100% to the Reserve fund), and outside income. Cell phone companies renting rooftop space for an antenna is a common example.

Q: **When setting up replacement cost, if you have a current expectation of a $10,000 cost, how much increase do you factor over the 10 years of funding to arrive at future cost of replacement?**

A: At 3% per year for 10 years, that means in the Funding Plan you should expect to prepare for an expense of approximately $13,439.

Q: **My Reserve Study company uses <u>year-end</u> fund balance/FFB instead of <u>year-start</u> cash on hand/FFB. Which is right?**

A: The field of Reserves is gradually maturing. The original drafters of National Reserve Study Standards (NRSS) did not anticipate providers would use anything than the year-start balance, so it was not stated explicitly in NRSS. Here in 2022 NRSS are being updated, so expect by 2023 this “yr start vs yr end” confusion will be eliminated.

Q: **If the HOA Reserves are funded at 6%, how would you recommend addressing this? The HOA does not have ample funds in the Operating Account to make a large transfer. Should a Special Assessment to fund the reserves be put to a vote of the membership OR can an Emergency Assessment be implemented?**

.A: It all depends on the timing of upcoming Reserve projects, your Governing Docs, and State Law. See your Reserve Study provider for guidance specific to your association.

Q: **Our Reserve Fund is 135% Funded but noticed so many components were past due. Can % be correct in this case?**

A: I have one client that continues to make properly sized Reserve transfers from Operating to Reserves every month. But boy, do they have a hard time spending that cash! Many of their projects are past due. They are over 100% Funded. They delay doing projects simply due to being stingy spenders, not due to lack of cash.

Q: **Is a majority vote of homeowners required for HOAs that were using the straight line method for funding reserves prior to builder turnover and want to switch to the pooled method after builder turnover?**

A: I’m presuming you are in FL (the only state where this is an issue). Please consult with your local Reserve Study provider to develop a strategy.

Q: **Our 50-unit HOA was surprised with by a Reserve Study recommendation to modernize elevators. We're looking at about $600,000 3-5 years in the future. Just raising HOA dues does not seem workable. After the project receives bids for the best final cost, what might be the pros-cons of a Special Assessment vs. an HOA loan (say, 10 year)?**

A: It is unfortunate that this was surprising. Elevators <u>have been</u> expensive, they <u>continue to be expensive</u>, and modernization projects are <u>very predictable</u>. Ideally your association should have been preparing for this expense for many years. I presume you’ve gone over this issue with your Reserve Study professional, and you’ve learned that you just plain don’t have enough time to collect funds gradually over time. Presuming that to be the case, we would recommend a special assessment. It is then the board’s job to contact local financial institutions (those that deal with associations regularly) to see if their loan package is financially attractive. <u>It will be expensive</u>, because interest is costly! Consider a hybrid solution… a discount for owners that can pay a special assessment up-front, a multi-yr special assessment, and longer term loans for the rest (where any outstanding balance would be paid off immediately if that unit is sold during the term of the loan). It doesn’t have to be a “one size fits all”.

Q: What does Association Reserves recommend for the ideal percent of full funding, specifically related to the FAIRNESS issue, that is fair to both current AND future owners of the association?

A: You are mixing two things. Full Funding is a measure of cash in the bank. Fairness over the years sounds like ongoing Reserve funding (balancing who pays in… spreading the funding burden over current and future owners). Because deterioration is ongoing, it is only fair that current owners pay for the deterioration occurring <u>while they own a home in the association</u> (which is exactly the way a hotel operates, rental car companies operate, etc.… maintenance and replacement is included in their fee structure). So we recommend associations fund very close to the “pace line” described in the webinar, adjusted for inflation and any accelerations needed to prepare for upcoming major expenditures.

RESERVE COMPONENT QUESTIONS:

Q: Can HOAs use funds from the reserve for pool furniture?

A: Absolutely, if the project passes the National Reserve Study Standards four-part test (which it often does when pool furniture is replaced in bulk). See our Reserve Studies 101 webinar (here) for more information.

Q: What happens with Reserve funding once an item has reached "the end of life" but the item still has life left?

A: This is only an issue for associations using the Component (straight line) Method of Reserve funding, where Reserve funds are assigned to a particular purpose. In those cases, the funds are re-distributed to other needy components, and Reserve funding remains relatively stable (no “drop” due to one target being achieved).

Q: **How do you handle it when the component reaches zero remaining useful life, but does not need to be replaced?**

A: Your Reserve Study professional adjusts/updates the Reserve Study to reflect the latest Remaining Useful Life estimate for that component. Reality trumps the budget plan. See more information here.

Q: **How do you look at tennis courts, replace in total or resurface? Are there two different issues?**

A: Resurfacing and replacement are two different issues. Generally most tennis courts only need to be resurfaced. If the soil is not stable and the tennis court is moving and cracking, it may need to be structurally removed and replaced. Expect your Reserve Study professional to provide useful guidance on this matter.

INFLATION QUESTIONS:

Q: **How is the costs of inflation calculated for pricing over time? (i.e., 10 year example)**

A: Inflation compounds. That means with 3% inflation, $10,000 grows to $10,300 the first year. Then the next year it grows by another 3% to $10,609. Then after another year at 3% it grows to $10,927 and change. A current $10,000 project growing with 3% inflation over 10 years grows to an expected $13,439.

Q: **Can you speak a bit about much the impact that the current increase in the inflationary environment should concern us vs our current Reserve Studies?**

A: Inflation makes your costs higher, which means your Reserve Funding needs will be higher. Don’t get behind on your Reserve Funding! It is hard to play “catch-up”.

Q: **Why do you leave out inflation out of your funding calculations in the webinar?**

A: Because we were teaching. We’ve learned we teach concepts more effectively when we eliminate that additional layer of complexity.

Q: **How do we factor in the future impact of inflation on our reserve balance today?**

A: Reserve balance today is what it is. Inflation should increase how much we will recommend you have in your Reserve balance tomorrow (and 10 or 20 years downstream). That means most of our clients will see an increase to our recommended Reserve funding.

Q: What impact will the current inflation rate have on Association Reserves reserve studies on both future costs and recommended contributions to the reserve fund?

A: We are raising our "current cost" expectations in line with what we currently see in the market… steep increase from last year in many cases. We continue to keep a nominal inflation factor in our Funding Plan, because we do not expect current high inflation rates to continue for any extended period of time. And finally, we expect most of our clients will see an increase to our recommended Reserve funding because of the higher current and future costs of projects at their association.

LEGAL QUESTIONS:

Q: What is the legal requirement to get a reserve study done in California?

A: Paraphrasing California Civil Code (see here), a with-site-visit is required at least every third year, and that Reserve Study needs to be updated or adjusted annually. Please see an attorney for a legal interpretation!

Q: What are the legal restrictions on investing a Reserve Fund?

A: Generally investments of funds held on behalf of another person or entity (such as at an association) are required to be held in "safe" investments where there is no chance of "loss of principal". Please see an attorney for a legal interpretation!

MISCELLANEOUS QUESTIONS:

Q: To the point of increasing the assessments every year, the "dark side " of that practice is that your association's annual assessment may be higher than other associations of similar size. That can make the individual house less marketable and contribute to a stagnation or decline in real estate values. Thoughts?

A: Curb appeal is real. Take good care of your property with properly sized assessments, and that will overwhelm anyone's concern for "higher" monthly assessments. Besides… Real Estate agents know, and if the association has a history of special assessments that negative information will somehow be communicated to the prospective buyer. Higher assessments allow the property to remain well maintained (with high property values). Associations with a strong Reserve Fund can and should boast of their low expectation for future special assessments.

Q: **Is it possible to see the first session (101) which I missed? I am interested in how components lists are created. We are a small HOA in Atlanta area (48 homes).**

A: Yes – see here.

Q: **What % of associations have an adequate reserve?**

A: 30% of associations have a weak Reserve Fund (0-30% Funded, with a high risk of special assessments), 40% of associations have a fair Reserve Fund (30-70% Funded, with only a medium risk of special assessments), and the remaining 30% have a strong Reserve Fund (over 70% Funded, with a low risk of special assessments).

Q: **The treasurer of our association wants to perfectly balance the financial statement at the end of the year. Because of the depreciation, she won't make the required reserve contributions because she says we don't have the money and this will result in a loss on the financial statement. What should I tell her and the board as we need to make these contributions?**

A: The goal is to have the funds needed to care for the association, not have "perfectly balanced" financial statements. Encourage higher assessments so the money exists to care for the property. A "perfectly maintained" property is of move value than perfect books.

Q: **Any recommendation about how to respond to long term homeowners who have kicked the can down the road for years and now object to a special assessment to fund the reserves.**

A: People will always complain. Don't worry about it. Make it clear that the costs are what they are… roofing, painting, asphalt, etc. Ask your Reserve Study professional to calculate your Reserve "pace line" – your annual rate of deterioration. It's a pretty clear argument that the building requires funds to keep in good repair. Make that information readily available for all owners – they deserve to know the facts. Even so, don't expect that you'll "convince" everyone. Levy the special assessment and move on.

Q: **If a concrete swimming pool has so many cracks in it that it's more cost effective to replace it with a fiberglass pool, how does the new pool get reflected in the reserve study if it was funded via a separate project cost and a special assessment?**

A: If the pool removal and replacement was funded without Reserve funds, then you effectively have a new pool on your hands. Add fiberglass pool resurfacing as a Reserve Component, so that Reserve funds are building up for its upcoming resurfacing (in about 15 -20 yrs or so).

Q: Where do capital improvements get accounted for and funded in a reserve study? Or, should that be in a separate place, such as a capital improvement plan? I'm specifically talking about items that are brand new to an association, such as a new playground?

A: Capital Improvements occur outside a Reserve Study. Reserve funds are set aside to offset ongoing deterioration of existing assets, so the funds grow as the asset deteriorates, so that the cash exists at the right time to perform the major repair or replacement. New assets are typically purchased/installed with special assessment funds, or a side "capital improvement fund". Once the asset exists, the asset should be listed in the Reserve Study so the funds begin to accumulate to offset its ongoing deterioration, preparing the association financially for the asset's replacement.

WEBINAR QUESTIONS ASKED BY PRIOR YR ATTENDEES

Q: **What do we do about items that are not a component in the Reserve Study such as plumbing pipes? We have cast iron pipes that are deteriorating and will need to be replaced, but they are not part of the Reserve Study.**

A: If a major plumbing project is missing from your Reserve Component List, and if it passes the National Reserve Study Standards (NRSS) four-part test (which major plumbing projects are likely to do, once one can reasonably predict the anticipated cost of the project and when it is expected to occur), have that project added to your Reserve Study at your next update.

Q: **May not be on point for today's topics, but your very nice book indicates most reserve studies have 30-50 line items. We have 88 and I believe it's a bit unwieldy. Should we reduce line items, and if yes, how do we go about reducing them?**

A: If a component passes the NRSS four-part test, it should be included in your Reserve Study. Some associations, due to natural simplicity or complexity, have less or more components than "most" associations. 30-50 components is not an objective.

Q: **Is an Association required to have an independent Reserve Study professional prepare an updated reserve study between the on-site visits?**

A: It is a good idea, of course (since Reserve contributions are such a significant portion of an association's annual budget, and the size of that line item deserves annual scrutiny), but I do not know of a state that requires it. Perhaps check your Governing Documents for such a requirement?

Q: **What investments can safely be used for reserve funds?**

A: Investments that protect (preserve) principal. Board members are preserving and protecting the assets of others (the physical common areas and the financial assets of the association). While taking some risk to maximize interest earnings beyond what "safe" investments provide may be tempting, it is not a good idea. The board's responsibility is to protect the assets of the association, not maximize return on investment.

Q: **If the board knowingly underfunds reserves, what liability do they have?**

A: Most Governing Documents charge the board to care for the assets of the association, providing for their physical care and budgeting so the finances exist to fulfill that mission. When boards knowingly underfund Reserves, they do so at their own peril. If an owner sues the board for their decision to underfund Reserves (which results in a special assessment or their pending home sale falling through), those board members may be held individually responsible. While the association's D&O insurance may defend the board members (the carrier may not pay for their defense if board actions were perceived to be contrary to their responsibilities per the Governing Documents or State Law), it will certainly not pay for any financial damages.

Q: How do you handle improvements (creation of new assets)? For example, we want to add ramadas, picnic tables, and artificial turf in several of our open community areas.

A: If incidental, handle from the Operating Fund. Significant additions to common areas are Capital Improvements. Because planned improvements are not currently a common area maintenance responsibility (test #1 of the NRSS four-part test), in most cases Reserve Funds cannot be used. See more here.

Q: Recently, a Reserve Study professional stated that we should not include trees in the reserve study. We have over 300. Yet, I'm pretty sure that in reading the materials you have online, they MAY BE included. Which is correct? (We have to spend significant amounts trimming and treating them for bugs and disease prevention.)

A: Everyone's entitled to their opinion. But not all opinions are equal. If a proposed project passes the NRSS four-part test (which greenscape items often do), projects such as tree trimming and periodic replanting can be included in the Reserve Component List. There is no blanket prohibition against doing so.

Q: What if a component is estimated to cost $10,000, but the actual cost turns out to be $25,000 (pool resurface project)?

A: Perform the project and update your Reserve Study with the higher cost estimate for future planning purposes. Expect your Reserve contributions will increase slightly due to "overspending" from Reserves, and to accommodate the more expensive future cost of this project.

Q: What about future cost values? I.e., roof will cost more money 20 years from now. How do you calculate to allow for interest rate and materials cost increases?

A: We certainly expect costs to be higher in the future. Estimates for interest and Inflation are built into our Funding Plan calculations. For the purposes of making the point about the ongoing cost of deterioration during the webinar, we removed the complexity that interest and inflation would have added to that teaching point.

Q: Can you speak to inflation? Some Reserve Study providers in our market do not consider inflation.

A: That is unfortunate to hear. Interest and inflation are very real economic factors in our world today. Those who fail to appreciate them and incorporate their significant influence on a multi-yr financial plan, are doomed to suffer from the consequences. Interest does not offset inflation (interest is only earned on the Reserve balance on-deposit, while inflation has its effect on the entire cost of all Reserve projects). I don't know what inflation will be over the next 10-20-30 years. But I know that it's not going to average zero. So we make a reasonable estimate, based on what has been the case the last few decades.

Q: The funds set aside for reserves should earn some interest. Shouldn't this be recognized in the calculations?

A: Absolutely. Our standard procedure is to include a reasonable estimate for interest earnings in our Funding Plan calculations.

Q: If you add in local or known costs each year, can you safely drop inflation?

A: Not really. Because costs can be reasonably expected to change for all 30 years (or how far into the future your Reserve projections are made), inflation tells you of 30 years of higher costs. So even with annually updated "current costs", ignoring higher costs in future years will always underestimate the association's funding requirement. The association's Funding Plan will then be in position of always "catching up", never being properly aimed at the future target.

Q: How do you figure in inflation for those Reserve projects expected to occur far into the future?

A: Like in our discussion about the Funding Plan, our primary goal is to offset ongoing deterioration. If we do that, with an eye to future costs, we will have the association in a good state of preparation every year, and with regular Reserve Study updates we can regularly make adjustments for costs that change different than the "average" rate of inflation.

Q: What inflation indexes do you folks use for your Reserve Studies?

A: We look backwards, believing that the best indicator of the future is past performance, so we are currently using a historically stabilized inflation rate in the range of 2.5% - 3%.

Q: What is the minimum funding an association needs to have? 20%?

A: The FHA requires at least 10% of total budget go towards Reserves. Many major mortgage entities (Fannie Mae...) also look for that minimum level of Reserve funding. That 10% level is commonly not sufficient, as our experience tells us that most associations need significantly more going towards Reserves to offset deterioration and provide for inevitable future expenses. See more here.

Q: Does HUD have a minimum reserve funding balance like the 10% funding minimum?

A: Yes. The HUD requirement references the FHA requirement, which is that a minimum of 10% of total budget must go towards Reserve contributions. That's usually not sufficient, but it's an easy metric to observe.

Q: Are associations required to have a percentage funded or minimum Reserve balance?

A: Other than the Hawaii law requiring one of two funding options, one of which is to be 50% Funded, I know of no State Law requiring a minimum Percent Funded or minimum Reserve balance.

Q: How do your reserve study professionals deal with Boards that dispute the component list or the replacement/restoration cost estimates you have provided?

A: The board has hired our company based on our expertise and experience. It is our logo that goes on the cover of our finished product. It is our job to deliver a quality product that is compliant with National Reserve Study Standards, not make the board "content" or "happy".

Q: Should limited common elements be in the reserve study?

A: All projects that pass the NRSS four-part test should be included in the Reserve Study. "Private" condominium balconies, for instance, are often considered Limited Common areas (common area, but usage is limited to less than all members). In most cases the association is financially responsible for balcony deck sealing, painting, and maintenance. Thus relevant "Limited Common Area" projects are candidates for inclusion in the Reserve Study.

Q: How often do you we need to have a site visit update vs a no-site-visit update of the prior year's report?

A: We find that a good pattern is a With-Site-Visit update every third year. That balances the higher cost of the With-Site-Visit update with the lower cost No-Site-Visit update, providing regularly updated Reserve Study information with an eye to a cost-effective multi-yr plan.

Q: We recently conducted a reserve study. However, the engineer that completed it said he never wanted to see our reserves "Fully Funded" as that is not fair to owners that have moved away as they overpaid their fair share.

A: The person making that statement has an incorrect understanding of "Fully Funded". When the Reserve balance is equal to deterioration at the association, the association is "Fully Funded" and everyone has arguably paid their "fair share" of existing deterioration (no more, no less). Underfunding Reserves, making lower contributions that keep the Reserve balance lower than Fully Funded, exposes the owners to "catch-up" special assessments where all they saved gets taken from them in a single moment. On the other hand, in the years an association is strengthening their Reserve Fund towards the Fully Funded level, one might argue that in those years the owners are paying more than their fair share. But while they are doing so it reduces their risk of a special assessment. So it is a fair tradeoff.

Q: What is your opinion of reserving for trees and or insurance and/or insurance deductibles?

A: Seeing major tree care (pruning, replacing…) in the Reserve Component List is actually quite common, as those major periodic projects often pass the NRSS four-part test. But insurance payments are an ongoing cost of business best handled from the Operating fund, and Insurance deductibles fail test #3 of the NRSS four-part test (because they are not predictable).

Q: Can an association go bankrupt?

A: I'm not aware of an association ever going bankrupt. I'm only aware of some associations where a judge has installed a trustee to manage the affairs of the association due to lack of leadership, in order to handle the business affairs of the association. I would expect that since the association has a viable membership roster, owners would be called upon (via a special assessment) to make up any association financial shortfall.

Q: Would NRSS support the concept of a fixed maximum percentage increase in Reserve contribution?

A: No, as every association's situation is unique. Some of our clients find themselves (for one reason or another) with trivial Reserve contributions, such as $100/mo even though their rate of deterioration might be $5000/mo or so. In this predicament, we get them started on a multi-yr plan to begin meeting their Reserve obligations, perhaps starting with $1000/mo Reserve contributions this year, then $2000/mo next year, etc. But while it may be only a $900/mo increase in that first year (from $100/mo to $1000/mo), that represents a 1000% increase in their Reserve contributions. Sometimes, a big increase like that needs to happen.

Q: How about a contingency fund in reserves for components that fail early?

A: A "contingency" component fails the NRSS four-part test in that it has no anticipated timing or replacement cost. The best way to prepare for inevitable "surprises" about components that are more expensive than anticipated, or fail earlier than anticipated, is to have a strong Reserve Fund (above 70% Funded) that provides a bit of "margin" for these unexpected extra costs.

Q: Will you be discussing "Contingency Funds" or something similar to handle "acts of God" that aren't calculated in current reserves?

A: As stated above, true surprises should be the only reason for a special assessment. And hopefully in most cases, those "true surprises" (Acts of God) are covered by insurance, so the association's exposure is limited to the deductible. Then the board decides if they can handle the expense from "margin" in Operating account, or if they need to levy a special assessment.

Q: I am struggling with parts of components, RUL and valuing replacement costs, in a building that in our garage alone contains garage door, ceiling lights, compressor, etc. In to how many separate parts (Components) should one divide the building?

A: An experienced Reserve Study professional handles all those issues in a normal day. If you are struggling, then it's probably not a task for which you are well equipped. A boardmember is not responsible to be an expert in everything, or do everything, for their association. Boards should expect to hire qualified professionals when necessary, as part of their job to responsibly provide for the needs of the association.

Q: How local can replacement costs be refined?

A: Replacement cost estimates should be both regionally adjusted and unique to the property. While zip code "general" cost estimates are great, we find that uniqueness of the property (against a hillside, irregular asphalt layout, unique roof geometry, overgrown trees, reputation of a difficult board, etc.) regularly are more influential than even "local" pricing.

Q: If we don't use any funds for one component in the year it was scheduled, what happens to that unpaid component?

A: Those funds remain in the Reserve Fund, available for use the next year (or year after). The component itself continues to display with a Remaining Useful Life of zero (or whatever Remaining Useful Life value is deemed appropriate).

Q: If $$ are pulled forward & spent for an asset, does the subsequent reserve study do a catchup for these years?

A: Yes. Funds spent more than anticipated, or earlier than anticipated draw down the Reserve Fund. Expect future contributions to be slightly higher to compensate.

Q: Our cement pool deck was never included as a component in our HOA reserve study. Now it has deteriorated and needs a waterproof seal coat. But we have no monies in our reserve study. Was that a mistake in our reserve study?

A: Predicting the future will always be imperfect. Sometimes project needs don't become clear until they draw very close. If the project passes the NRSS four-part test, it is a Reserve Component (whether or not it was anticipated and appears in your Reserve Study). Spend the funds from Reserves and add this new component in the Reserve Study update you perform for your upcoming Fiscal Year.

Q: Why does low funding raise Board liability?

A: Because the board's responsibility is to care for, and provide for the care of, the common areas of the association. If the board chooses to underfund Reserves, they risk not being able to fulfill their responsibility to the owners, which creates liability exposure (to the board as a whole, and likely to boardmembers personally, depending on what the record shows about how they voted on the budget).

Q: What happens if there are not enough funds in Reserves to spend on Reserve projects?

A: In that case, the association experiences deferred maintenance (things going from bad to worse) and property values suffer while the board considers passing a special assessment or looks for a bank that believes they are a good credit risk for a loan. Unfortunately, associations that run themselves out of money generally have demonstrated to bankers that they are not good loan risks. Banks offering loans generally require a significant boost in homeowner assessments, the same solution that was available to the boards prior to finding themselves in a cash flow crisis situation.

Q: Did I understand you to say a well funded HOA is anything over 70% funded?

A: Yes. In those associations, the evidence shows that the risk of a special assessment is very low.

Q: Why wouldn't every association strive for 100% funding plan? Why is 70% okay?

A: I believe 100% is a safer place from a legal point of view (if I was standing before a judge, being sued regarding my decisions as a boardmember, I'd like the stronger position of saying I voted to be 100% Funded). But from a practical point of view, sensitive to the budget pressures on boardmembers, we find that in associations above 70% Funded, there is sufficient cash margin in the Reserve Fund such that special assessments are extremely rare, even considering the "normal" amount of surprises that occur among associations.

Q: Our reserve items are listed in the Reserve Study, and funds collected separately for each component, but our documents do not state that they need to be that way. Can we take money from one line item to cover the cost of another item that is being done this year that was funded but our funds for that item came up short?

A: Associations in Florida by default use the *Component Method* (aka "Straight Line") to calculate Reserve contributions. In that methodology, funds are dedicated to a particular component, but they can be re-assigned as necessary. Unless mandated by Governing Documents, the *Cash Flow Method* is much more advantageous to the association, as it uses funds more effectively. No magic, as the funds provide for exactly the same Reserve expenses. It's just that when (usually scarce) Reserve funds can be used when and where needed, as in the Cash Flow Method, it is advantageous to the association. See more here.

Q: Can you put a minimum threshold level of reserve funding in your by laws or Governing Documents?

A: That's a good question for your association attorney. We recommend crafting either a Reserve Policy or Reserve Investment Policy. Both provide multi-yr stability, and both are things you can do yourself.

Q: What are the thoughts of borrowing money to complete projects, particularly with current low interest rates?

A: I believe it is unwise. You know now that deterioration is occurring on a day-to-day and month-to-month. That is an obligation you are accruing. You don't know if low rates will exist in the future when you need those funds. And there is the fact that failing to "pay the bill" of ongoing deterioration looks very self-dealing (keeping your assessments lower so others in the future can pay higher assessments). That invites liability exposure. And there's the financial fact that every day, in every way, I'd rather have the bank paying me interest on the funds I've put in on-deposit, than be paying the bank interest on a loan that I took out.

Q: Why are the costs for a reserve component that are listed on a current reserve study in many cases lower than what the actual costs end up being?

A: That is unfortunate. Reserve cost estimates are designed to be sufficient to provide for the entire project (permits, shipping, installation, disposal…). Often the real reason Reserve Study costs are low is that they come from an old Reserve Study. Those documents show old pricing (from 2015, for instance). No one should be surprised that those costs now appear underestimated.

Q: Doesn't the "Here and Now" reserve contribution theory only hold true if you are already at the point of being Fully Funded?

A: No. Most associations function without special assessments with contributions very close to their rate of ongoing deterioration. Associations with truly minimal Reserves (in the 0-30% range) need to keep a close eye on their cash flow, as a large expense may be looming for which "ongoing deterioration" sized contributions may not be sufficient. But one does not need to start at the Fully Funded point for contributions that offset ongoing deterioration (or contributions very close to that amount) to provide for the timely execution of anticipated Reserve projects.

Q: Our condo owners primarily come from being stand-alone home owners. They are resistant to the concept of collective, joint ownership of the association, and contributions to a common fund. Like in the homes they came from, they prefer holding onto their own cash, "spending it" (providing it to the association) only when needed. That means a life of special assessments. What can you say to encourage them to buy into Reserve planning?

A: Reserve expenses are the largest expenses an association will face. If an association prepares over time, offsetting ongoing deterioration, the "cost" typically results in Reserve contributions that are on the order of 25% of total budget. Like a gym or rental car company, you expect that your ongoing "membership fee" would cover infrequent and large capital expenses. Membership in an association is mandatory, you can't just pick up and leave when leadership apologizes that they need to charge you more to put a new roof on the gym or buy new tires for the car you just rented. Due to mandatory membership, the board is legally responsible to responsibly manage the affairs of the corporation on behalf of the owners. Expect that education about mandatory membership, and the role the board plays, needs to be an ongoing component of board communication with owners. As a boardmember I would not want to stand in front of a judge, uncomfortably saying that I didn't do my job to set an appropriate budget *because it wasn't popular*. Boardmembers take care of the owners, they are not there to do the bidding of the owners. A boardmember is not collecting funds "for the future". All they're doing with Reserve funding is offsetting the ongoing cost of deterioration. It is incumbent upon association leadership to pay the bills - the ones submitted by the power company and the landscaper every month, and the "deterioration bill" from the roof and other major components. While they may not receive a "roof bill" in the mail, nevertheless that bill still needs to be paid.

Q: For the time value of money calculation, do you have a standard rate of inflation that you use?

A: At this time we are using values that have been desensitized to "immediate" values, and are using values representative of multi-decade trends. So we are using values in the 2.5% - 3% range.

Q: **What happens if you partial fund the Reserves for many years and never "catch up" to the Fully Funded Reserve figure? Do you special assess? How do you "catch up"?**

A: Your Reserves do not need to be Fully Funded. That is just a strong level, and as shown in the webinar associations above 70% Funded have a very low incidence of special assessments. Special assessments should only be levied when there is an immediate need for cash. Reserve Fund strengthening is best done with stronger Reserve contributions.

Q: **Where does Association Reserves get cost-of-replacement and useful life numbers for components?**

A: Fundamentally from our background of experience with properties in your region, with your components. We supplement with interviews with your association vendors, and national cost guides (localized by zip code) as necessary.

Q: **In theory what is the benefit/liability of having a "green" Percent Funded status (over 70%) versus yellow? Wouldn't that lead to significant special assessment to homeowners to build up Reserves?**

A: The benefit of a strong Reserve Fund (green, over 70%) compared to yellow (Fair, 30-70%) is a lower risk to your owners of special assessments. To strengthen your Reserve Fund from yellow to green usually involves raising contributions a few dollars a month, over the course of years. Not a big deal and nothing to fear.

Q: **How does inflation impact the analysis?**

A: Inflation plays a strong effect on your Funding Plan, because it makes all your future expenses that much larger. This means your Reserve contributions, even with interest earnings, need to be building towards these future-sized expenses.

Q: **How do you arrive at current cost if all you know is last replacement amount paid? In other words how do you adjust historical cost (with inflation) to current cost?**

A: You check to see what current pricing trends are for that component, compare to the inflated value of the prior cost (inflated from five years ago, for example), and make a wise decision based on that comparison.

Q: **Pool furniture example showed $4600. Aren't reserve items things that cost 10k or more? Or can it be less than 10k? I'm from FL.**

A: FL law requires that projected expenses at or above $10,000 be funded through Reserves. But many predictable projects <u>under</u> $10,000 (especially for smaller associations, where $8000 might be a whole lot of money!) meet the National Reserve Study Standards four-part test and should be funded through Reserves. While not required by FL law, if that predictable, significant common area project is left off it would unsettle the Operating Fund when it eventually occurs. Best to include in your Reserve planning!

Q: How do you address the problem that current board members don't plan to live at the place for a long enough time before big repairs become due in a new building?

A: The board is responsible to manage the affairs of the association. Emphasize that adequate Reserve contributions reflect their true cost of ownership (instead of "surprising" them every few years with a special assessment) and maximize home values. See here and here.

Q: I realize all condos are different, but is there a place to find a good component list example?

A: Every association is different, so their component list will be different. See a sample Reserve Component List here or here, as presented in our "sample" Reserve Studies.

Q: For a community that has been severely underfunded for 40 years, do you suggest an additional assessment to make up for lost time as projects are coming due?

A: Special assessments are "last resort" solutions to providing sufficient Reserves to perform necessary projects at your association. Increase your Reserve contributions to begin building up your Reserve Fund, getting closer to offsetting ongoing deterioration, and lowering the chance you'll need special assessments to perform necessary projects.

Q: What if costs are more than "current cost" when it's time to replace the component?

A: Perform the project. You should expect some projects will be more than expected, and some will be less than expected. When your Reserve Study is updated, cost estimates will be updated and your Funding Plan will be recalculated.

Q: What did you mean by "rebalance" in pool chairs example? How does one do that? Is it a mathematical calculation in the Reserve Component List?

A: Let's say a project was more than budgeted. That extra expense drains the Reserve Fund, making less $ available for other projects. See above. The process will be slightly different depending if contributions are calculated based on the Component Method or Cash Flow Method.

Q: What is the best way to respond to a board that wants to keep monthly assessments low and believes that if money is needed for major repairs they and the membership prefer to levy special assessments?

A: The board's motives are fundamentally different than owners. The board's job is to maintain the assets of the association. Owners wish to keep more of their own money. The board needs to be reminded that it is better that owners pay their fair share of ongoing deterioration while they are owners (rather than play the special assessment lottery), and that special assessments are never "for sure" to pass, and the delays may make projects more expensive.

Q: So what is wrong with having the total cost saved NOW, in advance? In other words, if the lifetime cost is $1M, but the FFB would be only $500k, why can't you have that full cost saved at any given time for rainy days so special assessments don't have to be levied?

A: Having the entire cost now, long before it is needed, far in excess of its deteriorated value, represents "excess" Reserves. This is inappropriate for three reasons.

1. It puts the association in the position to have more funds than warranted, which could be construed as (taxable) net profit.
2. It does nothing to minimize special assessment risk. That is achieved at the 70% level, and special assessment risk is not further reduced by being 200% Funded (a $1M balance when the FFB is only $500k).
3. It goes against the NRSS Funding Principles of equitable distribution of contributions and budget stability, because you've collected far more from "current" owners than the value of the deterioration they've enjoyed. They have in essence given a gift to future owners, and now the contributions towards this asset's replacement can stop. Because it is not equitable through the years, and because contributions are then irregular through the years, it is inappropriate.

Q: You may have covered this in the first session, but does the component list have to be exhaustive? For example, if a common element was not included on the study but needs to be replaced, can it still be covered under the reserve fund?

A: Yes, this was covered in our Reserve Studies 101 webinar (see it here). Your Reserve Fund is there to pay for projects that pass the four-part test. Hopefully those appear in your Reserve Component List. But even if they don't, the NRSS four-part test is the higher authority. Just make sure to update your Reserve Study the next year if you pay for a project not on your Reserve Component List.

Q: Rather than using national average replacement costs in higher cost parts of the country, such as Southern California, does Association Reserves adjust for local costs when determining Component costs in those areas?

A: Yes. Again, see more about components in our Reserve Studies 101 webinar here.

Q: How is Covid-19 affecting reserves contributions? Should the board consider suspending or reducing contributions to the reserves?

A: Watch your email for a notice on this subject. We are developing a new webinar to address this topic… how to safely and temporarily use Reserve funds (or redirect Reserve contributions) to offset higher delinquencies due to our current 2020 COVID-19 situation.

Q: What cushion do you recommend for items that see a significant cost increase between establishing the price to replace/repair and actually hiring someone to do it?

A: NRSS stipulate current costs be entered in the Component List. No "cost-padding" needed. Expect that some projects will come in above budget and some below budget. Expect also that the "margin" of a strong Reserve Fund will help absorb the temporary blow of a project or two that occur higher than budgeted.

Q: Should the budget clearly outline projects or is it fine to spend out of reserves as board sees fit…no disclosure?

A: The more tightly defined the Reserve Component, the better. For instance: don't just list a component as "Fence". Say "Fence – Replace" or "Fence – Repaint". Every Reserve component, and every Reserve expense, should pass the NRSS four-part test. And I'm no CPA or attorney, but I would recommend any non-Reserve expenditure from Reserves be very clearly documented and disclosed.

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 inflation every year.

A: Per National Reserve Study Standards, the current year Percent Funded is calculated using current costs, to give you a current indication of Reserve Fund strength. 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.

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: What do you think of a "permanent" special assessment instead of an assessment increase?

The board is in the best position to provide funds for the ever-increasing expenses of the association if they are honestly collecting income to offset expenses. A permanent, or "ongoing" special assessment is essentially the same thing as an assessment increase. Don't be silly. You are not fooling anyone… the cost of running the association is what it is.

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. Note that Percent Funded can be projected for future years, using a projection of Reserve cash balance and a projection of Fully Funded Balance (using Remaining Useful Life values and expected replacement costs appropriate for those future years).

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. We see what you are doing, and model expected outcomes from your ongoing maintenance/repairs in our Useful Life estimates.

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. Every owner 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.

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**

in three years, but we need to replace walks now or townhome siding is scheduled four years away, but 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 enjoyed but failed to pay their share of the "deterioration bill". Special assessments reveal a board of directors failing to see the true cost of ownership of the property. Special assessments are unwanted and unsettling.

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.

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. Some components projects should be done on time, some can be delayed without significant consequence.

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, not make owners "happy". Boards accomplish their job by setting a budget that provides for major repair and replacement obligations of the association.

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 calculate Percent Funded (Reserve Fund Strength) with any Reserve contribution methodology.

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. After you've calculated your Percent Funded, use whatever method you choose to then calculate contributions.

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, not contribution size. You are talking about making 80% of necessary contributions.

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

A: Current costs are used in current year Reserve Fund strength calculations. To communicate key concepts in the limited time of this webinar, interest and inflation were ignored in my illustration of contribution 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: Yes. Inflation is an economic reality in our world today, and should be included 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 a value close to that is what 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: Part one – definitely a Reserve expense that just went over budget (expect some will go over budget, some will come in under budget). Second question, if the expense doesn't pass the NRSS four-part test, it is not a Reserve expense and use of Reserves for that project should be considered borrowing.

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 because of your duty to protect, maintain, and enhance the assets of the association. Set the Reserve income (contributions) to what they need to be to offset deterioration. It's the right thing to do, and it minimizes your liability exposure. You invite liability (and risk property values) when failing to do your job to maintain the property on behalf of the owners.

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. My understanding is 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 CA, boards are required to identify the needs of the association, create a plan to deal with those needs, and communicate that plan to the owners.

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

Q: If our Reserve Study estimates are much higher or lower than bids received, should we ask our Reserve Study professional to make an adjustment?

A: Yes. 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! Boards are responsible to maintain the property, and boards who fail to budget to offset deterioration will fail at their task when they find owners rejecting special assessments. The result is dissatisfaction and lower property values. Nobody benefits from underfunding Reserves.

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". It only matters if it passes the NRSS four-part test. See here. 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. If you take care of offsetting ongoing deterioration year after year after year, 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.

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 allow associations across the country to meet or exceed their local 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). See the explanation of NRSS on this matter here (p 6).

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

A: Good question, but another topic we cover in our 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. The expense is the same (the association needs to pay the same amount to the roofer) no matter how the funds were collected. It is going to cost the owners either way. You might as well fairly spread it over the owners, over the years, rather than "surprising" them with a special assessment every few years (unless you're into pain and suffering).

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 of 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. A Transition Report reveals if the association is being turned over to the homeowners with adequate Reserves and with appropriate Reserve contributions. In addition, 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: The NRSS four-part test doesn't require ownership of the asset, just maintenance responsibility. So if your association doesn't own it, but is responsible for its maintenance, it is entirely appropriate to Reserve for the component. Just make sure that it indeed is your maintenance responsibility! No reason to be spending your good money on things someone else should be maintaining!

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, sometimes through the ongoing operating budget (a partial repair here or there as part of ongoing landscape maintenance) or every few years as a Reserve project. If you can anticipate significant projects at predictable intervals, partial or complete irrigation system repairs could qualify as a 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 true emergency (insurance deductible) or non-reserve project like a capital improvement, and that's why there appears to be a tiny blip near the 100% point. There are so few special assessments in that range that one may stand out.

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" the expense. 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 out. And start your own savings account, so you'll be ready with the cash when they call for a special assessment.

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 re surfacing.

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 cover in our 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 from the board of their expectation for any *upcoming* special assessments, or a comparison of Reserve Study *recommended* contributions compared to *actual*. Check with local statutes and your accounting professional.

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. Follow the law. Commission the annual audit, and increase homeowner assessments to pay for the service. It is just the "cost of doing business" in your state.

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

A: Those guidelines establish a minimum contribution rate. We find that Reserve contributions typically need to be 15-40% of an association's total budget, so actual contributions generally need to be more than that 10% minimum. So the 10% you mention is not "in addition" to, it is "part of" the Reserve contributions collected to offset ongoing Reserve deterioration at 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: You may wish to be taking legal advice from an attorney, not a manager. CA Civil Code 5570 states this is an annual disclosure (see 5570.b.3). I've not heard an association attorney say anything to the contrary.

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 55,000 Reserve Studies, the evidence shows that special assessment risk is low when the Reserves are above 70% Funded, no matter the type of association. Associations with Reserves in the 30% Funded range regularly experience special assessments.

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 an effective way to personalize and make the expense more "real" to current owners, but large projects meeting the NRSS four-part test are best handled as 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. And with annual updates, we continually refine our estimates as the expense approaches.

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 raises or lowers its interest payments, or if the association misses a contribution, you'll likely still be well funded, but not exactly 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. Watch as we anticipate release of our online Reserve calculator tool, uPlanIt, in Q2 of 2020.

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 every 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, because at that time the needs of the association drop. 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.