ASSOCIATION RESERVES™
Planning For The Inevitable™

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Reserve Studies 103 – The Funding Plan

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Miss the webinar? Watch it here.

Every year, every boardmember is confronted with the question "What do I do now? with respect to budgeting to care for the property. It's tempting to say "Reserves are for the future", and leave Reserve funding to future boards and future budgets. But Reserve funding offsets ongoing deterioration. Just because the roof doesn't send a bill each month doesn't mean it is a bill that can be ignored. Besides, the expense is going to happen, and owners will need to pay it. Your choice is having homeowners pay in little increments each month as part of their ongoing assessments, or in an unexpected and unwanted special assessment when the large asset eventually fails. That's where we come in… helping the board know the smoothest and fairest way to the future.

Deterioration is real and expensive. There's no dodging those huge expenses.

So it's up to you to decide how those Reserve expenses will be paid. Your responsibility is to have the funds available one way or another, so the owners can enjoy their homes and hopefully maximize home values. We are guided to help you reach these goals with four Funding Principles that we balance and apply when crafting your Funding Plan (see at right).

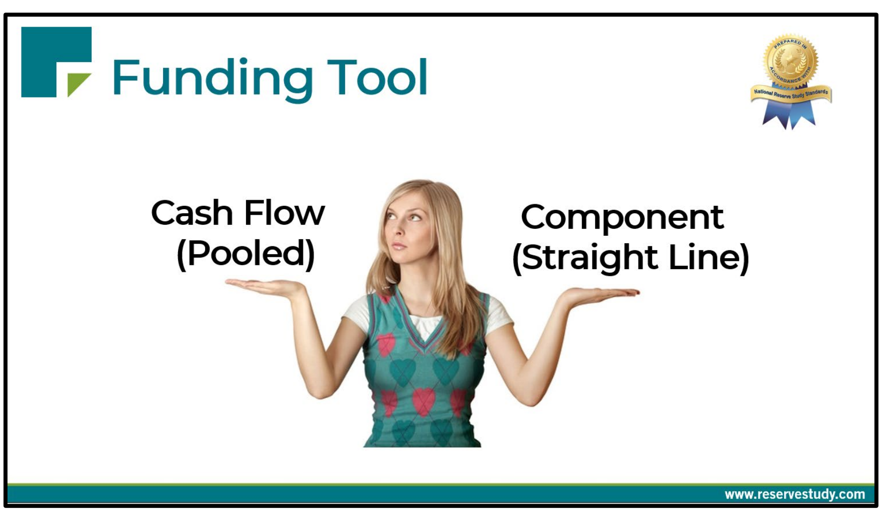
RESERVE FUNDING PRINCIPLES

Now we address exactly how big do the Reserve transfers need to be at your association. Your Reserve funding needs will be unique and different, even from similar associations, because of four influences:

There's almost nothing you can do about your Component List. You have assets (roofing, painting, hallways, a tennis court, etc.). At your association, they are your responsibility to maintain. It's not like you can choose to "not fund" your roof. Starting Reserve Strength is another factor. But that's your starting point. Prior years and prior boards got you to this place. Your challenge is how best to go forward from here.

Margin for the unexpected is where you begin to have some choices. Our recommendation is that because nothing ever goes exactly according to plan, it is in your best interest to plan for some margin. Since Reserve projects are so expensive, the amount of margin included in your Reserve funding plan is just a small portion, typically 10-20%. And that's the little more "margin" that can shrink your exposure to unsettling special assessments from around 50% to almost zero.

Then there's the issue of which mathematical tool you use in developing the Funding Plan. Usually, you don't care which tool a business partner uses... which software your attorney uses to draft new governing documents, the accounting software used by your mgmt. company in tracking owner accounts, or the financial software used in preparing your monthly financial reports. But with Reserves, the tool matters. The choice is the Component Method or the Cash Flow Method.



One (Component) funds each Reserve component separately, line by line. The other (Cash Flow) funds Reserves based on the cash outflows each year, no matter if those outflows are one component or a cluster of expenses. Because the Cash Flow Method fundamentally uses association Reserves more effectively (none is socked aside waiting for a future expense when it can be used for another project), the Cash Flow Method is preferred by professionals nationwide.

The Cash Flow Method also allows more flexibility in designing the Multi-yr Funding Plan. This means Cash Flow Funding Plans can better achieve the four Funding Principles stated earlier (Equitable Distribution and Fiscally Responsible) with a plan that gradually floats upwards over the years, matching inflationary trends. The Component Method fundamentally starts high and decreases over the years. As a result, while the overall 30-yr total of funds going towards Reserves will be about the same, in the initial few years Cash Flow Reserve Funding recommendations may commonly be half or even less of the Reserve Funding recommendations calculated by the Component Method.

Making wise decisions about Reserve funding takes a seasoned guide, someone who has crafted successful solutions for their clients hundreds *or thousands of times* before, someone like Association Reserves!

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

More questions? Download our eBook on Funding Plans, or find more information on the Resources tab of our website here.

Want out help? Click here for a Reserve Study proposal for your association, or click here to find the Association Reserves office in your region. Don't expose your association to unsettling surprises because of poor Reserve Funding choices!

Webinar Questions Asked by 2022 Attendees

Q: The useful life of our new roofs are 20 years, but insurance companies won't insure our Association's roofs if they are older than 12 years. Can we substitute a 12 year target for funding our roofing reserves?

A: It is unlikely that your Reserves will fail right when you lose your insurance coverage. Remember that insurance is only for accidents, not deterioration. We're going to plan your budget so you have sufficient funds to replace your roof when we expect they will actually need to be replaced, which is when they reach the end of their life expectancy.

Q: What or where is the best method or place to invest excess reserve funds not needed for 3-5 years?

A: Safe investments, where there is no chance of loss of principal. Seek the advice of an investment counselor or community association banking specialist if your Reserves exceed $250,000.

Q: Can you list some Banks that lend to HOA for Reserve projects?

A: Please see your local CAI chapter's directory of service providers. Note that some long-term community association banks have recently come under new ownership, so some have new (unfamiliar) names.

Q: Do you have experience with the Florida Senate Bill 630 of 2020 having to do with reserves going forward?

A: Please see a FL community association attorney for a discussion on Florida SB 630.

Q: What impact will Fannie Mae new mortgage requirements have on how reserve studies are prepared and potential new disclosures by reserve study companies.

A: Tighter requirements by financial institutions should prompt tighter scrutiny on an association's Reserve Study provider. So, ensure your Reserve Study is prepared by a "RS" or "PRA" credentialed individual, meaning their company is following and serving your association with national standard principles. This will put more pressure on un-credentialed Reserve Study providers to upgrade their capabilities and credentials or exit the field.

Q: If there is not enough in reserves for a large, expensive project, which would you suggest as better - a Special Assessment or an HOA loan?

A: Special assessments are less expensive, but loans are options for some associations (not all qualify) to spread the additional cost over a number of years.

Q: **Many (most?) states do not have a minimum reserve fund balance. In the wake of the Surfside disaster, do you envision legislative action on a state or federal level that will require a minimum balance anytime soon?**

A: We are seeing new proposed or passed legislation in many states that tighten up Reserve Study or Reserve funding requirements. I don't see new legislation on a federal level, but I see national influences (financial institutions like Fannie Mae and Freddie Mac, large lenders, large insurance companies, etc.) that affect all associations in the country.

Q: **I am the GM of a 50+ year old large scale single family HOA the size of a small city with $60M of reserve projects due by 2040 (and that amount doesn't include the COVID and supply chain impacts on those costs). Our 2021 YE Reserve balance was $7M. Our Board has historically been reluctant to increase assessments rapidly enough to get beyond a persistent PAYGO situation. How would you suggest I help my Board understand that cutting reserve contributions is the antithesis of fiduciary duty?**

A: You are correct in that it is typically clearly stated in the Governing Documents that the board's job is to provide for the needs of the association. Work regularly with your credentialed Reserve Study provider and your attorney to find the funding solution that is designed to provide for the needs of your (large) association, with sufficient margin for the unexpected.

Q: **What is the calculation for the Cash Flow Funding Method?**

A: The Cash Flow method is fundamentally two steps. First, one projects the expenses from the Component List out at least 20 yrs into the future. Then you test the "cash flow" of various multi-yr Funding Plans in order to ensure that sufficient funds exist through those years to maintain not only a cash-positive Reserve balance (Baseline Funding), but also some margin for the unexpected (Threshold or Full Funding).

Q: **If we want to learn/read more on our own regarding Cash Flow calculations, what resources/books do you recommend?**

A: You can do research online or order our book "Understanding Reserves" on Amazon. See more here.

Q: **How many years out should a reserve study go?**

A: A minimum of 20 yrs of income and expense projections are required by National Reserve Study Standards. Some states require 30 yrs, so it is common to see Reserve Studies project either 20 or 30 years into the future.

Q: How do you folks treat inflation?

A: As if it's real. Current costs are much higher than last year. That said, we don't expect this high rate of inflation to remain for any extended period of time. Our long term (30 yr) inflation projections continue to be in the 3% range.

Q: Can you give any examples that you have seen that are poorly funded and the consequences of that - worst case scenario type issues?

A: Many associations continue to "kick the can" down the road and not fund to offset ongoing deterioration. In addition to lacking funds, they often find they've not updated their Reserve Study for many years, so that Roof that they once expected would be $100k is now $150k or higher, and perhaps it is failing earlier than was anticipated five years ago. The path to success is updating your Reserve Study regularly (at least every third year), funding Reserves as recommended, spending Reserves as recommended, and augmenting your Reserve Study periodically with an infrastructure inspection.

Q: If an HOA is less than 30% funded, they obviously need a Special Assessment, but eventually they are going to need to fund their reserves correctly. How do we reconcile both them paying a special assessment and increase their reserve funding to the recommended amount?

A: Actually, associations under 30% Funded don't obviously need a special assessment. They only need a special assessment about 50% of the time. Typically, special assessments make up for the past, while reserve funding prevents special assessments in the future. Some associations balance these two needs by temporarily reducing ongoing Reserve funding during the worst of the special assessment burden on the owners.

Q: Do you have any preferred recommendations for investing replacement funds to keep even with inflation?

A: You have to let go of the idea that interest earnings will ever offset inflation. The goal of Reserve funds is that they exist, not that they make maximum returns. So invest them safely, where there is no risk of ever going down. Design your funding plan to work with the returns you anticipate earning.

Q: How come that the uplanit is only available for a very limited time during the reserve study review time and not all year long? Generally, as a board member I am extremely busy with just coming up with the annual budget during the same time so the reserve study is kind of put on the back burner. It would be nice to have access all year long to "play" with different scenarios and update component costs.

A: uPlanIt is designed for unlimited "what if" testing, so the board can take ownership of their numbers. Since a Reserve Study is for a particular budget year, once the budget is finalized and the association has moved into the next year, it is time to begin plans for the next update, not continuing to make adjustments on the last year's budget.

There comes a time when boardmembers need to "let go" of the last Reserve Study and move on to the next year's budget planning process.

Q: Our board seems to think their fiduciary duty is to keep the dues low. Is that one of their duties?

A: No. The board's duty is to provide for the needs of the corporation, sustaining its physical and financial assets. Check the Governing Docs. That should be very clear. Nowhere does it say the board's job is to "keep the dues low".

Q: Do you anticipate states mandating reserve studies in their condo association laws for older condo associations.

A: We anticipate states tightening up Reserve Study and Reserve funding requirements for all associations.

Q: Can you explain the use of an architect as opposed to an engineer when performing the balcony inspections for SB 721?

A: Sorry, California's SB721 (now codified into law as California Health and Safety Code Section 17973) applies to apartments. A similar law, SB321 (now California Civil Code 5551) applies to condominiums with 3 or more units, requiring the inspection be performed by a "licensed structural engineer or architect". The combination of observation, documentation, statistical analysis, and specific background required to perform this inspection any preference most people have for this inspection being done by an "architect" or "engineer".

Q: I had a home buyer calling me yesterday saying that despite the 5 year reserve study requirement per Virginia law, their lender would not accept a reserve study older than 3 years for a condo. Are you aware of this new requirement?

A: Lenders are putting their money on the line. As such, they get to make their own rules before making a loan on a property. CAI concluded last year in their Condo Safety Report that best practice is to update your Reserve Study every three years (see here, pg. 12). I'm sure laws in many states will catch up with this growing expectation that waiting five years in-between Reserve Studies does not provide sufficient guidance.

Q: Ten years ago, we were told that our reserves would be better using the "straight line" (Component Method) because a BOD could not use the money for projects which were not necessary, whereas the Pooling allowed monies to be pulled for projects, leaving reserves short on some items. Now the advice is pooling. What happens if a BOD uses pooled money for projects that are not determined to be urgent and come up short for important projects?

A: Reserves funds should only be spent for legitimate Reserve expenditures, whether the Reserve funding is calculated on a line-by-line basis (Component Method) or as annual expenditure totals (Cash Flow Method). That was not wise counsel given years ago… it was just fearful statements made about a "new and improved" way to calculate Reserve funding obligations.

Q: Are services available to potential condo buyers to evaluate and offer a written opinion regarding the status of the prospective association's reserve study?

A: Not as a commercial product, but a new company recently launched that scores associations on a number of factors that include Reserve Study and Reserve funding issues. That may be more valuable than just a review of the Reserve Study. See more here.

Q: I have a new reserve study done which recommends a reclad of our building. We are under an insurance claim etc. Can I delay future reserve studies for 1-2 years until we address our current issues?

A: Best practice is to regularly update your Reserve Study. In your case, you have a key assumption (who will pay for new siding… us or the insurance company). You may actually wish to have your Reserve Study updates prepared two ways… so the board and owners can be accurately appraised of what the future might hold. Delaying is rarely a good decision. There are typically so many issues in play (roofing, asphalt, hallways, elevators, etc.) that delaying "because of one component" is not a good idea.

Q: How do we decide to use your program with a site visit or the program without a site visit as a first year Reserve Study co-op?

A: It is always best to start with strong information. So best practice is to start with a "Full" Reserve Study, where a credentialed Reserve Study professional (RS or PRA) establishes your Reserve Component List. From that strong foundation, in future years you can confidently retain a professional to perform cost-effective "With-Site-Visit" or "No-Site-Visit" updates of that information.

Q: Using the threshold method, how much cash should be in the reserve fund during a threshold year?

A: That's a million (hundred thousand?) dollar question. Since that is subjective, we recommend just choosing a "Full Funding" objective. That is an objective based on the $ value of deterioration at the association, not a "gut feel" guess.

Q: What does an HOA do when the reserve study suggests we use 60% of our budget for reserves? Also, they want to add 25 other items to the reserves.

A: As explained in the webinar, the ongoing cost of Reserve deterioration is as real as any other bill the association faces (management, insurance, utilities, etc.). If that's what it takes at your association to prepare for inevitable Reserve projects, that's what it takes. Gas is expensive now. But still, it needs to be paid. And if additional components are appropriate to be added, add them and begin preparing for those future expenses.

Q: In our association the owners have the right to reject suggested increases to the reserves. What are the consequences of this? How does the Board meet expenses?

A: Failing to fund Reserves results in physical deterioration and increased costs since deferred maintenance makes projects more expensive than if done "on time". If the board doesn't have the money to sustain the facilities, they decline. Sometimes, as we learned last year, lack of budget for caring for the building contributes to building collapse.

Q: I'm new with the reserves. Our last reserve study was done in 2018. Do we need to hire a company to assess the building, roof, etc.?

A: Yes. Best Practice is to update your Reserve Study based on a diligent visual site inspection at least every third year. Hire a credentialed Reserve Study professional, learning what it costs to care for your building, and which projects to do and when.

Q: A Reserve Study normally assumes a component starts with a current cost and that cost will increase due to inflation during its expected life. How do we handle a component that has a known declining cost? How do we handle a component that has zero cost for part of its life and then an annual cost for the other half of its life?

A: Interesting. Very few components decline in cost (based on ever-cheaper technological components like closed-circuit camera systems). Your Reserve Study professional can set the "current cost" perhaps artificially low so that the projected "future cost", inflated with all other components, will hit the projected future cost target.

Q: When reserves don't include all community assets that meet the four criteria that have been deferred, how do you increase the reserve funding to meet the deferred required funding?

A: Associations get behind on their Reserve obligations for a number of reasons. Often it is due to insufficient funding, sometimes due to projects that are more expensive than expected, and sometimes due to projects that had not yet become predictable. That is the reason for regular Reserve updates, to rebalance the needs of the property, the size of the Reserve Fund, and the size of required ongoing Reserve funding. When you learn the Reserve funding requirements are higher than before, it is time to update your budget with increased Reserve funding.

Q: Please provide a response to those owners who dislike reserves, but are more than willing to write a check for whatever the association needs. They feel they can better use the reserve funds on their own.

A: Good for owners to state their preference. But it is not their choice. Boardmembers have the legal responsibility to provide for the needs of the association. They do so by setting the income to offset the expenses. Hopefully the $20 the homeowner loses in interest they could have earned from the $1200 ($100/mo x 12 mos) the association is holding of “their money” (but it never really was their money, as they legally agreed to pay their fair share of the bills of the association), won’t prevent them from having a comfortable retirement.

Q: So we need a “date installed’ in order to do a reserve study, correct?

A: No. A Reserve Study professional may ask for an installed date (when “new”) but based on age and other factors they can usually make a pretty close estimate. Components don’t always deteriorate “chronologically”, so aging a component strictly by date does not always yield accurate results.

Q: Should replacement costs of components go up 3% each year for inflation purposes?

A: That would be our recommended expectation. Right now inflation is high, so we are increasing the current cost of components for our clients much more than 3% over last year’s estimates, but we have no expectation that current “high inflation” will last for any extended period of time.

Q: How do you justify a future inflation assumption of 3% in your 2022 study reports when actual construction inflation in 2018-2022 is more than double that rate (without pandemic supply chain disruptions)?

A: We have the ability to separate between a temporary exception to the historical norm (supply chain, pandemic, war in Ukraine, etc.), and what history has taught us to expect over longer periods of time.

Q: When do you recommend funding to begin for a capital improvement not yet built but soon to be completed - such as a seawall?

A: As soon as it is installed. If it is a seawall with a 50-yr Useful Life and it will be completed in two more years, we would model it with a 50-yr Useful Life and a 52 yr Remaining Useful Life.

Q: Can we use Uplanit to manage reserves for maintenance of existing assets PLUS construction of new assets. An example might be an association with current assets, but no community pool, but wants to "save up" to build a pool in five years.

A: You could (that’s the beauty of uPlanIt… you can use it any way you want), but we would recommend against co-mingling Reserve funds and capital improvement funds. We’d recommend keeping them separate.

Q: Should the Estimated Replacement Cost for each component be increased 3% each year to cover costs of inflation?

A: Something nominal and stable like 3% is our long term inflation recommendation.

Q: We got our updated 2022 Reserve Study and in order to be able to fund all items it is asking for $ 1,000,000 and more for the next 5 years. Lobby Renovation, Concrete restoration, Waterproofing and painting building, Waterproofing pool deck planters, possibly a replacement of the pool deck membranes, new elevators, new cooling towers, new alarm system, ETC. It will be an increase per unit of $530 a month and more if we fund Reserves as recommended for the next 5 years. We have had no special assessments since 2006, but we might be facing one now. We might have to get the membership to vote on Reserve funding strategies for the items that need to be accomplished. We have Reserve funds totaling over $2M, but the Board doesn't want to deplete it to a dangerous level. How does it look financially when an association decides to not funds Reserves as recommended?

A: Welcome to reality. It sounds like you have many projects "coming due". It is unfortunate that prior boards did not set aside sufficient funds, forcing current owners to arguably pay more than their fair share. Deterioration is expensive, and those who have not paid their fair share in the past have put a heavy burden on current owners. Work with your Reserve Study provider to test alternatives… perhaps phasing out some projects, perhaps investigating a bank loan to supplement current weak Reserves, etc.

Webinar Questions Asked by Prior Year Attendees

Q: **If your docs don't specify, how do you decide what to include in the Component List? The CUOA (condo unit owners association) is divided on what should be included (as some things benefit just one owner in our very small assn. - 3 units)**

A: Your Reserve Study professional is in the best position to decide what is appropriate to fund through Reserves, by following the national Reserve Study Standard (NRSS) four-part test. That is not an expertise the average boardmember should expect to master.

Q: **How does Association Reserves determine the Component List if Board list does not agree with governing documents?**

A: It doesn't really matter if the board "agrees" with the Governing Documents. The board's job (and our job) is to follow the Governing Documents, not agree or disagree with them.

Q: **What are your feelings about funding property insurance deductibles in Reserves?**

A: They don't belong. They fail the National Reserve Study Standard (NRSS) four-part test, specifically #3 in that such occurrences are not predictable.

Q: **What about Master insurance costs?**

A: Since premiums are paid multiple times throughout the year, Insurance premiums are an Operational budget line item (not Reserves).

Q: **You referenced inflation as a factor, but you did not discuss it at all. Seems like you overlooked a significant factor.**

A: Inflation was not the focus of the webinar. Interest and inflation only complicate the illustrations used to compare Cash Flow vs Component Methods. We include assumptions for interest and inflation in our Funding Plans, because as you suggest they are very real factors in our world today.

Q: **What is a reasonable inflation rate to use in 2022 reserve plan?**

A: Since every Reserve Study is a 20-30-yr plan, we recommend using an inflation rate that can be expected to be somewhat stable (average) over that time period, meaning around 2.5 – 3%/yr.

Q: **The PPI and CPI are currently running somewhere between 4.5 to 6.5%. Is it fair to use these two indexes or do you folks have some other indexes that might be more accurate?**

A: Those indices report current inflation. Since the Reserve Study projects out at least 20 years into the future, it is better to use an inflation rate that is more stable (a 20+ year running average). It is inappropriate to use a short-term (current) inflation rate that is either too low or too high.

Q: **We use 1.5% increase in projected costs to allow for CPI increases per year. Is that enough?**

A: Likely no. I believe over the long run you will find that you will have underestimated all your expenses.

Q: **Explain how inflation impacts each method - in the calculations.**

A: In the Component (Straight Line) method, one would use costs in the contribution calculations that are inflated for the projected future point in time when the expense is anticipated. Similarly, in the Cash Flow method, one inflates the anticipated costs into the future, so the Funding Plan can be developed to offset those inflated, future costs.

Q: **The term "inflation" was mentioned in describing the Cash Flow (pooled) method vs Component (straight line). But neither of the example charts actually accounts for inflation, which would increase the slope of both charts as time progresses.**

A: Correct. Inflation works on the expenses, which as we mentioned (multiple times) were identical for both funding methods. So if inflation had been included, the contributions for both would have increased proportionally. But this webinar was about the difference between the two funding methods, more clearly compared without inflation.

Q: **I added up all 30 years of projected contributions to our replacement reserve fund and all 30 years of projected expenses from that fund. I found that we put in quite a lot more than we spent. Is this a good plan? Shouldn't inflows and outflows balance?**

A: Reserve income should offset ongoing deterioration. That is its only purpose. If your Reserve income has been outpacing your Reserve expenses, I wonder if your Reserve Fund is growing in anticipation of a large upcoming expense, or if you are measuring "budgeted" Reserve contributions and not "actual" Reserve contributions. In far too many cases, budgeted Reserve contributions are significantly larger than actual Reserve contributions

Q: **Can an association fund a separate 'rainy day fund' to cover deductibles?**

A: Absolutely. Just not through Reserves. Create a separate fund.

Q: **It looks like special assessments occur because known expenses are not provided for. You are not trying to help associations to provide for unexpected disasters. Is this right?**

A: Correct. We are in the business of budgeting for predictable upcoming expenses. We are not in the guessing business.

Q: **Should the reserve study show only one replacement of each items in the study?**

A: No. The Component should be listed only once. But if it has a "short" Useful Life (like 5 years), you will see it recur every many times as an expenditure throughout the 20+ years covered in the Reserve Study cash analysis.

Q: **In terms of a percentage (%), how much of a Condo Association's "Operating Budget" should be allocated to its "Reserve Fund Contribution"? In other words, if the Condo Association's Annual Operating Budget is $100,000.00/year, should the Condo Association allocate ten percent (10.0%) of its "Operating Budget" to funding its "Reserve Fund"?"**

A: Every association is different and needs different Reserve contributions. That's what you'll find in your updated Reserve Study. But as you'll see here, it is common for Reserve contributions to comprise 15-40% of an association's total income. So if the association's Operating Budget is $100k, it would be very reasonable to expect that realistic Reserve contributions, that offset ongoing deterioration, would be $33k. So at $33k, your Reserves would then be 25% of your total $133k assessment income.

Q: Our building is 20 years old and has not been funding reserves adequately. How do we build up our reserves balances now that more expenses are being incurred? We need a strategy to make it as palatable as possible to owners.

A: Increase your assessments, so you can increase your Reserve contributions. If you can't take a "big step" forward this year, consider a multi-yr series of smaller steps. You may wish to consider what we call our "$10 Solution" here.

Q: We are a condominium created with attached villas, 6 units per building. The Association is responsible for roofs, siding, paint, landscape, roads and irrigation. Each Homeowner is responsible for electric, plumbing, and all interior repairs to the inside of their unit. How much will a Reserve Study help us, or the average townhome association?

A: Tremendously! Special assessments are bad, and Reserve Studies prevent special assessments. The major common area repair and replacement projects within a townhome community are very predictable. It is best to offset the deterioration of those expenses with properly sized Reserve contributions, so when the roof fails and the asphalt needs resurfacing, the funds are there (avoiding an "emergency" special assessment). The result of effective Reserve planning is that everyone will have paid their fair share, nobody gets hit with a special assessment, and property values are maximized!

Q: Can you briefly discuss the effects that special assessments, both pending and in the recent past, can have on property values and sales?

A: They depress property values. People hate special assessments. Real Estate agents know their territory, and they know all the stories (good and bad) they learn about the associations in their "territory".

Q: How do you deal with owners whose 'lifetime' ownership will end in 5 or 10 years?

A: Everyone should pay their fair share of expenses at the association. If an owner has a life horizon of 5 to 10 years and is trying to get by without paying Reserve contributions that offset ongoing deterioration while they owned in the association, when their heirs inherit the property, the property value will be depressed by more than the value of the Reserve contributions that should have been made. There is no free lunch.

Q: **In Southern Florida what is the longest practical useful life for a shingle roof?**

A: That depends on the quality of the roofing material, the workmanship, exposure to a salt-air environment, etc.

Q: **How do you account for the impact of a robust maintenance program that continuously extends a components useful life?**

A: When an update is performed, both the Useful Life and the Remaining Useful Life are extended. For instance, it is common to find a 15-yr fence can last 20 years with good maintenance, and the same is true for many components. Time and money spent in ongoing maintenance more than pays for itself in extended life expectancies (longer intervals between replacements).

Q: **I don't recall that our study broke down our needs in a Component vs. Cash Flow manner. Did I miss that comparison?**

A: Most Reserve Studies are prepared with contributions calculated using either the Cash Flow method <u>or</u> the Component method, not <u>both</u>. If that comparison was to be made, it would show that the Component method is <u>not</u> advantageous to the association.

Q: **Who decides whether to use Component or Cash Flow?**

A: Typically, that is a choice made by the Reserve Study professional. Almost without exception, that person will recommend and use the Cash Flow method, as it offers the most flexibility and multi-yr fairness in designing a Funding Plan for the client.

Q: **When you say % of reserves, what is the base for 100%?**

A: "Percent Funded" is a term defined in National Reserve Study Standards that is the accepted measure of Reserve Fund size/strength. It compares the cash in Reserves to the amount of common area deterioration at the association, allowing associations of all different sizes and types, with very different Reserve cash balances, to effectively report and compare their Reserve Fund strength. Percent Funded is a measure of how well the Reserve Fund is prepared for upcoming expenses. See more here and here.

Q: **On components - is there a better way? Realistically we manage "project based". i.e. balcony replacement will require door replacement and some stucco repair. Essentially, many components need to be dealt with at the same time because of necessity or doing the project correctly.**

A: Components are the “cash drops” required to maintain the common area assets. Wise planning means similar projects are grouped together… such as hallway painting and hallway carpeting. We call this “logical cycling” of such projects. Each meets the NRSS four-part test for a Reserve component, but we agree with you that some different projects are wisely coordinated together.

Q: **Can you plan for obsolescence with a reserve component? Our community is 50 years old.**

A: We fully expect that some components should be “upgraded” at the end of their Useful Life – old air conditioners are replaced by more efficient units, old key-based or key-code gate systems are replaced by Key Fob systems, etc. So, on an individual project basis, we expect things to be gradually upgraded over time. Older communities, as you suggest, have extra challenges. In addition to having a Reserve Study professional on your team, it is wise to have an engineer or architect on your team to help the board plan to avoid age and decay of the association as a whole. Read the “Aging Infrastructures” research report here by the Foundation for Community Association Research, or their informative & short (2:40) video introduction to the topic here.

Q: **Historical asset cost depreciation is not the same as projected replacement cost. Take insurance policies as an example which can be used to insure for replacement cost. Why talk in terms of asset depreciation instead of providing for replacement cost that may include inflation factors?**

A: Depreciation is indeed an accounting term referencing a historical cost basis. We used that word to describe the way an asset “financially” deteriorates over time to make the point that Reserve planning should involve ongoing payments to offset ongoing physical deterioration. The Reserve Study is indeed the way the way a property prepares for future replacement costs by gradually building the Reserve balance towards that future financial replacement cost target.

Q: **I manage an association that is still under developer control. Several of the components in the reserve study are assets that will benefit unbuilt homes (i.e. gate entrance, exterior community fence, etc.). How do we best determine whose responsibility it is to fund the reserves for these assets?**

A: Laws on developer obligations vary from state to state. It is common that infrastructure assets (roadways) exist before the homes they support are finished and occupied. While some states have higher standards for developer funding of these assets prior to home sales, even at worst case the association can begin funding for these "almost new" assets with the expectation they will have many years before the first expenses begin to occur. The critical mistake to avoid is presuming that original developer budget is applicable for the first five or ten years of the association's existence. Update it regularly!

Q: **Do you have a list of questions unit owners in a condo association can ask the board to determine if they truly understand "how to identify the components of a capitol reserve study, how to manage the funds of the reserve over 30 years, and what % of HOA fees need to fund the reserve account year over year?" Our association is in our 25th year and due to deterioration of the components, maintenance is now becoming expensive. We were a newly built community, and our funds are in the low to mid 6 figures (46 units). I want to ask the board specific and clearly defined questions, because information is not flowing to the unit owners and $$$ are being spent without supporting documentation with increases in HOA fees and possible assessments.**

A: We have not compiled a list, but you should ask to see the last Reserve Study (remembering a Reserve Study is a perishable asset, and it rapidly loses its value as a planning document), learn the association's Percent Funded at that time (0-30% is weak, 30-70% is Fair, over 70% is strong), and compare the association's Reserve contributions to what was recommended in the Reserve Study. That will tell you how the association's Reserves are doing, and if the board is following that plan or "winging it".

Q: **Doesn't the cash flow method result in special assessments in the first few years?**

A: No. Each method provides the cash needed for upcoming expenses. The Cash Flow method is actually more "forgiving" with respect to special assessments than the Component method.

Q: **Is it valid to include a "futures" approach to adapt to the present impacts of COVID-related price-hikes, with the possibility of contributions actually deflating a bit as costs of goods decrease as the supply chain is re-established?**

A: I appreciate your thinking, but we have observed the opposite effect. Many service providers raised their prices significantly over their “artificially depressed” 2020 pricing and supply chain issues have caused price spiking for a number of raw materials. So, if anything, in general it appears pricing has risen more than normal in 2021. We are living in “unsettled” economic times.

Q: **There was discussion about using 3% to factor in inflation and interest in future costs. Is that year over year, or just one time? For example, if I paint the building this year for $600,000, how would I calculate the cost to do it again 8 years from now?**

A: Year, over year, over year. To calculate the effects of ongoing 3% inflation on $600k for 8 years, multiply $600k by 1.03, by 1.03, by 1.03 (eight times), and you’ll get $760,062. That is reasonable approximation for a known current cost eight years into the future. Even so, update that current cost and redo the calculation each year along the way!

Q: **Does the Cash Flow method of calculating reserve contributions only show a larger contribution when a community is new, or would this also be true if a community started using this method much later in its history?**

A: I believe you meant the Component method creates a Funding Plan with higher contributions in the first few years of the plan. Higher contributions are characteristic of the Component Method when the association is underfunded (which is the case for 70+ % of all associations). The Cash Flow method’s hallmark is a smoother distribution of contributions over the years. For well funded associations (above 70% Funded), the differences between the two are much less significant.

Q: **I know that the community I live in has not done the maintenance actually required on a consistent or timely basis, so how would using reserve expenses over the last 35+ years be a good way to calculate what might be needed now or for future contributions?**

A: Old data is only slightly better than no data. So you are right… a “repaint” cost from long ago (2002?) is likely not a good “benchmark” price indicator for your association. Hire a credentialed Reserve Study professional to prepare a Reserve Study for your association, and that experienced individual will base the Reserve Study on their knowledge of current pricing expectations.

Q: Can you change from Component method to Cash Flow method once into the life of the building?

A: Yes. It is a strategy decision (like changing your Funding Goal from Full to Baseline or Threshold), so it is best to not be changing strategy year after year, but it is always a good time to make a good decision.

Q: Why would an association use the Component method when the Cash Flow method ends up in the same place with greater flexibility?

A: Can't think of a good reason. Stubbornness? Reluctance to change?

Q: My association (FL) is operating with no Reserves. I thought that was illegal, but I'm having difficulty finding it in the statutes. From what I recall, you can waive fully funding for three years but then certain items need to be fully funded. For example paving, roofs and painting.

A: We're not in position to give legal advice, but per our reading of FL Statute 718, all condo associations must annually propose full funding of reserves, including roofing, painting and pavement resurfacing, and any other asset with a replacement cost exceeding $10,000. However, the Board is only obligated to *propose* it. A majority vote of the owners is all that's needed to "underfund" the reserves, or to waive reserve funding entirely. If a majority vote does not pass, then the "full funding" budget goes into effect by default. In other words, the ownership can collectively decide to opt out of funding (as opposed to having to vote to "opt in."). There's no limit to how often this can happen—it can happen every year. Of course, the association will then be battered by regular and unsettling special assessments for predictable projects that could have been paid for on a monthly basis by the very owners who lived in the association and enjoyed the use of those components.

Q: What % of associations use Component method vs Cash Flow?

A: As those statistics are not reported, I can only state that associations using the Component method are currently a minority, shrinking with each passing year.

Q: I notice that on our report we use the Cash Flow Method. But we do not see what the difference might be if we used the Component Method. This

knowledge would be useful in explaining the choices we are making as a Board.

A: I have never seen a Component method analysis that is favorable compared to a Cash Flow method analysis. Due to the flexibility to craft a custom funding plan that does not penalize near-term owners with unfair high contributions, and the ability to share cash more efficiently between components, the Cash Flow method will always be advantageous.

Q: The Cash Flow method seems more akin to reality than the Component method. Is the only reason one uses the Component method because it leads to a higher % funded and therefore is safer? Or is there another reason?

A: There is a historical bias. Before computers, only calculators were used, and the Component method is very "calculator-friendly" as it can be done one component calculation at a time. The Cash Flow method requires a computer (a "spreadsheet") that can quickly and easily test one multi-yr Funding Plan after another until an effective solution is found. Unfortunately, (early) FL law didn't just stipulate Reserve requirements, it stipulated how Reserves were to be calculated (using the Component method). For many years now, associations in FL have had the option to switch to the Cash Flow method, but boards are often reluctant to change from prior precedent. But as we showed in the webinar, there are no good reasons to stick with the Component Method.

Q: Is there any documentation that describes the mathematics behind the cash flow method of developing a Funding Plan?

A: I believe we covered (documented) that in the webinar – it is just a matter of laying out the expected expenses in future years, identifying the current starting Reserve balance, and developing a multi-yr Funding Plan that yields the desired objective (Baseline, Threshold, or Full Funding).

Q: I understand funding contributions include the effects of inflation and interest. Why wouldn't the Reserve Fund Strength be calculated to also

reflect inflation and interest so to be on same basis? Isn't Reserve Fund Strength therefore understated?

A: No. Reserve Fund Strength, for this year, is a "snapshot in time" comparison between your current Reserve Fund balance and the current amount of deterioration of your Reserve components. There is no "time" duration in this comparison, so interest and inflation are irrelevant. If projections are made of Reserve Fund strength in future years, then interest and inflation get involved. See here, beginning at p10.

Q: Can you explain when units change owners, which calculation method is more fair for the separate owner's fair contribution of their actual use of the components?

A: First, let's discount "actual use" as a factor. That is irrelevant. For example, an owner is responsible to pay their fair share of the pool deterioration because they are a part-owner of the pool, whether they are a swimmer or not. The cash value of component deterioration (the "deterioration rate" mentioned in the webinar) floats upwards over the years due to inflation. The fairest Funding Plan for the owners, so everyone who joins and leaves the association pays their fair share, is a multi-yr Funding Plan that floats upwards with inflation. That is possible using the Cash Flow method.

Q: Our reserves have varied between 15% to 30% Funded for the past 20 years. We have had numerous assessments and a bank loan. We are now at 22% funded. What do you think is an appropriate % funded for us to target, and in how many years should we aim to get there?

A: First, aim to get out of the weak "0-30% zone" in less than 5 years. Then set a target to get to the 70% level after five more years. Our common recommendation is what we call the "$10 Solution". It is a series of nominal annual increases to the Reserve contribution rate, $10/owner/month each year which breaks down progress into very "passable" annual Reserve contribution increases. As mentioned in the webinar, it doesn't take a lot of money to be making appropriately sized Reserve contributions.

Q: Any recommendations for Associations established in 2001 that did not start funding reserves until 2016?

A: Get a Reserve Study, get a grip on your situation, and ensure your Reserve contributions are providing for the needs of the association. It might be too late to dodge a special assessment or two, but craft a multi-yr Funding Plan to provide for the needs of the association and strengthen the Reserve Fund.

Q: Is there a legal, as opposed to a moral, obligation for a board to fully fund reserves?

A: You should check with your attorney. Typical Governing Documents require boards "adequately" fund their Reserves, to provide for the protection and preservation of the common areas. See the national definition for Adequate Reserves here (top of pg 12). In addition, consider that D&O insurance is for accidental events. Decisions to underfund Reserves are conscious, willful actions, meaning that board liability arising from underfunding Reserves will likely not be defended by the association's D&O insurance provider.

Q: We are a co-op that has been in operation for 57 years. When I became CFO there was a budget item for restoration, basically to fix damages. The dollar amount was a guess. I opted to use the reserves to do these repairs as the co-op owns the apartments. We contribute about 20k per month to reserves. Consequently our reserves are not accumulating as I had hoped to get to 70% of $1.4 million. An assessment is out of the question. Any other ideas for building the reserves?

A: First, get a Reserve Study so you and the rest of the stakeholders have a grasp on the facts. Then consider what we call the "$10 Solution", a process of nominal annual increases to the Reserve contribution rate. Chip away at the underfunding problem a little bit each year.

Q: How do you determine the rate of inflation?

A: I keep a crystal ball in my office, but I can't figure out how to get it to work. So we look at trends. And the trends say that inflation has been relatively stable over the last few decades in the 3% range. So we feel that is a good value to use in projecting the future.

Q: We invest reserve funds at about 2-3% but this never equals the cost of inflation so we always are playing catch up. Any suggestions?

A: 2-3% is actually a pretty good return nowadays (common rates of return are closer to 1%). So congratulations! But interest can never be expected to offset inflation. You need to raise your Reserve contributions.

Q: Let's presume a project occurs early or over budget. Using the Cash Flow method, access to cash is not a problem so the project gets done. But what do you do? A small special assessment to get the funding plan back on track, or push out the "pain" into the future?

A: We have every expectation that our projections will miss their mark. Some projects will occur early, some will be late. Some will be under-budget, some over. With that expectation, hopefully these missed estimates will tend to average out "close to plan". But since one of the National Reserve Study Standard Four Funding Principles (as mentioned in the webinar and articulated here) is budget stability, we recommend regular (annual) Reserve Study updates to stay on top of all changes. These annual updates should smooth out irregularities and spread them out over multiple years.

Q: How does the Cash Flow method account for items which are deferred?

A: See above. Some projects occur later than projected (but hopefully not so late that they cause damage that increases the scope/cost of the project!). Changes in timing and cost are handled in your regular Reserve Study update, which incorporates the current condition of the components, the current Reserve balance, and current expectations for interest and inflation.

Q: We have a reserve item for the insurance deductible (12K). How do we account for this when it is fully funded without a known use frequency?

A: Insurance deductibles should not be handled from Reserves, as they fail tests 2 and 3 of the National Reserve Study Standard four-part test. See more in our Reserve Studies 101 webinar here. Set the funds aside in the Operating Fund (or a side fund) as an insurance deductible contingency.

Q: What to do when the component list is missing or underestimated, such as refurbishing the cooling tower?

A: The National Reserve Study Standard four-part test defines a legitimate Reserve component. It is the higher authority, compared to “appearing in the Reserve Study or not”. So if it passes the four-part test (refurbishing the cooling tower) and is missing from your Reserve Component List, spend the funds from Reserves, and update your Reserve Study prior to your next fiscal year (to rebalance projected Reserve income and expenses).

Q: If the board does a cosmetic project not listed on among Reserve Components, can funds be taken out of the cash reserves to fund the project?

A: The nature or type of the project is not significant (cosmetic vs repair vs replacement). The National Reserve Study Standards four-part test is a higher authority than your Reserve Component List. So if it passes that scrutiny, it is a legitimate expenditure of Reserves. Just make sure to update your Reserve Study prior to your next fiscal year (to rebalance projected Reserve income and expenses).

Q: Reserve Studies are supposed to be 'independent', right? If a board president manipulates the reserve study numbers by insisting on his own hand-picked vendor even though they have been shown to be incompetent, what recourse do owners have?

A: We can’t control boards. We can control the content in our Reserve Studies – it is our logo on the cover so it is our opinion in the document. Clients don’t manipulate our numbers – that is the value of an independent, credentialed Reserve Study provider. If you are doing your own Reserve Study in-house, you are subject to the biases of the provider. That is unfortunate. As an owner, you don’t really have a recourse other than setting some funds aside for inevitable special assessments (when projects don’t last as long as they should, or need to be redone), run for the board to improve the quality of board decisions, focus on enjoying other aspects of living in the association, or sell and move.

Q: My HOA BOD will not listen to me. Any advice?

A: See above.

Q: If an association is in a catch up mode, would they need to start with the component method and then switch to the cash flow method?

A: No. The Cash Flow method is especially well suited to associations in catch-up mode, as the Funding Plan can be crafted to provide "just enough" cash near term to build up Reserve Fund strength to a reasonable level, without "overcharging" near-term owners. It can still be a funding plan that predominantly rises with inflation (as opposed to the short-term high, long-term lower profile characteristic of the Component method).

Q: How do we Fully Fund when the roofs are already 12 years old?

A: You've likely got some catching up to do. Your Reserve Study will provide you a funding plan that provides for replacement of the aged roof, while guiding the association towards being Fully Funded. While a Component method funding plan will force becoming Fully Funded rapidly (in time for the roof project), the Cash Flow method will give more time to become Fully Funded.

Q: How do you convince an owner who expects to leave after 5 or 10 years to pay to fund long term expenses, 25 years out?

A: Every owner should only pay their fair share… the amount of deterioration that occurred <u>while they were an owner</u>. Nobody is being asked to set aside funds for the future. They are just being asked to offset ongoing deterioration. When everyone pays their fair share along the way, nobody gets left "holding the bag", and the future takes care of itself.

Q: In the example 30yr Funding Plan charts shown, comparing the Component method to the Cash Flow method, it didn't appear that you considered inflation. Is that true? Why not?

A: Good eye! We were trying to clearly show the characteristics of the two calculation methods. We found that the comparison is clearer without inflation. The point could have been made with inflation included, but it would have taken more words and another slide or two. The point is that net 30-yr Reserve contribution cash is generally very similar between the two (as it should be… the expenses do not change), the difference is in the <u>profile</u> of contributions over the years.

Q: At year 31 where are the contributions? One profile has year 30 funding much higher than the other.

A: That was just a consequence of failing to include interest and inflation for the purposes of the "Component vs Cash Flow" method comparison above. In reality, Funding Plans are designed (as we showed in the webinar) to follow the four Funding Principles, which includes budget stability. We design multi-yr Funding Plans that are as smooth from yrs 10 to 11, and yrs 20 to 21, as they are in yrs 30 to 31… every year should be a minor change from the prior year.

Q: When a portion of your reserves are ballot-restricted to a component due to a construction loan, can the HOA still apply Cash Flow (pooled) to the rest of the component inventory?

A: Yes, as you state, with that project (component) excluded. When that issue is resolved, the component (and contributions towards that component) can be folded into the updated Reserve Study.

Q: In Nevada, we are required to choose 1 of 3 types of funding … FULL funding … THRESHOLD funding … BASELINE funding. Can you speak about each of them?

A: We briefly discussed those National Reserve Study Standard Funding Goals in the webinar. We discuss them in more detail in our Reserve Studies 102 webinar which you can find here. You can read about them in National Reserve Study Standards here (beginning on p12).

Q: Do have a method for reserving for elevators that distinguishes between refurbishing the car vs replacing the mechanical components, etc.

A: Yes. We cover that in our Reserve Studies 101 webinar about Reserve components here. It is common that one asset has more than one Reserve component due to different Useful Life and Remaining Useful Life (and cost) factors. Elevators are a good example – a long cycle for modernization of the equipment, and a shorter cycle for cab remodel… typically at least two components for an asset as significant as an elevator.

Q: **Our HOA is 16 units, built in 1976. Originally, the homeowners were interested in dealing with repairs with special assessments, thereby current owners were paying for repairs that they would see the benefit. Now we are trying to strengthen our reserves. I have owned for 18 years, and I have unfortunately had to pay several special assessments, but on the other hand I am feeling cheated to now pay into the reserve for future expenses that will likely happen after I am gone. Am I playing "twice"?**

A: No, you are not paying "twice". Special assessments are "catch-up" payments, unfairly placed on the set of owners at the time of the expense, catching up for inadequate Reserve contributions of prior years. Owners had built up a Reserves "balance due". Now, making adequate Reserve contributions just means you are offsetting ongoing deterioration. There will be no future (catch-up) special assessments, because you're finally paying your fair share along the way. You're not setting funds away "for the future". Each month, you're just offsetting that month's deterioration.

Q: **Hawaii has 50% requirement. Does this apply to the Cash Method?**

A: Hawaii law is unfortunately written with words that conflict with National Reserve Study Standards terminology. One can interpret that requirement to be that the association's Reserve fund be at least 50% Funded (Threshold Funding), or that association's contributions need to be at least 50% of what is "needed" (which will quickly lead to special assessments). Setting a responsible Reserve plan with a goal to be at least 50% Funded will keep the association clearly above either of those two minimum requirements.

Q: **For our HI association, in a future year we anticipate Reserve expenses of $4M and our Cash Flow projections only anticipate having $2M at the time (50% of requirement). What do we do?**

A: Plan to raise your Reserve contributions (if you have enough time/years to generate the additional $2M by increased Reserve contributions), or brace yourself for a special assessment. This points out the shortcoming the interpretation of HI regulations that only 50% of required contributions are necessary. Clearly, that is not sufficient. It will only lead to special assessments. Replace whoever prepared your Reserve Study. Get someone who can design a Funding Plan that provides for the needs of the association. As you saw in the webinar, "Providing Sufficient Cash" is one of the four Reserve Funding Principles.

Q: Is there a minimum amount of reserves that are required by law?

A: No, with an asterisk. Some states require a minimum threshold of Reserve contributions (10% of total budget…), and Hawaii requirements can be interpreted multiple different ways (this paragraph got long when I started to list them!), but generally no. It is the board's job to run the association in a sustainable manner, providing for the needs of the association. That is the objective, not looking around for a state law to satisfy.

Q: When using the component funding, how/when do you determine the percentage to fund a particular component?

A: There is no "percentage to fund…" in the Component method. It is simply the expense minus the funds presently accumulated, divided by the Remaining Useful Life. For example… a $10,000 pool resurface, where $2000 are currently set aside means $8000 yet to collect (no interest or inflation in this simple example). If the Remaining Useful Life is 6 years, $8000 / 6 means you need to collect $1333.33 per year for six years. Do the same calculation for all your other components. Of course, update your assumptions regularly!

Q: Some owners think strong reserves might result in overspending and that they would prefer the control allowed by voting for or against special assessments? How would you respond?

A: Overspending is a problem in itself. Expenditures should be measured compared to the estimated cost found in the Reserve Fund, and scrutinized closely when they go over budget. Restraint should always be exercised, *no matter the strength of the Reserve Fund.* Budgeting and spending to care for the common areas is the board's job. They should not be asking permission from the owners to do the job they were elected to perform.

Q: Is there a beneficial use of Special Assessments to keep monthly dues low?

A: No. "Low monthly dues" are never an appropriate objective. The board's job is to maintain the common areas, and that takes cash. Special assessments keep Reserve contributions low, but they often prevent the timely execution of Reserve projects (when waiting for the special assessment to pass), and they unfairly distribute the cost of deterioration on the owners unfortunate enough to live in the association at the time of a special assessment. The goal is everyone paying their fair share along the way (no more, no less), a well-maintained property and maximized home values, and low liability for the board. All those good things happen when there are appropriately sized Reserve contributions.

Q: In the "Cost of Deterioration" portion of your presentation, were those current dollars or future dollars?

A: Current dollars. For this simple example, we calculated this year's deterioration rate, which is done with this year's (current) component costs. At that stage in the presentation, we were making the point that contributions more than the "cost of deterioration" over the years will lead to a strengthening of the Reserve Fund, and vice-versa. Showing actual effects of inflation would have confused the illustration. In reality, the "cost of deterioration" rises each year because inflation causes component costs to increase. So in reality, contributions need to increase every year *just to keep pace* with the rising cost of ongoing deterioration.

Q: Once a budget has been passed or published, and if the budgeted contributions are not being made, are the "non-contributions" considered a loan to operations from reserves?

A: I have heard divided opinions on this, but the majority clearly fall on the side of contribution shortfalls being considered a loan to the operating budget that needs to be repaid. If the owners were told $60k was going towards Reserves this year and the board chooses to only set aside $30k, there will be a Reserves shortfall. That means Reserve funds are being used to prop up the Operating budget, and that is borrowing.

Q: Using pool furniture replacement life, if you are able to refinish/restore for much less, how do you recalculate life?

A: Establish two overlapping components. Instead of discarding pool furniture every 5 yrs, if you decide to refinish in the fifth year and get another five years of life, you effectively now have replacement after 10 years. But you now have refurbishment at the 5-yrs-old point, every 10 years. So for instance create a replacement component at 10 yrs UL and 5 yrs RUL, and a refurbish component at 10 yrs UL and 0 yrs UL. That way you can refurbish it now, and expect to refurbish the next set in 10 yrs when that set is 5 yrs old.

Q: Owners often say they would rather save and invest their funds, and accept the limited special assessment in a 10 year period; how to respond?

A: Thank them for their opinion, but remind them that the board's job is to maintain the assets of the association. And that takes a stable income stream that leads towards the board's ability to do their job. There may be different owners in the future unable to pay special assessments. The board sets policy and is burdened with the job of running the association, not the owners.

Q: When is partial funding of reserves justified?

A: The only time I can think partial funding of Reserves would be justified is in a time of emergency, when essential services of the association are at risk. At that time, reducing Reserve contributions temporarily (to improve association cash flow… trading a present problem for a future problem) may be a survival strategy. See this issue addressed in our "Reserves to the Rescue?" webinar.

Q: What do Florida Statutes say about borrowing approximately $1.5 million from the "pooled reserve fund"? Should the vote state the exact $ amount to be borrowed, and how and when it is to be re-paid?

A: You should check with a FL attorney for interpretation of FL law. I would expect that any borrowing from Reserves, no matter what state, should be supported with clear documentation of why, when, how much, and (as you state) how and when it is to be repaid.

Q: Does the % funded change annually based on the components that are replaced in the year?

A: Yes. When funds are spent on a project, the Reserve balance drops, but the Reserve needs of the association also drops. So there will be fluctuations from year to year as the ratio of cash in Reserves compared to Reserve needs of the association change.

Q: How do you overcome the "pay as you go" attitude?

A: We <u>encourage</u> the “pay as you go” attitude, where every owner pays their fair share of common area deterioration every month on an ongoing basis, with nobody getting stuck unfairly for a lump sum payment (special assessment) for years of deterioration, likely some of which occurred before they became an owner at the association.

Q: What collateral power does a bank have when they are extending a loan to an HOA?

A: The association assigns part of their income stream (assessments). The higher homeowner assessments required to support loan payback (plus interest and fees) are typically <u>far more</u> than the higher homeowner assessments that 10 yrs earlier would have <u>prevented</u> the need for the loan. The lesson? Make your necessary budget adjustments now, so you won’t need a loan in the future. Save your owners the high cost of interest and fees!

Q: If I use a responsible threshold funding program, I believe straight line funding requires higher than needed assessments. What do you think?

A: As we demonstrated in the webinar, in most cases the pursuit of the same funding goal can be achieved with lower contributions by using Cash Flow methodology due to elimination of the rapid “catch-up” contributions that are commonly found in “straight line” (Component method) calculations. Confirm your assumption by laying out the projected income and expenses for at least 20 yrs to confirm the funds will be there when needed.

Q: What about the 90/10 rule?

A: I'm presuming you are referring to the FHA's requirement that at least 10% of the budget be directed towards Reserve contributions. In this article we explain that we've noticed that typically it takes 15-40% of budget going towards Reserves to offset ongoing deterioration and avoid "catch-up" special assessments. So "10% of budget" should not be viewed as government suggested minimum, nothing to do with sufficiency.

Q: We're a small homeowner HOA in FL and our builder left us with no reserves and previous boards have mismanaged our funds. How can we get the homeowner to buy into "full" reserve funding?

A: By demonstrating the real and measurable annual deterioration and cash flow needs of the association. A Reserve Study will identify very real and predictable upcoming expenses, and will demonstrate the adequacy, or lack thereof, of the cash flow generated by the current budgeted reserve contribution rate. As I stated in the webinar, a good beginning strategy is to communicate the expenses in the cash flow summary over the next five to ten years (simple addition and subtraction exercise), before looking at years farther into the future. That should help owners appreciate that the funds need to be set aside!

Q: Has any correlation been drawn between reserve contributions as a % of annual budget with respect to Full, Threshold, and Baseline levels?

A: In our experience we have found that for most associations, Full Funding contributions are only 10-15% higher than Baseline contributions. See article here. Full Funding contributions typically range from 15-40% of an association's total annual budget.

Q: How often should you update replacement or deferred maintenance costs?

A: Reserve needs and contributions are a significant portion of the annual budget (see above), so are worthy of being updated annually.

Q: We are a Florida HOA. Originally we had specific reserves for roads which are scheduled to be fully funded when they are due. As time has gone by,

our Property Management Company recommended that we convert these specific reserves to pooled reserves. Your thoughts on this strategy?

A: In FL and in every state, pooled Reserves are a more efficient way of accounting for Reserve funds. You still need to set the money aside for the same upcoming expenses. But if there is ever a shortfall, a pooled methodology means the funds are there without having to officially transfer them from one "account" to another. It saves an administrative step.

Q: What is the best way to fund a project that is going to cost about 40% more than estimated? Should the board just decide to spend the extra funds from the reserve fund or have a vote on a special assessment OR have the entire HOA vote on spending the extra funds?

A: First, I assume your project can be viewed as a legitimate reserve expense, versus a capital improvement (new asset that did not previously exist). Look at your reserve study, and work with your reserve study provider to assess your options. Also be sure to determine if your governing documents have anything to say about procedural requirements for projects of certain types, or dollar amounts. In all cases, transparency with the owners should be the rule. Special assessments and loans should be viewed as last resort due to their extra costs and administrative time.

Q: Our association is facing a 5 million dollar assessment. How do you start a reserve fund after a hit like that when you have never had reserves?

A: By now, it must be clear to your ownership that a well formulated reserve plan, funded on an ongoing basis, would have prevented your current problem. You don't want that to happen again. Your Reserve Study is crucial to illustrate the deterioration that will begin again, the first day after the project(s) that were completed via special assessment. Perhaps the phrase "fair share" is an overused sound bite, but every owner should pay their fair share of ongoing deterioration.

Q: How often should a Full reserve study be done?

A: A "Full" Reserve Study, if properly executed, typically only needs to be done once. During the Full study, there is work that should not be necessary to repeat: e.g. review of the governing documents, site measurements. All other studies update that base information through a With Site Visit update, or a No Site Visit update. It is common that associations prepare a With Site Visit update every few years, with No Site Visit updates in the in-between years.

Q: Would a reserve study cover the deductible for insurance?

A: Insurance deductibles fail the National Reserve Study Standards four-part test for inclusion within a Reserve Study. See article here.

Q: If you find you have underestimated the cost for a certain component and need to fund it immediately, do you just take the extra funds from the "total" reserve for the year if you are using the pooled method?

A: Yes. In the pooled method, there are no separate accounts for each reserve component – they exist in the same pool. Cash is allowed to flow through to any necessary expenses in a given year. The impact of those expenditures to the funded status, and contribution recommendation, is factored within the subsequent reserve study update. When something costs more than anticipated, expect your Reserve contributions to go up slightly to make up for that "overage" and allow the association to prepare for the next occurrence.

Q: Our HOA is located in California. Do you have tips for handling earthquake surprises?

A: There are multiple facets to a question like this. I would suggest beginning your investigation by consulting with your insurance agent to understand what is, and is not, an insured loss to your association, and learning your policy options. You may wish to also consult with a structural engineer to assess the existing seismic provisions of the buildings, and recommend any retrofits that may be wise preventative measures. You also need an understanding of any requirements in your particular regulatory jurisdiction. See this article referring to buildings within the city of Los Angeles.

The bottom line is that in every geographic area, there will be natural hazards (wildfires, floods, hailstorms, earthquakes, tornadoes, etc.). Since they cannot be anticipated, natural hazards fail the National Reserve Study Standards four-part test for a Reserve component. A well-prepared Reserve Study will limit the association's exposure to special assessments to true unpredictable emergencies like these.

Q: Our board had to take out loans to fund projects due to inadequate Reserves. How do we get them to be more responsible in the future?

A: I assume that you are talking about projects that were somewhat predictable, not as a result of hidden damage, or defect. The components identified in a reserve study are quite predictable, measurable, and deteriorating every day, in plain sight. Funding those projects via a loan and/or special assessment are costly approaches when compared to setting aside stable, regular reserve contributions over time. Boards must have the courage to make decisions in the best interests of the association as they discharge their duties. Sometimes electing new board members (or running for the board yourself!) is necessary to get steady and responsible hands on the wheel.

Q: We use the straight line method and have built our percent funding to just over 100%. I've noticed that now the recommended monthly funding amount grows about 5% annually. Why?

A: Sorry, too many unknowns in your question for me to answer specifically. Even so, a multi-yr Funding Plan consisting of nominal annual "inflation-offsetting" increases is generally a preferred way to fund the Reserve needs of the association.

Q: If you are using the straight line method, can you use the pooled method for withdrawing funds? You can use the next reserve fund study to adjust the contribution to accommodate the change, especially if you are near or at fully funded.

A: Your question points out the benefit of the "pooled" (Cash Flow) method. Using Cash Flow methodology, funds deposited to Reserves are not designated towards a particular component, and funds expended from Reserves don't have to come from only one component's "account"… they are just "Reserves". You save so much administrative time with the Cash Flow methodology by not concerning yourself with continually rebalancing and redistributing funds in all the separate "accounts".

Q: If we are to consider inflation and interest rates when factoring the amount to contribute to reserves...what is a good percentage to add into the contribution?

A: You may have two separate questions here:
1) What interest and inflation assumptions should we use? We generally use the actual interest rate of return of our clients, and based upon historical CPI data, about 3% inflation going forward. There is some art involved with near-term projects expected in a high-inflationary market – i.e. you may wish to increase your costs beyond 3% to provide for some contingency if you are in a market experiencing currently high demand of construction related goods and services. A knowledgeable study provider can counsel you on these matters.
2) Is it wise to plan to increase reserve contributions each year, accepting the fact that interest and inflation matter? Reserve contribution rates should be stable rate and fairly distributed over the years, and that typically means gradually increasing in upwards at roughly the same pace as inflation.

Q: But we still need to have the component list in order to figure what to contribute to pool. Are you saying not to worry about the component list, such as to keep them listed on the reserve budget?

A: No. A well-formed component list is the foundational basis of any reserve study, regardless of the computation method (component vs. cash flow).

Q: If the association puts off doing an item on the reserve schedule when it is due (for example paving), are they saving money over time if there isn't an issue with the component?

A: The reserve study is a budget guidebook, not a rulebook. If the project is due per the study, but the association's knowledgeable vendor, or consultant, indicates you can safely add time to the remaining life, by all means feel free to do that! Because most components are only a small fraction of the entire component list however, it is not likely to result in a significant decrease in the recommended reserve contribution rate of the next study – but it will have a positive impact to some degree.

Q: **Although contributions to reserves are budgeted, it seems that the board always finds new things to try/study/buy from expenses so that reserve contributions are not made, year over year. Any suggestions? Any way to encourage boards to live within budget?**

A: A budget is just a guide. It sounds like the board needs to take a hard look at the budget, and appreciate that they need more margin in order to make the budgeted Reserve contributions. Reserve contributions are for very real and predictable Reserve expenses. So it sounds like it is time to increase the "unanticipated expenses" line item in the budget, so the board can draw from that pool of money for those unanticipated expenses, leaving room so the Reserve contributions can make it to the Reserve fund!

Q: **If you have a rock entrance monument that most likely will never be replaced, should it be in your reserve study?**

A: Not if there isn't a predictable basis for replacement, or periodic repair expenses (e.g. clean / mortar work / repair) that exceed typical maintenance allocation in the operating budget. Some "rock" monuments however are cultured stone over wood structural components, and are susceptible to deterioration if not maintained well. Some rock monuments have shown over the years to need replacement due to settling from poor compaction and drainage provisions, or mortar work.

Q: **We had a flood and lost a spillway that cost 800k to repair. It was not in the reserve study due to the expected life being all concrete. We are now discussing if the new unit should be included in the reserve study. Thoughts on putting it in the reserve study?**

A: Consult with an appropriate civil engineer to determine if the spillway meets National Reserve Study Standards four-part test for inclusion as a reserve component: 1) association responsibility 2) predictable life 3) predictable remaining useful life 4) significant in cost (at $800k this is clearly significant!). Also talk to your insurance agent to investigate potential policy coverages for this unlikely event in the future.

Q: **What notification provisions to owners are required when funds are borrowed from Reserves here in Washington State?**

A: Please check with your attorney, but our understanding is that it depends upon the overarching statute: If the property is a condominium and governed under the "Old Act" RCW 64.32 (generally prior to July of 1990), or the "New Act" RCW 64.34 you can find reserve borrowing and notification provisions within RCW 64.34.384. This language, while found in the new act, retroactively applies to the old act. Common interest communities created on, or after July 1, 2018 are bound by the Washington Uniform Common Interest Ownership Act, RCW 64.90 You can find the requirements within RCW 64.90.540

Q: How can such different Reserve contributions be calculated when using the same component list?

A: As shown in this slide in the webinar, the primary difference between the Component Method contributions and the Cash Flow Full Funding contributions is in the first year. Because the shape of the Funding Plan profile is different over the years, the 20-yr or 30-yr differences are relatively small. In addition, there is a difference due to lower objectives… meaning the Reserve Fund will be smaller and have less and less margin for the unexpected. They do not represent an "apples to apples" comparison as there was between the two Full Funding contribution plans.

Results…

Method	Objective	Contribs/mo
Component	**Full**	**$2,724**
Cash Flow	**Full**	**$2,140**
Cash Flow	**Threshold**	**$1,900**
Cash Flow	**Baseline**	**$1,790**

Q: Looking at my Reserve Study, how do I find out if our contributions were calculated using the Component or Cash Flow method?

A: According to National Reserve Study Standards, a disclosure of the funding methodology (Component or Cash Flow) is a required disclosure within in the Reserve Study.

Q: If mid-year Reserve expenses or your contributions are very different than budgeted, should you re-compute your Reserve contributions mid-year?

A: No. Your owners deserve stability. A Reserve Study is an annual document. Don't update it more than once a year. Everything changes, so issues like this are another good reason to update your Reserve Study annually, and not let multiple years go by.

Q: How can you calculate contributions using the Cash Flow method yet use "straight line" calculations for Reserve Fund strength (Percent Funded)?

A: Reserve Fund Strength calculations and Funding Plan calculations are two different tasks, and different calculation methods are appropriate.

Q: Our Funding Plan is calculated using the Cash Flow method. How important is it that we also calculate Percent Funded?

A: No matter which method (Cash Flow or Straight Line) you use to calculate your Funding Plan, it is very useful to know the measured strength of your current Reserve fund. That is one of the three key results from every Reserve Study. An association that is 15% Funded (high risk of special assessment) cannot casually address needed Reserve contribution increases. An association that is 85% Funded (low risk of special assessment) likely has more margin to perhaps spread a necessary increase over a few years, instead of immediately. You should know that.

Q: Do you recommend including estimates for interest and inflation?

A: Absolutely. Interest and inflation are very real. Interest rates are currently small, but they provide significant interest over the years as the earnings compound! While we may not know future inflation rates exactly, based on prior years we can make a reasonable projection. Note that inflation is much more significant than interest since it has its effect on the entire replacement cost of all components, while interest is only earned on reserve cash actually on-hand. So interest and inflation are not close to offsetting each other. Inflation effects are always going to significantly outpace interest earnings.

Q: How do you adjust for future costs in a funding plan?

A: See above. Incorporate inflation in the funding model, so projected costs in the future are larger than "current cost" values presented in the Component List.

Q: What do you do if you can't make the Reserve contributions? We want to start strengthening our Reserve fund.

A: The primary responsibility of the Board is to protect, maintain, and enhance the assets of the corporation. It is the Board's job to protect and maintain the assets of the corporation, so their job is to set an appropriate budget that provides the necessary income. If you believe it would cripple the association to make the size of Reserve contributions that are currently recommended, budget for an increase you can manage. And increase those contributions next year, and the year after, until three to five years from now your Reserve contributions will have grown to where they offset ongoing deterioration and owners are paying their fair share.

Q: What's the best way to get your association to take Reserve contributions serious? Our board has a "fix it when it beaks" mentality.

A: That's unfortunate. Reserve expenses are large, and they are predictable. To have sufficient funds available for timely repairs and replacements requires years of financial preparation. Ignoring that financial reality, exposing owners to special assessments and the high cost of deferred maintenance is fiscally irresponsible. Suggestion: characterize Reserve contributions as "offsetting ongoing deterioration". This way Reserve contributions are correctly characterized as a bill as real as any other bill at the association. Ignoring a bill that needs to be paid is irresponsible.

Q: What are best practices for boards to persuade members (who can vote to reject the budget) that it is unfair and wrong to pass major costs on to future owners?

A: As above, characterize Reserve contributions as offsetting the ongoing cost of deterioration, a cost as real as any other bill. It's only fair that people owning homes in the association pay for the deterioration of the assets they've enjoyed using. In addition, Reserve costs are minimized (saving owners $) when Reserve projects are done on time because deferred maintenance can be avoided, and home values are maximized (making owners $) when the facility is well maintained. So stress the fundamental fairness of everyone paying as they go, and their desire to keep assessments low while maximizing home values.

Q: How important is maintaining consistent Reserve contributions as opposed to changing it each year by 25% - 30%?

A: A National Reserve Study Standard Funding Principle is for Budget Stability. So it is good to have relatively consistent Reserve contributions through the years, gradually floating upward with inflation (and homeowner assessments in general). But if they are too low to provide for the Reserve needs of the association, they need to be raised. Raising them 25-30%/yr for a few years (if you have time before a large upcoming expense) is more stable and palatable to your owners than doubling them immediately. It is a tradeoff.

Q: What is Threshold Funding?

A: Threshold Funding is when the Board selects a particular cash or Percent Funded target, usually in-between the Baseline Funding (zero) level and the 100% Funded (Full Funding) level.

Q: What is a reasonable or common Threshold Funding objective?

A: Common Threshold objectives we hear clients asking us to "run a case" to investigate are 50% Funded or 70% Funded.

Q: Are you recommending trying to get 100% Funded using Component Method (Straight Line) calculations?

A: I illustrated that Component Method calculations lead only to 100% Funded. Pursuing the goal of being 100% Funded is responsible. It is more smoothly and fairly achieved using Cash Flow Method calculations.

Q: What period of time should be used when figuring reserve expenses and contributions? Next year? Next 5 years? Next 30 years?

A: National Reserve Study Standards require a presentation of a minimum of 20 years of income and expense projections in a Reserve Study. Many Reserve Study providers expand that horizon to 30 years.

Q: I don't understand your statement that Reserve contributions are typically 15-40% of total monthly association fees, especially if our other fees are low because owners do maintenance work themselves.

A: The cost of Reserve component deterioration is high. Most associations require 15-40% of their total income going towards Reserve contributions. If your common area maintenance responsibilities are atypical, or if your operational expenses are atypical, expect that you'll be at one end of this 15-40% spectrum or the other, or even outside this range. Get a well-founded Reserve Study to find the correct Reserve contribution rate (and thus fraction of your overall budget) for your association. Don't rely on "typical" or "average" figures.

Q: We have a large association with a large budget that includes significant payroll, management, legal, and other contracted services. So 15-40% of what?

A: Reserve contributions are commonly 15-40% of your total assessment income. Note that we find that in complex, large associations, there are often many expensive Reserve components, so the 15-40% stands true for a broad spectrum of associations, even large ones.

Q: How do I to calculate Reserve Contributions using the Cash Flow (pooled) method?

A: Many individuals prepare a Cash Flow analysis using a spreadsheet, which you can set up to lay out the future irregular annual expenditure totals from all the components. Knowing your starting balance, you then begin testing different steady multi-yr Funding Plans that provide for all those anticipated expenses with an appropriate amount of margin.

Q: How do I calculate Reserve Contributions using the Straight Line (Component) method?

A: One component at a time. At its simplest, take the projected (future) expense for a component, subtract the funds already set aside for that project, and divide the funds still to be collected over the Remaining Useful Life of the component. That gives you the contributions necessary to provide for the future expense of that component. Then do that same calculation for all the other components, summing all those individual contribution elements together to find the recommended current year Reserve contribution.

Q: What are the legal differences between straight line (component) and pooled (cash flow)?

A: Don't consider this legal advice, but to my knowledge only FL and HI associations have to stipulate which methodology they use to develop their Funding Plan. It is probably more correct to say they are mathematically different, not legally different. As stated in the webinar, the Component Method tends to front-load the contributions, making those plans more financially challenging for underfunded associations. This makes contributions developed with the Cash Flow method easier to adopt (and thus arguably easier for a board to pursue in their interest to provide for the needs of the association). See more on legal issues between the two here.

Q: Are Reserve contributions or a Reserve Fund required by law?

A: 30 states have laws on Reserve Funds, Reserve contributions, and Reserve Study-related disclosures, so it depends on your location. But the simple answer is that board members are held to standards of Fiscal Responsibility in all 50 states, so Reserve contributions and a Reserve Fund is a practical necessity.

Q: Do we need to track reserve expenses by component in order to update the component list changes?

A: You need to know which components were repaired or replaced in order to update your component list. This is not an accounting issue or a funding method issue. This is an issue of knowing what work was done.

Q: Our contributions keep changing (increasing) because component information changes so much each year. Is that a problem?

A: Inaccurate information should be updated. Hopefully your component information (Useful Life, Remaining Useful Life, and Current Replacement Cost) will stabilize, so the Funding Plan can begin to stabilize (one of the four Funding Principles!).

Q: In your example of the cost of ongoing deterioration ($20,170/yr), is that affected by interest & inflation?

A: That figure was a "current rate of deterioration", so interest or inflation do not apply.

Q: Some associations collect association assessments on an annual basis (not monthly). How does this affect things?

A: Not much. The Reserve Study provider should be informed if assessments are collected at the beginning of the year or the end of the year, as it will affect cash flow. As long as the total annual needs of the association are met, it doesn't matter if the income comes in monthly or annually.

Q: What are the decision points between funding Reserves with a special assessment (or series of special assessments) and "temporary higher ongoing assessments".

A: Actually the difference may be only in semantics. It may boil to what is more palatable to the owners. If the board promised "no special assessments", then call them "temporary higher assessments". If the owners fear "temporary higher assessments" will stick, call it a multi-yr special assessment.

Q: Would it lower your Reserve contribution if you don't do a project (for one or more years) when its Remaining Useful Life is at zero?

A: Just a little. You may not have spent the money, but the money still needs to be spent. What you've effectively done is stretch the component's last Useful

Life a bit… and every time you stretch a Useful Life, Reserve contributions should drop a little bit. Just don't expect to see much of an effect.

Q: What index basis for interest rate (for component cost inflation) do you recommend and why?

A: We look at the last 10, 20, and 30 years of the general CPI. Looking backwards on a multi-decade basis helps us project forward on a multi-decade basis.

Q: Can an association be overfunded? And what should the association do in that case?

A: The entire spectrum of association funding levels exists. See our article here. Certainly an association can be overfunded (Reserve Fund in excess of 100% Funded). We don't really become concerned until they are over 130% Funded. At that point, we recommend purposefully, gradually, and in a controlled manner slightly underfunding their Reserves in order to bring the Reserve Fund strength down closer to the 100% level, while maintaining budget stability from year to year.

Q: Our association has two CDs… one 3-yr and one 5-yr. We also have a savings account. Is that a good idea, or unnecessarily complicated?

A: That sounds like a great idea. Many financial professionals recommend setting funds aside (locking them up) in investment vehicles that maximize interest earnings when those funds are not expected to be used, and leaving some Reserve funds available for use. So a combination of CDs or other similar vehicles, timed so the funds will mature before a big project, and a combination of readily available funds is a great idea.

Q: Which is better for control purposes, tracking Reserve balances on a component-by-component basis, or simply cash flow for a given year?

A: As I stated in the webinar, since associations so often re-assign funds from one component to another, the net total Reserve fund is the significant figure. See more here.

Non Funding-Plan Questions

Q: I thought you couldn't Reserve for painting or power-washing (or trees) per IRS requirements?

A: Please visit our Reserve Studies 101 webinar and its outline on our Webinars page, which addresses the topic of Component selection. It is true that the IRS defines painting as a "maintenance" project (not Reserves). But the IRS creates rules for tax preparation, not Reserve Study preparation. Painting or tree trimming projects regularly meet the four-part test of a Reserve Component found in National Reserve Study Standards. Prepare taxes according to IRS standards, prepare your Reserve Study according to National Reserve Study Standards.

Q: What do you find is the average annual budget increase needed by your clients?

A: Our average Reserve Contribution recommendation is 9% higher than the association's current Reserve contribution rate. That typically translates to a 2-4% increase in overall assessment rate.

Q: How much does a Reserve Study prepared by an independent, credentialed professional cost?

A: The wonders of supply and demand have created a growing network of qualified and credentialed Reserve Study professionals serving the needs of associations across the country. Request a proposal for your association here.

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

A: Once a year as part of the Reserve Study update (with figures projected as-of the first day of the Fiscal Year, as part of the budget planning process for the upcoming year).

Q: How do you calculate Percent Funded for a future year?

A: First calculate the Fully Funded Balance for that future year, which for each component is the fraction of life used up in that future year times the projected current cost in that future year (an inflated number). Sum those to get the total FFB for that future year, and compare that to the projected Reserve Fund Balance in that year to compute that year's Percent Funded.

Q: Is it possible for an experienced association manager to prepare the Reserve Study?

A: It is possible. It is not advisable, because preparing the Reserve Study is rarely the manager's expertise, and the manager has no independence from the association being managed (creating possible conflicts of interest). Best practice is for at least the more significant With-Site-Visit Updates to be prepared by an independent, credentialed professional.

Q: What do you do when the board chooses not to have a Reserve account?

A: If you mean "don't contribute to Reserves", you'll end up with deferred maintenance, special assessments, lower property values, and board members will have a significant liability exposure for not meeting one of their responsibilities. If you mean "no Reserve account", and your Reserve Funds are co-mingled with your Operating Funds (warning… not sound financial practice!), note that a separate Reserve account is often required by the association's Governing Documents. Having a separate account makes it harder to mistakenly spend Reserve funds for Operating expenses, or vice-versa. In addition, the size of the Reserve Fund and the infrequency with which withdrawals are made allows an association to take advantage of an interest-earning savings account.

Q: Reserves are taxed. What expenses can be used to offset that tax?

A: Only interest earned on the Reserve Fund is taxed, so taxes are a relatively minor amount. Check with your accountant for particular tax-planning strategies.

Q: We have around $40,000 in Reserves and a very small common area. Is it necessary for us to have a Reserve Study?

A: If you are not sure of your situation, you need a Reserve Study. If that Reserve Study shows that your Reserve Fund and Reserve Funding needs are truly minimal, then money spent on that Reserve Study was well spent because you now conclusively know the answer to that question (you didn't just base the future of your association on a presumption). If your association has minimal Reserve needs, you may not need to update it for many years (until some future Treasurer asks that same question!).

Q: California's Davis-Stirling Act requires "Major Components" to be listed in the Reserve Study, but doesn't define what a "Major Component" is. Help!

A: This is another Component question, addressed in our Reserve Studies 101 webinar. Fortunately, California Civil Code (the Davis-Stirling Act) does not try to define a Reserve Component. The definition of a Reserve Component (Major Component) is left to National Reserve Study Standards. See article here on the topic.

Q: Is "sewer pipe" a major component that should be funded through Reserves?

A: If the expense meets the National Reserve Study Standard four-part test, it is appropriate to be funded through Reserves.

Q: Can we legitimately have a "contingency" Reserve component to pay for the significant projects that regularly hit our association (tree roots, water line breaks, sidewalk or fence repairs, etc.)?

A: According to the National Reserve Study Standard four-part test, the project needs to be predictable. If your association has a pattern of miscellaneous predictable projects ($10,000/yr, $20,000/yr, etc.) it passes the four-part test as being predictable and repeatable. Try to define it as tightly as possible, so it is not a "slush fund" and so the funds are not spent carelessly. The Operating budget often also has a Contingency (or miscellaneous) expense line item.

Q: Should we be paying for unpredictable repairs (roof leaks) from Reserves before the full asset is replaced?

A: Normal minor maintenance should be handled through the operating budget. If it is large or significant enough to change the Useful Life or Remaining Useful Life, then it is a legitimate Reserve expense.

Q: How are accurate costs established? We don't want to Reserve for components that are incorrectly estimated.

A: Reserve Study professionals typically base their replacement cost estimates on association historical experience, the cost experience of other similar associations, interviews with local service providers, and standard reconstruction cost guides.

Q: If our Reserve Study provider gives a low estimate for a specific repair or replacement, should the board correct it?

A: By all means communicate your knowledge of historical expenses to your Reserve Study provider. It helps sharpen their estimates of costs at your association. Note however that if there were special circumstances surrounding a particularly low (or high) expense and it is unlikely to be repeated, your Reserve Study provider may use a value they believe is more representative of a commercial price.

Q: If a component is noticed to be failing early (well in advance of its Useful Life expectancy), should we alert our Reserve Study preparer?

A: Absolutely. Most components deteriorate on a very predictable schedule. If materials, weather, installation, or other factors are not allowing it to reach its designed Useful Life, tell your Reserve Study preparer so they can make appropriate adjustments in your next update.

Q: We have just created our Reserve Fund, so it is pretty small. But we need to spend money from it for necessary projects. How do we keep it above the "10% of total budget" threshold required by the FHA?

A: The FHA is looking only for the size of your Reserve contributions (wanting them to be at least 10% of total budget). The FHA doesn't care about the size of your Reserve Fund. Read more here.

Q: Our last audit noted we were not in compliance with State Law and FASB because we didn't have an independent Reserve Study. So we got one. Do we have to review it for accuracy and do anything with it, or just give it to our auditor upon request?

A: By all means – review it and incorporate its findings! Compliance is only one reason to get a Reserve Study update. Get a Reserve Study, review it, get it adjusted if needed, communicate its findings to your homeowners, and apply it to guide your association towards a fair assessment structure and maximized property values, minimizing your chances of deferred maintenance and special assessments.

Q: At our relatively new association, we commissioned an independent, professional Reserve Study. Not surprisingly, it recommended significantly higher Reserve contributions than the Developer put into our budget. It was prepared without board/staff input, so it is very conservative (Useful Life estimates short, replacement cost estimates high). Now I have two problems: the Board feels the Reserve Study needs adjustment, and any prospective buyer looking at it would be afraid and lower their offering price.

A: I'm sorry to hear of your predicament. As a Board member, get in touch with the Reserve Study provider and suggest changes. If too much time has lapsed and a revision is not possible, likely that means it is time to commission an update. Get involved in that process, and get a Reserve Study reflective of the component reality at your association. Then implement the Reserve contributions necessary to deal with the financial reality of keeping your association a great place to live. A truth-based, sustainable budget will point your association in the right direction, spreading contributions fairly over the current homeowners and giving prospective buyers appropriate expectations about what it will cost to live there.

Q: What is wrong with being consistently in the 40% Funded range? Why would that be inadvisable?

A: History shows that associations at 40% Funded have special assessments slightly above 10% of the time. As a board member, your job is to care for the assets of the association on behalf of the owners. Trying to get through 30 years with a 1 in 10 risk of special assessment in every one of those years is asking for about three special assessments, no matter how good your intentions.

Q: How do you, or how does an association, evaluate its own Special Assessment risk due to uncertain events? Would a Monte Carlo risk assessment work?

A: Great question! A Monte Carlo risk assessment allows the user to find the range of different outcomes when the underlying (uncertain) data is changed within a controlled range of possibilities. It is certainly possible to run such an assessment on an association's own Reserve Study data, but the Special Assessment risk chart shown in the webinar is based on tens of thousands of data points. This means the chart is based on an incredibly wide variety of circumstances and possibilities experienced by the associations in the data pool, providing the user a high confidence in its results and lowering the need for further evaluation of outcome sensitivities for an individual association.

Q: Our homeowner assessments are different for different units (larger units are charged more). In addition, some of the same size units have balconies and some don't. So even within the same category of homeowner (2-bdrm owners), Reserve components are not distributed evenly. Do we attempt to charge Reserve contributions differently depending on what a unit has to enjoy?

A: In general, common areas are common areas. Owners on the first floor may not use elevators, while arguably only owners on the top floor use the roof. The common areas are usually not all enjoyed equally (some people swim or use the gym, some don't). Still, they are common areas. Reserve contributions are designed to sustain the common areas, regardless of how much they are used or by whom. Each owner is obligated to pay their share of Reserve contributions as dictated by the governing documents. If in a 50-unit association each owner pays 1/50th, then that's how the Reserve contributions are collected from each owner (just like the regular assessments), regardless of which common areas they're attached to or use. If different size units pay different fractions of the total based on their size, that's how the Reserve contributions are to be collected from each owner (just like the regular assessments), regardless of which common areas they're attached to or use.

Q: Have you ever seen a situation where a special assessment was based on owner years of ownership (to catch up on Reserves)?

A: No. Assessments and special assessment responsibilities of individual owners are defined in the Governing Documents. I've never seen one that had adjustments for owner tenure.

Q: Are your Reserve Studies adjusted differently when the association has a low shoulder occupancy season?

A: Our Reserve Studies are customized for each association. When occupancy is only seasonal, that affects the component list because some components may last longer due to limited wear and tear. In addition, that may dictate when projects are best accomplished (during periods of low occupancy).

Q: When buying and selling, what influence does a poorly (or properly) funded Reserve have?

A: Curb appeal is real. When the funds exist to perform projects on time, the association thrives. We've found a strong Reserve Fund rewards condo owners with over a 10% price boost over condo owners in similar associations with a weak Reserve fund. See full article here.

Q: Do you use standardized pricing for component replacements, or do you take accessibility and other local factors into account?

A: Our Reserve Studies are customized. We think like the vendor thinks – if the roof is hard to access it is more expensive, if the building is built into a steep tree-lined hill it will be more expensive to repaint, etc.

Q: You mentioned 15-40% of total assessment income is typical for Reserve contributions. Is there a "typical" for how much to have in Reserves?

A: No. Reserve balance varies with the condition of the assets… higher when a big project is about to occur, lower after a big project (or two) is accomplished. So it varies from year to year.

Q: Is it necessary to disclose to membership that the Reserve Study has been updated?

A: I've never seen a requirement to disclose that to members, or a timeline within which such needs to be disclosed, but it is always a good idea. To build confidence in association leadership, and to run an open and honest association, the owners should be informed. I can't think of a situation where hiding information is a good idea. It is not "protected" information such as litigation status or delinquency issues that should be discussed privately in executive session.