Building a Better Tomorrow Using Reserves

By Sean Erik Andersen

Reserve Study, Defined

Reserve planning isn't about predicting the future; it's about preparing for the inevitable. The responsibility of reserve analysts, community managers, and board members is to manage the present while building a better future for their communities. A reserve study is the foundational tool that helps homeowners associations maintain their assets, equitably distribute the cost of deterioration among owners, promote quality of life, and preserve property values.

The reserve study serves as a budget planning tool that evaluates the status of an association's reserve fund (represented by the "percent funded") and outlines a stable, equitable funding plan for anticipated common area expenses. To accomplish this, there are three essential steps.

Step 1: Create the Component List

The component list is a detailed inventory of an association's major common area assets. HOAs should rely on reserve study standards to guide them in creating the inventory. If a component is the association's obligation, if it can be reasonably anticipated, and if it represents a significant cost to the association, it should be included on the component list. Each component, once it passes this three-point test, should be assigned a Useful Life, a Remaining Useful Life, and a Current Cost.

Not all components are created equal. Some are far more influential than others. In creating the list, the HOA should consider not just the total cost of a component but also its cost per year. These components with recurring costs are what we call "dominant components." They have a larger impact on funding than others, even if they are not the most expensive. For example, a $100,000 roof with a 20-year life span requires $5,000 per year in contributions. In contrast, a $50,000 painting project that needs to be redone every five years requires $10,000 per year – twice as much!

HOA boards must focus on recurring costs, preventive maintenance, and long-life items. Components are not optional – they define the cost of ownership. Mother Nature and Father Time determine the cost; the board's job is to manage the cost.

Step 2: Calculate Reserve Needs

The next step is to calculate future reserve needs. This involves determining the rate of deterioration, calculating the fully funded balance, and comparing it to the projected reserve balance. This comparison yields the "percent funded," a key indicator of the reserve fund's strength.

The percent funded answers the question: Do we have enough?

- Above 70% Funded (Strong): Low risk of deferred maintenance or special assessments
- 30–70% Funded (Fair): Medium risk
- Below 30% Funded (Weak): High risk

Step 3: Design a Funding Plan

Once the percent funded has been determined, a funding plan should be created to ensure that sufficient funds will be available when needed. This is essential for avoiding costly special assessments and deferred maintenance.

Deterioration is one of the most critical factors in a reserve study. It is ongoing, inevitable, and part of the cost of ownership. It never takes a day off. A reserve study acknowledges this reality and provides a road map for proactive asset maintenance. Reserves are not for the distant future; they address the deterioration happening right now. Therefore, the reserve contribution needs to, at the very least, offset that rate of deterioration. If HOAs are underfunded, they need to make sure they are making reserve contributions that are higher than the rate of deterioration; this will lead to increased strength in the reserve fund and lessen the risk of a special assessment.

Key Consideration: Inflation

Inflation is an especially important factor today. It increases the future cost of projects. Each additional percentage point of inflation can raise the required reserve funding by more than 22%. While interest earned on reserves provides some offset, it is limited, since interest applies only to cash on hand and inflation affects the total project cost.

This is why relying on loans or reacting to emergencies is a poor strategy. Deferred maintenance nearly always results in higher costs and dissatisfied owners.

A Mindset, Not Just a Spreadsheet

Good reserve planning is more than a spreadsheet; it is a mindset. The assets are owned by the associations and their members. All assets deteriorate, and associations need to be committed to maintaining them. Month by month, year after year, the "deterioration bill" must be paid – not as punishment, but as protection for the community.

Aging successfully as an association means regularly updating the reserve study, funding reserves as recommended, and spending wisely based on trusted data. A strong reserve fund is not a luxury; it is a necessity. Surprises should never be part of the HOA board's financial planning.

Sean Erik Andersen, PRA, RS, is a graduate of California State University, Northridge, and has earned Community Association Institute's Reserve Specialist designation. He began working at Association Reserves in 1999, opened their Orange County regional office in 2003, and is now president of the Orange County/Inland Empire/Coachella Valley region. Sean has completed over 2,000 reserve studies for properties ranging from small community associations to large master planned communities.