

Reserve Study Basics Seminar

(Slide 2) Having a Reserve Study, as a framework for making decisions, is important because Reserve deterioration, and the expenses that come from that deterioration, are inevitable! The only question is how prepared will your association be? A Reserve Study helps you avoid being surprised by an expense that was gradually approaching over the last 10 or 20 years.

(Slide 3) *What is a Reserve Study?* RS is a planning document & budget model. Purpose is to prepare for significant expenses over time, while minimizing or eliminating “surprises” and special assessments.

(Slide 4) Other reasons for encouraging regular, credible Reserve planning are:

1. Governing Documents: typically empower and require the Board to collect funds for major common area repairs and replacements.
2. State Laws: In serving our clients across the country, we’ve found that ~30 states now have laws requiring some level or frequency of Reserve Studies.
 - a. Does Arizona have a law requiring Reserves Studies? **NO, not yet. Does that mean you are not required to have one?**
3. Generally Accepted Accounting Principles (often referred to as GAAP): These are standard accounting practices across all 50 states. They call for associations to annually balance the physical deterioration of the common areas with a sufficient amount of cash to ensure the association is on-track to repair or replace their assets.
4. Then, there is the fundamental, practical need for information. Boards and Management need a periodic status update on the association’s upcoming repair and replacement expenses.

(Slide 5) While a Reserve Study may sometimes appear daunting – they can be anywhere from 10 to over 100 pages if you have looked at one – it really boils down to just 3 key results:
– a list of what you are Reserving for - **“Component List”**. This is the foundation of your study.
– a measurement of the adequacy of your current Reserve Funds - **“Percent Funded”**
– a plan to prepare for the expenses on the component list - **“Funding Plan”**

The first two results establish **“where you are”**, and the third is a recommendation of **“where to go from here”**.

When reviewing your Reserve Study, make sure you can locate those 3 key results!

(Slide 6) Let’s focus on those 3 key results of a Reserve Study by finding out how the Component List is assembled. The Reserve Component List forms the foundation of the Reserve Study. The other results are all based on the Component List, so it is important that it be current and credible.

(Slide 7) National Reserve Study Standards outlines a **4-part test** to help determine if an asset is appropriate for Reserve Funding.

1. The asset needs to be a common area maintenance responsibility,
2. with a limited life,
3. and a predictable remaining life,
4. Cost of the asset needs to be above a minimum threshold cost. That means the cost should be too large to be easily absorbed into the maintenance budget. The threshold cost is custom for each community and will be impacted by factors such as community size and budget flexibility. It is typically chosen by management and board members. Many associations have a threshold cost in the range of \$1,000 to \$3,000.

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(Slide 8) Let's now move on to an explanation of how Percent Funded is calculated.

(Slide 9) Fortunately, this is a pretty simple concept. I'll illustrate with an example of a \$10,000 expense that occurs every 10 years. I've eliminated the effects of inflation to keep the illustration simple. The question remains, "How much should the association have in the bank to prepare for this recurring expense?" Well, the answer is "it depends".

(Slide 10) It depends on which year you are in. In the years approaching the expense, the Reserve Fund should be growing closer to the estimated cost. After the project is accomplished, you start the cycle all over again. It is simply a matter of having the amount of funds on hand equivalent to the component's deterioration. If the component is $\frac{1}{2}$ used up, you should have $\frac{1}{2}$ of the replacement cost on hand.

(Slide 11) This concept is called the Fully Funded Balance. The Fully Funded Balance is defined as the fractional age of the component multiplied by the current replacement cost. This same calculation is done for all components to get a Fully Funded Balance total for the association. This is typically calculated as-of the first day of the fiscal year.

(Slide 12) Here you can see the Fully Funded Balance calculation for this set of Reserve components. Remember, this represents the deterioration, or accumulating Reserve needs of the association at a point in time. It does not reflect the total replacement value of your Reserve Components.

(Slide 13) Like the Fully Funded Balance calculation, the Percent Funded calculation is very simple. It is just the ratio of actual Reserve cash to Fully Funded Balance.

(Slide 14) Percent Funded measures how well Reserve funds match the association's needs.

(Slide 15) We have divided Percent Funded as a measure of Reserve Fund Strength into three ranges: 0-30% Funded is the weak range, 70-130% Funded is the strong range, and the middle 30-70% Funded is the Fair range.

**A low Percent Funded like 23% means the same thing to a large association with 200 units as it does to a small association with 10 units. That is how you can compare different associations. These two associations may have a big difference in the amount of actual cash in their Reserve Fund, but if their Reserve Fund Strength calculates to the same Percent Funded, their Reserves are comparable in strength.

(Slide 16) Now here is where you can see why we have these ranges, or categories, of Percent Funded. In the 0-30% weak range, special assessments are common. 37% Special Assessment Risk means that associations in the 0-30% Funded range have slightly higher than a 1 in 3 chance of needing a special assessment that year due to a lack of sufficient Reserve cash. At the other end of the spectrum, you can see that special assessments are rare among associations with Strong Reserves over 70% Funded.

(Slide 17) If you are wondering how associations compare, here is a national profile, compiled from about 25,000 reserve studies we have prepared over ~25 years. You can see that most associations are in the middle "fair" range, with plenty of others both in the red "weak" range and in the green "strong" range. It is a mistake to think that all associations are in the weak range, and that no association could ever afford to be well funded. The entire spectrum exists!

(Slide 18) Now let's spend a few minutes outlining the Funding Plan.

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(Slide 19) As previously mentioned, the first two Reserve Study results are findings, or disclosures, and this final result is a recommendation for action. The action the Board takes with respect to funding its Reserves now will affect the status of the Reserve Component List and Reserve Fund Strength in future years.

(Slide 20) In the big picture, there are 3 ways to fund Reserves:

1. Ongoing budgeted contributions
2. Special Assessments
3. Loans

(Slide 21) I am going to focus on budgeted Reserve contributions as the preferred way to fund Reserves, because it is the least expensive way to provide for the Reserve needs of the association. National Reserve Study Standards require every Reserve Funding Plan to be based on 4 principles:

1. Create a Funding Plan that provides sufficient cash to meet the association's needs
2. ...that is fair and stable through the years
3. ...that is evenly distributed across the ownership base – meaning it is fair to both current owners and future owners
4. ...that is fiscally safe and responsible

(Slide 22) Why not just deal with future expenses by getting a loan or passing a special assessment? Unfortunately, there are some real problems with that kind of thinking.

(Slide 23) Consider a \$250,000 roof project that needs to be replaced every 15 years. If the association sets money aside through regular budgeted Reserve contributions, (even with today's tiny interest earnings), the association will have \$250,000 after only contributing roughly \$232,000 due to compound interest.

- If the association plans, or needs, a last-minute special assessment, they'll of course need a \$250,000 special assessment to pay a \$250,000 expense, but that unfairly penalizes the current ownership.
- But if the association takes out a loan, in addition to paying the \$250,000 principle back to the bank, they'll pay some significant interest and fees, paying out over \$320,000 for that \$250,000 roof project.

Projects can get very expensive when you don't plan ahead. Budgeted contributions are the least expensive way to fund a Reserve project.

(Slide 24) And remember, there is no guarantee that the homeowners will approve the special assessment needed.

(Slide 25) While I'm on the subject of Funding Plans, I want to take a moment to talk about Reserve funding objectives. The Funding Objective is more important than the Funding Method (like Cash Flow and Straight Line).

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(Slide 26) So let's focus on Funding Objectives.

- How strong do you want your Reserve Fund to be?
- How tolerant is your association of special assessment risk?

National Reserve Study Standards clearly defines three funding objectives: Full Funding, Threshold Funding, and Baseline Funding.

(Slide 27) Full Funding means the conservative objective of having the goal to achieve 100% Funded where special assessments are rare. Baseline Funding is the other extreme, which means it has the goal to just barely keep your Reserves cash-positive through the years. Threshold Funding is a strategic choice of a particular Percent Funded target somewhere between the Baseline and Full Funding objectives.

(Slide 28) This is what a Full Funding profile looks like...starting at about the 55% Funded level, but having the goal to reach, and remain, at the 100% Funded level. Note how the association is never in the 0-30% "high risk of special assessment" weak range when following this Funding Plan.

(Slide 29) Here is the same association, but now we've slightly lowered the Reserve contribution rate, because they are pursuing a Baseline Funding objective. It still takes some pretty significant contributions to keep Reserves from going below zero. Remember that a Baseline Funding Plan is still supposed to provide enough Reserves so all the association's projects can get done on time, so don't make the mistake in thinking Reserve contributions can be significantly decreased by pursuing this objective. It is designed to never go below zero, but notice that there are 9-years where the association is in the 0-30% "weak" range. If you remember from the discussion on Percent Funded, this means that given the roughly one in three odds of having a special assessment any time you are in the weak range, there is a good chance this association will have about three special assessments scattered through those years.

(Slide 30) We have found that, on average, Reserve contributions for a Full Funding objective are only 13% more than contributions required for a Baseline Funding objective. Full funding does not require 2 or 3 times the contribution rate of a Baseline plan as many might believe.

(Slide 31) To summarize Reserve Funding, pursuing a Full Funding objective points the association towards low risk of special assessment. While associations pursuing a Baseline Funding objective enjoy a "slightly" lower Reserve contribution rate, they have a significantly higher exposure to special assessment risk.

(Slide 32) I want you to leave this session with the keys to leading your associations to the financial health and stability that you get from a Reserve Study.

- Lay a stable foundation with a credible Reserve Component list.
- Know your Percent Funded, and understand what it is telling you.
- Craft a Reserve Funding Plan that leads to a successful future.
- Finally, keep your Reserve Study credible by keeping it current. A Reserve Study for a prior fiscal year is an expired, out of date document.