AdvanceHOAManagement
Moving Communities Forward

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## IMPORTANCE OF RESERVE STUDIES

Maintaining the association's common property is among the manager and board member's highest responsibilities, and it takes a long range plan to prepare successfully for repair or replacement of the association's major common area assets. The reserve study is the plan by which the association expects to offset ongoing deterioration and prepare for inevitable future expenses. Reserve projects are typically the largest expenses that an association faces, and proper financial preparation takes many years.

A reserve study is a budget planning tool that considers the current status of the replacement fund and determines a stable and equitable funding plan to offset the anticipated future major common area expenditures. The reserve study can also be very useful for developing a fund budget.

Consequences of not having a reserve study:

- Under funding: special assessments, bank loans, deferred maintenance, or a combination of these.
- Over funding: paying too much for the benefit of future owners
- Board member liability: Exposure to claims of fiscal irresponsibility and loss of D&O insurance coverage.

Reserve study benefits are as follows:

- Fulfilling fiduciary responsibility
- Meet individual state requirements (if regulated states)
- Compliance with American Institute of Certified Public Accountants audit guide
- Reduce personal liability from claims of financial mismanagement
- Save valuable time with prioritized business plan for capital repairs and replacements
- Effective communication tool to keep owners informed
- Reserve study can turn up items that haven't been budgeted in ongoing operations.

It's important to understand the various types of reserve fund methods. A summary is as follows:
<u>Fully Funded Balance:</u> The amount of money you should have saved based on how much an item will cost you in the future divided by the amount of time you've had to save.

<u>Cash Flow Method:</u> The amount of money you need to offset the variable annual Reserve component expenditures.

<u>Baseline Funding Method</u>: The amount of money you need to keep your Reserve Fund cash balance above zero dollars.

Threshold Funding Method. The amount of money you need to save to keep a desired Reserve Fund balance – typically between 30-70%.

**Most communities use the Threshold Funding Method to guide the funding requirements**. 30% and below is considered Weak, 70% - 80% is considered Fair, over 80% is considered strong. Below is a chart that depicts the Percent funded and its relationship to the likelihood of needing Special funding.

| Percent Funded | Special Funding |
|---|---|
| 71%+ | 1% |
| 41% - 70% | 7% |
| 21% - 40% | 22% |
| 0% - 20% | 45% |

Whenever possible, use an experienced, qualified person to prepare a reserve study because of the technical detail involved. State laws do not specify the type of professional who may prepare a reserve study. If an association cannot afford to use a specialist, some reserve companies offer a do-it-yourself kit. This kit provides the software programs and worksheets needed to complete a reserve study. However, the board will still be liable for the effect of incorrect data.

The value of having the reserve study conducted by Reserve Specialist is as follows:

- Reduced liability exposure: association managers and board members can limit liability by relying on expert advice.
- Independence: No potential conflict of interest
- Focus: Allows managers and board members to concentrate on running the association.
- Credibility: If the person or committee preparing the reserve study isn't credible enough to effect a change in the association's budget, it is a waste of time from the start.
- Accuracy: The Reserve Specialist does this year-round, and is well-versed in the implications of all the decision points.

Obtain bids from more than one specialist and ask fellow-managers about their experiences with a particular specialist. Some questions for the specialist may include, additional cost for on-site analysis, turn- around time, and expected rates for updates.

The manager and the board should review the reserve study annually; particularly the funding plan because the association's physical assets may deteriorate at different rates, interest and inflation rates change, and the association may change its reserve strategy from conservative to aggressive. Each replacement fund budget line item should be updated each year using current cost, estimated remaining life, and current funds on hand.

*Source: Community Association Institute*