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Developing the Funding Plan

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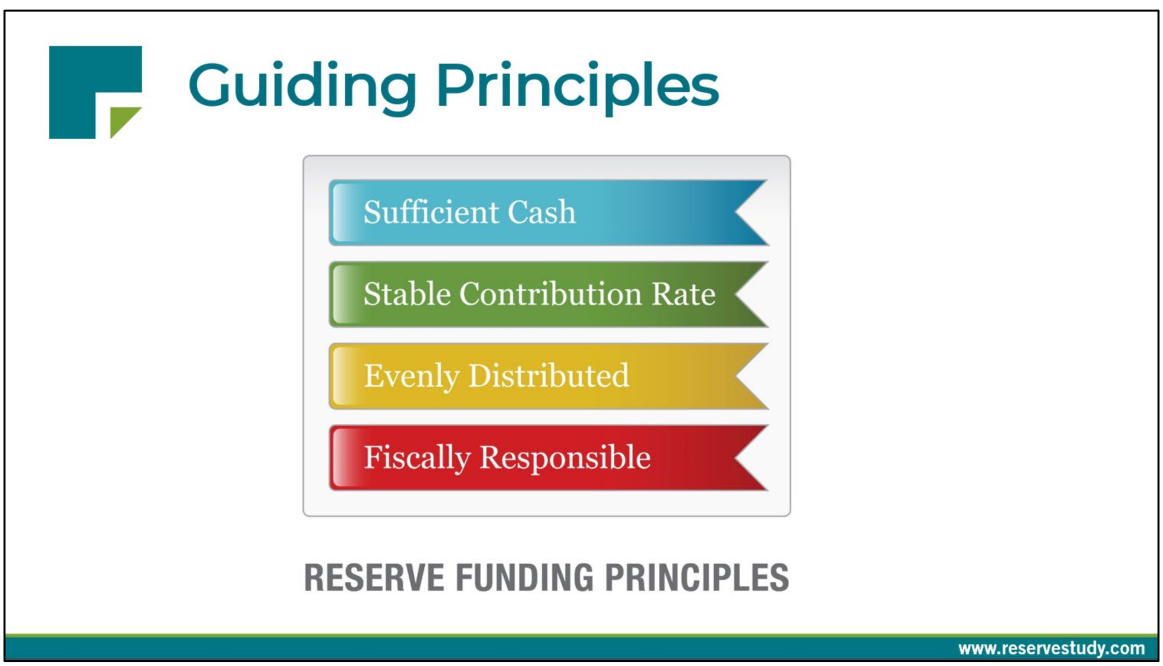
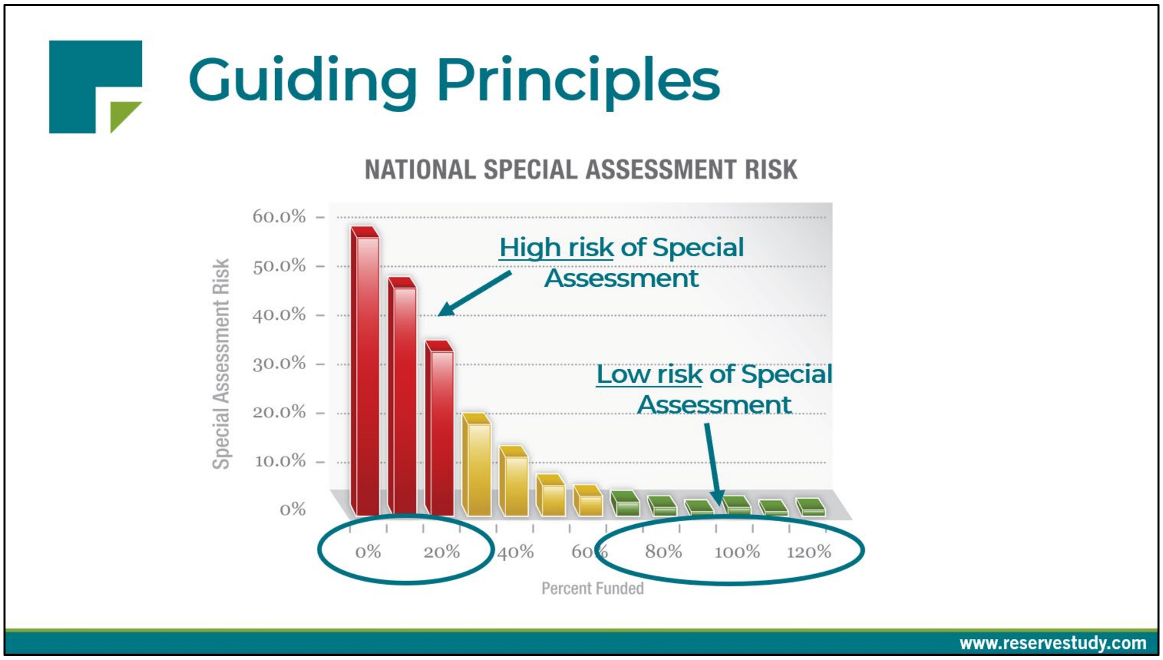
Miss the webinar? Watch the full (32:41) webinar here.

What's the first thing most of our customers do when they receive their reserve study? They flip to the Reserve Funding recommendation to see how much the monthly contributions need to be. Not surprisingly, that single number gets a great deal of attention. But how do you know that number is right for your association? This webinar begins with the principles and thought processes that when applied result in a great Reserve Funding Plan for your association, moves to a demonstration of "funding theory" put into practice, then ends with some recommendations to help our clients apply Reserve Study results. The budget challenges you face are real. But this webinar is one of many tools at your disposal to help you apply the Reserve Study and set a Reserve budget that provides the money your association needs to thrive.

First: Funding Principles, the four principles to balance when establishing a multi-yr Funding Plan.

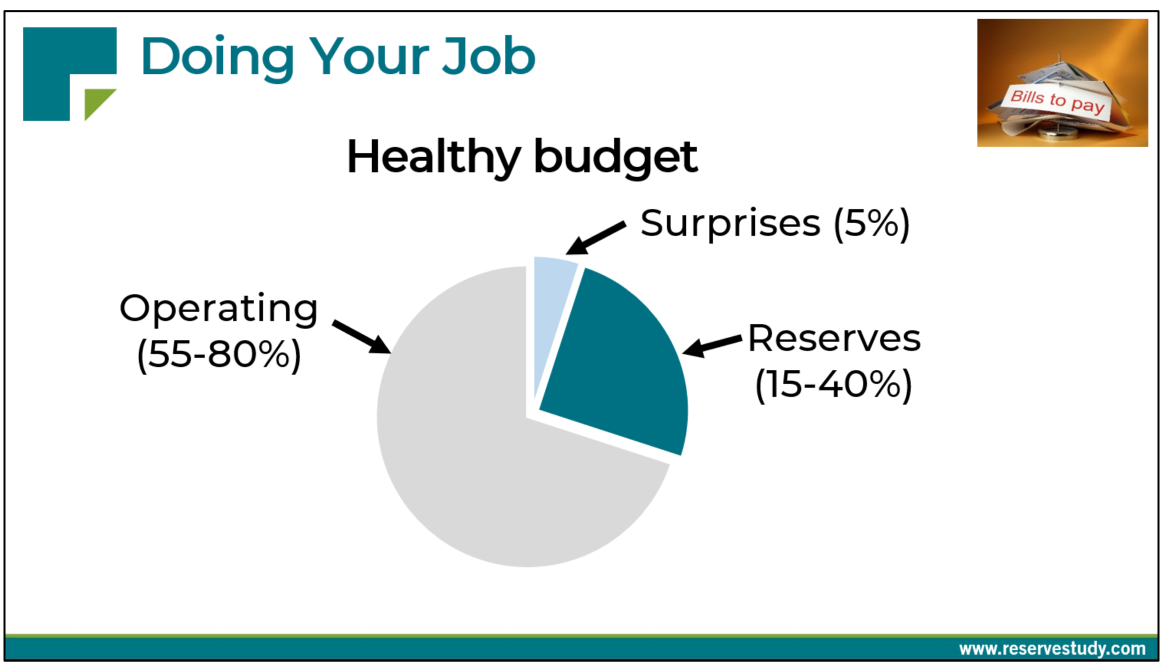


Next, understanding the goal (objective). It's most effectively measured by Percent Funded, the ratio of actual Reserves to the Reserve needs of the association.

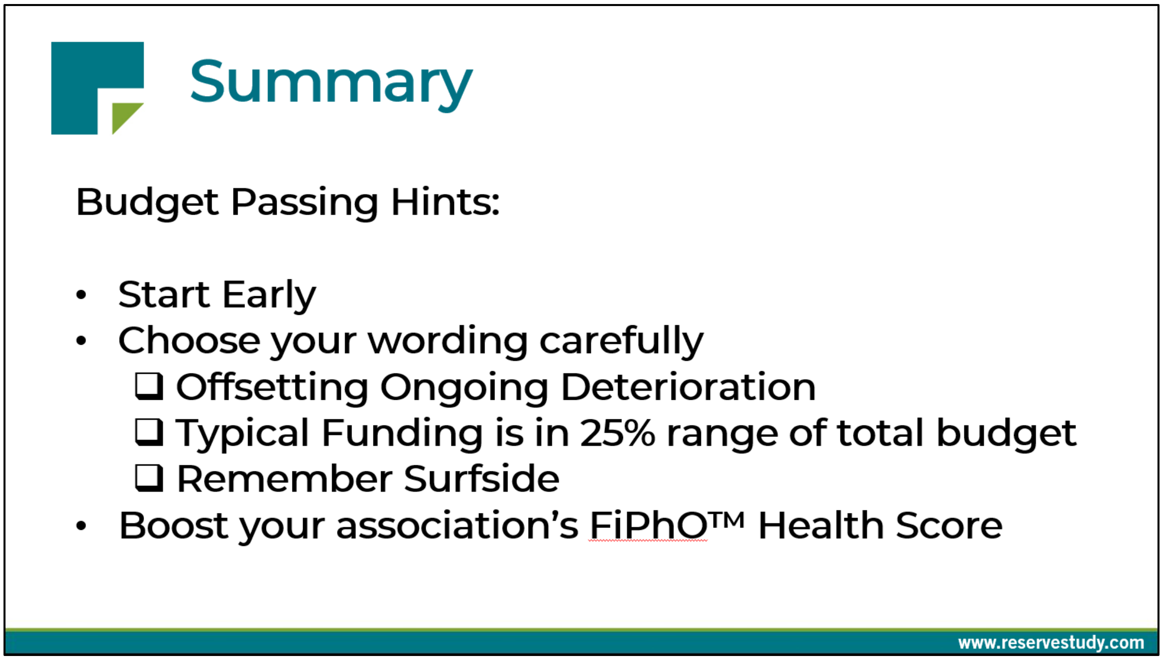


After the demonstration, during your time of Reserve Study application, we remind you that your choice is only between <u>how</u> Reserves are funded (on an ongoing basis, or in last minute & unfair special assessments), not <u>if</u> the expenses need to be faced.

A healthy budget looks generally like this profile, so aim at this target:



Finally, for associations where owners have approval or veto power over all or portions of the budget, you may need some help with budget passing hints:



Key Links:

The CAI Research Foundation's "Aging Infrastructure" report, documenting how an association can age successfully, can be found here.

More information about uPlanIt, the online Reserve calculator tool we used in the analysis, can be found here.

More information about an association's FiPhO™ (Financial, Physical, and Operational) "health" score can be found here (a brief 3:44 introductory video) and here.

Enjoy our book "Understanding Reserves" and have ready access to key Reserve Study and Reserve funding questions. Get the book online or download Chapter 1 for free here.

Looking for more related resources? See additional recorded webinars on our "webinars" page here.

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Webinar Questions Asked by Attendees

Q: What is the FiPhO health score that you mentioned as a "motivation" near the end of the webinar?

A: The FiPhO™ health score is a combined evaluation of an association's financial, physical, and operational status. It gives a board key insights into how the association is doing, so they know where the association stands (on an overall scale, and compared to other associations). Like a person's FICO score, this new score gives the board and owners an objective, virtuous goal to pursue instead of the all-too-common destructive goal of "low monthly assessments". See more here and here.

Q: Please define a "fully funded Capital Reserve". What does that mean?

A: "Full Funding" is a Funding Goal defined in National Reserve Study Standards as "Setting a reserve funding goal to attain and maintain reserves at or near 100 percent funded. "Fully Funded" is where your association is within a few points of the 100% level.

Q: Can you discuss how upgrades/renovations/modernizations are added to the reserve study or should they be added?

A: Upgrades/modernizations are accomplished when the project is accomplished. There is no need or requirement to replace "like for like". Continual upgrades & modernizations are encouraged.

Q: Based on your experience, what percent of communities you deal with are in the strong range (Percent Funded equal to or greater than 70% Funded)?

A: Approximately 27.8%. Our encouragement is for those associations with a lower Percent Funded to join them.

Q: In uPlanIt, why is Special Assessment blanked out (not usable for the first five years)?

A: On the Funding Plan Override tab, the special assessment fields are indeed "grayed out" and are unusable. That is because special assessments for the first five years are driven by entries on the Recommendations tab. We didn't want controls for the same thing on two different tabs.

Q: For timeshares, does your reserve study include appliances and furnishings as well as a physical property?

A: Yes. Villa interior assets dominate the Reserve needs of our timeshare clients.

Q: **What do you do when the scope of a particular component changes over the years - or requires two different scopes? Do you make two separate components?**

A: In some cases, yes. A classic example is a minor renovation of a clubhouse at the 10 yr point (carpet and paint), with a major renovation when it hits 20 yrs (carpet, paint, kitchen remodel, new furniture, etc.). One way is to model it with two overlapping 20-yr cycle projects. When new, it would be modeled as a minor renovation at 20 yrs UL, 9 yrs RUL, and a major renovation at 20 yrs UL, 19 yrs RUL. This yields a 20 yr cycle of different sized projects every 10th year.

Q: **Why not use different inflation rates for near term (next couple of years?) and then general inflation rate for balance of the 30 year report? For example - a 9% inflation assumption for the first 3 years and 3% assumption for the next 27 years?**

A: Frankly speaking, we didn't build that option into our software development (and I don't know a firm with that software capability). Development of that feature is not a trivial endeavor. So, our effective application is to boost prices in the first few years, keep long-term inflation assumptions stable, and expect to update the Reserve Study regularly.

Q: **Why doesn't uPlanIt allow for different rates of inflation like it allows for different rates of increase?**

A: We had to draw the line somewhere. It was a level of complexity we did not feel would serve the best interests of the majority of users.

Q: **Is it reasonable to use a 25 year average of inflation as the guide?**

A: Something like that. We would recommend a multi-decade average inflation value, as a Reserve Study is a multi-decade projection looking forward.

Q: **How do you indicate that an item has been completed or if the lifespan has been extended?**

A: Indicate it on the Component List. If it is due to fail at any time, keep the RUL at zero. If you expect it will last two more years, change the RUL to two. If the project has been completed, reset the RUL to the appropriate length of time.

Q: **What happens to reserve expenses that occur beyond the 30-year study period?**

A: The software calculates the growing "Fully Funded" obligation (the value of deterioration) of that expense. So, at any time, we are aware of the deteriorated state of the assets at the association. If it is a 50 yr seawall, 35 yrs into the future, in the 29th year our software will suggest the association have 29/50ths of the then-current replacement cost on hand in the Reserve Fund.

Q: **Suppose a component life has 50 years. Should I put it on the reserve when there is 30 years of life left?**

A: No. If that distant expense passes the National Reserve Study Standards four-part test, it is a component now whether it has a Useful Life of 5 yrs or 50 years. There is nothing magic about the 30-yr threshold.

Q: **Assume an asset with a current average cost of $1 million, a UL of 30 years and a RUL of 15. The plan shows the entire $1 million cost occurring in the 15th year. How best to adjust the plan to spread that cost over a term of years (maybe from year 12-18, or 14-20, etc.)?**

A: Your Reserve Study professional will likely create multiple line items. Perhaps 25% of the expense in yr 13, 50% of the expense in yr 15, and another 25% of the expense in yr 17, breaking it down and spreading it around as much as they feel is appropriate. Note that having it simply modeled as all occurring in the 15th year effectively gets the association "ready" for some $ needed early, some $ on time, and some $ left over to use later.

Q: **Do you recommend setting your annual dues in 2 funding lines - Operating Funds and Reserve Funds, so that when you need to increase reserves, you increase only the reserve contribution, and only if your operating expenses (utilities, etc.) increase, then you can increase the operating contribution?**

A: Most associations have two budget categories, Operating and Reserves. For instance, if your assessments total $400/mo, your Operational subtotal may be $300, and your Reserve funding would be $100. They are different budgets for different purposes. Set them appropriately.

Q: **How should reserve components be tracked for the purpose of calculating total deterioration value when the item is not replaced on schedule? Should the deterioration value continue to increase past the point of 100% (for example, an item with a 5 year UL, what is the correct rate of deterioration value on YR 6) or reset back to a YR1 rate?**

A: The software handles all this. When something is scheduled to be replaced, 10 yrs UL and 0 yrs RUL, the software calculates the Fully Funded Balance as the current replacement cost. If you don't do the project that year, the RUL is likely still zero next year, so the funds are still "needed". In other words, the Fully Funded Balance is still the (then, future) current replacement cost.

Q: **How do mixed-use condo associations budget for Reserves? All together in one long list of components, or separated into commercial and residential Reserve Studies?**

A: When different owner categories are paying different assessments to offset the use & enjoyment of different assets, hopefully the governing documents are structured so there are two separate Reserve funds. In that case, we craft two separate Reserve Studies for the two different accounting entities of the association.

Q: Assume an asset with a current average cost of $100,000, a UL of 1 years and a RUL of 0. What about if you convert to a UL of 5 with a RUL of 4, with a $500,000 cost? Will that improve the % funded?

A: What you're describing is a classic example of modeling painting in five equal phases (one phase per year) compared to painting the entire facility in the fifth year. The two methods influence Percent Funded differently. But your primary objective remains to be caring properly for the facility, not gaming your project timing to maximize Percent Funded.

Q: Does uPlanIt have the capability to use a matrix of assessments reflecting differential rates by unit type - for example, waterfront vs. interior units? We have five levels of assessments within our 400 unit cooperative based on a table of rate percentages in our governing documents.

A: Yes. If you have proportional ownership interests, there are tables within uPlanIt that display the association's total Reserve funding ($10,000/mo for instance) broken down to the level of each individual owner's interest ($119.25/mo for one person, $204.33/mo for another owner, etc.).

Q: We're currently a bit over 50% Funded. Our current plan is to get to 70% within 5 years. What would you say to a board member that believes we need to get to 80%+ within the next 2-3 years?

A: Check with your Reserve Study professional. It depends on the multi-yr expense scenario.

Q: How do you deal with a large reserve funding shortfall and a Board that does not have the ability to pass a large special assessment because the ownership has to vote to pass a special assessment? What if the vote fails? Does the Board have to revert to passing emergency special assessments for every major component that needs to be replaced?

A: One of the skills of a boardmember is being a salesman and politician. Lobby the ownership for their support. We had one client that piled the debris from a failed balcony by the front gate, so every day every owner had to confront what could happen soon to their own balcony. Check with your association's legal counsel to learn what emergency powers the board has in your state.

Q: **The attitude of my community is I don't use the amenities why should I pay to fix them? I would think the Board could be liable for ignoring aging infrastructure. Thoughts?**

A: I'm not an attorney, but I've regularly heard that your job as a boardmember is to sustain the assets of the association. Ignoring that responsibility tends to increase your liability exposure and drops property values. Check with your association's legal counsel in this matter.

Q: **How often should a reserve study be refreshed?**

A: Every year the Reserve balance changes, the costs change, and the economic environment changes, so we say our Reserve Studies are valid for one year. Regular updating, as you suggest, is critical. CAI recently stated that Reserve Studies should be updated at least every third year that included a diligent visual site inspection. We agree with that assessment, suggesting annual and inexpensive "No-Site-Visit" updates in the in-between years.

Q: **How do we get the program Bryan used?**

A: Access to uPlanIt is free for the remainder of the association's budget season to every Association Reserves Full, Update-With-Site-Visit and Update-No-Site-Visit client. It is also available for a $149/budget season to everyone else. See more here.

Q: **Using 100% funded reserves seems like overkill, and a big waste of owners' retirement funds, since they never can get those funds back, even if they leave the Association. There is always the reasonable option of using a special assessment since that allows the owners to invest their own money at a much higher rate than the reserve account will ever attain. Thoughts?**

A: The job of the board is to provide for the needs of the association. They do that by collecting funds on a smooth basis, spreading out the obligation over owners who enjoyed the use of those assets during their tenure as owners. Special assessments are always unfair and always uncertain. Special assessments are not a reliable way to provide funding for the needs of the association in a timely manner. In actual practice the difference between potential higher interest earned, on a per-unit-owner basis, compared to what the association (of which they are a part-owner) obtains, is trivial. Let it go. Sell your home for a higher value because it is well maintained and has a strong Reserve Fund. That's how you recoup your ongoing Reserve funding.

Q: **How can we convince owners that special assessments (they seem to prefer them to higher monthly dues) are not good, especially since we still have strong sales despite special assessments?**

A: In most cases, the board doesn't need to "convince" the owners unless the owners have veto power over the budget. The board just passes the budget that is necessary to provide for the needs of the association. That is the board's fundamental job. If your owners have veto power over Reserve funding or the budget, start early and explain that roof deterioration is as real as the water bill. It is irresponsible to push that cost on to the shoulders of future owners. Your Reserve Study professional is going to recommend stable Reserve funding, it is their job. And it is the board's job to fund for the stability of the association (not relying on last-minute "emergency" special assessments to pay for something that deteriorated in plain sight, over many years, right on schedule. That kind of behavior can actually raise the board's liability exposure.

Q: How do I obtain access to uPlanIt? Should our management company engage you? I am a volunteer board member.

A: If your manager would have hired us to perform the Reserve Study, then your manager should be the primary point of contact for a uPlanIt subscription.

Q: Who is the controlling or sponsoring company for uPlanIt?

A: Association Reserves. uPlanIt is the client version of the Reserve analysis software used by our staff.

Q: What takes precedence: something written into a reserve study or what it says in the governing documents?

A: Usually the Governing Documents take priority. But when they are written in an unworkable manner, a "well established association precedent" (which the Reserve Study follows) can be the "law of the land" for the association. Check with your attorney on this matter.

Q: Our reserve balance is extremely deficient with only 4 years to go before roofs need replacement. If the owners agree to increase monthly contribution to avoid special assessments there would be overfunding in the years after the roof project. Can uPlanIt handle multiple adjustments to the level of funding during a 30 year plan?

A: Yes. Higher funding in the first few years, then lower funding in later years. No problem. That's what the "Funding Plan Override" tab is for.

Q: From our starting point, we expect to reach 70% Funded in about 13 years. What happens if you force it to 9 years?

A: Check with your Reserve Study professional. There are no "gold stars" awarded for getting to a strong level of funding "early". Two of our Funding Principles are budget stability and equitable distribution. It's not worth rushing if it is unsettling to the budget, and if there is no tangible benefit.

Q: Our Reserves are woefully underfunded. You suggested the "$10 rule". How does that affect the year you reach 70%?

A: When you increase homeowner Reserve funding ($10/mo more per homeowner), that strengthens the Reserve Fund. Boosting Reserve funding $10/mo per homeowner for a few consecutive years commonly gets an association into the range where they are adequately (responsibly!) funding their Reserves.

Q: Is there an additional value to the Reserve Study? Would it be fair to say that by including items that do not need funding helps schedule maintenance for those items such as your example of the city-maintained (ha!) trash dumpster?

A: It is best practice to keep Reserve funds for Reserve projects. It is also best practice to have a maintenance schedule for the association (guiding the ongoing projects around the association during the year).

Q: When are reserves adjusted? Annually? Only during budgeting? Or upon completion of a project and a new amount selected going forward? For example, if a project is completed mid-year, are the reserves adjusted for the rest of the year?

A: Annually, as part of the budget process.

Q: Is the monthly amount set aside for reserve decreased since the project is now at zero?

A: No. In the interest of smoothness, any "minor excess" accumulated towards an asset that is in "wait-mode" is redirected by the software to the Reserve needs of the association's other upcoming projects.

Q: We have 25 miles of sidewalks installed over the 30 year history of our development. Actual install dates varied over the years and in greater or lesser lengths. Do we need therefore to establish 30 sidewalk components all with their own RUL. Same thing for 120 roads covering 30 miles of road. Suggestions?

A: This might be a great application of what we professionally call an "allowance" component. Rather than multiple specific breakdowns/sections of the asset, it may be prudent to simply do one line item like repairs to $1/25^{th}$ of the sidewalk, every year, so in theory, the entire sidewalk asset can be replaced (where needed) over a 25 yr time period.

Q: Please recap the 4 Funding principles.

A: Sufficient funds, budget stability, equitable distribution over the owners, and Fiscal Responsibility.

Q: Is it ever responsible to reduce HOA fees if the Association is well funded?

A: Yes. Associations are not-for-profit entities.

Q: **What is the definition of 'baseline'?**

A: Per National Reserve Study Standards, "Establishing a reserve funding goal of allowing the reserve cash balance to never be below zero during the cash flow projection."

Q: **Is it allowable to budget for 'unknown amenities'?**

A: That is not best practice. Best practice is to budget for predictable major common area repair and replacement projects. "Margin" for the unknown is typically handled on the funding side, by funding Reserves with more than the bare minimum (more than "Baseline").

Q: **Can you export the data out of uPlanIt if necessary?**

A: Yes – there is an "export to .xls format" feature.

Q: **How can you project "investment" of existing reserves into this plan?**

A: Just as the software calculates the effects of inflation on the costs, interest earnings on Reserves "on deposit" are calculated (reinvested back into the Reserve Fund).

Q: **Can the reserve study history show how our "low" reserve fund of 15.1% got this way?**

A: Reserve Studies are forward-projecting documents. You'd have to look at historical association budgets to see what went on. Typically, a low Percent Funded is due to underfunding, not over-spending.

Q: **We are an association in southern Florida and are just completing a major concrete restoration project which required us to almost completely replace every column and tie beam in the building. The assessment was about $60,000 per unit. Our previous boards had voted down all reserve contributions. Given the new legislation, what is our obligation with respect to reserve studies and timing?**

A: The new "Structural Integrity Reserve Study" was legislation that was rushed into place, so it has some kinks to be worked out. As stated presently, it needs to be performed every 10^{th} year (much like the milestone inspections). Best practice for performing a "normal" With-Site-Visit Reserve Study update is still every third year.

Q: **Do you think a developer's original "public offering statement" budget in a growing, phasing community actually dictates the needs of an HOA for the next year after being turned over to the HOA? I have noticed most of the amount budgeted in a phasing community is under-budgeted.**

A: That is an accurate observation. A developer's budget is designed to provide for the needs of the association and comply with state laws. They have no long-term motive, as homeowners do who care about the sustainability of their property values. That is why most boards commission an independent Reserve Study prepared by a credentialed professional in the year after transition to homeowner control.

Q: Is a new fountain a capital improvement or a Reserve project?

A: If the fountain did not previously exist, it is a capital improvement. Installation of a capital improvement is not an appropriate use of Reserve funds.

Q: Is it okay to borrow money from Reserves to be paid back over 10 years?

A: Check with your attorney, as some states limit borrowing from Reserves, and check with your Reserve Study provider to see how that affects the availability of funds for other projects.