

# RESERVE STUDY

## GUIDE FOR HOA Boards & Property Managers



RESERVE DATA ANALYST

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# Introduction

This ebook has been put out together to help bring some clarity to the Board members and Property Managers who have an interest in all things related to Reserve Studies. I have tried to touch on the topics that most often come up without getting too much into the concepts, math or gray areas which can be confusing for those that do not deal with them every day. Please feel free to download and share this ebook, use it as a reference tool or simply as a cheat sheet at the next HOA or Board meeting you have.

This book is easily navigable with the Table of Contents. You will find reserve analyst tips in this ebook as well as links to additional resources like videos, PowerPoint presentations and WA State links.

Is there anything you would like included or answered? Just let me know and I can add it to this book. This is an evolving project so please help me, help you!



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# Table of Contents

Introduction.....	2
WA State Reserve Study Laws .....	5
<b>1. How often does the WA State Law state a reserve study must be conducted?</b> .....	5
<b>2. What does "unreasonable hardship" mean?</b> .....	6
<b>3. What are the levels of reserve studies defined in the RCW's?</b> .....	6
<b>4. What contents is required to be included in a reserve study report?</b> .....	7
<b>5. What funding plans are required in a reserve study per the RCW's?</b> .....	7
<b>6. What is required to be disclosed to the community membership?</b> .....	7
WA State Disclosure Requirements.....	9
What is a Reserve Study.....	11
Why is a Reserve Study Important? .....	12
<b>Fiscal Responsibility</b> .....	12
<b>Community Appeal and Values</b> .....	12
<b>Fairness Among Community Members</b> .....	13
<b>Financing</b> .....	13
Hiring a Reserve Study Professional .....	14
<b>Step 1 – Ask your Associates/Board Members</b> .....	14
<b>Step 2 – Look for Experience</b> .....	14
<b>Step 3 - Look for a Designation</b> .....	14
<b>Step 4 – Find Local Professionals</b> .....	15
<b>Step 5 – Confirm Turn Times</b> .....	15
<b>Step 6 – Confirm the Studies Meet Statutory Requirements</b> .....	16
Document Review .....	17
<b>Governing Documents</b> .....	17
<b>Financials</b> .....	18
<b>Bids, Invoices, Work Orders</b> .....	18
The Reserve Study Process.....	19
The Component Analysis.....	20
<b>What Components to Include</b> .....	20
<b>What Common Area Components to Exclude</b> .....	21
<b>Site Inspection</b> .....	22
<b>Component Cost &amp; Useful Life</b> .....	23
<b>Where does the Cost Data and Useful Life come from?</b> .....	23
<b>How is Remaining Useful Life of Components Determined?</b> .....	24

<b>Hidden Systems / Components</b> .....	25
The Financial Analysis.....	26
<b>Goals of the Reserve Analyst</b> .....	26
<b>1. There are adequate reserves when needed</b> .....	26
<b>2. The budget should remain stable across years of changing membership and boards</b> .....	26
<b>3. The costs are fairly distributed to the membership</b> .....	27
<b>4. The financial strategy must allow the Association / board to be fiscally responsible</b> .....	27
About Percent Funded .....	28
<b>Percent Funded Ranges</b> .....	29
<b>70-100 % Funded - Good</b> .....	29
<b>30 – 70 % Funded - Fair</b> .....	29
<b>0 – 30 % Funded – Poor</b> .....	29
About The Fully Funded Balance .....	31
Timeline of Expenses.....	32
<b>Cost Efficiencies</b> .....	32
About Funding Plans .....	34
<b>Funding Strategies</b> .....	35
<b>Full Funding Strategy</b> .....	35
<b>Baseline Funding Strategy</b> .....	35
<b>Threshold Funding Strategy</b> .....	36
<b>Statutory Funding Strategy</b> .....	36
Updating the Reserve Study.....	37
Definitions.....	38
<b>Funding Goals</b> .....	38
<b>Funding Method (or Funding Plan)</b> .....	38
<b>Levels of Reserve Studies</b> .....	39
<b>Percent Funded</b> .....	40
<b>Useful Life (UL)</b> .....	40
Additional Resources.....	41

# WA State Reserve Study Laws

Numerous Washington State Laws were implemented with regards to reserve accounts and reserve studies in 2012 for common interest communities. These laws were created to protect the membership of these communities from unnecessary or unexpected special assessments from known and expected common area expenses such as roofing, asphalt, paint, window replacement etc.



## **1. How often does the WA State Law state a reserve study must be conducted?**

Per the Washington State law a reserve study must be completed annually unless doing so would result in an "unreasonable hardship" for a community. Below are additional stipulations in the law regarding reserve studies.

- The initial reserve study needs to include a site inspection and be performed by a reserve study professional.
- The reserve study needs to be updated annually.

- At least every three years the update must include a site inspection and must be performed by a reserve study professional.
- Associations must follow their governing documents if they have more strict requirements for the reserve study frequency.

## **2. What does "unreasonable hardship" mean?**

That is a great question that really has no concrete answer. We have found that most communities will benefit greatly from a reserve study and the expense of one is not so much that it would cause any significant impact on most community's budget. When communities follow a funding plan they will see significant savings by foregoing loans or implementing special assessments as well as protect property values. Ignoring costs that are on the horizon or planning to utilize loans or special assessments is a much greater expense to a community than a reserve study.

## **3. What are the levels of reserve studies defined in the RCW's?**

- Level I - Considered a full reserve study with site inspection, measurement & quantities of components and a full financial analysis with funding plans.
- Level II - An update to the Level II which includes a site inspection for condition/useful life assessments but utilizes measurements and quantities of components from a prior level one or level two study. A full financial analysis and funding plans are included in this level of study.
- Level III - This is an update with no site inspection. Measurements, condition assessments and useful life are taken from the prior Level I or Level II Study. Updates to the costs of the components, useful life and financials of the Association are completed.

#### **4. What contents is required to be included in a reserve study report?**

- A Component List - e.g. roofing, siding, windows, plumbing and any other component which costs more than 1% of the Association's annual budget.
- Component Measurements/Quantities - useful life, remaining useful life, current costs, future projected costs.
- Disclosures - reserve account balance, percent funded calculation, planned special assessments/loans, interest & inflation assumptions, current reserve account allocation rate.
- A projected reserve account balance for 30 years without reliance on unplanned special assessments.

#### **5. What funding plans are required in a reserve study per the RCW's?**

- A Funding Plan to achieve one hundred percent funded within a 30 year time-frame.
- A funding plan that has a goal of keeping the reserve account balance above \$0 for the 30 year time-frame in the reserve study (Baseline) and without reliance on special assessments.
- A contribution rate recommended by a reserve study professional.

#### **6. What is required to be disclosed to the community membership?**

Washington State law requires the Board to disclose a summary of the budget to the community membership every year. This summary is very extensive and requires knowledge of the reserve study process and concepts that few outside the reserve study industry have put in the time to learn. Below is an outline of what is required to be in this annual disclosure to the community:

- The current amount of regular assessments budgeted for contribution to the reserve account, the recommended contribution rate from the reserve study, and the funding plan upon which the recommended contribution rate is based;
- If additional regular or special assessments are scheduled to be imposed, the date the assessments are due, the amount of the assessments per each unit per month or year, and the purpose of the assessments;
- Based upon the most recent reserve study and other information, whether currently projected reserve account balances will be sufficient at the end of each year to meet the association's obligation for major maintenance, repair, or replacement of reserve components during the next thirty years;
- If reserve account balances are not projected to be sufficient, what additional assessments may be necessary to ensure that sufficient reserve account funds will be available each year during the next thirty years, the approximate dates assessments may be due, and the amount of the assessments per unit per month or year;
- The estimated amount recommended in the reserve account at the end of the current fiscal year based on the most recent reserve study, the projected reserve account cash balance at the end of the current fiscal year, and the percent funded at the date of the latest reserve study;
- The estimated amount recommended in the reserve account based upon the most recent reserve study at the end of each of the next five budget years, the projected reserve account cash balance in each of those years, and the projected percent funded for each of those years; and
- If the funding plan approved by the association is implemented, the projected reserve account cash balance in each of the next five budget years and the percent funded for each of those years.



# WA State Disclosure Requirements



Along with reserve study laws with respects to the reserve study there are also disclosure requirements for common interest communities related to the findings in the reserve study. To comply with the Washington State Assessment & Reserve Funding Disclosure Law the below information must be shared annually.

1. The current amount of regular assessments budgeted for contribution to the reserve account, the recommended contribution rate from the reserve study, and the funding plan upon which the recommended contribution rate is based.
2. If additional regular or special assessments are scheduled to be imposed, the date the assessments are due, the amount of the assessments per each unit per month or year, and the purpose of the assessments.
3. Based upon the most recent reserve study and other information, whether currently projected reserve account balances will be sufficient at the end of each year to meet the association's obligation for major maintenance, repair, or

replacement of reserve components during the next thirty years?

4. If reserve account balances are not projected to be sufficient, what additional assessments may be necessary to ensure that sufficient reserve account funds will be available each year during the next thirty years, the approximate dates assessments may be due, and the amount of the assessments per unit per month or year.
5. The estimated amount recommended in the reserve account at the end of the current fiscal year based on the most recent reserve study, the projected reserve account cash balance at the end of the current fiscal year, and the percent funded at the date of the latest reserve study:
6. The estimated amount recommended in the reserve account based upon the most recent reserve study at the end of each of the next five budget years, the projected reserve account cash balance in each of those years, and the projected percent funded for each of those years.
7. If the funding plan approved by the association is implemented, the projected reserve account cash balance in each of the next five budget years and the percent funded for each of those years.

**\*Reserve Analyst Tip**

Utilize the services of a reserve study company that provides the disclosure document with their services. This will ensure the numbers match the reserve study findings and compliance with the law is met.

# What is a Reserve Study

A reserve study is a report which outlines the common area components that are an Associations responsibility as well as the expected replacement costs associated with them over a long period of time (30 years is typical). A reserve study will provide a replacement schedule for these common area components (e.g. roofing, paint, windows) as well as indicate how much an Association will need to set aside now to have enough for these future obligations. Below is a list of what you will find in a reserve study:

- Summary of the recommendations and adequacy of the reserve account
- List of common area components (Associations Obligations)
- Current and future expected costs related to these components
- Useful life and remaining useful life of components
- A timeline of the expected repair & replacement of these components
- Numerous funding plans that meet statutory requirements, client goals and the reserve analyst recommendations

# Why is a Reserve Study Important?

A comprehensive reserve study will help guide an Association's Board in their funding and budgeting decisions related to the reserve account and how much is adequate to set aside in the reserve account to meet the long term obligations of the community. Without a report that provides a clear list of obligations, costs and a timeline of the estimated expenses a Board is left to make guesses as to how much is enough to set aside in a reserve account.

## **Fiscal Responsibility**

Boards have a legal and fiscal responsibility to the community membership in common interest communities. According to most community governing documents and legal requirements Boards must strive to maintain and adequately prepare for costs related to common area obligations. Refraining from adequately preparing for or making poor decisions which place in the Association in a poor financial position can open the door to legal liabilities, lawsuits and community membership which loses confidence in the Board. Obtaining the services of a reserve study company shows a community that the Board is serious about the matter and is a first step in following a path of fiscal responsibility.

## **Community Appeal and Values**

For the long term health of a community, the appeal of the units/homes in the community and to protect property values a long term funding plan which can be utilized over many years and by changing Boards a reserve study is extremely important. A community which relies only on guesswork is also one that will typically rely on special

assessments, loans and deferred maintenance issues - all of which negatively impact the appeal and values in a community.

### **Fairness Among Community Members**

Additionally a reserve study will provide funding scenarios which fairly distribute the costs amongst all the community members (current and future) so that current members are not underpaying or overpaying their share to the reserve account. This is an extremely important concept and has the additional benefit of reducing the likelihood for reliance on special assessments or loan. If everyone pays their fair share to the reserve account then when the cost occurs there will be a sufficient amount in the reserve account.

### **Financing**

As Lenders have become much more knowledgeable about reserve accounts and the process in which the accounts are funded they have become much stricter in their lending guidelines. Fannie Mae, Freddie Mac and FHA all have requirements with regards to how much must of the budget must be budgeted to the reserve account. They have been enforcing these guidelines and often require a copy of a reserve study by an independent professional to verify the guidelines are met. This has come up consistently over the last several year with purchase & sales in communities, refinances of units and for loans to the Association for projects in the community.

# Hiring a Reserve Study Professional

There are many reserve study companies to choose from so to narrow the list down to several that are likely to provide comprehensive bids and studies to the community we recommend following the below steps:

## **Step 1 – Ask your Associates/Board Members**

We have found that the best predictor of future performance is their past performance. A company that has provided accurate bids, shows up on time, treats all parties with professionalism and provides a top quality product is likely to do the same in the future. Other Property Managers or Board Members will be able to provide their experience with different reserve study companies and with different property types. This is a great starting point.

## **Step 2 – Look for Experience**

Companies which have reserve analysts which have years of experience will often be able to provide a more comprehensive reserve study as they will have more experience with various property types and have likely seen a community just like the one you are managing. This helps to ensure the component list is more accurate.

## **Step 3 - Look for a Designation**

There are two designations in the reserve study industry which are widely accepted as helping to elevate the industry standards and professionalism. The Community Associations Institute (CAI) has the Reserve Specialist (RS) designation and the Association of Professional Reserve Analysts (APRA) has the Professional Reserve Analysts (PRA) designation. A designation ensures the reserve analyst is following ethical

and industry specific criteria in providing comprehensive and reliable reserve studies to common interest communities. Obtaining these designations require significant amount of work related experience, references and/or ongoing educational requirements to keep up on industry trends.

Ensure that the reserve analyst actually completing the study has a designation as some companies hire inexperienced staff to complete the site inspections and write up the report and have one experienced & designated person trying to review all their work. While this business model is more profitable for the person who owns the reserve study company the final product is usually less accurate than if an experienced reserve analyst completed the work from start to finish.

#### **Step 4 – Find Local Professionals**

It has been our experience that in the past there has been many reserve study companies that appear and then disappear never to be seen again. These are usually out of state reserve study companies which are run by people getting into the field to make ends meet before going back to their usual industry. Often they are contractors, engineers, architects, builders, etc. who are not familiar with many of the concepts of the local statutory requirements or National Reserve Study Standards. We have seen many reports which do not even meet the minimum statutory requirements for reserve study contents in Washington State. Additionally when questions arise or revisions are requested many communities have a difficult time getting answers in a timely manner if at all.

#### **Step 5 – Confirm Turn Times**

Often reserve studies are ordered at the last minute and are needed by specific dates such as a Board Meeting or to comply with the end of year Disclosure requirements. Let the reserve study company know of the date the study will be needed by and confirm they will be able to meet the deadline. This ensures you have done your due diligence

which in the end makes you look better to the community which you are managing. Reserve study companies can often get backed up during the summer and fall months so make sure you let them know of the deadline you are needing the report back by. There is nothing worse than having to show up at a Board Meeting to discuss the reserve study with the Board and have nothing to review.

#### **Step 6 – Confirm the Studies Meet Statutory Requirements**

Even though laws have been passed in Washington State for reserve study contents we still regularly see reports which do not meet these minimal requirements. A reserve study which does not meet the minimal requirements is likely not going to provide the community with the necessary information to complete the annual disclosure requirements to the community membership. In the end this will be a negative reflection on you as a property manager who they have entrusted to find qualified and professional vendors.



# Document Review

The reserve analyst completing your reserve study will review the community's governing documents to interpret what is listed as an Association's obligation and review the financials with regards to the reserve account to complete a study that is most helpful for the Association.

## **Governing Documents**

These will often be listed as common areas, limited common areas, limited use areas or limited common elements. There will typically be definitions of what the different common areas are defined as and a maintenance schedule indicating who is required to pay for the maintenance and repair/replacement of them (e.g. Unit Owner or Home Owners Association).

When reviewing the governing documents of a community like the Bylaws, Declarations and CC&R's there may be common areas which are left out, not fully explained or are very vague in who's obligation it may be to repair/replace them. When we encounter this scenario we will ask the Board how the Board has historically treated the common area in question and then utilize that prior history as precedent for the reserve study. Additionally we always suggest the Board utilize the services of an attorney for clarification and interpretation of the Governing Documents in question, if a revision to the reserve study is needed we can do so or incorporate the findings into future reserve studies for the Association.

## **Financials**

The reserve analyst will also need to review financial information regarding the reserve account in order to create a catered study which is most beneficial to an Association. Typically the reserve analyst will at a minimum need to know the reserve account balance, the reserve account allocation rate, and any special assessments or loan which have already been implemented or are planned.

## **Bids, Invoices, Work Orders**

Additional documents like bids from vendors, invoices for past work performed or work orders are very helpful to the reserve analyst who can incorporate these actual costs into the reserve study. Utilizing actual cost figures will lead to a more accurate and well documented reserve study for the Board to rely on. It's important to remember that without actual costs figures the reserve analyst will be utilizing averages which can vary significantly from actual costs to the community.

# The Reserve Study Process

A Reserve Study completed by a reserve study professional will be done in numerous steps. Each of these steps is extremely important to end with a comprehensive and catered reserve study report. Over the next several pages we will dig a little deeper into each step of the study so a basic understanding of the process can be formed.



# The Component Analysis

The Component Analysis is the first step in the reserve study. This step involves determining what components to include in the study, completing a site inspection, quantifying the components, evaluating the common area components for useful life & remaining useful life and determining the current cost for the common area components.

Because the remainder of the study is based on these findings it is extremely important that the reserve analyst have an accurate list of components, accurate cost figures and accurate useful life/remaining useful life of the components. This component list should be reviewed closely by the Board to make sure it is in line with their governing documents and the historical way the components are treated (e.g. windows are covered by Unit Owners) when there are grey areas. A large error here can have a significant impact on the funding plans developed and for an Association.

## **What Components to Include**

Determining what components to include in a reserve study is the first step in the Component Analysis. Based on a review of the governing documents, interviews with Board Members, Statutory requirements and applying a four part test outlined in National Reserve Study Standards, the reserve analyst will be able to create a comprehensive reserve study list. The four part test outlines in the CAI's National Reserve Study Standards is outlined below:

- The component an obligation of the Association
- The component has a limited useful life expectancy
- The component has a reasonably defined remaining useful life

- The cost of the component is above a minimum expense threshold set by the Association

Typical common area components that will be seen in a reserve study can include:

- Roof Replacement
- Fencing Replacement
- HVAC Equipment Replacement
- Asphalt Overlay / Sealcoat
- Siding Replacement
- Paint
- Pool Re-plastering
- Lighting Replacement

The above four part test covers the vast majority of the components in a community however there are gray areas which will require some additional due diligence by the reserve analyst. Gray areas can include components which are not clearly defined or mentioned in the governing documents. In these scenarios we will typically consider how the component(s) have been historically treated by the Association, based on how they have interpreted their governing documents, and then utilized that historical precedent in the reserve study.

### **What Common Area Components to Exclude**

Some common area components may have been left out of the study or been included in the component list as an “excluded item” and not been funded for. These components will typically fall into one or more of the categories listed below.

- Below Threshold Costs - Component repair and/or replacement costs that are deemed too small to be considered capital expenses and are typically included in the operational or maintenance budget of the Association have not been funded for in this study. Minimal threshold costs are determined by the Association or by the reserve analyst based on the typical minimal threshold

costs for similar sized Associations.

- Operational Expenses - These occur at least annually and can be effectively budgeted for each year. They are characterized as being reasonably predictable both in terms of frequency and cost. Operational expenses include all minor expenses which would not otherwise adversely affect an operational budget from one year to the next.
- Very Long or Unpredictable Useful Life Expectancy - Components which, when properly maintained, have a very long useful life and which cannot be accurately predicted, have been excluded from this reserve report. These components may require maintenance and upkeep which is typically funded from the operational budget of the association.
- Unit Improvements - Improvements made to the property that fall within the Governing Documents' unit description summary (owners responsibility), are not typically considered to be community owned or the responsibility of the association.
- Other Non-Association Owned - Improvements installed on the property but which are owned by other parties such as governmental agencies, utility companies, the US Postal Service, etc., are not included in this reserve study. The replacement and maintenance of these improvements are not typically the responsibility of the Association.

### **Site Inspection**

The site inspection will take from several hours to several days depending on the size of the community and the number of common area components to evaluate and quantify. The reserve analyst will be taking lots of pictures, notes and measurements so that an accurate component list and quantities will be included in the reserve study.

The visual inspection of the components is done to quantify, determine an estimated useful life, remaining useful life and complete a basic visual condition assessment. This visual inspection is not a building inspection and there is no destructive or invasive testing conducted; issues that are not apparent from a visual inspection will not typically

be known. It is important to remember that a reserve study is for cost and budget planning and should not be substituted for an engineering report, building inspection or code compliance inspection which are all well beyond the scope of a reserve study. Anytime there are concerns with a building or grounds component we recommend a qualified professional come out and inspect the component to determine the scope of the issue and the cost to repair it; this can then be incorporated into a reserve study.

### **Component Cost & Useful Life**

The costs and useful life data of components is the foundation on which the remainder of the reserve study is based as all recommended financial strategies are directly impacted by the estimated current and future costs for repair / replacement. Inaccurate data during the component analysis portion of the reserve study will likely lead to inaccurate projections in the future and funding plans which may not meet the goals of the community and statutory requirements.

### **Where does the Cost Data and Useful Life come from?**

Cost data and useful life both have significant impacts on the funding recommendations and long term timeline of projected expenditures in the study. Every effort is made to include a prior replacement schedule or make very educated estimated based on the following:

- *Prior Studies* - The most reliable data we have is a database of thousands of prior reserve studies. Many of these have invoices and bids from vendors which were reviewed and included as actual costs data into these prior studies. Our database is updated regularly to reflect actual costs data from these vendors for all types of building and grounds components. The useful life of components is also listed in these prior studies and are specific to each community as we assign a placed in service data for each component. Example: When a composition shingle roof last about 25 years for the vast majority of

buildings we encounter this is a good sign that it will also last approximately 25 years on your building.

- *Cost Manuals* - We also regularly utilize cost manuals such as RS Means and Marshall & Swift both of which are extremely accurate, updated quarterly and specific all the way down to the zip code. These cost manual companies interview thousands of vendors for many thousands of ground and building components to determine average costs and then provide them in very comprehensive cost manuals. We have found these to be extremely accurate. Architectural, Engineering and to a lesser extent Cost Manuals also supply Useful Life of Components. These again based on interview of vendors who deal with these materials every day as well as manufactures indicators related to warranties and in house tests for longevity.
- *Client History* - When we complete a reserve study for our Clients we ask for any relevant bids, vendor invoices and known historical expenses so that we can incorporate these into the reserve study. These are generally pretty reliable with the exception of some that did not obtain numerous bids and overpaid or hired a vendor who has provided a bid for work that is less than the recommended standards (e.g. one sealcoat layer versus the recommended two). The reason vendors provide high or low bids are numerous and can include: they do not really want the job (too big or too small), they are too busy, they lack the necessary equipment (high bid to purchase it), not experienced with some aspect of the job, etc. It has been our experience that the most accurate indicator of the Useful Life of a component is the prior history of that component in a specific community. All site characteristics and building designs are different so materials will wear at slightly different rates (e.g. if the roof on a building has been replaced at 20 years twice prior we will likely fund for replacement at 20 years again.) All types of items impact useful life including sun exposure, rain, wind, sand/dust, wooded, desert, arid, humid, etc. The more information we have regarding the historical timeline of replacement of components the more accurate and catered the reserve study will be.

### **How is Remaining Useful Life of Components Determined?**

Remaining Useful life of components is based on the placed in service data (client historical records) as well as the comprehensive onsite visual inspections. Typically an



experienced reserve analyst will have a good read on the remaining useful life for more typical components such as roofing, siding, fencing, paint, and asphalt as they have seen these thousands of times prior and are familiar with the different condition levels during the life cycle of these more common components. Mechanical equipment can be much tougher to determine just by looking at it so we will often also rely on serial number data to determine manufacturing dates.

### **Hidden Systems / Components**

Then there are components completely out of view such as plumbing, electrical, drainage systems, etc. These are much more difficult to place a condition assessment on, determine costs and determine a remaining useful life; often the reserve analyst must rely only on data provided to them from the client. These types of components are often addressed with a contingency in a reserve study based on the prior history of repair for the component. If the community has averaged about \$5,000 every 3 years in plumbing repairs, in recent history, that would be a good projected amount for the future. Revisions to the costs and remaining useful lives can always be made in updates to the study if repairs become more costly or the Client has a professional analysis of the systems completed; determining a scope, timeline and costs for large scale replacement of these hidden systems.

# The Financial Analysis

The second step in the reserve study is the Financial Analysis which utilizes all the findings and research in the Component Analysis to project out costs and develop funding plans that an Association can follow. Additionally the reserve study will indicate the current adequacy of the level of reserves for an Association versus an ideal reserve account balance based on its future obligations; this is known as Percent Funded and is generally a good indicator of the financial strength of a reserve account. We will dig a little deeper into the financial analysis in the next few pages.

## Goals of the Reserve Analyst

In developing funding plans for a community a professional reserve analyst will follow National Reserve Study Standards Principles. These four principles are listed below:

### **1. There are adequate reserves when needed**

The recommended funding plan will take into account that some years will have dramatically higher expenses than others (often referred to as Peak or Threshold Years). The overall financial strategy should result in a reserve account balance which is large enough to cover expenses in all periods of time. There is little need for a reserve funding strategies which result in an Associations failure to meet its fiscal responsibility to the membership. Implementing a funding plan developed by a reserve analyst will likely result in a positive reserve account balance and adequate funding for those common areas covered in the study.

### **2. The budget should remain stable across years of changing membership and boards**

Costs related to common areas fluctuate widely from one year to the next, sometimes with minimal expenses for a decade or longer. The reserve specialist will develop a strategy that fairly assesses reserve contribution dues while still remaining stable; requiring membership to pay their fair share over time. Often an allocation rate increase

that matches the inflation rate is adequate and is considered a “stable” annual increase rate. Note that this stable budget concept does not mean there should be no increases to the allocation rate, in fact the exact opposite is true. A stable increase of 3% per year follows this concept (typical to offset inflation) whereas wide variances such as 1% one year and 7% the next is not fair to the membership in either year.

### **3. The costs are fairly distributed to the membership**

The cost to replace the common areas should be fairly distributed across years of membership in a community (current and future members). An adequate reserve allocation rate to the reserve account on an annual basis ensures the community members are paying their fair share of the deterioration of the components. The costs may fluctuate wildly over a 30 year period but if the reserve study is updated annually the Association will be able to assess a fair amount to the membership in any given year and be adequately prepared for the common area replacement expenses when they come up.

### **4. The financial strategy must allow the Association / board to be fiscally responsible**

The membership of a community is counting on the Board to make good long term budgeting decisions. A financial strategy which removes reserve funds to pay for a large capital improvement (e.g. construction of a recreation building ) is not a fiscally responsible decision and does not follow the concepts in the National Reserve Study Standards. A reserve professional will develop a plan which the Board can rely on and implement; the result is a community which stands on solid financial ground.

# About Percent Funded

Percent funded is a measurement of the financial health of a community with regards to its reserve account balance. Essentially it is the calculation of how much the community has in the reserve account versus how much it ideally should have at one particular point in time. This figure can be helpful for Community Membership, Boards and outside parties such as Lenders to grasp the current financial health of the reserve account.

However, percent funded is only part of the entire picture in a reserve study. Additionally there are graphs, charts, projections and a cash flow analysis for all the funding plans provided a comprehensive study. Just because a community has a high percent funded level today does not mean it will continue that way into the future. Large expenses will often drive down the percent funded level so it's important to review the projections of the expenses and the cash flow analysis in the study to see how a community's reserve account balance is impacted in time periods of large expenses, falling percent funded and the risk associated with a low percent funded level versus expected expenditures.

Typically one of the goals of the recommended funding plan in a reserve study will be to increase the reserve account balance and the Percent Funded to a high (above 70%) percent funded range within the time frame covered in the report. In Washington State all reserve studies for common interest communities must have a funding plan that increases the Percent Funded to 100% within 30 years.

## **Percent Funded Ranges**

The goal of this reserve study is to guide the Association towards a path of becoming fully funded over the 30 year period covered in this report. The different ranges in levels of funding are explained below.

### **70-100 % Funded - Good**

At this level, the Association is considered to have a good level of funding. The risk of special assessments and deferred maintenance is minimized. While the goal is to reach and remain at the 100% funded mark the actual funding level will likely fluctuate above and below 100% due to changing component expenses in any given period of time covered in this reserve study.

### **30 – 70 % Funded - Fair**

A fairly funded Association is typically one on the right path to becoming fully funded but one that can also run into trouble if large expenses arise such as unexpected component failures or rapidly rising costs, specifically in years when large expenditures come to fruition. Additionally it is important that the Association is vigilant with their goal to reach a high percent funded level as there is often pressure to reduce HOA dues or utilize money elsewhere as the reserve account balance grows to a level which is perceived to be large. HOA Board's often have difficulties in continuing with the longer term goals in years of economic downturn when much of the community seeks lower HOA dues or a reduced allocation to the reserve account.

### **0 – 30 % Funded – Poor**

A poor funding level often forces an Association to rely on special assessments and/or loans. With insufficient funds the Association may not be able to meet predictable common asset expenditures. At this level of funding many communities choose to ignore condition deficiencies over time and suffer from significant deferred

maintenance issues which in turn hurt property values. Note that Associations can often stay within a poor funding range for many years before any apparent negative impact. The reality of the financial position of the Association will often become apparent in "peak" expense years when one or several large expense component projects occur (e.g. roofing, asphalt, siding, windows) which will require special assessments to be implemented or loans secured.

**\*Reserve Analyst Tip**

If your Association has a goal, such as reaching a certain percent funded range within a specific time period, let the reserve analyst know so they can incorporate it as one of their funding plans into the reserve study. This could be for lending/financing purposes or just to hit targets set by the Board. The reserve study should be a catered document that takes into account both Client Goals and Statutory Requirements.

# About The Fully Funded Balance

A Fully Funded Balance is a reserve account balance which is equal to the estimated accumulated deterioration of the Association's common area components. As common area components grow older, they deteriorate until they no longer perform their intended function, at which time; the component is fully deteriorated and must be replaced. The fully funded balance is the estimated monetized amount that will match this deterioration to the assets at any specific point in time.

## *Example*

An Association which has a building that needs to be painted in 5 years at a cost of \$5,000 will need to set aside \$1,000 into their reserve account annually to have enough in the reserve account to pay the painter in year 5. If the Association has \$1,000 in the reserve account at the end of year 1 they are on track to pay for this paint job and are considered to have a Fully Funded Balance as the paint job has deteriorated by  $1/5^{\text{th}}$  and the amount in the reserve account is  $1/5^{\text{th}}$  of the total amount needed. At the end of year two this community would need \$2,000 in the reserve account to remain Fully Funded (ie.  $2/5^{\text{th}}$  deterioration of the paint and  $2/5^{\text{th}}$  the total in the reserve account). This would go on each year until year 5 when the building is painted and the process starts over again.

The fully funded balance is simple enough to determine if the community has only one common area component but most communities have many components and a corresponding fully funded balance that ranges from one year to the next as components are repaired/replaced, remaining useful life expectancies are updated over time and the common area component list grows or shrinks over time.

It's important to realize that a fully funded balance is not the total replacement cost of the common area components. A community which has a fully funded balance one year then decides against following recommended increases to offset inflation will very likely fall below a fully funded balance in a very short period of time. This is a common scenario when membership request lower dues and the reserve account balance appears to be very large.

# Timeline of Expenses

The reserve study will include a schedule of expected expenses related to the common area components in the reserve study. This will include the expected year the project will need to be completed as well as the expected costs at that time (inflated costs based on inflation rate). This is one of the most valuable tools in the reserve study should a Board or Property manager decide to utilize it properly. Most of the time "surprises" can be minimized as a review of the expected expenditures will provide a community years of advance notice. This is especially helpful for large expense projects like roofing or roads which may require a Board to look into funding options ahead of time.

## **Cost Efficiencies**

When the reserve study professional creates a timeline of expenses one of the goals is to make sure components are timed appropriately for cost efficiency. An example of this would be to include a siding repair component being timed with the paint cycles of the building. Below is an example of an annual expenditure report.



Description	Expenditures
<b>Replacement Year 2020 continued...</b>	
Bathroom- Refurbish	6,556
Elevator- Cab Refurbish	16,391
Entry Access System	3,825
Fencing- Wood- Replace	13,572
Kitchen- Refubish	6,556
Landscape- 25% Refurbish Contingency	9,400
Mailbox Clusters- Replace	1,661
Retaining Wall-Masonry- 20% Conting.	3,734
<b>Total for 2020</b>	<b>\$63,225</b>
<b>Replacement Year 2021</b>	
Central Vacuum- Replace	1,970
Hot Water Heater/Tank- Replace	2,251
<b>Total for 2021</b>	<b>\$4,221</b>
<b>Replacement Year 2022</b>	
Concrete Surfaces- 3% Repair Contingency	4,039
Paint- Garage Walls/Ceiling	16,727
Paint- Wood Fencing	5,039
Paint/Seal- Ext. Wood Surfaces	7,871
Sump Pump- Garage- Replace	5,796
<b>Total for 2022</b>	<b>\$39,473</b>

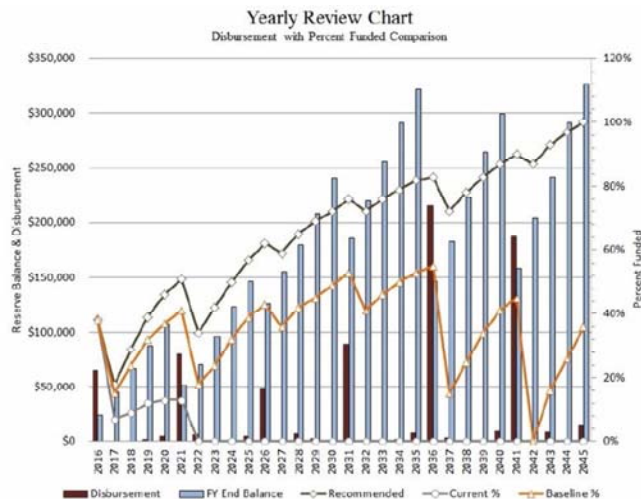
# About Funding Plans

The reserve analyst will be developing numerous funding plans for a common interest community as there are several important considerations to take into account. These include:

- Statutory requirements
- Association goals
- Reserve analyst recommendations

Additionally there may be "what if" scenarios or funding plans that meet certain third party requirements, such as a Lender. It is important to notify the reserve analyst of special request so these plans can be taken into consideration during the process of developing the catered reserve study.

Below are some examples of different funding scenarios on a comparison graph. Some are more conservative than others and may meet different goals or Client requests.



## **Funding Strategies**

There are four basic funding strategies most commonly utilized and accepted in the reserve study industry. It is recommended that associations consult professionals to determine the best strategy or combination of plans that best suit the Association's need. Additionally, associations should consult with their financial advisor to determine the tax implications of selecting a particular plan. The four funding strategies and descriptions of each are detailed below.

### **Full Funding Strategy**

Given that the basis of funding for reserves is to distribute the costs of the replacements over the lives of the components in question, it follows that the ideal level of reserves would be proportionately related to those lives and costs. If an association has a component with an expected estimated useful life of ten years, it would set aside approximately one-tenth of the replacement cost each year (ignoring interest and inflation for this example). At the end of three years, one would expect that three-tenths of the replacement cost to have accumulated, and if so, that component would be "fully-funded." This model is important in that it is a measure of the adequacy of an association's reserves at any one point of time, and is independent of any particular method which may have been used for past funding or may be under consideration for future funding. The formula is based on current replacement cost, and is a measure in time, independent of future inflationary or investment factors. When an association's total accumulated reserves for all components meet this criteria, its reserves are "fully-funded."

### **Baseline Funding Strategy**

The goal of this funding method is to keep the reserve cash balance above zero. This means that while each individual component may not be fully funded, the reserve balance overall does not drop below zero during the projected period. An association

using this funding method must understand that this is a higher funding plan as even a minor reduction in a component's remaining useful life can result in a deficit in the reserve cash balance specifically in years when cost are substantial.

### **Threshold Funding Strategy**

This method is based on the baseline funding concept. The minimum reserve cash balance for threshold funding, however, is set at any predetermined dollar amount by the Client or Reserve Analyst.

### **Statutory Funding Strategy**

This method is based on local statutes. Per Washington State statutory requirements all reserve studies must include a Baseline Funding Plan, a Reserve Analyst 's Recommended Funding Plan and a Funding Plan that results in a 100% funded reserve balance within 30 years.

# Updating the Reserve Study

It's very important for an Association to update its reserve study annually. Washington State Law requires an annual update and the disclosures from the update are also required annually.

Many communities will try and update their reserve study in house by a Board member who may have some experience in the construction industry or in finance. While this may seem like a good idea to save some money this more often than not ends up changing the financial plan from what was originally created by a reserve study professional and to a degree that causes the study to lose credibility.

Whoever completes a reserve study update will need to be familiar with construction costs, components life expectancies and be familiar with reserve study concepts. The research needed could involve calling vendors, purchasing cost manuals, taking classes and researching reserve study concepts so that the reserve study update will remain credible. The annual disclosure requirements will also need to be completed utilizing the updated figures from the reserve study so it is important that the person updating the reserve study can extrapolate this information from the study.

## **\*\*Reserve Analyst Tip\*\***

Updates to reserve studies are typically inexpensive for years when a site visit is not required. The amount saved by doing it in house is typically only a few hundred dollars but risk can be significant if the data being updated is not accurate. Our tip, establish a relationship with a reserve study company you trust and have them update annually. This is cost efficient and removes significant risk and liability from the Board.

# Definitions

## **Full Funded Balance (FFB)**

Total Accrued Depreciation. An indicator against which the FY Start Balance can be compared. The balance that is in direct proportion to the fraction of life “used up” of the cost.

## **Funding Goals**

A) *Baseline Funding* - Maintaining a Net Reserve Balance above zero for length of the study.

B) *Full Funding* - Maintaining a Reserve Balance at or near Percent Funded of 100%.

C) *Statutory Funding* - Maintaining a specified Reserve Balance/Percent Funded per statutes.

D) *Threshold Funding* - Establishing and maintaining a set predetermined Reserve Balance or Percent Funded.

## **Funding Method (or Funding Plan)**

An association’s plan to provide income to the reserve fund to offset expected disbursements from that fund. The following represents two (2) basic methodologies used to fund reserves:

A. *Cash Flow Method* - A method of developing a reserve funding plan where allocations to the reserve fund are designed to offset the variable annual expenditures from the reserve fund. Different reserve funding plans are tested against the anticipated schedule of reserve expenses until the desired funding goal is achieved.

B. *Component Method* - The component method develops a reserve-funding plan where the total contribution is based on the sum of contributions for individual components. The component method is the more conservative (typically higher reserve account balance) of the two funding options, and assures that the association will achieve and maintain an ideal level of reserves over time. This method also allows for computations on individual components in the analysis. However this method has also limitations with respects to variations in actual useful life of components and is much more time intensive to accurately follow this funding strategy.

### **Levels of Reserve Studies**

A) *Level 1 Reserve Study (Full or Comprehensive)* - A Reserve Study in which the following five Reserve Study tasks are performed:

- a) Component Inventory (based upon on-site visual observations)
- b) Condition Assessment (based upon on-site visual observations)
- c) Life and Valuation Estimates
- d) Fund Status
- e) Funding Plan

B) *Level 2 Reserve Study (Update, With-Site-Visit/On-Site Review)* - A Reserve Study update in which the following five tasks are performed:

- a) Component Inventory (from prior study)
- b) Condition Assessment (based upon on-site visual observations)
- c) Life and Valuation Estimates
- d) Fund Status
- e) Funding Plan

\*Note- Updates are reliant on the validity of prior Reserve Study.

C) *Level 3 Reserve Study (Update, No-Site-Visit/Off-Site Review)* - A Reserve Study update with no on-site visual observations in which the following three tasks are performed:

a) Life and Valuation Estimates (from prior study - updated)

b) Fund Status

c) Funding Plan

\*Note- Updates are reliant on the validity of prior Reserve Study.

### **Percent Funded**

A comparison of the Fully Funded Balance (ideal balance) to the Fiscal Year Actual Start Balance expressed as a percentage, and used to provide a 'general indication' of reserve strength.

### **Useful Life (UL)**

Total Useful Life or Depreciable Life. The estimated time, in years, that a reserve item can be expected to serve its intended function if properly constructed and maintained in its present application or installation.



# Additional Resources

Below you will find links to articles and videos about the topics noted.

## **WA State Reserve Study Law**

<http://app.leg.wa.gov/rcw/default.aspx?cite=64.34.380>

## **WA RCW Reserve Study Contents**

<http://app.leg.wa.gov/rcw/default.aspx?cite=64.34.382>

## **Sample RDA Assessment & Disclosure Form**

<https://www.rdanorthwest.com/mt-content/uploads/2017/10/sample-wa-state-assessment-disclosure-form.pdf>

## **RDA Reserve Study PowerPoint Presentations**

<https://www.rdanorthwest.com/reserve-study-professionals/knowledge-corner/slideshare/>

## **Lender Requirements – The 10% Rule**

<https://www.rdanorthwest.com/reserve-study-professionals/knowledge-corner/condo-fha-fannie-mae-freddie-mac-approval/>

## **Fairness in a Reserve Study**

<https://www.rdanorthwest.com/reserve-study-professionals/knowledge-corner/fairness-in-funding-plans/>

## **Special Assessment Reality**

<https://www.rdanorthwest.com/reserve-study-professionals/knowledge-corner/special-assessment-reality/>

## **WA State Condominium Law Handbook**

[http://www.condolaw.net/uploads/-\\_2015\\_Handbook\\_for\\_Community\\_Associations\\_FINAL\\_9.16.15.PDF](http://www.condolaw.net/uploads/-_2015_Handbook_for_Community_Associations_FINAL_9.16.15.PDF)

## **Why HOA Dues Should Continue to Increase – Inflation**

<https://www.rdanorthwest.com/blog/hoa-dues-and-inflation/>