ASSOCIATION RESERVES®
Planning For The Inevitable

Apr 9, 2025

Reserve Studies 103 – The Funding Plan

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Miss the webinar? Watch it here.

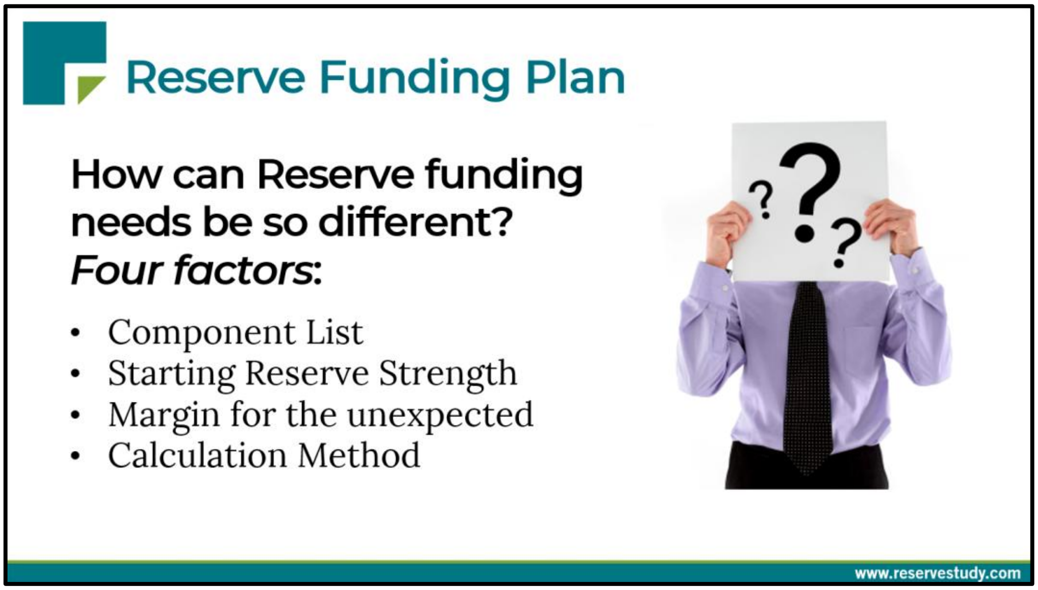
Every year, every board member is confronted with the Reserve Funding question "What do I do now?". It's tempting to say "Reserves are for the future", and to leave Reserve funding to future boards, and future budgets. But Mother Nature and Father Time laugh at those associations. Your deterioration doesn't stop or slow down when you stop or slow down your Reserve Funding, which is designed to offset ongoing deterioration. Just because the roof doesn't send a "deterioration" bill each month doesn't mean it is a bill that can be ignored. The expense will happen. Your choice is whether homeowners pay in small increments each month as part of their ongoing assessments, or as an "unexpected" and unwanted special assessment when the asset eventually fails. That's where we come in… helping the board know the smoothest and fairest path to prepare for predictable upcoming projects.

Deterioration is real and expensive. There's no dodging those huge expenses.

You don't get to decide about the expense. But you do get to decide how it will be paid. You are responsible, per your Governing Docs, to provide for the care of the common areas. Your responsibility is to have the funds available one way or another, so the owners can enjoy their homes and benefit from maximized home values. We are guided to help you reach these goals with four Funding Principles that we balance and apply when crafting your Funding Plan (see at right).

RESERVE FUNDING PRINCIPLES

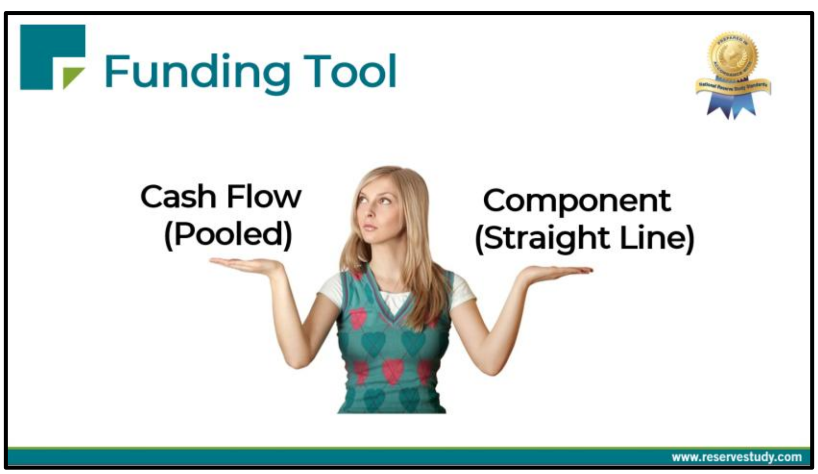
Now we address the question of how big the Reserve transfers need to be at your association. Your Reserve funding needs will be unique and different, even from similar associations, because of four influences:



There's almost nothing you can do about your Component List. The assets (roofing, painting, hallways, a tennis court, etc.) exist. At your association, they are your responsibility to maintain. You can't responsibly choose to "ignore" the needs of your roof. Starting Reserve Strength is another factor. But that's the starting point prior boards handed you. Your challenge is how best to go forward from here.

Margin for the unexpected is where you begin to have some choices. Our recommendation is that because nothing ever goes exactly according to plan, it is in your best interest to plan for some margin. Since Reserve projects are so expensive, the amount of margin included in your Reserve funding plan is just a small portion, typically 10-20%. And that's the little "margin" that can shrink your exposure to unsettling special assessments from around 50% to almost zero.

Then there's the issue of which mathematical tool you use in developing the Funding Plan. Usually, you don't care which tool a business partner uses... which software your attorney uses to draft new governing documents, the accounting software used by your mgmt. company in tracking owner accounts, or the brand of lawn mower used by your landscape maintenance company. But with Reserves, the tool matters. The choice is the Component Method or the Cash Flow Method.



The Component Method funds each Reserve component separately, line by line. The other (Cash Flow) funds Reserves based on the cash outflows each year, no matter if those outflows are one component or a cluster of projects. Because the Cash Flow Method fundamentally uses Reserves funds more effectively (none is set aside waiting for a future expense when it can be used for another legitimate Reserve project), the Cash Flow Method is preferred by professionals nationwide.

The Cash Flow Method also allows more flexibility in designing the Multi-year Funding Plan. This means Cash Flow Funding Plans can more effectively achieve the four Funding Principles stated earlier (especially Equitable Distribution and Fiscal Responsibility) with a plan that gradually floats upwards over the years, matching inflationary trends. The Component Method fundamentally starts high and decreases over the years. As a result, while the overall 30-yr total of funds going towards Reserves will be about the same, in the initial few years Component Method Funding recommendations are commonly twice or more than the Reserve Funding recommendations calculated by the Cash Flow Method.

Making wise decisions about Reserve funding requires a seasoned guide, someone who has crafted successful solutions for their clients hundreds *or thousands of times* before, someone like Association Reserves!

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Planning For The Inevitable

More questions? Download our eBook on Funding Plans, or find more information on the Resources tab of our website here.

Want out help? Click here for a Reserve Study proposal for your association, or click here to find the Association Reserves office in your region. Don't expose your association to unsettling surprises because of poor Reserve Funding choices!

<u>Webinar Questions Asked by Attendees</u>

General Reserve Questions

Q: **I'm Treasurer of our HOA Board and want to have a property management company and an association manager on site. My question is what is or should be expected of my involvement with the Reserve Studies. For example, I want to ensure that any *new and pending* assets are included in our current in-process reserve study, and I'm not confident that the association manager will be able to clarify this new asset as it involves technology and replacement parts in the future. The manager is saying I cannot be involved directly.**

A: A great Reserve Study is based on the most accurate information. We welcome your involvement! We'd rather have too much information and need to sift it down, than have questions about what we're seeing or what the association is planning.

Q: **I was wondering if expenses related to SB326 (the CA Balcony inspection law, which became CA Civil Code §5551 in 2019) can be funded through Reserves.**

A: Yes. The inspection itself can be funded through Reserves (an "every 9 yr" significant expense), as can the cyclical repairs or corrective repairs revealed by the inspection that need to be accomplished. This is covered in our Reserve Studies 101 webinar (see here or search for it on YouTube) that focuses on Reserve component selection.

Q: **If an HOA had a large-scale damage to the community and filed an insurance claim is it best to wait until all repairs are completed to get an updated reserve study or can they only update the financial investment piece during the construction phase?**

A: A Reserve Study should be a regular part of your budget process. Remember that all your components are in a constant state of change. If you wait for everything to be "settled", you'll never update your Reserve Study! Update your Reserve Study with the best estimates available, <u>when</u> the Reserve Study needs to be accomplished. That will give your association effective budget guidance.

Q: **Is a reserve study the best first step in creating a budget for capital expenses?**

A: Absolutely. A reserve study is foundational. It tells you what to expect, when to expect it, and what it'll likely cost, gathering information about the amount and types of common area assets the association is responsible to maintain, their individual condition and repair/replacement costs, and the current Reserve balance. Think of it as your capital budget roadmap. Without one, you're driving blind into the future.

Q: **Are there any nuances between condos and co-ops when it comes to reserve studies?**

A: Co-ops and condos may have different ownership and financial structures, meaning they may have significantly different common area amenities. But both are non-profits that need some help in regularly balancing the amount of cash they have against the timing and magnitude of upcoming predictable projects, so they can smoothly spread out the costs over the owners over the years, so every owner pays "their fair share". So yes, there are nuances in the differences between the two, but that has mostly to do with the composition of their Component List.

Q: Will we be able to watch the webinar after you close?

A: Of course! We believe in education, and replaying the material helps deepen your understanding. The webinar will be posted on our [website]() and on YouTube.

Q: Is there a list of these additional resources available on the website?

A: Yes—visit https://www.reservestudy.com/. We've got articles, videos, sample reports, policy templates, and eBooks to help boards and managers have success with their Reserve planning.

Q: With all the new laws about what now must be part of the reserves, should we have an on-site visit instead of an off-site one this year?

A: Actually, National Reserve Study Standards provide good, consistent guidance for what a Reserve Study is, and what components are contained in it. If you're Reserve Study provider is following National Reserve Study Standards, you'll be in compliance with your local State laws. Note that national Best Practice is for an update based on a diligent visual on-site inspection at least every third year, with inexpensive No-Site-Visit Updates in the in-between years. Timing is your driving factor, not particularly if or when your State Law was changed. Mother Nature and Father Time are pretty darn consistent, so you consistently need an updated Reserve plan no matter what your state law says.

Q: How do you plan for the future in times of economic upheaval, life now?

A: We give you an accurate budget plan for the upcoming year based on a 30-yr look forward. As stated above, Best Practice is to update your Reserve Study regularly to account for all the twists and turns in interest, inflation, supply chain disruptions in pricing, wear-and-tear, and your Reserve Balance (that isn't always what it should be). Get a solid foundation with a With-Site-Visit update by your local credentialed Reserve Study professional at least every third year, consider very inexpensive annual No-Site-Visit updates, and you should rest comfortably that you have a good plan, even in the most tumultuous times.

Q: How do you prepare for the volatile nature of the economy?

A: We recommend following national Best Practices and updating your Reserve Study regularly (see above). It also helps on the client-side if they adopt a safe and conservative Funding Plan that allows them to plan ahead, rather than having a marginal (Baseline) Funding Goal that always leaves them in "catch-up" mode.

Q: How can we close the gap outlined in our updated reserve study, since we've not been funding as much to Reserves as recommended in prior years?

A: Accept the fact that in our inflationary environment, you should expect annual increases to your amount of Reserve funding. And if you've been "underfunding" your Reserves, expect higher funding requirements for a few years as you catch-up and prepare for upcoming projects. Mother Nature and Father Time laugh at associations who skimp on their Reserve Funding. Blame it on them when you communicate the need for higher budgeted assessments at your association. Help your homeowners understand that there's no getting away from the fact that owning and caring for Real Estate is expensive!

Q: If we have had recent reserve study done, should we propose to our Boards to have an updated study done due to the recent tariffs being implemented?

A: No. Reserve planning is regularly an annual project. We collect and create a plan based on the best information available at the time. If you wait for everything to "settle", you'd never update your Reserve Study. it could be a smart move. And besides, tariffs can come and go or go up or down on almost a daily basis. Annual updates to your Reserve Study are a wise move, especially in unsettled economic times.

Q: What happens to the reserves when a property is being bought out by a developer?

A: That's a great question (for an attorney). I expect it varies from case to case, but I expect the cash in Reserves would be distributed in the same proportion that the big buyout check is distributed… based on each owner's ownership share in the association. Your legal counsel should provide good guidance through that process.

Q: Will the study recommend a sequence for the work? Like scheduling natural companion projects (e.g. windows & siding) at the same time?

A: Yes, we often group "natural partners"—think windows and siding, or roofs and gutters, recarpeting and wall painting. Coordinating projects saves time and money, ensures consistent themes and styles and conditions, and minimizes disruption to residents. Most credentialed Reserve Study professionals attempt to "cycle" certain projects together wherever possible.

Q: Why is the timeline covered in a Reserve Study? Typically 30 years?

A: Yes. National Reserve Study Standards require a display of at least 30 years of Reserve income and expenses. That has become the standard in the industry. Note that many (most?) Reserve Study providers also include plans to fund major components even beyond 30 yrs in their objective to identify the true ongoing cost of deterioration at the association.

Q: **A Reserve Fund can contain 100,000s of dollars. Do you have recommendations, or are there guidelines for investing this?**

A: Yes—your Reserve Funds should be invested with three priorities: safety, liquidity, and return—in that order. We're not financial advisors, but we do advise keeping investments in government-insured institutions and investment vehicles, staggering "laddering" investments appropriately to provide liquidity when needed yet maximize interest earnings. If your association is approaching the $250k FDIC-insured limit, it is best to seek professional assistance (such as HOAInvest.com or equivalent).

Q: **Our HOA has never had a reserve study, but as Vice-President, I can't convince the board of the importance of it. I'm just being labeled as a troublemaker because I'm told "We didn't need one before it worked fine before you arrived." How can I make them understand?**

A: A Reserve Study (regular Reserve Study updates) are national Best Practice for leading and managing an association. They fundamentally provide guidance on how to offset the major, predictable, but commonly irregular big projects necessary at an association, providing a budget plan that allows every homeowner to "pay their fair share" along the way with the result that the association has the cash it needs when it needs it, financing projects without "emergency" special assessments. It's what other responsible associations do all across the country. Those who don't do Reserve planning are called "special assessment" communities.

Q: **We're concerned about potential buyers getting a mortgage. We understand Fannie Mae has a blacklist and Freddie Mac has an exclusion list which make it difficult to get a mortgage, lowering home values significantly. Does a Reserve Study, or your Reserve Fund Strength, put us in a safe position?**

A: See our article on the topic here. Fannie/Freddie are looking for things that would compromise the security of their investment... meaning the value of the Real Estate that is collateral for the loan. So doing everything you can to take good care of the property is in your best interests.

Because so many associations don't have a Reserve Study, Fannie/Freddie look for minimum Reserve standards, which for a condo association means setting aside at least 10% of total budget towards Reserves. That's easy even for a loan processor to check! That it is nowhere near the 15-40% typically needed by an association to adequately offset ongoing deterioration and minimize special assessment risk, but "% of budget going to Reserves - Yes or No" is an easy Q to ask on a mortgage application. My understanding is that size and date of prior special assessments is a common mortgage question. You can minimize your exposure to special assessments by having a Reserves Percent Funded above 70%.

Owning and maintaining a home is expensive. Fund your Reserves so you stay out of the quicksand of deferred maintenance everywhere you turn your head, and no money to pay for it. That's when Fannie and Freddie will not be interested in underwriting mortgages in the association... because the real estate is just "not worth it".

Q: How do I begin? We tend to not look ahead, we just react when something breaks (or falls down or leaks…).

A: Commission a Reserve Study by your local credentialed Reserve Study professional. It doesn't cost that much (typically under 1% of your total budget, even for a "Full" Reserve Study). Click here to get a proposal from our firm. Subsequent updates are significantly less expensive. That will give you the information you need to run your association in a fiscally responsible manner – with everyone paying their fair share over time, and with funds available when needed to accomplish major projects when they need to be accomplished.

Q: If there are some repairs and maintenance along the way but not major ones, should those small replacements be expensed through the Reserve account or Operating?

A: There is a national Reserve Study Standard three-part test described in our Reserve Studies 101 webinar (see here… that the component must be a common area maintenance responsibility, that the project must be reasonably predictable, and must be "significant" in cost to the association). So check with your local credentialed Reserve Study professional. That dollar amount threshold is typically in the range of .5% to 1% of your annual budget. Bottom line – minor repairs should be funded from your Operating budget. The larger ones (to be funded by Reserves) will be listed in your Reserve Study.

Reserve Component Questions

Q: Do you find that staining cedar fences is worth the cost? Does it extend useful life?

A: Yes, if done right and consistently, it can extend the useful life and be very cost-effective. See our "Understanding Components of a Reserve Study" webinar here for a further discussion and more examples like this.

Q: We have common area A/C units throughout the building. Each is about $5-6k to replace (individually a relatively small cost for our association), but we have 35 of them. Should they not be combined?

A: If you expect to replace them all at once, then yes, combination makes sense. If they are random ages and conditions, perhaps schedule for 2 or 3/yr on an ongoing basis (for about a net average 15-year Useful Life for each. Please discuss with your local, credentialed Reserve Study professional to ensure this replacement project is modeled appropriately.

Q: **Our reserve fund is so low that the Board has opted to roll several components to future years to get the reserve account back up. These components are working well, are in good condition with no repairs needed this year. Will this affect us financially in future years, as more components will be due, or is the Board on the right track?**

A: It depends. Clearly, these projects did not "go away", they were just deferred. So, they will make future years more expensive. Please discuss with your local, credentialed Reserve Study provider in the process of getting a Reserve Study update to ensure all conditions are correctly identified and your funding plan can support future repairs and replacements.

Q: **Our latest reserve study update will be finished soon. How will the reserve study be affected if I install a new component system or equipment shortly after the new reserve study is completed? Should I let the RS specialist know before this study is completed?**

A: Yes—keep us in the loop. We want your study to be accurate and current. Let us know before it's finalized so we can include the new asset(s) in the Component List, so you'll be setting funds aside for its future repair or replacement.

Q: **When using the Component Method for calculating a Funding Plan, does an HOA have to fully fund the component before they can pay for that component?**

A: No. You start funding "where you are". Sometimes (often) Component Method calculations find the association in a "catch-up" mode, which as we discuss in the webinar, yields relatively high recommended Reserve transfers during those "catch-up" years.

Q: **How do I know the life of any item? Ie how long will a chair last?**

A: Your local, credentialed Reserve Study professional is familiar with normal life expectancies, and will likely ask about furniture usage history (daily, monthly, annual meeting only) and evaluate its styling sensitivity (current or dated or neutral) in developing a recommendation for your association.

Q: **For far in the future components, how do you predict the cost of a component that needs to be replaced in 5, 10 or further in the future?**

A: We never predict the cost of a component far into the future. We establish the current cost. The software then inflates the costs for future years in the development of the Funding Plan. We have every expectation that regular Reserve Study updates will re-anchor those costs at least every third year into the future, guiding the way forward.

Q: **When do you recommend that an association begin inspections by, for example, structural engineers, master electricians, etc. in order to properly budget for invisible components?**

A: When the building is 5 yrs old. The earlier you start, the earlier you identify trends in how your building is aging, and you give yourself the opportunity to find and fix things when they are small and (relatively) inexpensive. Then review everything regularly, on a 5-10 yr cyclical basis. Waiting is not in your best interests!

Reserve Funding Questions

Q: What if your association has a strong Reserve Fund now, but is still using the Component Method to develop its Funding Plan? Should we change to cash flow?

A: Yes. The Cash Flow Method provides more flexibility and a smoother plan.

Q: If your current reserve balance is too low, do you recommend a special assessment to bring it up to where it should be?

A: It depends on when, and how large, your upcoming expenses are. A special assessment should be your last resort, because it so unfairly places a huge cost burden on current owners. It is best to spread out the cost of deterioration over time, over a large set of owners. Discuss your best path forward with a local, credentialed Reserve Study professional. Special assessments (and loans) are to be avoided when possible.

Q: We're not currently funding our low reserves as recommended yet. How does it sound to at least Fund the reserves with what we can afford until we approve raising our monthly HOA fees after not increasing them for 9 years?

A: Yikes! It is not a question of "if you can afford it", it's "how you'll afford it". The costs are what they are. If you fail to prepare, you'll pay those costs through a big special assessment. It is always best to have owners pay their small, fair share over time. They'll pay either way. Choose to do it the fair way. Raise your assessments at the earliest opportunity (perhaps incorporating a short 3-5 yr ramp-up period?), and start funding your Reserves responsibly.

Q: What is considered a good/solid percentage level of funding?

A: 70% or higher Funded is generally considered strong. Below 30%? That's high-risk territory, where special assessments are common.

Q: Is there a percentage range for funding status? I see 'Moderate Risk' on a report that's at 44%. Wondering what's the Baseline, Threshold, etc.

A: You're confusing two things: Reserve Fund size, and Reserve Funding Goal. Regarding Reserve Fund size, the "fair/moderate" range is the 30-70% Funded range. A Baseline Funding goal allows means that in the future, you'll allow the Reserve Fund to drop as low as zero. A Threshold goal is a chosen minimum amount (cash balance or Percent Funded) that in the future, you'll allow your Reserve Fund to drop to.

Q: **Can we account for an insurance deductible in our reserve funding?**

A: No. Insurance is for accidents. Reserves are for predictable (inevitable) upcoming projects. So since insurance is for unknown events at an unknown point in time, deductible payments fail test #2 of the national Reserve Study Standard three-part test. See more in our Reserve Studies 101 webinar here.

Q: **We're scheduled to have your firm complete a reserve analysis later this month. However, we're also expecting a significant cash inflow in the next 30-60 days. We plan to add that cash to our reserve balance. How could we adjust our reserve balance in the reserve analysis to reflect the cash contribution if it happens after you complete the analysis?**

A: Just let us know. We can adjust the starting Reserve balance in the report to acknowledge and incorporate the anticipated cash balance if the deposit has not yet hit the bank.

Q: **What is the best means for preparing for unexpected costs that are assessed by a city/government assessed need?**

A: If they are unexpected, your best defense is to have an Operating Budget that provides you with margin for the unexpected (like this), or a strong Reserve Fund that you can loan to the Op Fund (zero interest loan?) to pay this bill. Reserves are for predictable projects. The money is needed for those projects. Don't blow that cash carelessly on "other things", leaving your Reserve projects underfunded. You've just traded one problem for another.

Q: **Under what circumstances would an association elect to fund using a bank loan?**

A: When expenses are imminent and the Reserve Fund is insufficient, and your board deems a special unpalatable. But loans are expensive, saddling future owners with high payback obligations for prior projects, exactly when the owners should be funding Reserves to offset current deterioration. Loans should be a last resort, not Plan A.

Q: **The two graphs showing the Component Method vs the Cash Flow Method seem to be counter intuitive. The component method is front loaded but then is constant for the remaining of the cycle. The pooled method, the contribution to the Reserve is lower at first but keeps increasing. Why would one select the pooled method?**

A: What was shown was a situation where there was no interest or inflation. The Component Method is known for significantly high early year funding requirements during the "catch-up" years (affecting most associations). The Cash Flow Method allows your association to catch-up over more years in a smoother manner, with a Funding Plan that models inflationary trends, so each owner pays their fair share over time, over the years.

uPlanIt Questions

Q: **Are we able to do a free (or discounted) trial of the uPlanIt program.**

A: No, we are currently not set up for clients to test/try uPlanIt. Please see more information on our uPlanIt web page here, or on a recent webinar dedicated to showing its features here. Bottom line - it's a powerful tool for customizing your plan in real time.

Q: **Can we contact our reserve study specialist for help with the uPlanIt tool? It may be simple, but to start out I need some help.**

A: Absolutely, but we expect that you've watched the short tutorial videos on each page first. Our professional assistance is provided on an hourly charge basis. Anything more than "where is this done?" becomes a professional service.

Interest/Inflation Questions

Q: **How do you adjust this for inflation and interest?**

A: We apply estimated inflation to future project costs and credit modest interest earnings on reserve funds. This keeps your funding plan realistic and aligned with economic trends.

FL Specific Questions

Q: **How do you handle costly items crossing the $10k threshold if they are not crucial items for safety or structural aspects?**

A: Sounds like a FL question (where there is a $10k legal threshold, and there is a requirement to fund for "structural integrity" items! So how to handle them? Fund for them. There are many predictable projects under $10k (a significant cost item to most associations) that would be more readily handled if the cash was sitting there in Reserves, rather than it being a budget-breaker event that you try to handle from the (already lean) Operating budget. The same is true for non-mandatory (in FL) components like carpeting and elevators and HVAC systems – you should fund them. They are predictable common area projects. Plan to repair and replace them via Reserves. That's what your Reserve Study is for. Doing just the bare legal minimum leaves you exposed to regular unsettling special assessments.

Q: **Our association's Reserve Study & SIRS were prepared by separate companies. Other than the component aspect is there a difference between funding obligations?**

A: Yes—SIRS funding is mandatory in FL, while owners still (crazily!) have the power to waive Reserve Funding for all components except for the few components the FL legislation determined were "required". In the future, to make sure there are no gaps in your Reserve planning it is best to have one company do both.

CA Specific Questions

Q: **Due to an SB326 (Civil Code §5551) inspection and the repairs that were required, in our community whose reserves were weak to start with, is a Special Assessment or a Bank Loan a better Option?**

A: Of the two, a special assessment is a better (significantly less expensive) option for your homeowners. We recommend you discuss your situation with your local credentialed Reserve Study professional to make sure you are handling this wisely. And get a head start – communicate to your homeowners that an assessment increase is forthcoming to fund these repairs and provide Reserves to offset ongoing deterioration in order to prevent future special assessments!