COMMON FOUNDATIONS

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How Much is Enough?

Energy and Sustainability

Whenever a reserve study is performed, it is also a good time to look at community practices and opportunities for improvement. For example, if the HVAC system in the clubhouse is to be replaced, should it be replaced with similar equipment or more efficient equipment? The answer might seem obvious, but how far does one go? A more efficient unit might also require structural modifications. Operating procedures might also need to be modified. There are many opportunities to reduce costs for owners, improve the sustainability (green) the association, take advantage of financial incentives, and make for a more comfortable and habitable environment? An engineering evaluation that includes an energy audit as well as a LEED (Leadership in Energy and Environmental Design) evaluation can be an important value-added service at the time of the reserve study. Criterium Engineers has many LEED Accredited Professionals (LEED AP) and Certified Energy Managers (CEM) to assist you.

We are often asked, how much should an association keep in their reserve fund? At first blush, the answer seems simple – enough to cover all anticipated expenditures over the reserve period. Upon further analysis, the answer is not so simple at all. A number of interrelated factors may affect this decision dramatically.

1. The condition of the common elements. If maintenance has been deferred for a number of years, or elements are reaching the end of their useful life, more money may be needed sooner, rather than later, giving the association little time to accumulate reserves.

2. The time value of money. We all know that things will generally cost more tomorrow than they do today. That's inflation. At the same time, most associations invest their reserves such that they earn interest or some other return on that investment. Both factors, and the spread between the two, can have a dramatic impact on reserves over periods as long as 20 or 30 years.

To attempt to create some logic behind funding strategies, the Community Associations Institute (CAI) has come up with the concept of Full Funding. This is defined as *"the reserve balance that is in direct proportion to the fraction of "used" life of the current repair or replacement cost."* In other words, if an item has an Estimated Useful Life (EUL) of 10 years and will cost $10,000 to replace, in order to be fully funded, the

association in year three should have $3,000. Sounds simple enough. Do the same thing for each common element and there is your reserve budget.

The implicit assumption is that being "Fully Funded" is a good thing. Unfortunately, this strategy tends to overfund reserve accounts. The following example, using a study recently performed by Criterium Engineers, serves to illustrate that point.

The association is a small community of 18 units. Our Reserve Study indicated that over the next twenty years, they will face $117,785 in capital expenditures; an average of $7,842 per year. They currently have $4,000 in reserves and each unit owner is contributing $11.60 per month.

As a result, they are only at 13 percent of their full funding balance (of $30,660) and will be underfunded by next year, and increasingly so thereafter.

To become fully funded, the association would have to increase the monthly reserve payment from $11.60 per unit per month to $85.57 per month, a 600 percent increase! What's more, they would end the reserve period with a $270,560 balance, an amount that is almost 35 times their annual expenses.

Interestingly, even if this association were fully funded today, their current reserve contribution of $11.60 per month would not be enough to see them through the next 20 years. Given this situation, one might argue that the association is in pretty bad shape. Not really.

They do need a significant increase in reserve contributions right now because some major deferred maintenance (asphalt repairs and repairs to stairways) are coming right up in the next year. However, we project a more modest (threefold) increase in reserve funding now to address those concerns. Thereafter, a gradual increase (5 percent per year or $3/month every two years) will maintain a positive balance throughout the period and yield a very comfortable balance of $38,857 at the end of the 20 years.

Several other factors also serve to drive the funding strategy. These include, among perhaps many others:

- Rainy days funds. The consultant may not be able to foresee all potential defects or the results of natural disasters. Many associations establish an account balance, or threshold, below which they never want to go.
- Improvements. Communities are not static. Owners may wish to make improvements, whether they are adding amenities, replacing existing equipment with that of higher quality rather than in-kind or complying with new regulations like the Americans with Disabilities Act.
- Statutory requirements. As associations come under increasing regulation, various entities such as state and local governments, lenders (e.g. FannieMae – see Common Foundations, Spring '09), and insurance companies may have their own requirements.
- Actual performance. Many consultants rely on tables of Estimated Useful Life to determine when a component must be replaced. In fact, components rarely wear out at exactly the end of their EUL, and preventive maintenance can extend that even further. Your engineering consultant can schedule the work more accurately based on their experience and observations in the field.

- Vacancies and delinquent accounts. These days, owners are under stress and the number of units in foreclosure has gone up dramatically. Reserves should consider the inability to collect from some unit owners at any given time.

So you see, the answer to the question "how much is enough" is not as straightforward as it seems. Some basic parameters might include:

- Never fall below the average annual reserve expenditure.
- Maintain a funding balance of 60-70 percent of the fully funded balance.
- Update your reserve study on a regular basis.

Above all, you should freely discuss with your consultant any or all of the issues mentioned above so that you are actively managing your reserves rather than letting them manage you.