Frequently Asked Questions

Which components should be included in the Reserve Study?

There is a nationally standardized test to determine when an asset should be identified as a reserve component. To qualify, the component must be a common area maintenance responsibility for the Association, of material value, with a limited and predictable useful life. It should be noted however, that the inclusion or omission of certain components may be subject to the interpretation of governing documents, decisions by the Board of Directors, or legal opinion.

How are the replacement costs determined?

Strictly defined, the replacement cost is the estimated expense of repairing, replacing or refurbishing a reserve component at current year prices. From a practical standpoint, they are determined through a hierarchy of sources. First, and most accurate, are client records of recently completed projects, closely followed by current bids for work planned in the near future. Next is our in house database and finally national industry cost estimating guidebooks are consulted.

Replacement costs are highly sensitive to many variables including selection of materials and contractors, timing of work to be performed, accessibility issues, geographical and weather impacts, availability of labor, and economies of scale. Since variations in any of these factors can cause dramatic fluctuations in actual costs, the projected replacement costs are intended to provide a reasonable estimation for budgeting purposes. As the reserve components near the end of their useful lives and more specific information becomes available, replacement costs are adjusted to reflect additional data as well as decisions made by the Board Of Directors and/or management team.

How do you arrive at the projected reserve balances?

Ideally, your Reserve Study should coincide with your financial year-end. Since this requires advance preparation it becomes necessary to project the ending balance of available reserves. This is achieved by a simple accounting roll-forward, beginning with the reserves currently available, adding anticipated contributions and subtracting planned utilization to arrive at a projected year-end reserve balance (please refer to the schedule identified as “Projected Available Reserves”).

Once the Projected Available Reserve is established in aggregate form we must distribute them among the various components. This is accomplished formulaically within our software and is common among all reserve study providers. **Since our goal is the calculation of the optimum funding requirement this distribution may not coincide with your Balance Sheet or other financial statements on a line-by-line basis. This is typically corrected by a simple accounting entry at the end of the fiscal year**. It is also important to note that a “line item” mentality should be avoided. A needed repair or replacement project **should not** be postponed due to lack of available reserves **for that particular component**. Your accumulated cash reserves are a pool of resources, which are available at any time for any reserve component.

How is the monthly funding requirement calculated?

The calculation is performed by subtracting the available reserves from the current replacement cost and dividing the result by the remaining life of the component. A one-year remaining life indicates replacement within the next twelve months. A zero remaining life is never used. An underfunded reserve would trigger a calculated contribution which is higher than normal in order to improve financial strength over time. Conversely, an over funded condition would result in a suppressed funding requirement to absorb any excess over future years. As equilibrium is achieved contributions will return to normal levels.

It should be noted that these funding requirements reflect our recommendation as your consultant. Currently, there are no legal requirements that mandate the Association fund its reserves at any specific amount or maintain its reserves at any specific level. However, a Board must act in a manner it believes to be in the best interests of the Association, and with such care as an ordinarily prudent person would use under similar circumstances (the "business judgment rule"). **The Boards decisions should be made in compliance with such standards, and acted upon in accordance with their fiduciary responsibilities to the Association and its members**.

What is the Ideal Reserve?

One of the fundamental goals of reserve funding is to evenly replace physical assets with financial assets over the course of the anticipated life cycles of the components. The concept of an "Ideal Reserve" provides a benchmark to that end. Basically, the calculation is a simple straight-line depreciation model. The ideal reserve for each component is calculated by dividing the current replacement cost by the anticipated useful life and multiplying the result by the consumed life. If a component currently valued at $10,000 has a useful life of ten years we can estimate the annual wear, or the annual provision for the replacement fund at $1,000. By the end of year five, assuming no inflation, this component has accrued a liability of $5,000. This is commonly referred to as its "Ideal Reserve".

What does the percent funded calculation mean?

Reserve Study providers are statutorily mandated by the State of California to perform the percent funded calculation. It is simply a comparison of the total ideal reserve with the total accumulated reserve fund. Expressed as a percentage, it indicates a measure of the overall financial strength of the Association. To further the above example, if the Association had accumulated $5,000 in the reserve account by the end of the fifth year it would be "Fully Funded" or 100% funded to its Ideal Reserve. If however the reserve balance was only $2,500 at the end of the fifth year, the Association would be 50% Funded to its Ideal Reserve.

How high should our percent funded be?

It is generally considered optimum for an Association to be "Fully" or 100% Funded to its Ideal Reserve. When operating at or near this level cash flow problems are rare and the Association can absorb the inevitable bumps in the road without resulting in financial chaos. However, since each client is unique with a distinctive set of challenges and requirements the following "rule of thumb" is offered for consideration. A reserve fund in the 70% - 100% range is considered good, 30% - 69% fair, and 0% - 29% poor. Again, there are no current legal requirements that mandate the Association maintain its reserves at any specific level, **however, the Boards decisions should be made in compliance with the above mentioned standards, and acted upon in accordance with their fiduciary responsibilities to the Association and its members. A poorly funded Association may face serious consequences.**

How do we satisfy the reporting requirements for the Reserve Study portion of the Annual Budget?

Once the Reserve Study and Annual Budget are finalized simply include the Executive Summary from the Reserve Study and the proposed Assessment And Reserve Funding Disclosure Form (provided under separate cover) in the annual budget package.