AN EXPLANATION OF CAI'S RESERVE STUDY STANDARDS

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An Explanation of CAI's Reserve Study Standards

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ABOUT THE AUTHORS

Robert Browning, PCAM, RS, NV RSS, founded Browning Reserve Group in 1999 in Sacramento, Calif. The company now serves client communities in the western U.S. and is affiliated with Community Associations Institute and several of its chapters as well as the Association of Professional Reserve Analysts and the California Association of Community Managers. A former member of CAI's Board of Trustees, Browning is a past president of the CAI California North Chapter and the Foundation for Community Association Research and is an active member of CAI's California Legislative Action Committee, among other volunteer endeavors.

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FOREWORD

One of the primary responsibilities of any community association's board of directors is to protect, maintain, and manage the community's common elements (shared property). For major components with a long useful life, boards of directors must plan years in advance to accomplish this so funds are reserved and available when needed for repairs or replacement.

As reserve study professionals, the goal is to give client community associations the tools to anticipate and prepare for the repair and replacement of their common elements. CAI's *Reserve Study Standards* inform and guide the reserve study provider, such as a Reserve Specialist (RS™), with the minimum requirements necessary for the preparation of a reserve study and to provide consumers, including community association boards of directors and community association managers, with information to help navigate the reserve study and funding process.

The four sections here clarify the *Reserve Study Standards* to ensure their consistent interpretation and application and to illustrate terms that are used frequently in preparing reserve studies.

The purpose of this document is to offer a clarification and amplification of the *Reserve Study Standards* and to ensure the standards are interpreted and applied consistently, thereby benefitting all community associations and the community association industry.

Reserve Component Inventory

SELECTING RESERVE COMPONENTS

The component inventory is the foundation of every reserve study. It identifies which component replacement expenses are anticipated, when, and at what cost. For budget planning purposes, a consistent methodology is essential for an association to divide between operating expenses, reserve expenses, and expenses that fall outside these two categories, including capital improvements, insurable losses, true surprises, etc.

The following three-part test, clearly described in the *Reserve Study Standards*, identifies which components should be funded through reserves. According to the standards, an expense related to a component must meet all three criteria listed below to qualify as a reserve expense:

1. **Association obligation to maintain or replace.** The component must be the current financial responsibility of the association. These components are typically associated with the common elements as defined by the association's governing documents.

2. **The need and schedule can be reasonably anticipated.** The need and schedule for repair or replacement of the component does not have to be due to physical deterioration, but it may reach the end of its useful life due to aesthetics (out of style), economic obsolescence (no longer energy efficient), maintenance or inspection best practices, or other reasons.

3. **Total cost of the project must be "material" to the association, must be reasonably estimated, and includes all direct and related costs.** The reserve study professional must be able to reasonably estimate the cost for the entire component-related project. Being "material" means that the project expense must be more than what can be readily absorbed by the association's ongoing annual operating budget. If the projected expense is not knowable within a reasonable certainty after prudent research, then it fails this test.

Please see the Component Selection Guidelines in the standards document for further amplification and clarification. This three-part test helps all reserve study providers consistently identify the significant, predictable expenses for which the association should become financially prepared. If a project does not pass all three elements of this test, it should not be funded through the reserves portion of the association's budget.

Adhering to the test ensures a consistent approach and a stable budget planning platform, enhancing our credibility as an industry and minimizing our liability exposure.

MORE ABOUT USEFUL LIFE AND REMAINING USEFUL LIFE

We encourage review of the association's maintenance responsibility matrix, preventive maintenance manual, and its most recent structural integrity inspection report. Lack of regular preventive maintenance should reduce your estimates for useful life and remaining useful life, increasing reserve funding costs. The structural integrity inspection report will provide information about potential upcoming corrective maintenance projects outside the scope of your reserve study inspection. Please see the component selection guidelines found in the standards for additional information on these topics.

Minimum useful life. The standards do not define a "minimum useful life." Thus, identifying expenses occurring as frequently as annually (useful life = 1 year) as components is acceptable if, in your judgment, the client is best served by the expense being funded through the reserve portion of their budget. Note that some jurisdictions may provide additional guidance or restrictions on this matter.

Maximum useful life or remaining useful life. Although the standards require that reserve studies display a minimum 30 years of income and expenses, they do not dictate a maximum useful life[1] limit. Major projects, such as roofing, siding, elevator modernization, etc., may have useful life expectancies and remaining useful life expectancies in excess of 30 years. Homeowners enjoy lower reserve requirements when the cost of such large and expensive projects are spread over the entire useful life of a component rather than only the last 30 years[2]. But such distant projects (beyond 30 years) may fail your reasonable certainty test, so use your good judgment in this matter.

Remaining Useful Life (RUL or RL)
Per the definition of remaining useful life found in the standards, a project anticipated in the initial budget planning year of the reserve study should have a zero remaining useful life.

Also, there can be no negative RUL values. When a project needs to be accomplished, its RUL is zero. The RUL may stay at zero for multiple years if the client continues to defer the project, but it does not go negative.

Current Costs
The standards clearly stipulate in "life and valuation estimates" and other areas that repair and replacement costs that appear in the component list should be for the current year and include all related expenses the association should expect to complete the project — materials, labor, shipping, engineering and design, permits, installation, disposal, etc. While project costs may be adjusted for inflation in the funding plan, only current costs should appear in the reserve component list.

CAPITAL IMPROVEMENTS
The standards define a capital improvement as an addition to the common elements that previously did not exist. Because reserve funds are intended to provide for anticipated expenses related to the association's existing assets, inclusion of a capital improvement in the component list is inappropriate.

The standards do not prohibit that when a component is replaced, the new component may offer new materials and modular assemblies, advanced technology, energy-efficient systems, or need to change to serve an evolving membership demographic within the association. Replacing components "in like kind" is not always prudent. We encourage the use of good judgment in defining components that help the board protect, maintain, and improve the association for the good of the homeowners and their property values. While not stated in the standards, it is encouraged that consistent judgment be used among reserve providers in distinguishing between an acceptable upgrade and an inappropriate capital improvement by considering the following:

An expense meeting the three-part test may be defined as a reserve component if the new or different project:

- **Is incidental**, such as a nominal growth of an existing component, like replacing 16 pool-side chairs with 20 or adding a microwave during a clubhouse kitchen remodel.

- **Is a natural evolution.** This may be due to items, materials, or technology that was not previously available, like new weather-resistant decking surfaces, color video surveillance cameras instead of black and white, or replacing one 2 million BTU boiler with multiple smaller more energy-efficient boilers. It also may be due to a change that is appropriate for the community's evolving membership or neighborhood, such as installing

basketball backboards as part of a tennis court refurbishment to maximize usage of the asset. Note that it is not the reserve provider's role to dictate the client's evolutionary pace or course of action but to use good judgment to incorporate the obvious or accommodate the expressed intention of the board.

- **Is part of an existing asset or system**, such as replacing one modular 8-slip boat dock with a similar 12-slip unit or adding a new homeowner bypass lane to increase traffic efficiency when the entry control system of a large community is renovated.

Reserve funds should not be used for capital improvements, particularly when the project:

- **Is a discretionary change,** such as adding an extensive entry fountain where a fountain previously did not exist.

- **Has an entirely new purpose, use, or capability,** such as upgrading an old storage shed to a security office with bathroom.

- **Includes additions that are reducible** into smaller or separate component parts, like adding individual shade structures to each tennis court (because shade structures would qualify in the future as a reserve component, separate from a tennis court resurfacing project).

CONSTRUCTION DEFECTS

A reserve study assignment with an association that is involved in construction defect litigation can be complicated because the association may have engaged experts who have opined on construction issues outside the skill set of a reserve provider.

You should stay within your area of expertise and prepare your work product according to the standards and the scope of your assignment. Let the defect experts opine in their area of expertise, which may mean that life or cost estimates in your reserve study may differ from the defect experts' report about a specific component because of improper construction or installation.

It is a good idea to identify the affected components and litigation timeline and document your assumptions about what is being reconstructed, when the modification occurred, and what funds were used. For example, if you presume that construction defect settlement funds will be used to replace or rebuild a defective component, you can set the remaining useful life of the component and the next occurrence of the expense to occur after defect reconstruction. In most cases, the most effective way of handling these issues is for the reserve study to be regularly updated to reflect the transition settlement as it relates to the components.

TAXATION AND LOCAL LAWS

The Internal Revenue Service does not dictate how reserve studies are prepared or which components to include. Reserve studies should be prepared according to the standards, and association tax documents should be prepared per IRS regulations. After reviewing an association's reserve study, tax preparers may need to make some adjustments when preparing a tax filing for an association.

> "Reserve study providers have no obligation to prepare a reserve study in compliance with another industry's standards. Doing so may undermine the effectiveness and credibility of the reserve study and increase their liability exposure."

A reserve provider's work product should always meet local and state laws. In states that require a list of specific components, those lists should be considered minimum standards, not a checklist that defines an acceptable end result.

Please consult the client association's accountant or tax preparer if you have any concerns about component presentation. Keep in mind, however, that these professionals answer to their own industry standards, just as Reserve Specialists (RS™) answer to the standards. Reserve study providers have no obligation to prepare a reserve study in compliance with another industry's standards. Doing so may undermine the effectiveness and credibility of the reserve study and increase their liability exposure.

LET COMPONENT LISTS EVOLVE

As boards evolve, so do their philosophies, just as subsequent reserve providers may not always agree with their predecessors' judgments. We encourage readers to consider modifying component lists as needed during update engagements rather than only during a full reserve study engagement. In other words, allow for — and expect — minor differences in a reserve component list with update engagements in addition to components previously estimated to be over 30 years away now falling within that window. In the normal process of presenting a complete and effective reserve component list, consider the need to:

- Split or phase out some components.
- Improve the accuracy of some quantities as part of normal quality control.
- Add components that previously were overlooked or considered too far into the distant future.
- Reclassify a project from operating to reserves or vice versa.

Remember that the scope of work for a with-site-visit update includes component verification, not quantification, so there is no obligation to remeasure all components to the degree performed in a full reserve study.

Measurements Are Required

According to the required disclosures found in the standards (see #10), disclosure of measurements and quantities is required in every reserve study because of the disclosures' value to the board, association vendors, and the next reserve study provider.

NOTES

[1]Some states or jurisdictions require component lists to include components that are under a specific useful life or remaining useful life threshold. Rather than consider these to be limitations on which components to include, the authors encourage readers to use their best judgment to apply the three-part test to include components with a reasonably certain useful life or remaining useful life beyond the minimum requirement.

[2]In the financial analysis, the component method of developing a reserve fund plan will accommodate any useful life and remaining useful life values. The cash-flow method of developing a reserve fund plan can fund for components beyond the chosen 30-year window by funding toward a phantom proportional expenditure in the last year of the window or by funding toward a future fully funded balance target (the cash value of deterioration).

# # #

Calculating Percent Funded

To gauge an association's level of preparedness, the reserve balance can be evaluated in terms of cash or percent funded. Percent funded is the ratio between the actual (or projected) reserve fund balance and the value of deteriorated components. For anyone calculating percent funded in current or future years, this explanation can help ensure a consistent interpretation and application of the standards.

In the application to obtain the Reserve Specialist (RS™) designation, a sample work product (Appendix C) is required. The work product must contain a general statement or opinion describing the association's current reserve fund status in terms of cash or percent funded. Note that as one way to measure reserve fund size, calculation of percent funded is not associated with a particular funding method nor is it a measure of the adequacy of the reserve funding.

In addition, to its use in evaluating current reserve fund balance, percent funded also may be referenced as a funding objective or a way to measure progress through the years toward a funding objective.

"Percent funded also may be referenced as a funding objective or a way to measure progress through the years toward a funding objective."

Calculating Percent Funded

Calculating percent funded is a three-step process:

1. Calculate the fully funded balance (FFB) for each component.

   Note that per the standards, FFB = Current Cost X Effective Age/Useful Life.

2. Sum the individual component FFB values together for a property total (See figure 2 below.)

3. Divide the actual (or projected) total reserve balance by the property total FFB.

Percent funded should be calculated relative to the end of the fiscal year. Be clear in your report about your practice of using either the first or last day of the fiscal year. Because FFB and percent funded are annual values tied to the fiscal year end, they should not be recalculated mid-year.

Figure 1: Sample Reserve Component List

Component	UL	RUL	Cost
Pool Furniture - Replace	5	0	$4,600
Pool - Resurface	10	5	$10,000
Roof - Replace	20	18	$80,000
Asphalt - Seal	5	2	$5,000
Asphalt - Resurface	20	2	$25,000
Building - Repaint	10	1	$50,000
Elevator - Modernize	20	5	$80,000
Hallways - Refurbish	8	6	$24,000

Figure 2: Sample Fully Funded Balance Calculation

This figure shows the calculation of FFB for each component and the sum for the property total.

Component	UL	RUL	Cost	FFB
Pool Furniture - Replace	5	0	$4,600	$4,600
Pool - Resurface	10	5	$10,000	$5,000
Roof - Replace	20	18	$80,000	$8,000
Asphalt - Seal	5	2	$5,000	$3,000
Asphalt - Resurface	20	2	$25,000	$22,500
Building - Repaint	10	1	$50,000	$45,000
Elevator - Modernize	20	5	$80,000	$60,000
Hallways - Refurbish	8	6	$24,000	$6,000
				$154,100

Figure 3: Sample Percent Funded Calculations

At the point in time referenced in the reserve study, regardless of the funding method or contribution size, the FFB is $154,100. This figure demonstrates percent funded results with different reserve fund balances.

Reserve Fund	FFB	Pct Funded
$308,200	$154,100	200%
$154,100	$154,100	100%
$77,050	$154,100	50%
$15,460	$154,100	10%

Since the percent funded calculation is based on so many estimates, to avoid any inappropriate presumptions of high accuracy, we recommend presenting percent funded results to no more than one decimal place, i.e., 63.2 percent funded.

Future Year FFB Calculations

As a funding objective, or to measure progress toward a funding objective, one can calculate percent funded in future years. This requires a consistent way to calculate a future FFB to which the future reserve balance can be compared.

For consistency with the standards, FFB is always calculated using that current year's cost and effective age. While the effective age will naturally change in future-year projections, if inflation values are considered in the analysis, the "current cost" for those future years also will change.

To illustrate this concept, see Figure 4 below. It shows a projection of the component list in Figure 1 after one year with 3% inflation. Note that all components have been chronologically aged one year, one scheduled replacement (pool furniture) has occurred, and the current costs are slightly higher.

Figure 4: Sample One-Year Projected Reserve Component List

Component	UL	RUL	Cost
Pool Furniture - Replace	5	4	$4,740
Pool - Resurface	10	4	$10,300
Roof - Replace	20	17	$82,400
Asphalt - Seal	5	1	$5,150
Asphalt - Resurface	20	1	$25,750
Building - Repaint	10	0	$51,500
Elevator - Modernize	20	4	$82,400
Hallways - Refurbish	8	5	$24,720

Figure 5: Sample One-Year Projected FFB Calculation

The calculation of FFB, one year into the future, appears here.

Component	UL	RUL	Cost	FFB
Pool Furniture - Replace	5	4	$4,740	$948
Pool - Resurface	10	4	$10,300	$6,180
Roof - Replace	20	17	$82,400	$12,360
Asphalt - Seal	5	1	$5,150	$4,120
Asphalt - Resurface	20	1	$25,750	$24,463
Building - Repaint	10	0	$51,500	$51,500
Elevator - Modernize	20	4	$82,400	$65,920
Hallways - Refurbish	8	5	$24,720	$9,270
				$174,761

Similar projections are made in additional years to calculate future year FFB values. Consistent with the standards, percent funded in future years is calculated as the projected reserve balance in that future year divided by that year's projected FFB.

# # #

Reserve Funding Goals

Using consistent terminology, reserve study providers should describe clearly the goal of any funding plan shown in their reports. There are three funding goal choices: full funding, threshold funding, and baseline funding. One of the four funding principles listed in the standards is that sufficient funds exist when required. Different funding goals exist to describe the margin, if any, designed into a funding plan to mitigate the risk of having insufficient funds. With respect to reserve fund adequacy, the three funding goals are described below in the order of most aggressive to most conservative.

Baseline Funding

Establishing a reserve funding goal of allowing the reserve cash balance to approach but never be below zero during the cash flow projection. Since reserve cash balance is the numerator in percent-funded calculations, baseline funding also can be described as not allowing percent funded to drop below zero.

"It is increasingly rare for reserve providers to recommend that clients pursue a baseline funding goal."

Because a baseline goal defines a plan allowing an association to function with a minimal reserve cash balance, such associations risk deferred maintenance, special assessments, or loans as anticipated projects occur earlier or are more expensive than predicted. Because this type of plan can expose a client to significant risk of not having adequate cash when needed (one of the four funding principles listed in the standards), it is increasingly rare for reserve providers to recommend that clients pursue a baseline funding goal.

Threshold Funding

Establishing a reserve funding goal of keeping the reserve balance above a specified dollar or percent funded amount. While a threshold cannot be negative, it is possible for a threshold to be set above 100 percent funded, which would be more conservative than a full funding goal. Use of a threshold goal allows the reserve study professionals, board, or both to set a reserve-funding goal appropriate for the association.

Because threshold funding goals can be wide-ranging, the threshold should be clearly expressed. Two examples are:

- "Our goal is to have our reserve balance never fall below $100,000."
- "Our goal is to never drop below 50 percent funded."

When using a threshold goal, the reserve fund should attain and maintain the reserves of the association at or near the listed threshold.

The establishment of a threshold to "maintain the reserve fund above $0" (or 0 percent) should be described as a baseline plan, not threshold. Similarly, establishing a threshold to attain 100 percent funding should be described as a full funding plan, not threshold.

It is important not to confuse the percentage evaluation described above with the use of percentages in other ways such as certain banking institutions establishing a minimum funding level based on the community's total budget. It should be noted that while this minimum contribution amount may be used, it does not relate at all to the physical assets within a community and does not present a correct adequacy measurement.

In addition, while the use of arbitrary threshold values such as 5% or 10% of the total replacement cost may be used, it should be recognized that all communities are different and the use of the same measurement for all associations is not appropriate.

Full Funding

Setting a reserve funding goal to attain and maintain reserves at or near 100 percent funded. While the standards do not define a time period within which this goal is to be achieved, a stable and equitable multiyear funding plan should draw the association smoothly to the 100 percent level within the years projected in the reserve study. Minor variances in an association's percent funded status typically occur from year to year. Reserve providers should consider any association that is funded within a few percentage points from the 100 percent level to be fully funded.

"Reserve providers should consider any association that's funded within a few percentage points from the 100 percent level to be fully funded."

Computation Methodologies

Component method funding plans pursue a full funding goal, achieving that goal once every component project has occurred. Cash flow method funding plans offer greater flexibility for the reserve provider to guide the association toward full, threshold, or baseline goals. To facilitate percent funded-based full funding and threshold goals when using the cash flow methodology, refer to "Calculating Percent Funded" article above. It is a comprehensive guide to consistently calculating percent funded in the initial year and future years.

Reserve Providers as Leaders

Boards should be reminded often that they control the future of their associations. While there is value in multiyear stability, board philosophies — and thus funding goals — may evolve over time or as clients change their reserve study provider. Reserve providers should take leadership in presenting pros and cons of different funding goals and describe those funding goals in consistent terminology found in the standards.

# # #

Calculating Reserve Funding Plans

There are two calculation methods for developing a reserve funding plan: **component**, also known as "segregated" or "straight line," and **cash flow**, also known as "pooling." Each has its own strengths and weaknesses, as well as advocates and critics.

Both methods use the same component list, and thus both methods provide funds for the same project expenditures. Yet even with the same starting balance and the same expenditures, there may be significant differences in the funding recommendations calculated by the two methods, especially in the first few years due to reasons too numerous to explain in this short article. It is up to the reserve study professional to choose which method to use to meet the four funding principles found in the standards and the desired funding objective.

The concepts presented here are applicable to longer and more complex component lists. For simplicity, the examples do not include the effects of interest or inflation, although the standards require disclosure of the interest and inflation values used, zero or otherwise, in the funding plan.

Component Method

In this method, reserve funding requirements are calculated on an individual component basis. Those calculations are then added together to yield the recommended reserve funding rate. See Figure 1.

Figure 1. Sample Component Method Calculations

	UL	RUL	Cost	Reserve Balance	Reserve Needs	Funding Reqmts
Pool Furniture - Replace	5	0	$4,600	$4,000	$600	$600
Pool - Resurface	10	5	$10,000	$1,950	$8,050	$1,610
Roof - Replace	20	18	$80,000	$0	$80,000	$4,444
Asphalt - Seal	5	2	$5,000	$3,000	$2,000	$1,000
Asphalt - Resurface	20	2	$25,000	$22,500	$2,500	$1,250
Building - Repaint	10	1	$50,000	$45,000	$5,000	$5,000
Elevator - Modernize	20	5	$80,000	$0	$80,000	$16,000
Hallways - Refurbish	8	6	$24,000	$0	$24,000	$4,000
Total:				$76,450		$33,904

In this simple example, the existing reserve balance ($76,450) has been distributed among the components. The reserve needs, or the amount to be funded prior to the next occurrence of the expense, is the difference between the replacement cost and the reserve balance. Many variations of component funding plan calculations are possible based on how the existing reserve funds are distributed among the components and if interest and inflation are considered. But the key characteristic of a component method funding plan is the way separate but identical calculations are performed for each component and then summed together for the resulting recommendation.

Cash Flow Method

In this method, funding plans are tested against annual needs repeatedly until the desired funding objective is achieved. The nature of the cash flow method relies on choices made by the user rather than a fixed set of equations.

To illustrate this concept, consider the same component list, with expenses projected over the first seven years While this list is limited for illustration purposes, the reader should be reminded that a 30-year projection of income, expenses, and ending balance are required by the standards.

With the annual expenses now established, and with a known starting balance, a funding plan is developed to achieve the desired funding objective. For this illustration, the threshold is to maintain a cash balance in excess of a year's worth of reserve funding.

Figure 2. Sample Cash Flow Calculations

	Yr 0	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7
Pool Furniture - Replace	$4,600	$0	$0	$0	$0	$4,600	$0	$0
Pool - Resurface	$0	$0	$0	$0	$0	$10,000	$0	$0
Roof - Replace	$0	$0	$0	$0	$0	$0	$0	$0
Asphalt - Seal	$0	$0	$5,000	$0	$0	$0	$0	$5,000
Asphalt - Resurface	$0	$0	$25,000	$0	$0	$0	$0	$0
Building - Repaint	$0	$50,000	$0	$0	$0	$0	$0	$0
Elevator - Modernize	$0	$0	$0	$0	$0	$80,000	$0	$0
Hallways - Refurbish	$0	$0	$0	$0	$0	$0	$24,000	$0
Annual Total:	$4,600	$50,000	$30,000	$0	$0	$94,600	$24,000	$5,000

	Yr 0	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7
Beginning Reserve Bal	$76,450	$93,350	$64,850	$56,350	$77,850	$99,350	$26,250	$23,750
Annual Reserve Funding	$21,500	$21,500	$21,500	$21,500	$21,500	$21,500	$21,500	$21,500
Annual Expenses	$4,600	$50,000	$30,000	$0	$0	$94,600	$24,000	$5,000
Ending Balance	$93,350	$64,850	$56,350	$77,850	$99,350	$26,250	$23,750	$40,250

Two key characteristics of a cash flow method funding plan are:

- Funding is adjusted to achieve a particular funding objective.
- The composition of annual expenditure totals (whether one or many projects, whether roof or asphalt or elevator, etc.) are irrelevant.

Note that if the reserve study provider pursues a percent funded objective, annual percent funded values will be displayed through the years in addition to annual reserve cash values.

This article has been developed so reserve providers can consistently and clearly communicate their chosen methodology to their clients as required by the standards. With an effective multiyear funding plan, client associations should have the funds necessary to perform their reserve projects in a timely manner.

# # #

About Community Associations Institute

Since 1973, CAI has been the leading provider of resources and information for homeowners, volunteer board leaders, professional managers, and business professionals in the more than 365,000 homeowners associations, condominiums, and cooperatives in the United States and millions of communities worldwide. With more than 47,000 members, CAI works in partnership with 36 legislative action committees and 64 affiliated chapters within the U.S., Canada, the Middle East, and South Africa, as well as with housing leaders in several other countries, including Australia, Spain, and the United Kingdom. A global nonprofit 501(c)(6) organization, CAI is the foremost authority in community association management, governance, education, and advocacy. Our mission is to inspire professionalism, effective leadership, and responsible citizenship — ideals reflected in community associations that are preferred places to call home. Visit us at www.caionline.org and follow us @CAISocial.