

Budgeting For Adequate Reserves

It's budget time for many associations. Constructing an accurate operating budget is a fairly clear-cut procedure, since the operating budget includes those expenses which occur on an annual or greater frequency, no matter the size of the expense. Many of those costs are easily extrapolated from current financial statements or from new service contracts. The least understood, and most neglected part of the budgeting process, is the association's reserve fund. Arguably, the single largest problem facing community associations today is inadequate reserve funding.

Perhaps the most important duty of a community association is to maintain the condition, and preserve the value, of the homes and common property. To properly maintain the community, over the long term, associations must develop long range funding plans to provide for the inevitable replacement of the major structural components and infrastructure for which they are responsible. Reserve planning is every bit as important to a community association as a business plan is to a business; or a retirement plan is to most adults. Well maintained community associations don't just happen. They are planned. If you fail to plan, you have a plan for failure. Your association's reserve plan is, essentially, your business plan.

What Are Reserve Funds For?

Reserves are the money an association accrues over time to pay for future repairs and replacements

of those specific community assets which the association is responsible for. To identify how much money you should budget for reserves you must determine the projected future needs. You do this by conducting a reserve study.

There are two parts to a reserve study – a physical analysis and a financial analysis. During the physical analysis, a reserve provider evaluates information regarding the physical status and repair/replacement cost of the association's major common area components. To do so, the provider conducts a component inventory, a condition assessment, and establishes life and valuation estimates. The financial analysis assesses the condition of the association's reserve balance or "fund status" (measured in cash or as percent funded) to determine a recommendation for an adequate reserve contribution rate in the future known as the *funding plan*. It is this contribution amount that becomes your reserve line item in your budget.

How Much Is Adequate?

Webster's Dictionary defines the word adequate as being "sufficient for a specific requirement; also: barely sufficient or satisfactory". The definition for reserve is: "something reserved or set aside for a particular purpose, use, or reason; money or its equivalent kept in hand or set apart- usually to meet liabilities". So we might define adequate association reserves as: funds set aside, on a regular basis and in specified amounts, sufficient to meet the accruing liabilities and projected future expenses to fulfill

the association's legally defined obligations.

The Minnesota Common Interest Ownership Act, Statute 515B.3-114, states: "*The annual budgets of the association shall provide from year to year, on a cumulative basis, for adequate reserve funds to cover the replacement of those parts of the common elements and limited common elements which the association is obligated to maintain, repair, or replace...*" Your association governing documents probably contain similar language.

It should now be plainly evident that your reserve budget contributions cannot be arbitrarily selected. You must set aside specific amounts to meet specific objectives. Expenditures from your reserves should likewise be limited to those items for which the funds were reserved.

Is there a rule-of-thumb? No. How much reserve funding is adequate? Whatever it takes; but don't guess, do the math!

About the author:

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Other association reserve resources such as: GAP report #24, "Reserve Funding & Reserve Investment Strategies", the association leadership series video "Reserves" are available from the CAI bookstore. You can connect online through the Minnesota chapter website at www.cai-mn.com or www.caionline.org. The Minnesota Chapter offers periodic workshops and training on budgeting and reserves.