

Budgeting For Adequate Reserves...

If you fail to plan, you have a plan for failure.

A solid reserve budget is essential to your association's long-term success. Constructing an accurate operating budget is a fairly clear-cut procedure, since the operating budget includes those expenses that occur on an annual or greater frequency, no matter the size of the expense. You can readily extrapolate many of those costs 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 funding.

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 as the percent of accrued depreciation 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.

For example, the Minnesota Common Interest Ownership Act, statute 515B.3-1141, requires the association board budget adequate replacement reserve funds. Further, they are required to reevaluate the adequacy of their reserve funding at three-year intervals (minimum); fairly detailed information must be provided in resale disclosures and annual reports to the membership. Other states have varying requirements. Your association governing documents probably contain similar language.

Clearly, the association's reserve budget contributions cannot be arbitrarily selected. You must set aside specific minimum amounts to meet specific objectives. Expenditures from your reserve savings should likewise be limited to those items for which the funds are reserved.

Is there a rule-of-thumb for how much you should save? No.

How much reserve funding is adequate? Whatever it takes; but you cannot guess, you must do the math!

About the author:

Greg Pettersen holds credentials with both the Association of Professional Reserve Analysts and Community Associations Institute. He is president of Reserve Data Analysis, Inc. in Minneapolis, which is RDA's Midwest Regional Headquarters. You can reach him at (612)616-4817 or (866)780-7943.

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As consultants to property managers, accountants, attorneys and community associations, RDA focuses its expertise on the complexities of reserve funding and successful long term planning.

