

Otter Pond Homeowner's Association

Reserve Study Overview

Revised: January 10, 2025

Introduction

A Reserve Study consists of two parts: the Physical Analysis and the Financial Analysis of the HOA assets. The Physical Analysis includes developing and maintaining a list of all HOA common area assets. Each asset is known as a "Component". A Component is classified as required for "Reserves" if it meets the criteria of having an inflated replacement value of \$1600 or more and has a useful life of 30 years or less. A Component is classified as a "Future Reserve Component" if it meets the criteria of having an inflated replacement value of \$1600 or more but has a useful life greater than 30 years. The amount of reserve funding allotted to each reserve Component in any given year is based upon how much the Component has depreciated against its useful life in order to have sufficient funds to replace the Component once its useful life has expired. There are some Components that meet these criteria but because it is extremely unlikely the entire component will have to be replaced at once, it was concluded the Component should be classified as "Operational" since partial repairs or replacements are more likely. For example, Bank Rocks or sections of sidewalks.

In addition, components given classifications of "Operational" or "Annual Budget" should be considered under the Yearly Operating Budget. The classification of "Special Assessment" should be considered under the Special Assessment Budget. Components classified as "No Infrastructure" or "Unneeded Review" do not require any type of budget review.

The Financial Analysis contains an evaluation of the HOA's Reserve balance, as measured by the current percent funded, and then recommends a Funding Plan which would offset the anticipated Reserve needs and expenses.

The primary responsibility of the Board of Directors is to maintain, protect, and enhance the assets of the HOA as the physical assets age and require repair or replacement. It is important to maintain reserves by allocating funds annually against the depreciated life of a Component to minimize the need for Special Assessments. The Reserve Study is a document that helps keep physical and financial assets in balance, in addition to being a budget planning document. The primary information gained from this document is a list of the Reserve components, the current status (strength) of the Reserve Fund, and a recommended funding plan to support moving towards the full funding of the Reserve. The basic objective of the Reserve Study is to provide a plan to collect funds at a stable rate to offset the predicted Reserve expenses. Setting a stable Reserve contribution rate will help ensure that each homeowner pays their own "fair share" of the ongoing gradual deterioration of the common areas.

A HOA Reserve Study will help the HOA prepare for capital improvement projects. Unlike regular ongoing maintenance projects, which are fully funded by the annual budget, capital improvements generally are on a larger scale and have larger associated costs. For example, a roof repair can cost a few hundred dollars, but a roof replacement could cost thousands of dollars. It would not be feasible or practical to wait until a roof replacement was required and then pay for it out of the annual budget. The annual budget, most likely, would not be capable of making such a large expenditure. The Reserve Study is made to help the association anticipate and prepare for these larger capital improvement projects.

The Reserve Study starts with identifying and assessing the HOA's assets. This would include, in part, common areas and elements that the HOA is responsible for maintaining and repairing outside of the annual budget. The Reserve Study will look at and determine the current condition of the capital assets of the HOA and make an estimate of the remaining useful life of the asset and the cost associated with repairing or replacing the asset. This will allow the HOA to develop a timeline for saving adequate money/reserves to allow for a timely repair or replacement of the capital asset(s). The HOA Board will then determine if there is a need to increase the HOA dues or levy a special assessment.

The main purpose of the HOA Reserve Study is to try and ensure adequate resources are available to meet the capital needs of the association. With proper planning and an up-to-date reserve study, the HOA can protect the financial well-being of the association. The earlier the HOA plans for capital improvements, the smaller the financial burden will be for the homeowners.

Which Physical Assets are Covered by Reserves?

Reserve expenses are the larger, infrequent expenses that require significant advance planning. Operating expenses, on the other hand, are those ongoing daily, weekly, or monthly expenses that occur and recur throughout the year. Small surprises are typically handled as maintenance contingencies, while the larger ones may be covered by insurance or require a Special Assessment.

There is a national-standard four-part test to determine which expense items should be funded through Reserves. First, it must be a common area maintenance responsibility. Second, the component must have a limited life. Our HOA has determined a remaining useful life of no more than 30 years. Third, the limited life must be predictable (not a "surprise" which cannot be accurately anticipated). Fourth, the component must be above a minimum threshold cost. Our HOA has determined the cost to be \$1,600 or more. This limits the Reserve Components to major, predictable expenses. Most Reserve Studies do not typically Reserve for building foundations and major infrastructure elements since they do not have limited life expectancies. It is usually inappropriate to include unpredictable expenses such as damage due to fire, flood, or earthquake since these typically cannot be considered "reasonably predictable".

The Financial Analysis

A Reserve Component List is established to help determine the association's current Percent Funded and an appropriate Reserve Contribution Rate which would for a fully funded reserve. These two pieces of information are a major part of the Financial Analysis.

Computing the Percent Funded.

The Reserve Cash Balance can measure reserves, but the true measure is whether the funds are adequate for the needs of the association. Reserve Fund size is therefore measured by asking, "Is the Percent Funded (actual or projected) Reserve Balance, adequate to cover the deterioration based upon the age of each individual asset Reserve component?" The Fully Funded Balance (FFB) for each individual component is shown in the Reserve Study. To show how this works, let's assume that there is a \$10,000 component with a 10-year useful life that is three years old, the asset has deteriorated three-tenths of \$10,000, or \$3,000. The FFB must grow as the asset ages but shrinks as components are replaced. Deteriorated assets of a HOA have a higher FFB than an association with newer assets. The Fully Funded Balance changes each year can be predictable but is understood to be a moving target.

Special assessments and deferred maintenance are common when the Percent Funded is weak (below 30%). While the 100% point is ideal, a Reserve Fund above the 70% level should be considered "strong" because cash flow problems are somewhat lessened. Measuring the Reserves by Percent Funded tells how well prepared the HOA is for upcoming Reserve expenses. A HOA with a strong Reserve Fund should experience smooth sailing financially, while an HOA with a weak Reserve Fund should expect cash flow problems. The HOA members should be very aware of this important disclosure!

How much should we contribute?

There are four Funding Principles that should be balanced in developing our Reserve Funding Plan. First and foremost, the objective is to design a plan that provides us with sufficient cash to perform the required Reserve projects on time. A stable contribution rate is desirable because it indicates the association is being run on a stable financial platform, not being driven by the "winds" of change from year to year. For fairness, it is important to evenly distribute the contributions over the years, so each owner pays their fair share of the deterioration in direct proportion to the amount of time they are owners. And finally, any Funding Plan must be based on fiscally responsible principles. The funding plan selected should be done by a process where different solutions are tested until one is found to be the most successful in meeting all four of the above principles and which achieves the Funding Goal of the HOA.

What is the Funding Goal?

There are different Funding Goals to strive for, ranging from conservative to risky.

"Baseline Funding" means establishing a funding objective of keeping the Reserve cash balance above zero. The drawback is that there is little or no "margin for error" and expenses that are higher than budgeted or projects that occur earlier than planned, exposes an HOA to a high risk of Special Assessments.

"Full Funding" is when the HOA has the goal of becoming Fully Funded (Reserve Cash equals the FFB). Such an objective means the HOA is following the simple and responsible principle that you "replace what you use up". Believing this to be the responsible choice, this Funding Plan will direct a Full Funding approach. Fully Funded HOA's enjoy lower exposure to the risk of Special Assessments or deferred maintenance. Interest earnings may help to minimize the needed Reserve contributions. HOA members should be able to enjoy peace of mind that the HOA's physical and financial assets are in balance, and therefore a degree of insulation from claims of fiscal irresponsibility.

"Threshold Funding" is an option that is different in that the HOA selects a target other than 0% or 100%. The objective is to fund somewhere between 0% or 100%. This method is utilized when an HOA determines being Fully Funding is not necessary. By having some funding, the HOA is willing to defer required asset replacement when an asset outlives its useful life or issue Special Assessments that are less than 100% of the expense because they can allocate a portion of the overall Reserve Fund to help offset the total expense.

Projected Expenses

While this Reserve Study looks forward 5 years, we have no expectation that all these expenses will take place as anticipated. This Reserve Study needs to be updated annually because it is expected that the timing of these expenses will shift and the size of these expenses, over time, may differ materially from what is anticipated. There is more certainty of the timing and cost of near-term expenses than those expenses which are many years away. The projection was limited to a horizon of 5 years. As we mature with the process, our plan is to evaluate even further ahead.