



“Serving the citizens of Montgomery County residing in Common Ownership Communities since 1991”

Workshop “Is Your Community Prepared for Unexpected Costs?” for Common Interest Community Owners in Montgomery County

Presented to the residents of Montgomery County District 1

Presenters:

Mark Fine, Chairman, Montgomery County C.C.O.C.

Staci M. Gelfound, CMCA, AMS, PCAM, Vice Chair, Education Committee Chair

John D. Smith, Vice Chair – Education Committee, Commissioner

Linda S. Moore, PhD, Vice Chair – Education Committee, Commissioner

Terry Anderson, CMCA, AMS, Commissioner

Donald Perper, CMCA, PCAM, Commissioner

Cheryl Walker, CMCA, AMS, PCAM, Commissioner



Welcome and Introductions

- **Councilmember Andrew Friedson**
 - Representing western and southwestern Montgomery County from the D.C. line to the Frederick County border
 - Serves on the **Planning, Housing, & Economic Development** and the **Government Operations & Fiscal Policy Committees**.
 - Named **Best County Freshman Legislator of 2019**
 - Listed as one of **Maryland's 2019 Political Winners** as "the economic and fiscal center of the Montgomery County Council", and among Montgomery County's most influential political figures.
 - Recipient of the **2019 Phyllis Campbell Newsome Public Policy Leadership Award** from the Center for Nonprofit Advancement.
 - Prior to joining the Council, Andrew served as senior policy advisor and deputy chief of staff to the Comptroller of Maryland.

Agenda



WHAT ARE RESERVES, WHAT IS A RESERVE STUDY, AND WHY IS A STUDY NEEDED?



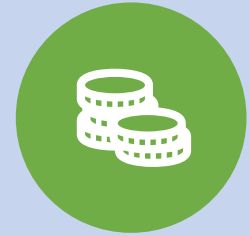
LEVELS OF RESERVE STUDIES AND HOW TO PERFORM A RESERVE STUDY



FUNDING RESERVES AND WHAT IS FULLY FUNDED?



IMPLEMENTING A RESERVE PLAN



PAYING FOR RESERVE PROJECTS WHEN RESERVE FUNDS ARE INADEQUATE

What are reserves?



A reserve fund is a budgeted portion of assessments collected from owners. Funds in reserve are set aside for paying the costs to repair and replace capital components when the need arises.



Reserves are intended to equitably distribute the cost of maintaining capital components over time. In a perfectly-funded system, each owner pays their “fair share” for the use of the property during their time of ownership in the community.

Why Contribute to Reserves Yearly?



Properly-funded reserves minimize the chance of having special assessments or loans to pay for repairing or replacing capital components.



With properly-funded reserves, the large costs of maintaining capital components can be evenly spread over time, making assessments more predictable.

What is a reserve study?

- Capital budget planning tool used to determine the physical status and repair or replacement cost of capital components and an analysis of an association's funding capacity to maintain, repair and replace capital components.



RESERVE STUDY



What is a reserve study?



Not a spending plan.



Not a prescription for the community.

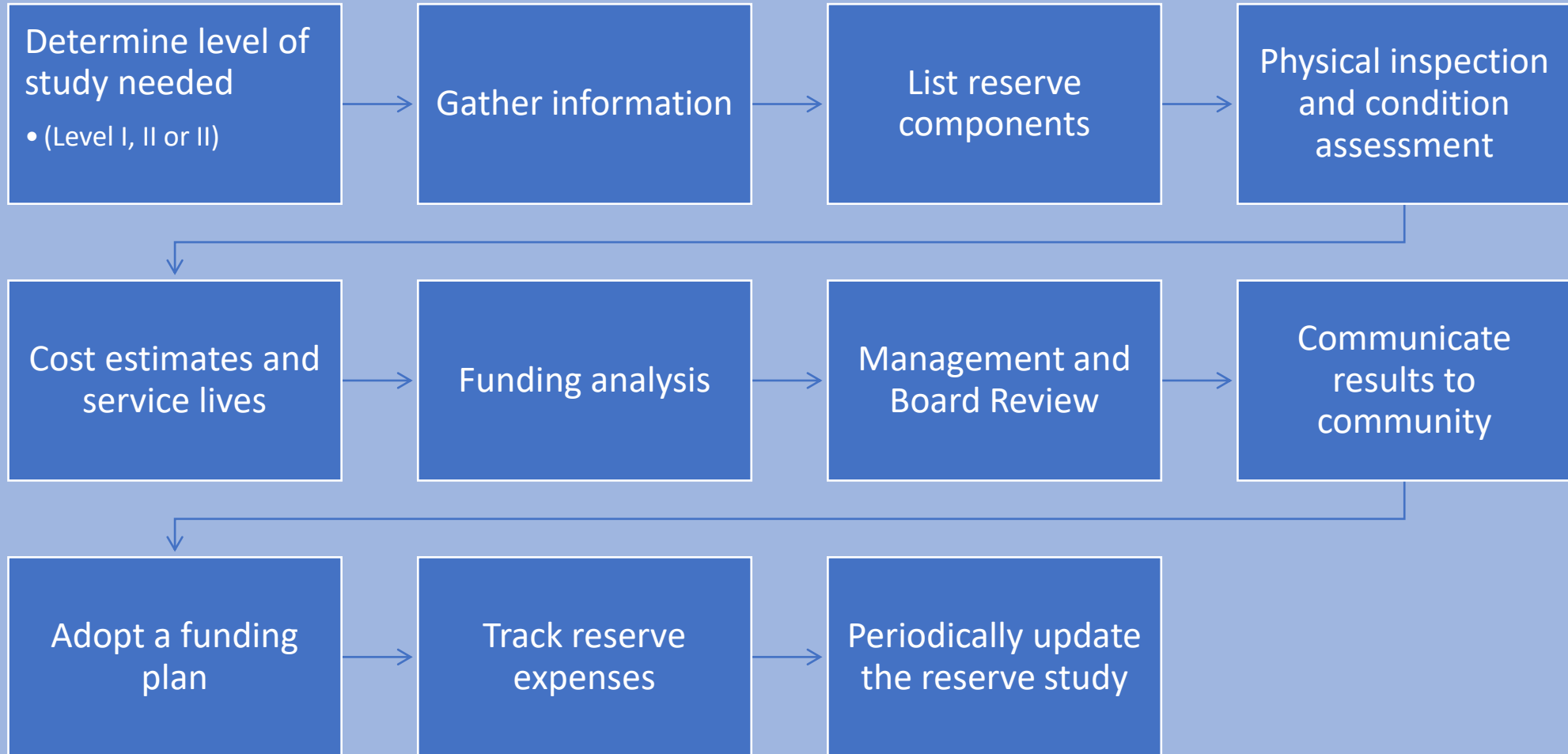


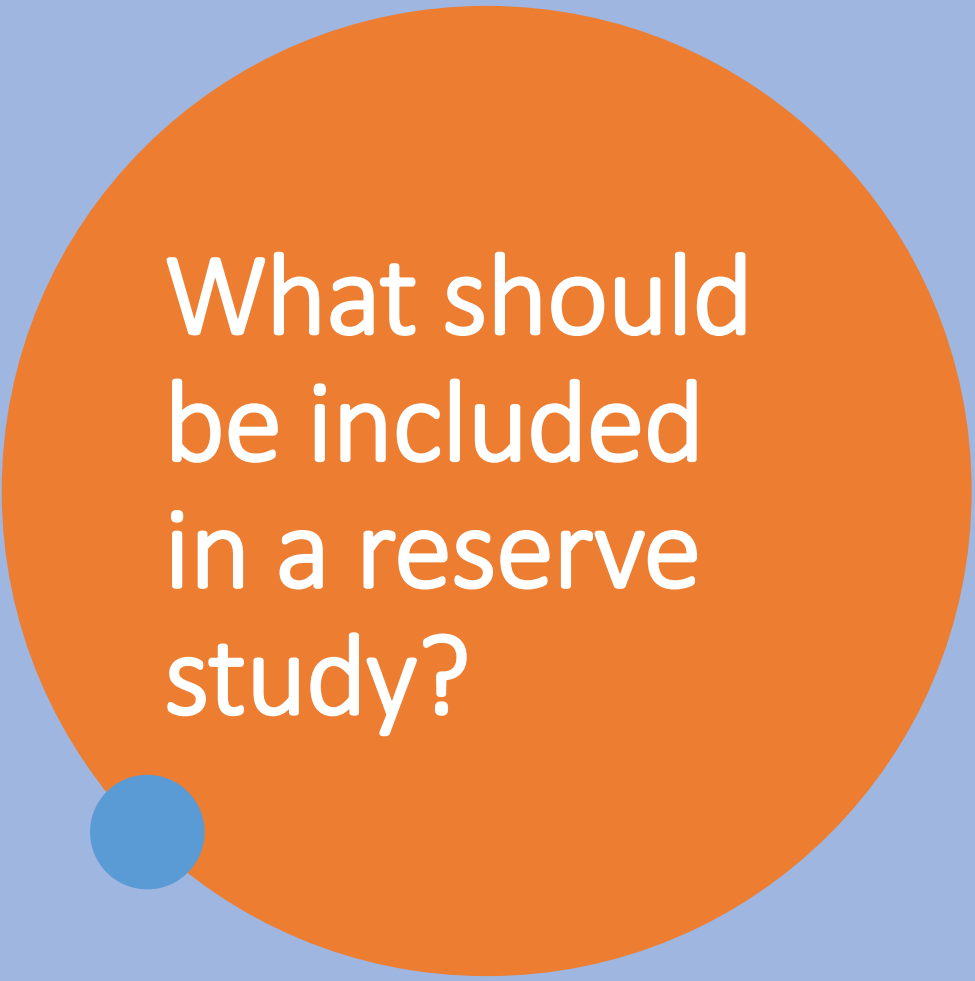
Provides a rational basis for budget planning.




- *The Board is the only entity that has the authority to decide on funding reserves.*

The Reserve Study Process





What should be included in a reserve study?

- 
- *Include:*
 - Capital items
 - Large projects that do not occur every year
 - *Do not include:*
 - Small projects
 - Items funded through the operating budget



Capital Components and Taxes

- Reserve assessments are used by most properties to collect funds for capital components and large projects that do not frequently occur.
- Example – Hallway redecoration projects are usually funded through reserve assessments even though “decorations” are not considered a “capital component” for tax purposes.
- Reserve assessments are a means of leveling out the assessments for such items. When the expenses are incurred, the accountant will decide how to treat the expense for tax purposes. Properties have different methods of accounting to handle these expenses.

Basic Property Information

- Number of units
- Number of buildings
- Year property built
- Year converted to condominium



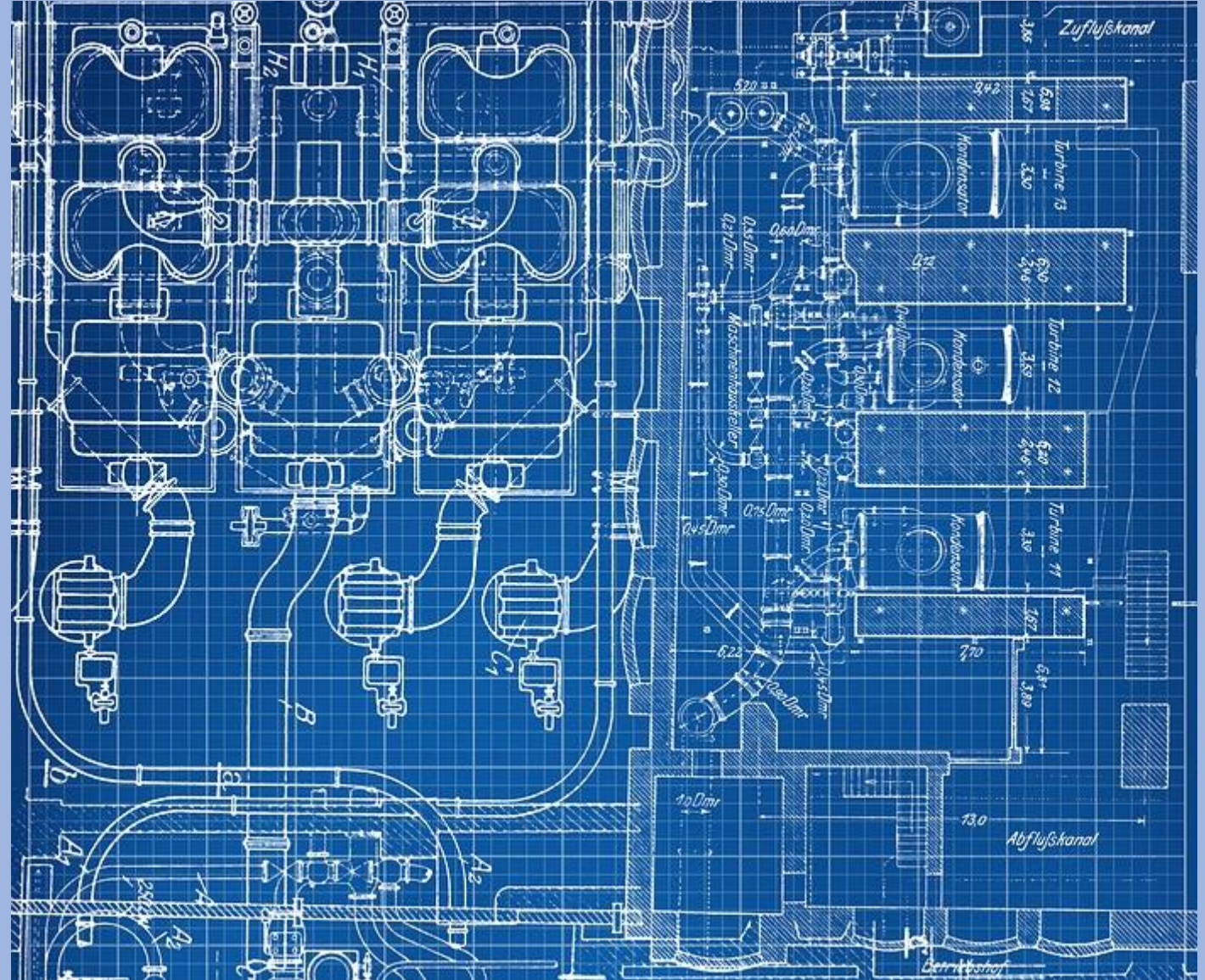
Chart Of Maintenance, Repair And Replacement Responsibilities

- Common elements
- Limited common elements
- Homeowner items
- Other entities



Drawings, Blueprints, Plats

- Plats – show property boundaries
- Site plans – show utilities, pavement, storm drain, etc.
- Design drawings or blueprints – property construction details
- Many properties do not have drawings that show construction details. This can limit the reserve analyst's understanding of the property.



Previous Reports



Previous reserve studies – this helps the reserve analyst understand the context for the current study.



Condition assessment reports – reports by technical specialists provides the best condition assessment at complex buildings.



Contractor proposals for projects. These help to improve the accuracy of cost estimates.



Maintenance contracts – can help with the condition assessment



Financial Information

- Current amount in the reserve fund (usually on the balance sheet)
- Budgeted current assessment for reserves (usually in the budget)
- What inflation rate to use?
- Is interest returned to reserves? What rate to use?



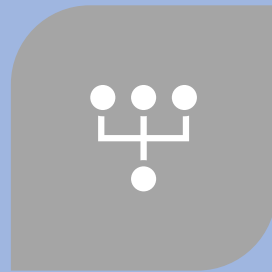
History of Reserve Expenses

- Recently completed projects funded through reserves
- History of reserve expenses
- An accurate and complete history of reserve expenses is one of the most useful tools for improving the accuracy of budget forecasting.

Information About the Community's Plans and Concerns



PLANNED PROJECTS TO BE FUNDED
THROUGH RESERVES



DOES MANAGEMENT HAVE A
SEPARATE RESERVE PROJECT LIST
APART FROM THE RESERVE STUDY?
IT SHOULD BE SHARED WITH THE
RESERVE ANALYST.



SPECIAL CONCERNS TO BE
ADDRESSED DURING STUDY



ARE THERE COMMITTEE
RECOMMENDATIONS THAT SHOULD
BE ADDRESSED?

Common Challenges in Preparing for the Reserve Study



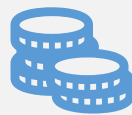
No history of previous projects, timing, and costs



Ambiguous allocation of maintenance, repair, replacement responsibilities



Conflicting objectives



Distinguishing reserve and operating budget items

Common Challenges in Preparing for the Reserve Study (continued)



How to handle information from contractors



Components that were not in the previous study



Differing opinions between last and current studies



Helping Board members to understand the study

Physical Inspection of the Property and Condition Assessment



Person knowledgeable about the property should accompany the reserve analyst



Inspect all common areas



Challenges in inspecting roofs



Challenges in inspecting balconies and decks

Cost Estimates



Best information is cost history from the property



Reference sources



Contractor estimates



Phased projects



Design and project management costs

Service Lives



Best information is property history



Reference sources

Funding Analysis – Calculation Methods

Component Method

Accrued Value

Baseline Funding Cash Flow

Threshold Funding Cash Flow

Component Method

Sometimes called Straight Line Method



Assessment = cost / service life



Example: \$10,000 replacement cost with 10-year service life, assessment = \$1,000 per year



Add assessments for all components for total annual assessment

Accrued value Similar to component method

Accrued fund balance for each component is:
(replacement cost/service life) * years in
service

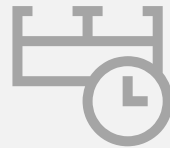
Example, \$10,000 replacement cost with 10
year service life, assessment = \$1,000 per year.
In third year of service, the fund balance for
that component should be \$3,000

Add accrued values for all components.
Percent funded is: actual fund balance/total
calculated accrued value

Baseline Funding – Cash Flow



Use cost estimates and service lives to generate projected total costs by year.



Select a study period.

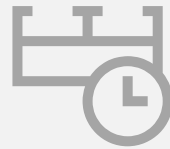


Start with current assessment and current fund balance, calculate a stream of assessments that will fund all costs during the study period.

Threshold Funding - Cash Flow



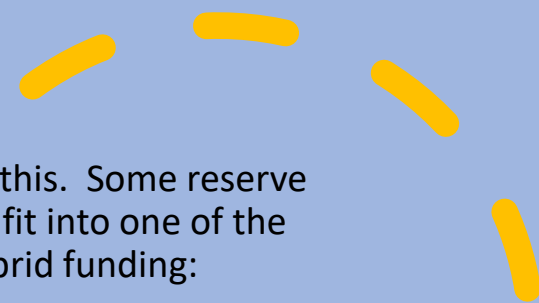
Use cost estimates and service lives to generate projected total costs by year.



Select a study period.



Start with current assessment and current fund balance, calculate a stream of assessments that will fund all costs and maintain a specified minimum fund balance during the study period.



What is the “hybrid” funding method?

- There is no generally accepted definition for this. Some reserve analysts show funding plans that do not exactly fit into one of the standard models. An example description of hybrid funding:
 - *Alternative Funding Analysis, Cash Flow Method, Hybrid Approach.* This plan provides the annual contributions necessary to maintain balances more consistent with the fully funded goal by increasing the annual contribution to specified amount next year and providing an annual escalation factor matching inflation thereafter. This plan allows for a gradual increase over time after the initial increase, and addresses generational equity issues.
- This is a cash flow analysis with non-uniform annual assessment increases.

Funding Methods – Comments & Limitations

- **Component method** – not often used.
- **Accrued value** – the method favored by the Virginia Common Interest Community Board guidelines, but is almost never used because it requires very large reserve fund balances to be fully funded.
- **Baseline cash flow** – most commonly used method.
- **Threshold cash flow** – second most commonly used method.
- **Hybrid** – since there is no accepted definition, it means whatever the reserve analyst says – read carefully

Fully Funded Reserves

- There is no generally accepted definition. It depends on how the reserve calculations are done and what the funding objectives are.
- Funding calculations (and consequently the definition of “full funding”) are dependent on the following factors:
 - Study period
 - Components included in the reserve calculation
 - Component cost estimates and service lives
 - Treatment of interest and inflation
 - History of assessments and expenses

Possible definitions of full funding

- Component Method – the assessment equals the sum of all of the component assessments
- Accrued Value – the reserve fund has the cumulative value of all of the accrued values for each component. This is a very difficult standard to meet.
- Baseline Funding Cash Flow – the reserve fund balance at the end of the year never goes to zero during the study period.
- Threshold Funding Cash Flow - the reserve fund balance at the end of the year never goes below the chosen threshold value during the study period.

What about inflation?

- Inflation can be incorporated into any of the funding analysis methods.
- Including inflation makes the numbers larger.
- Strongly recommended to include inflation.
- The assumed inflation rate is not critical, provided periodic reviews are done to update plan as circumstances change.

What about components with long service lives?

- Nothing lasts forever – the study should be clear about what items are excluded.
- Typical exclusions:
 - Complete replacement of structural components
 - Upgrades in systems to comply with future building code changes that may occur

What about new components?

- There are often new improvements that are planned for addition to the community.
- Common examples:
 - Electric vehicle charging stations
 - Solar panels
 - New fitness center
 - Conversion of recreational court to other use
- These can be addressed in a reserve study but the reserve analyst needs to understand the plan, timing, and budget costs.



What is the difference between reserve items and operating budget items?



Reserve items typically do not happen every year



Operating items are often contract service and routine maintenance that is done annually



The dollar value is also a concern – most properties choose threshold cost to distinguish reserve and operating items.



Often it is a question of how management wants to arrange the budget.

What is the difference between replacement reserves and operating reserves?



Replacement reserves are for capital items – however you define that term for your property.



Some properties have operating reserves to use as a buffer for unforeseen or unbudgeted repairs that exceed a certain threshold cost.

Can large projects be shown and phased over time and does this help reserve funding?

- Some large projects are often done in phases over multiple years for physical reasons. Examples:
 - Pipe replacement
 - Electric system replacement
 - Fire alarm system renovation
- Modeling these as phased projects in a cash flow analysis can be a helpful way of easing the pain of assessments when these large projects are done.

What does it mean to finalize a reserve study?

- The Board has sole authority for deciding reserves and assessments.
- A reserve report is only a reserve analyst's opinion.
- If a reserve study is done properly, it should incorporate the community's objectives and preferences, as communicated through the Board to the reserve analyst.
- When a reserve study is accepted as final, it only means that the Board is satisfied with the work product as it stands. It does not obligate the Board or the community to follow the reserve plan.

What if the Board and the reserve analyst cannot agree?

- Since a reserve study is only the reserve analyst's opinion based on a specific set of circumstances at a particular time, there is no single correct solution.
- The Board has the final say since they have the sole authority.
- If the reserve analyst disagrees with the Board so strongly that they will not endorse the Board's opinion, then the report may need to rest as a draft and not be finalized.
- If the Board cannot agree among themselves on a report, then the report may need to rest as a draft and not be finalized.

Implementing A Reserve Plan

Management review

Board review

Make adjustments with the reserve analyst to meet community objectives and preferences

Draft report to present to community

Incorporate community feedback into final report

Reserve study updates

- Types of reserve studies:
 - New reserve study – start from scratch
 - Update with site visit
 - Update without site visit
- Generally updates are done when the same reserve analyst updates the study.

When should a completely new reserve study be performed?

- If the Board has confidence in the reserve analyst's assessment, then continuing with the same analyst and doing updates is acceptable.
- If there is a loss of confidence between the Board and reserve analyst, then a new reserve study should be considered.
- If there are major changes in a property's circumstances, such as a major renovation or restoration after a large loss, then a new reserve study should be considered.

How often should reserve studies be updated?

- Generally accepted practice is to update every 5 years unless circumstances suggest that they be done more frequently.
- If the property is undergoing a series of major, costly projects, then more frequent updates can be helpful.
- If circumstances change dramatically at a property, then an update should be considered.

Why are reserve studies needed for a new property?



Reserves are most effective and least burdensome when fund accumulation starts early.



The idea of reserves is to provide an equitable distribution of capital costs over all owners over all time. This can only happen if reserves start as soon as the property is occupied.

What happens if current assessments are low and a large increase is needed?



Have a clear understanding of the need so that it can be clearly communicated to the community.



Discuss optional funding plans.



Discuss deferring large projects or phasing projects if this can be done without compromising safety or the community's objectives.



Remember that the reserve report is only an opinion. Get a second opinion if it seems advisable.

What are the options for raising funds when reserves are insufficient and assessments are too low?



LOANS – THERE ARE MANY BANKS EXPERIENCED IN WORKING WITH COMMUNITY ASSOCIATIONS.



SPECIAL ASSESSMENTS – THESE ARE UNPOPULAR BUT SOMETIMES NECESSARY.

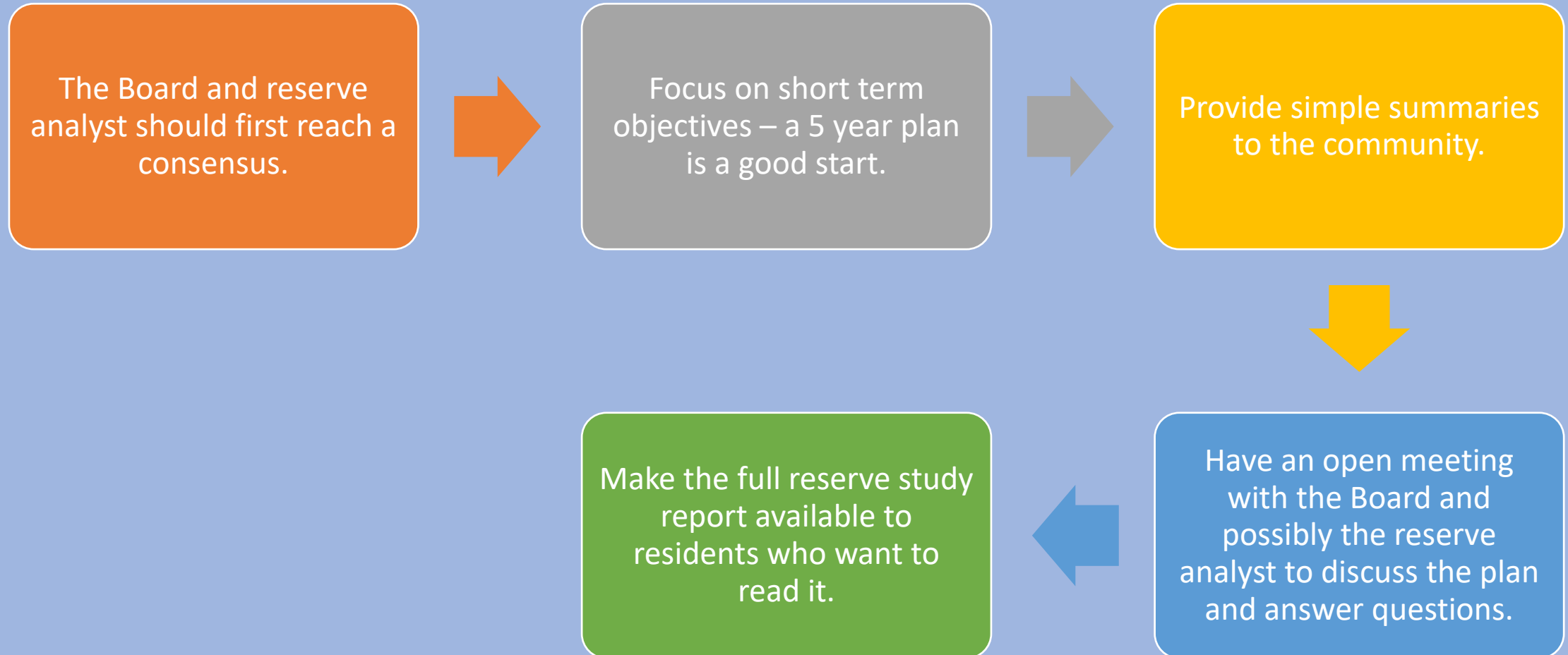


RAISING ASSESSMENTS GRADUALLY OVER TIME – THIS IS A GOOD OPTION IF THERE ARE SEVERAL YEARS BEFORE THE PROJECTED BIG CRUNCH.



A COMBINATION OF ALL OF THESE APPROACHES – GIVES HOMEOWNERS OPTIONS

Effectively communicating the reserve plan to the community



Tracking Reserve Expenses



It is important to keep track of reserve expenses over time. Knowing the history makes budget forecasting much better.



Track expenses on an ongoing basis in a spreadsheet and provide this to the reserve analyst.

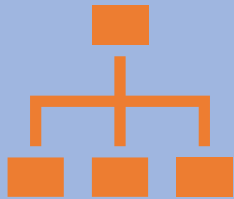


Relying on the general ledger report to track reserve expenses has proven not to work well.

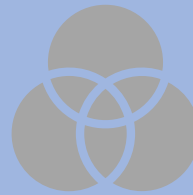


It helps if the tracking system items and reserve items match. Before doing a reserve study, discuss the structure of the report with the analyst so that adjustments can be made up front.

Annual Review of Reserves



The Board and management should review reserves each year.



Compare objectives with actual expenses and assessments.



Consult with the reserve analyst if there are major changes in circumstance or large discrepancies.