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# **CLEARING UP THE CONFUSION**

*Regarding*

**Reserve Study Funding Methods  
Percent Funded  
Adequate Funding  
Developer Transition Funding**

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## **I. RESPONSIBILITY**

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The Board of Directors (whether pre-transition developer members or post-transition homeowner members) of an association has a legal and fiduciary duty to maintain the community finances in a state which will allow for the ongoing and future maintenance of the community at a quality level (often referred to as the standard to which the developer originally built the community). Individual unit property values are significantly impacted by the level of maintenance and upkeep provided by the association as a part of the regular annual assessment charged to each owner.

## **II. PLANNING**

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While the annual operating budget is designed to address the “ongoing” annual expenses of an association, a prudent plan must be implemented to address the issues of long-range maintenance, repair and replacement of the common elements.

There is a fine line between “not enough,” “just right” and “too much” when it comes to member contributions. Each member of an association should contribute to the reserve fund for their proportionate amount of “depreciation” (or “use”) of those components defined as the “reserve components”. Through time, if each owner contributes his “fair share” into the reserve fund for the depreciation of the reserve components, then the possibility of large increases in regular assessments, reserve assessments or special assessments will be minimized or eliminated other than in those cases of unexpected or unplanned emergencies. In some states, like Nevada, “special assessments” are restricted to defined situations. The practice of using special assessments as a way of eliminating regular assessment increases is illegal. The attitude that “I won’t be here anyway so let the future residents pay for it,” never was acceptable for a board member and is now against the law in Nevada.

In order for the reserve analysis to be useful, it must also be understandable by a variety of individuals. Board members (from seasoned, experienced Board members to new Board members), community managers, accountants, attorneys and even homeowners may review and should be able to understand the basics of the reserve study. The reserve study must be detailed enough to provide a comprehensive analysis, yet clear enough to enable less experienced individuals to understand the results.

## **III. FUNDING METHODS**

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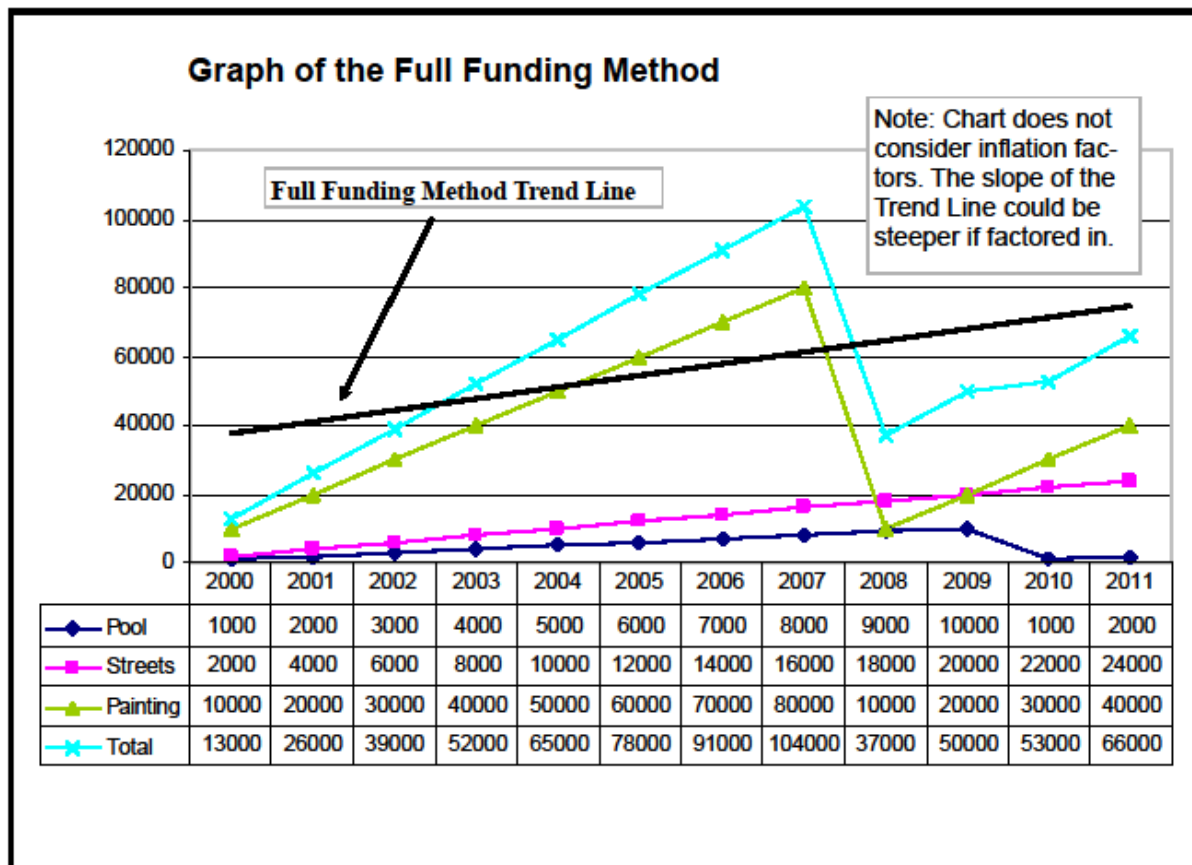
There are only three true calculation methods used for projecting future reserve requirements. Some articles in trade publications seem to indicate that there are dozens of “unique” and different reserve calculation methods (i.e. component, cash flow, pooling, front-loading, splitting, etc.). Most “unique” calculation methods are actually hybrid derivatives of either the full funding (also known as the component method), threshold funding or baseline funding.

## Full Funding Method – (Also known as the “Component” Method or “Straight Line” Method)

This calculation method develops a funding plan for each individual reserve component included in the reserve analysis. The sum of the funding plans for each component equals the total funding plan for the association and is typically the most conservative method and targets a funding goal of 100% (see next page for explanation). It structures a funding plan which enables the association to pay all reserve expenditures as they come due, enables the association to achieve the ideal level of reserves in time, and then enables the association to maintain the ideal level of reserves through time. It generally allows for variations in the plan without sacrificing maintenance requirements or risking inadequate fund levels.

One of the major benefits of using this calculation method is that for any single component (or group of components), the accumulated balance and reserve funding can be reported. For example, using this calculation method, the reserve analysis can indicate the amount of current reserve funds “in the bank” for the roofs and the amount of money being funded towards the roofs each month. Using other calculation methods, this information cannot be calculated and therefore, cannot be reported.

The following is an example of the Full Funding Method:



As an example of employing the Full Funding Method in the graph above, if an association needs to accumulate \$10,000 in ten years for swimming pool re-plastering, \$1,000 should be contributed each year to the reserve fund. Typically an inflation factor is also factored in to the contribution for components each year causing the overall contribution level to climb at a rate equal to the inflation factor.

Matching the Annual Contribution Increase to the Inflation Parameter indicates, in theory, that Member Contributions should increase at the same rate as the cost of living (Inflation Parameter) as is applied to the projected costs. Due to the “time value of money,” this creates the most equitable distribution of Member Contributions through time.

Notice, in the above figure, that each component can be graphed on a separate line and at any point in time, the reserve amount for that component, which should be accumulated for that period of time, can be observed. The Total Line is the summation of each of the individual component fund levels at any point in time. The Trend Line does not reflect the inflation factor. It also considers starting with a zero fund balance.

### **Baseline Funding Method**

This calculation method develops a funding plan based on current reserve funds and projected expenditures during a “window,” typically 30 years or less.

This calculation method is not conservative and will typically produce a lower monthly reserve contribution. This method structures a funding plan that attempts to create a scenario which enables the association to pay for all reserve expenditures as they come due, but it is not concerned with the ideal level of reserves through time. Consequently, this funding method can allow an association to become increasingly under-funded, while appearing to never run completely out of money during the “window.” It is also vulnerable to any changes in the initial “assumptions.” These assumptions include the inflation, component life cycles, level of maintenance, costs of maintenance, environmental issues, changes in board maintenance philosophy, utility costs, etc.

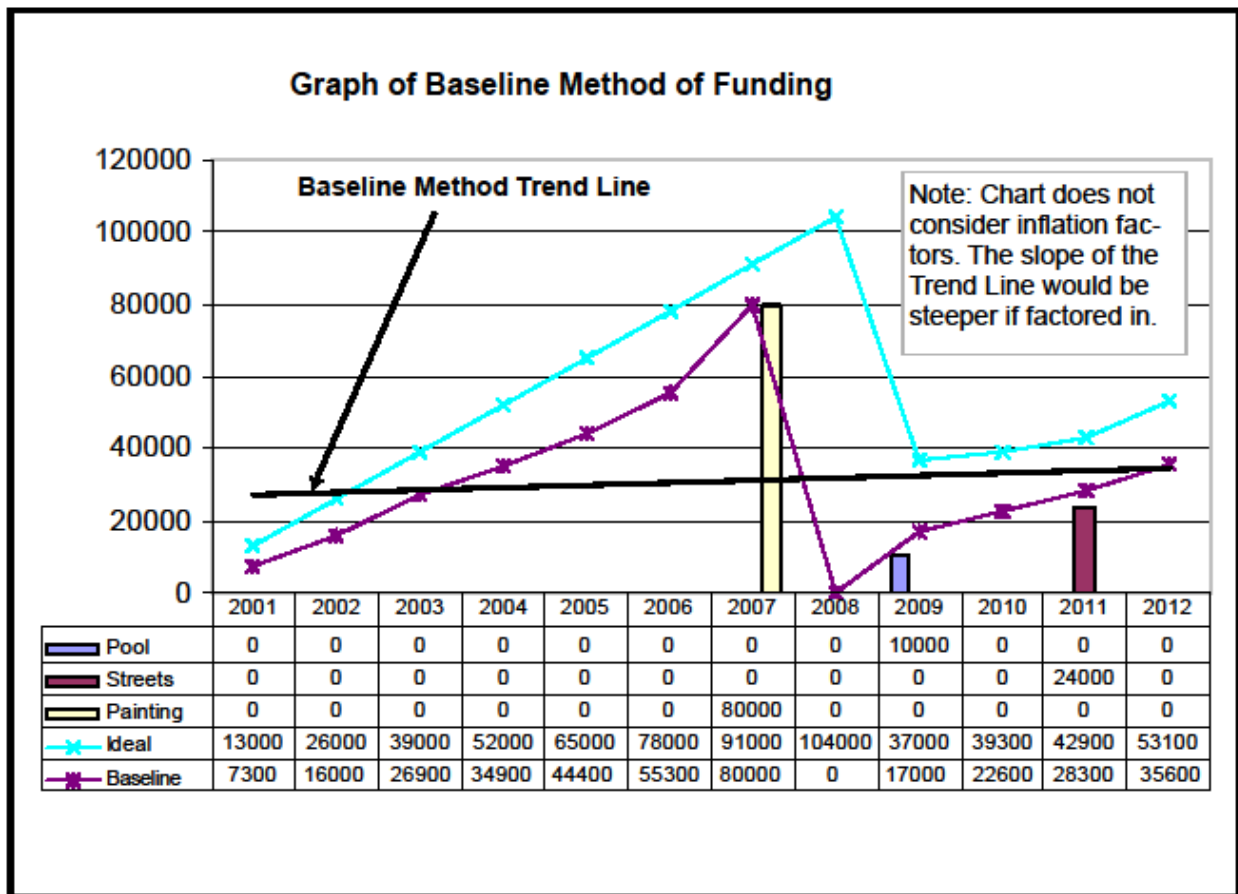
This calculation method structures a funding plan that estimates the “bare” minimum required to pay for all reserve expenditures as they come due during the “window.” This method disregards components that do not have an expenditure associated with them during the “window.” This method tests reserve contributions to determine the minimum contribution necessary, based on the association's beginning reserve balance and anticipated expenses throughout the window, so that the reserve balance in any one year does not drop below \$0 (but will, in fact, reach \$0 in one or more years).

Taking the same components shown in the Component Method chart, we will attempt to show how funding using the Baseline Method might appear. Again, the same condition exists in this graph as in the Component Method chart with regard to inflation factors.

Notice, in the graph below, that each component cannot be graphed on a separate line,

which allowed in the former example, for the reader to observe the fund amount for each component that should have been accumulated to that period of time. What it shows is where expenses occur over the timeline and a fund balance (the Total Line) required in order to minimally meet each upcoming expense. (Note: The Trend Line does not reflect the inflation factor. It also considers starting with a zero fund balance.)

This method of funding does not consider the actuality of an expense existing in the 31st year which may be considerable or the fact that expenses may fall earlier than predicted. As Nevada only requires a “New” Study at least every 5 years, the impact of pulling significant expense items in to the “window” could be significant to the overall assessment level each time the study is updated or “redone”.



### Threshold Funding Method

The third calculation method is a hybrid of the Full Funding and Baseline Method which enables the development of funding plans which may include, % funded thresholds or minimum reserve balance thresholds.

This method can be initiated using the results of the Full Funding Method or the results of the Baseline Method. Depending on which method you start with (Full or Baseline) it may only consider reserve expenditures during the “window.” This calculation method

can be used to calculate a reserve contribution that enables an association which may currently be in a poor financial state to become "Ideally Funded" at a predictable point in the near future.

## **Custom Funding**

Setting up a custom funding plan (typically a hybrid of any of the three fundamental methods) enables the development of "custom" or "non-traditional" funding plans which may also include, leveled contribution periods, deferred contributions or special assessments.

This practice can also be initiated using the results of the Full Funding Method or the Baseline Method. Depending on which method you start with it may only consider reserve expenditures during the "window." This calculation method can be used to calculate a reserve contribution that enables an association which may currently be in a poor financial state to become "Ideally Funded" at a predictable point in the near future.

## **IV. PERCENT FUNDED**

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Now that we understand the methodology behind funding the reserve budget, the following attempts to explain "% funded".

Typically, this is a measure of the reserve fund "health" (expressed as a percentage) as of the beginning or at the end of the fiscal year for which the reserve analysis was prepared. Remember, "100% funded" means the association has accumulated the proportionately correct amount of money, to this point in time, for the reserve components it maintains. It does not mean that the association has accumulated or plans to accumulate the total dollar amount necessary to maintain, replace or repair all of the components in the study at one time.

Since, the Full Funding Method (aka Component Method or Straight Line Method), might be considered the standard method of funding in the industry, it is always used as the reference for comparisons. Therefore, if an association requests or warrants the use of the "Baseline" method of funding, you should typically see a "% funded" column in the reports which essentially depicts the ratio of funding between the "Ideal or Full Funding Method" targeted fund level and the "Actual or Baseline Method" targeted balance. The percentage will normally be well under 100%, since the Baseline Method funding requirements are always lower than the Full Funding Method requirements. For example, if the Full Funding Method projects a reserve fund ending balance of \$500,000 in the 5<sup>th</sup> year of the study and the Baseline Method projects a reserve fund balance of \$250,000 in the same year, the fund is 50% funded. Beware of studies that state % funding for Baseline reports as comparison of the projected Baseline year end balance with the actual reserve balance at the end of that year. In this example, if the association reached \$250,000 in the example year, the association would be said to be fully funded. This is far from the truth.

In those situations where the Baseline Method is employed, the association should be keenly aware of the drawbacks in using the basic Baseline Method of funding. The “% Funded” numbers should not be ignored. Questions should be asked about the funding method and how the % funded number is derived.

## **V. DEVELOPER TRANSITION**

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A major area of confusion continues to exist at the point where the developer turns over control of the board of directors to the homeowners. This, in effect, turns over control of the association to the homeowners. It does not, however, have anything to do with the “turnover” of physical properties, parcels, etc. to the association. With the exception of those items stated in Statute, these tangible properties can be transitioned to the association at any time prior to transition by the developer.

**Nevada statute (NRS 116) requires that the developer transition control of the Association when 75% of the homes are sold. It also requires that the developer provide the association with “(116.31038.3) A complete study of the reserves of the association, ...” It also states that “(116.31038.3.a) Except at otherwise provided in this paragraph, deliver to the association a reserve account that contains the declarant’s share of the amounts then due, and control of the account.”**

While we may discuss the popular interpretation of the above paragraph, it leaves no doubt that the legislature needs to clarify this area with regard to the developer’s “share”.

The key words in the NRS text above are “... the declarants’ share of the amounts then due, ... (see NRS116.31038.3.a and NAC 116.425.2).” While the amount due can be determined by a study of the reserves which will reflect the dollar amount which should be in the reserve account at transition, the argument by developers is that they never owned any of the lots and therefore, they owe no, or minimal, money to the reserve account. This is due to the way lots are annexed into the association in Nevada. Each lot is annexed into the association at closing. Typically, while the major reserve components have been installed since the first lot was sold, the developer has never owned more than the sales lots. This is where the argument arises.

The easiest way to interpret the developers’ requirement until a better way comes along is to consider the funding requirements from the point where the major common elements (streets, walls, gates, pools, etc.) have been installed. A “build out” study (one which considers all lots sold) will provide the balances required at transition. It seems reasonable to assume that whatever the reserve report depicts as a fund balance at the point of transition is what the developer should turnover to the homeowners. Whether those funds are comprised of money from the developer or is a combination of funds contributed by owners to that point along with “Capital Contributions” is not relevant at this time. What is relevant is that the reserve fund passed to the owners is adequately funded as determined by the projections of the reserve analysis.

So ... What is “adequate funding?”

If considering the following: One way to interpret Adequate Funding (and the way the author interprets it), is to look at the following:

1. The statute requires that the association (whether developer or homeowner controlled) establish an adequate reserve.
2. The statute requires that the developer deliver to the association a complete study of the reserves of the association.
3. The reserve study, through analysis of the maintenance requirements of the association and the reserve component inventory, provides the required funding levels for the association at any point in time, within the 30 year window.
4. These funding levels provided by the reserve study provide for the ongoing long term maintenance of the reserve components in order to maintain the value of the community.

Therefore, if the above is factual, “adequate funding” should mean funding to the levels established in the reserve study. If the study establishes a reserve fund requirement of \$45,000 at the point of transition, the developer should be turning over a reserve account funded to that level.

In order to ease the transition shock for developers, a preliminary (or we might call it a “planning” study) of the reserve requirements should be conducted early on in the construction of the property. This would provide the developer with estimates of the funds required at build-out. The study would have to be “updated and finalized” upon the complete installation of all common area components.

It should also be noted, that even though the term “adequate funding” has been clarified in Nevada NAS (Nevada Administrative Code) to mean “the level of funding that the reserve study states or what the documents state (if so stated)”, the needs of established associations differ, and there must be flexibility with regard to how an association funds its reserves in order to allow for “reasonableness” while still providing for the ongoing and future maintenance, repair and replacement of common elements in the community.

The intent of this article was to help clear up some of the confusion surrounding the topics covered. Hopefully, we have achieved that goal while not adding further to the confusion.

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*Mr. Barry was awarded the national CAI Reserve Specialist designation (RS®) in March of 2000 and held the AMS® (Association Management Specialist) and PCAM® (Professional Community Association Manager) designation from 1994-2014. Mr. Barry is a registered Nevada Reserve Study Specialist (#0003). Mr. Barry has been providing services to the community association industry for over 30 years. Mr. Barry has been a working manager and co-owner of a successful Northern California Community Association Management Company and has served associations for many years in various supporting positions. Mr. Barry has a broad knowledge of association board management and maintenance responsibilities and the maintenance needs of association common elements. Over the past 30 years, Mr. Barry has written articles for community association industry publications and presented seminars at numerous industry events. Mr. Barry is currently a faculty member for the Nevada CAM (Community Association Manager) certification courses and has been a regular presenter at the Nevada State Ombudsman Training Seminars for Board Members. A local Nevada firm, CSIReserves is committed to providing quality solutions to Common Interest Developments and Developers.*