Determining a Reserve Threshold

The best indicator for setting a reserve threshold is an association's tolerance for risk.

BY MITCHELL H. FRUMKIN, PE, RS, CGP

While we all know what a reserve study is, I'm often asked, "What threshold should we use if we decide to use a 'threshold funding plan'?"

First, a little background about funding plans and how they relate to a reserve study. CAI's National Reserve Study Standards divides a reserve study into two critical, interrelated parts: the physical analysis and the financial analysis.

The physical analysis, which reflects a point in time, lists all of an association's components that eventually will need to be repaired or replaced; estimates the useful life and replacement cost of each component; recommends an amount to set aside in the reserve fund each year to cover the replacement costs when they're expected; and provides the total costs for all of the components included in the study.

The financial analysis converts the information from the physical analysis into a projection of the association's future financial needs and informs the association how much money to set aside in a reserve fund at regular intervals to be able meet those needs.

TYPES OF FUNDING PLANS

There are four ways an association can choose to contribute to its reserve fund:

Full funding—the most conservative approach. An association that prescribes to a full-funding plan contributes 100 percent of the money estimated to be needed at any point in time into its reserve fund. For instance, if a component is expected to last 10 years and its replacement value is $10,000, then the association should have $3,000 in the reserve fund for this item at year three.

Baseline funding—probably the most risky. With baseline funding, the association reduces its annual contributions to a level at which the reserve fund balance eventually drops to zero. If the replacement cost of any component exceeds the estimated cost, or if a component is replaced sooner than anticipated, the association could experience a deficit or require a special assessment.

Statutory funding—prescribed by state or local law. We'll skip discussion of a statutory funding plan because it's externally regulated.

Threshold funding—a combination of full and baseline funding. Most associations establish funding plans that are a blend of baseline and full funding—what's known as "threshold funding"—by determining the lowest amount they're comfortable contributing to their reserve account during the cash flow projection period.

DETERMINING A THRESHOLD

A "threshold" can depend on a number of variables, including the amount of risk an association is willing to take.

For example, an association that conducts a full annual reserve study or review has an up-to-date appraisal of the condition and estimated lives of its components. There's less risk that any one component will need to be replaced sooner than its predicted life span—and less risk that the replacement cost will be higher—than if the association conducted its reserve studies only every few years.

An association also may choose to base its threshold amount on the total cost of replacing all of its components at one time—which would require the most money that would need to be spent in any one year. A threshold also can be based on a percentage of an association's fully funded reserve fund balance.

Because individual boards analyze variables differently, it's unlikely any two associations—even if they're similar in many other ways—will use the same threshold.

For this reason, association boards and the managers who guide them should discuss the pros and cons of various scenarios with their reserve professionals.

And keep in mind that as an association's financial situation and risk tolerance changes, so will its funding plan and threshold amount.

Mitch Frumkin is founder and president of KIPCON, a New Jersey-based engineering firm. A past president of CAI, the Foundation for Community Association Research and CAI's New Jersey chapter, he headed CAI's Reserve Professionals committee during its development of the national standards. Frumkin also is author of Reserve Funds: How & Why Community Associations Invest Assets.

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