Reserve Fund Planning

Best-practice Report

The Origins of Reserve Fund Planning

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Buildings and Owners – Understanding Long-term Costs

1. What Happened to Buildings and Owners over the last Century?

Over the century, buildings have become significantly more complex. Canadian building codes are fashioned after a 1940s single-family home – this brings its own inertia. Plumbing, electricity, fire protection and energy systems are relatively new in residential developments and at the same time, they haven't changed much in nature since their introduction.

Types of ownership are also more complex. While condo | strata ownership has flourished since the 1960s – on a backdrop of increasing land value – the competing interests of buildings and owners and have required a better understanding of the true costs of developments.

Maintaining a building used to be based on predictable costs. The responsibility for these costs was spread over a few owners. They held on to their developments for long periods. Operation costs were more or less fixed and easy to plan for in annual budgets. Long-term costs – such as windows – were dealt with in numerous ways.

With added complexity and shorter ownership times, long-term concerns have become more challenging. The equitable replacement of the windows – building needs – and the distribution of the costs – owners' don't-wants – have generally been difficult to account for in a clear manner. Please consider the following scenario:

The Case of the Astute Owner

- An owner buys a strata lot in a development with two buildings and lives in it for 24 years.
- A new owner buy from the original owner and moves in during the 25th year.
- The new owner pays a special levy of $10,000 for the replacement of her share of the new windows in year 25.
- The new owner used a small percentage of the life of the windows but paid for 100 percent of the new windows.
- The original owner bought a strata lot in the same development's second building in the 25th year.
- The second building had its windows replaced in the 24th year.
- The original owner did not pay for either buildings' new windows.
- The new owner could have been savvy and negotiated for the special levy to be paid for by the original owner.
- The original owner would have gotten at least one set of windows for free.

2. What Happened to Reserve Fund Planning Over the last 50 years?

The scenario above raises two concerns:

1. how are we to maintain the value of a building's common assets and
2. what is the equitable distribution of costs to present and future owners?

Note that past owners 'got away with a good deal' – legally.

More is now asked of boards | councils. A valid equitable owner-neutral standpoint – defined by a board | council – implies dealing fairly and equally with all concerned after interpreting mandates and the law.

In jointly owned developments, it took until the 1970s and 1980s for accountants and associations of owners to present ways to deal with the aging of components and ways of raising monies to compose with the long-term repair or replacement of common assets.

With these efforts, the concept of capital assets and replacement reserves took hold and best-practice standards began appearing across North America in the 1990s and 2000s.

The relatively recent use of computer programs has allowed for a myriad of recommendations to flourish, from amateur and professional providers that are doing reserve studies as a side-work or providing full-time services.

While the spectrum of results is wide, protocol calls for the establishing of an inventory that includes units of measure, unit cost, useful life, remaining life and replacement cost. The number and range of inventory items make each condo | strata corporation unique.

The proper modelling of the components age, replacement cycle, type of use and aesthetic preference needs to be undertaken in conjunction by the strata council. An experiences generalist with specialized construction and financial knowledge is apt to guide the members according to clear established guidelines.

The inventory is only the first building block of reserve fund planning – it's the data. The scheduling of the inventory components' expenditures is the second analytical part of reserve fund planning, and its success depends on construction knowledge.

Imagine seeing all the components and their schedules expenditures over 30 years. Some years have inputs some none. Some components have no inputs over the 30 years and others repeat several times. Yet each year provides a total of expenditures.

Is the spreading of these expenditures over 30 years to be trusted as set-in-stone? – Not in the least. The best way to 'see' this, is to think that the scheduling year is more robust than the costing – if the writer has construction experience. Really though, it is up to the condo | strata board | council in place near the scheduled expenditure to decide how much of and how to spend the strata fees collected and when.

The Strata Property Act of BC asked for three scenarios specifically, we think, because it did not want to have strata corporations forced to impose the recommended plans as financial models.

We are not dealing with a regulated safety issue and this is not as if an engineer stamped a report forcing all occupants to comply to findings that would lead to an eviction notice.

The government was aware that it would take time for standards to be respected by writers and it opened up the field to all types of providers so that all types of needs could be met at all sorts of costs – the purpose was to determine what 'buy-in' the government would achieve with the strata councils of BC.

The dark side of doing it this way is that compliance after three years is still not that high and more importantly, that it's been the wild-west out there in terms of writers' recommendations and fees.

3. What Do We do with the Component Inventory and the Schedule of Expenditures?

Once you have the data – the inventory – and the scheduling of the expenditures, the next step is to prepare a cumulative scenario that factors in the other elements of reserve fund planning – available monies, inflation, interest earned on investments, regular contributions, special contributions if any, transfers, special levies etc. on a fiscal-year to fiscal-year basis.

Simply put, calendar year thinking leads to depleting monies by the end of the year so that the books close properly. But buildings do not behave like school-years with the wheel having to be re-invented every year. Developments have economic lifespans that extend into the 70 years range.

In other words, predictable future expenditures do not need bookkeeping – they require long-term planning, not 'closing the books'. The difference lies in the cumulative approach. Cumulative expenditures require cumulative funding and cumulative funding requires fiscal-year based estimates of how much monies are to be placed aside to deal with current-year and future years' expenditures.

With cumulative planning comes anticipated annual budget strata fees that factor in both operating and long-term replacement costs saved for in a reserve fund. All stakeholders in the present and future life of the development end up with the same information.

The selling price fluctuations of lots within buildings and across developments is partly mitigated by long-term planning and proper reserve fund planning. More importantly, with depreciation reports, all work is documented and accounted for, work standards go up, so that reputable contractors and consultants can be hired ahead of emergencies.

Let us re-visit the development with two buildings and what would have happened to the two owners if a reserve fund had been in place:

The Case of the Good Neighbours

- The original owner would have paid her share of the use of the windows before she sold.
- The new owner would have paid his share of the use of the windows.
- Both would have paid on a fiscal-year basis even if they moved during a fiscal-year as typically real estate deals factor in – special levies for example – on a fiscal-year basis.
- The plan would have kept the buildings in good condition and the monies in the reserve fund would have been build-up between all owners regardless of ownership duration.
- Any strata council of any year during the life of the development would be financially prepared to maintain the common assets – the buildings.

Complexity of construction has evolved with complexity of ownership and both have required the simplification of strata finances for all stakeholders – buyers, lenders and real-estate agents need to understand long-term implications when they are dealing with real-estate.

Motivated by a deeper understanding of construction matched with a better understanding of cumulative financing, condo | strata boards | councils can be equipped with a more systematic approach to their developments' major repairs and replacements.

All that is required is best-practice reserve fund planning that fits into budgeting fiscal-year strata finances and plans for the future.

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