2006 CCUCA Seminars & Trade Show

February 25, 2006

Paying for Today, Preparing for Tomorrow

(Taking the Mystery Out of Reserves)

Ralph A. Troiano

President

C.I.A. Services, Inc.

Ralph A. Troiano

Ralph Troiano is President of C.I.A. Services, Inc., a professional management company for community associations throughout Harris, Fort Bend, Montgomery, Brazoria and Galveston counties. With 22 years of experience in the trenches, Mr. Troiano has presented numerous seminars on a variety of topics such as "Coping with Disaster", "Finance and Operations", "Strategic Planning", "Practical Deed Restriction Enforcement", "Super Budgeting", "Risk Management" and "Myths in Management".

Prior to establishing C.I.A. Services in 1984, Mr. Troiano worked as an engineer and systems analyst for two major petrochemical companies. He has both bachelors and masters degrees in chemical engineering from MIT and has earned the PCAM designation from Community Associations Institute. His interest in community association management began by serving on the Board of Directors and being an active volunteer in each neighborhood he has lived. He currently also serves as the investment officer for a Fort Bend County Levee Improvement District.

C.I.A. Services, Inc.

9800 Centre Parkway, Suite 625
Houston, Texas 77036
Phone: 713-981-9000
Fax: 713-981-9090

5616 FM 1960 East, Suite 190
Humble, Texas 77346
Phone: 281-852-1700
Fax: 281-852-4861

www.ciaservices.com

Agenda

- The Questions
- About the Word “Reserves”
- The Concept of Funds
- Fund Calculations
- Financing Options for Projects
- Fund Trends
- Cash in Bank versus Fund Balances
- The Answers

The Questions

Every Board member should be able to easily answer two simple questions from homeowners:

- How much money should we have in the bank?
- What is the right assessment for our community?

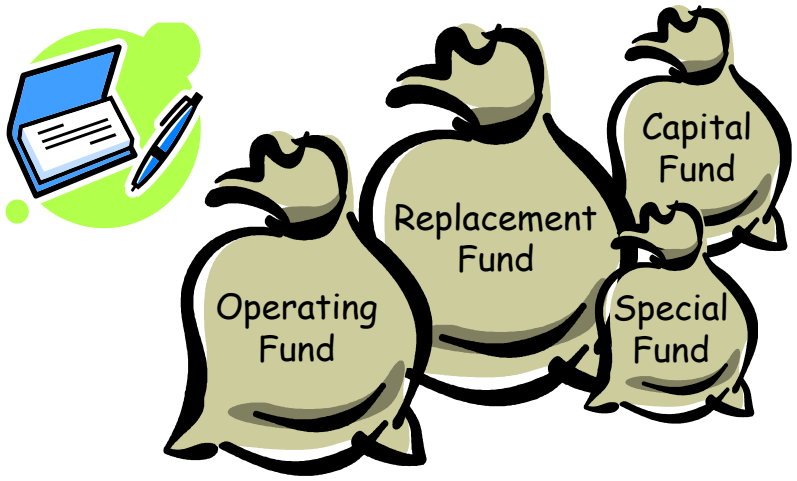
When we are done today, you will be able to accurately and confidently answer those questions. You'll also know how to project those answers five or ten years into the future.

About the Word "Reserves"

- "Reserves" is one of the most misused and confused words in budgeting and financial management
- It is a proper generic term signifying funds set aside, or reserved, for a particular future purpose
- The problem is that people have different things in mind when they hear and use the word:
  - Is it everything we have in the bank?
  - Is it the money we have in case the clubhouse burns down?
  - Is it the amount we have accumulated for the new playground?
  - Is it what we've put aside for a rainy day?
- Always use an adjective in front of the word ("Capital Reserves") or avoid using the word altogether ("Capital Fund")

The Concept of Funds

- A "fund" is an accounting category for moneys on hand for a designated purpose
- Using fund accounting facilitates planning for both short-term and long-term expenditures
- Using fund accounting allows the Board to set the proper assessment is set for the community
- We will review the four types of funds used in community associations:
  - Operating Fund
  - Replacement Fund
  - Capital Fund
  - Special Purpose Funds



Operating Fund

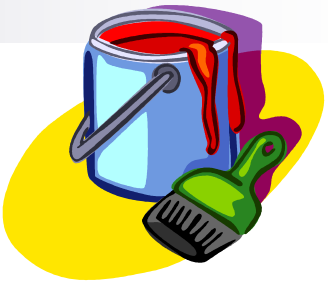
- The purpose of this fund is to protect against fluctuations in budgeted revenues or expenses
- In the 1980's there were major reductions in Association revenues streams as the economy faltered and some owners lost their homes and others could not pay their assessments
- At the same time, expenses rose greatly as inflation reached double-digits
- Normal assessment increases, capped at 3%, 5% or 10%, were not able to keep up
- We recommend 25% to 75% of the annual operating expenses as the ideal operating fund level depending on the type and size of community

Operating Fund

Examples

- Most DRs limit assessment increases so limit ability to increase revenues
- Interest on investments have plummeted since 2000
- Hearthstone & Kirkmont section II – cable franchise fees will disappear when current agreement term expires
- Electricity costs rose over 20% in 2001, stabilized and dropped slightly in 2002/2003 and jumped again by 2004 – all within a flat economy
- Quail Bridge & Pine Forest Village – board addressed security needs by adding security patrols
- Treehouse Condominiums – rash of internal leaks from aging piping resulting in excessive plumbing and sheetrock repairs

Replacement Fund



- The purpose of this fund is to pay for the predictable costs of maintaining and replacing major assets of the community
- If we plan to repaint our common area fences every five years at a cost of $20,000 then we need to put $4,000 into the fund every year
- We do not typically put funds aside for low dollar items with unpredictable lives (e.g. pool pumps)
- We do not typically put funds aside for items with very short lives (e.g. power-washing clubhouse) or very long lives (e.g. brick columns)
- The ideal replacement fund balance is calculated through a "reserve analysis"

Replacement Fund

Examples

- Sugarwood – replastered swimming pool and replaced chain link fence with ornamental iron
- Bridlewood Estates – cleaned, repaired and repainted perimeter ranch style fences
- Colony Grant – replaced original 25 year old lake fountain with a new floating model
- Hearthstone Meadows – replaced malfunctioning gate operating system including underground loops and phone lines
- Townewest – added crushed granite to jogging trail
- University Place Townhomes – reroofed every building over a three year period

Capital Fund

- The purpose of this fund is to pay for new community assets
- If we want to build a new $40,000 playground in 4 years then we need to put aside $10,000 each year to meet our goal
- Getting a loan for a capital project is just a variation – instead of accumulating the funds in advance and then doing the project, we do the project and then pay back the loan plus interest
- The ideal capital fund balance is based on the capital project plan – how many years do we have to accumulate how many dollars

Capital Fund

Examples

- The Highlands – replaced common area fences around community entries with brick walls – added columns to fences
- Vicksburg – assumed responsibility for the fences along the boulevards and replaced all of them
- Quail Run – built a clubhouse and recreation center for the community
- Colony Grant – added shade covers, fans and lights around the perimeter of the lap pool deck
- West Airport – constructed monuments on South Gessner to delineate boundaries of the community and beautify area
- Settlers Park – covered pool deck concrete with a durable, textured concrete surface

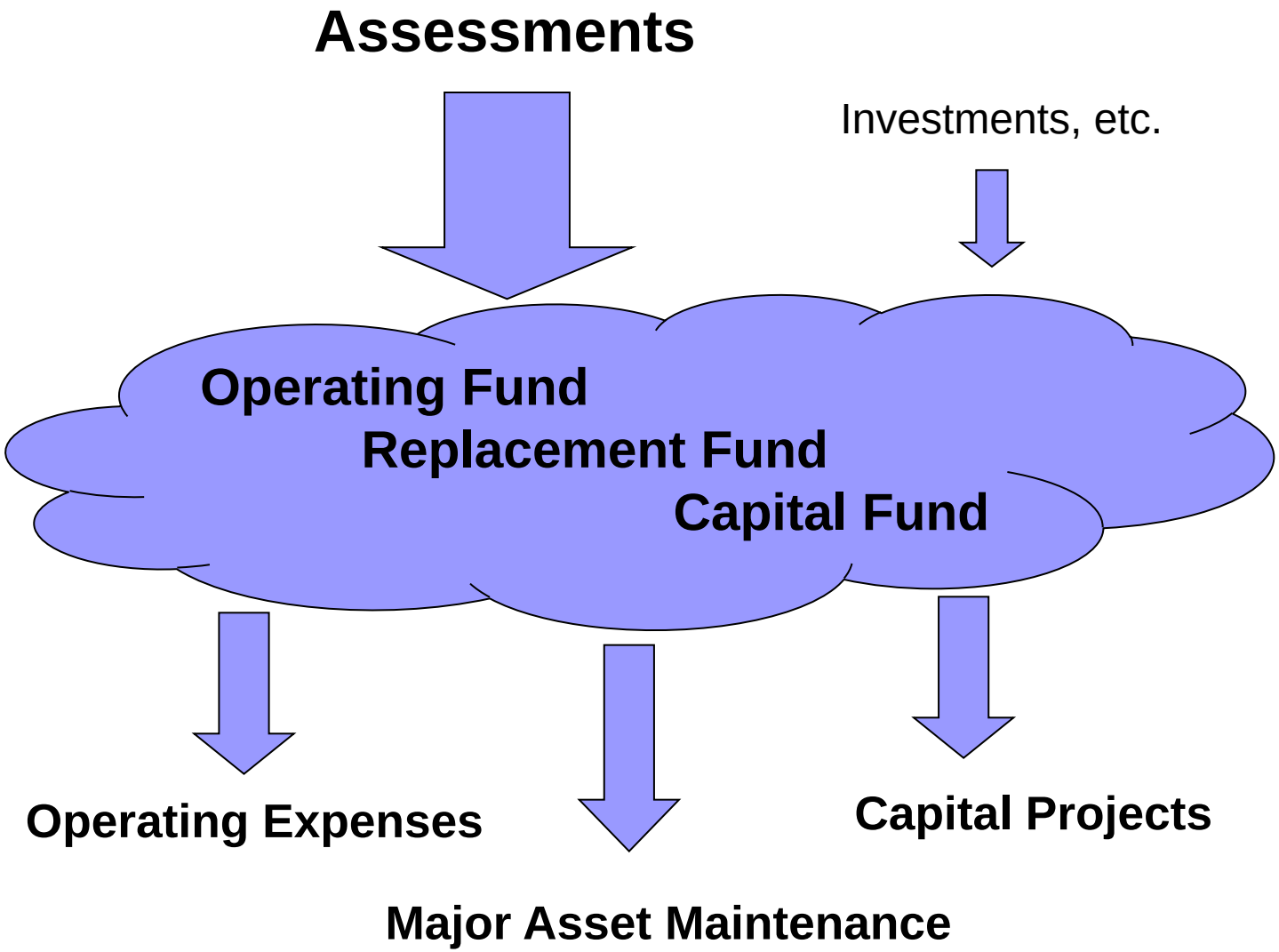
Special Purpose Funds

- Special purpose funds are any that are accumulated over time and are somehow restricted in how they can be used
- The ideal special fund balance is determined by their purpose and expenditure plan

Special Purpose Funds

- Valley Lodge – levied a special assessment for road repairs in 2002 and had a small amount left over after work was done – the extra is set aside and is being held for future road repairs
- Treehouse Condominiums – many years ago a cash settlement was provided by the developer over construction defects – the initial problems were repaired but the majority of funds were set aside to make repairs as problems arise
- Crestwater – a group of homeowners donated funds to the association for planting trees – the funds were set aside and combined with association funds to do the project
- Southglen Village – donations and fund raisers were used to build a new playground sooner than planned – the association set the funds aside until the playground was built

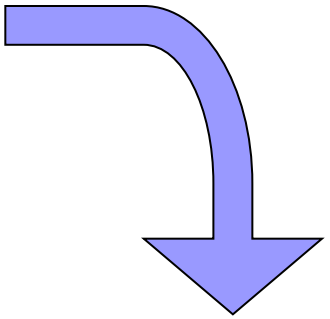
Where Does the Money Come From



Operating Fund Ideal Balance

- The ideal Operating Fund balance is a percentage of the normal operating expenses.

Total Revenues	$198,000
Total Operating Expenses	$163,000
Net Revenues After Operations	$35,000
Allocation to Replacement Fund	$11,320
Allocation to Capital Fund	$17,283
Allocation of Operating Fund	$6,397



times 33%

equals $54,000

Ideal Operating Fund balance

The Super-Budget model calculates this allocation based on how far each fund is from the ideal value.

Reserve Analysis

Asset	Last Repair Year	Useful Life	Next Repair Year	Current Replacement Cost	Accumulated Balance as of 12/31/2005	2006 Contribution
Pool plaster	2001	8	2009	$24,000	$12,000	$3,000
Clubhouse roof	1998	15	2013	$6,000	$2,800	$400
Boulevard fence replacement	2003	18	2021	$108,000	$12,000	$6,000
Boulevard fence painting	2003	5	2008	$9,600	$3,840	$1,920
Totals				**$147,600**	**$30,640**	**$11,320**

Asset Schedule

Sample

	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O
244				LAST			NEXT	CURRENT		2006					
245				REPAIR	USEFUL	REMAIN	REPAIR	REPLACE	1/1/2006	RESERVE					
246			ITEM	YEAR	LIFE	LIFE	YEAR	COST	BALANCE	REQUIRED		COST BASIS NOTES			
272			Repaint Shade Covers - Rec Pool	1995	10	0	2006	0	0	0		Plan to demolish in 2006			
273			Replace Furniture - Lap Pool	2002	20	16	2022	20,000	4,000	1,000		Based on new furniture purchased in 2002			
274			Replace Furniture - Rec Pool	2002	20	16	2022	30,000	6,000	1,500		Based on new furniture purchased in 2002			
275		TENNIS COURTS													
276			Repaint Tennis Court Light Poles (7)	2004	4	2	2008	4,800	2,400	1,200		Based on 2004 repainting cost - includes bulb replacements			
277			Replace Tennis Court Fence	1980	50	24	2030	14,400	7,488	288		Chain link fence 10' high - estimated length 900 feet - $16.00/ft			
278			Resurface Tennis Courts	1999	8	1	2007	12,000	10,500	1,500		Estimated $3000 per court			
279			Replace Coated Metal Tennis Benches (4)	1999	20	13	2019	1,200	420	60		Estimated cost $300 each			
280		PARKS & PLAYGROUNDS													
281			Replace Williams Trace Play Equipment	1995	20	9	2015	20,000	11,000	1,000		Estimated cost $20,000			
282			Replace Rec Center Play Equipment	1995	20	9	2015	15,000	8,250	750		Estimated cost $15,000			
283			Replace Williams Trace Ornamental Lights (3)	1984	30	8	2014	7,500	5,500	250		Estimated cost $2500 each			
284			Repaint Williams Trace Ornamental Lights (3)	2003	4	1	2007	600	450	150		Estimated cost $300 each			
285			Replace Coated Metal Swings (8)	1998	20	12	2018	4,800	1,920	240		Estimated cost $600 each			
286			Replace Coated Metal Benches (8)	1998	20	12	2018	4,000	1,600	200		Estimated cost $500 each			
287			Replace Wood with Iron/Concrete Benches (3)	1995	15	4	2010	600	440	40		Estimated cost $200 each			
288			Replace Coated Metal 8' Picnic Tables (2)	1998	20	12	2018	1,400	560	70		Estimated cost $700 each			
289			Replace Coated Metal 10' Picnic Tables (4)	1998	20	12	2018	3,200	1,280	160		Estimated cost $800 each			
290			Replace Coated Metal Square Picnic Table (1)	1998	20	12	2018	800	320	40		Estimated cost $800 each			
291			Replace Coated Metal Trash Containers (13)	1998	20	12	2018	2,600	1,040	130		Estimated cost $200 each			
292			Refresh fall surface under play equipment	2004	3	1	2007	3,500	2,333	1,167		Based on 2004 project			
293		LAKE													
294			Replace Large Fountain	2003	24	21	2027	24,000	3,000	1,000		Lake Management Services estimate for similar equipment			
295			Replace Small Fountain	1994	20	8	2014	15,000	9,000	750		Lake Management Services estimate			
296			Maintain Bulkheads	2004	5	3	2009	26,280	10,512	5,256		Estimated length 6000 feet - repair cost $146/ft - based on repair			
297		BOULEVARDS													
298			Replace Boulevard Fences	1993	18	5	2006	155,800	112,522	8,656		Estimated length 8200 feet - $19.00/ft			
299			Repair & Repaint Boulevard Fences	2004	5	3	2006	41,000	16,400	8,200		Estimated length 8200 feet - $3.50/ft painting & $1.50/ft repairs			
300			Repaint Curb Numbers	2004	5	3	2009	7,541	3,016	1,508		Estimated cost $5.00 per number - 1200 homes			
301															
302						TOTALS		621,296	328,492	51,549					

Capital Project Plan

Project	Added to Capital Project Plan	Project Ground Breaking	Estimated Project Cost	Accumulated Balance as of 12/31/2005	2006 Contribution
Install monument at 2nd entry	2002	2007	$20,000	$16,000	$4,000
Install 1/3 mile jogging trail	2004	2009	$36,000	$14,400	$7,200
Install exercise stations	2004	2010	$14,000	$4,667	$2,333
Install pavilion with park equipment	2004	2012	$30,000	$7,500	$3,750
Totals			**$100,000**	**$42,567**	**$17,283**

Capital Budget

Sample

	A	B	C	D	I	J	K	L	M	N	O	P	Q
142					1998	1999	2000	2001	2002	2003	2004	2005	2006
143					ACTUAL	ACTUAL	ACTUAL	ACTUAL	ACTUAL	ACTUAL	ACTUAL	OUTLOOK	BUDGET
144	**CONTRIBUTIONS**												
145		Contribution from Operations			90,000	100,000	140,000	56,187	59,133	67,153	50,000	57,921	71,000
146		Community Center Project Loan			0	0	0	0	0	0	0	450,000	0
147		**TOTAL CONTRIBUTIONS**			90,000	100,000	140,000	56,187	59,133	67,153	50,000	507,921	71,000
148													
149	**EXPENDITURES**												
150		PIP architect (1994-2000)			13,051	5,791	592	0	0	0	0	0	
151		PIP entry area lighting (1999)			0	19,693	0	0	0	0	0	0	0
152		PIP entry area landscaping (1999)			0	27,644	0	0	0	0	0	0	0
153		PIP boulevard brick columns (1999)			0	95,276	0	0	0	2,430	0	0	0
154		PIP entry walls (2000)			0	0	168,574	0	0	0	0	0	0
155		Shade structures at pool #1 (2000 & 2001)			0	0	5,660	3,285	0	0	0	0	0
156		Tube slide at pool #1 (2001)			0	0	0	6,187	0	0	0	0	0
157		Underwater lighting at pool #1 (2002)			0	0	0	0	9,133	0	0	0	0
158		Cul-de-sac landscaping and irrigation (2003)			0	0	0	0	0	20,226	0	0	0
159		Shade structures at pool #2 (2004)			0	0	0	0	0	0	4,438	0	0
160		Community center architect (2004-2005)			0	0	0	0	0	0	11,990	31,496	0
161		Tennis Court Renovation (2005)			0	0	0	0	0	0	0	86,307	0
162		Sundeck at pool #2 (2005)			0	0	0	0	0	0	0	23,250	0
163		Community center construction (2005-2006)			0	0	0	0	0	0	0	300,000	209,120
164		SPI fence at Hwy 6 & Lexington (2006)			0	0	0	0	0	0	0	0	19,500
165		Community center loan payments (2006-2015)			0	0	0	0	0	0	0	0	64,806
166		Unidentified/miscellaneous			0	0	0	0	0	0	0	0	0
167		**TOTAL EXPENDITURES**			13,051	148,404	174,826	9,473	9,133	22,656	16,428	441,052	293,426
168													
169	**NET CHANGE TO CAPITAL FUND**				**76,949**	**(48,404)**	**(34,826)**	**46,715**	**50,000**	**44,497**	**33,572**	**66,869**	**(222,426)**
170													
171	Inflation factor				0.81	0.83	0.86	0.89	0.91	0.94	0.97	1.00	1.00

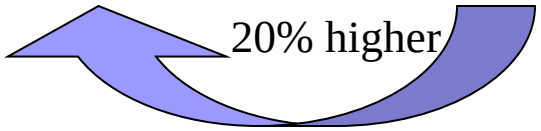
Alternative Financing

- There are alternatives for financing operations, replacement projects or capital projects:
  - Special assessment
  - "Borrow" between or within funds
  - Bank loan
- Ultimately, all financing will eventually come from the property owners (to make the special assessment, to repay the loan or to replenish the internal funds)
- Alternative financing simply changes the timing of cash flows and makes a small difference in the cost
- It could be argued that replacement expenditures should come from accumulated funds and capital projects from loans (why?)

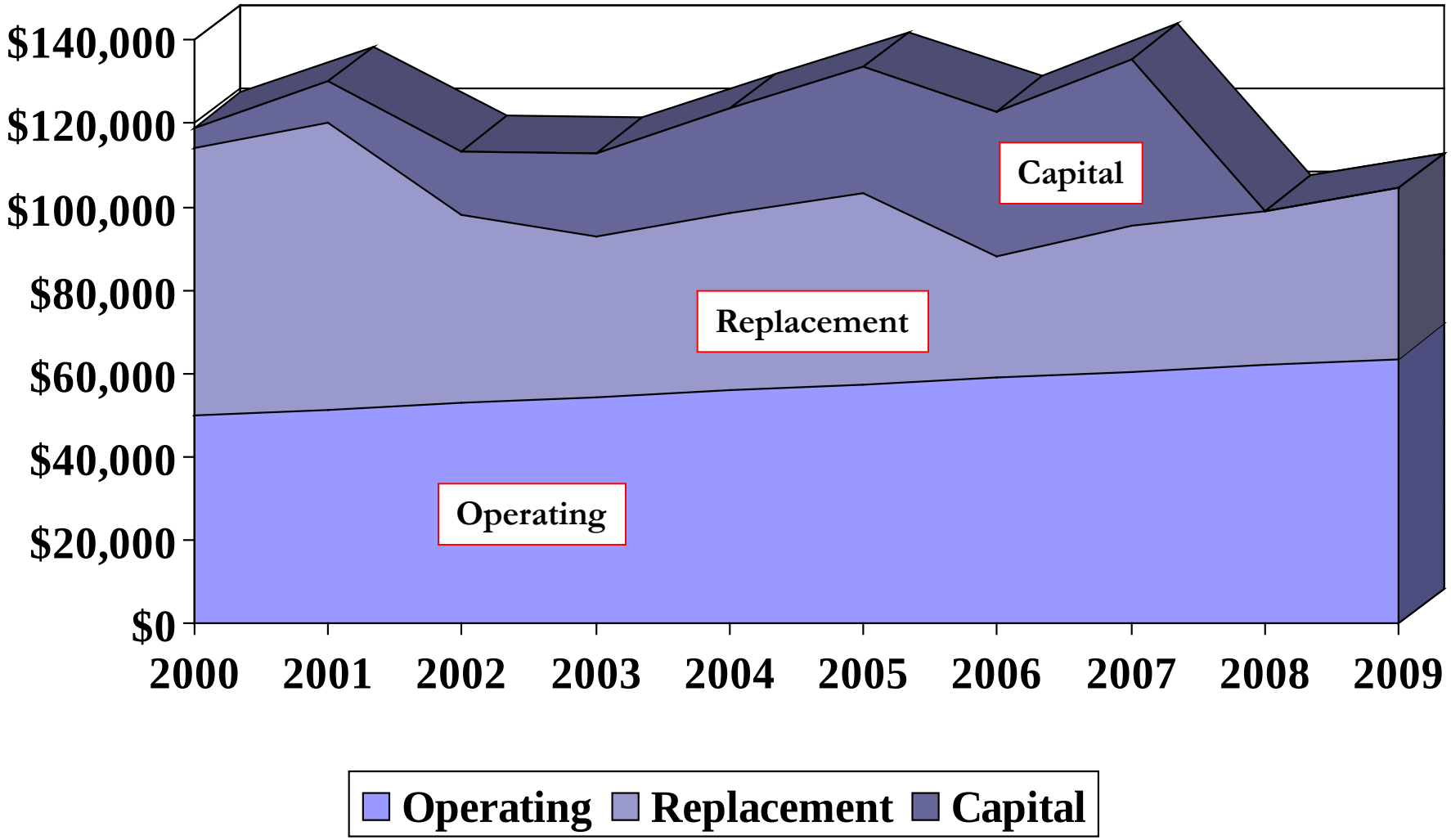
Alternative Financing - Example

- Scenario: a $100,000 playground – build it now with a bank loan or build it in 5 years after we've accumulated the funds
- The table below shows the project comparison

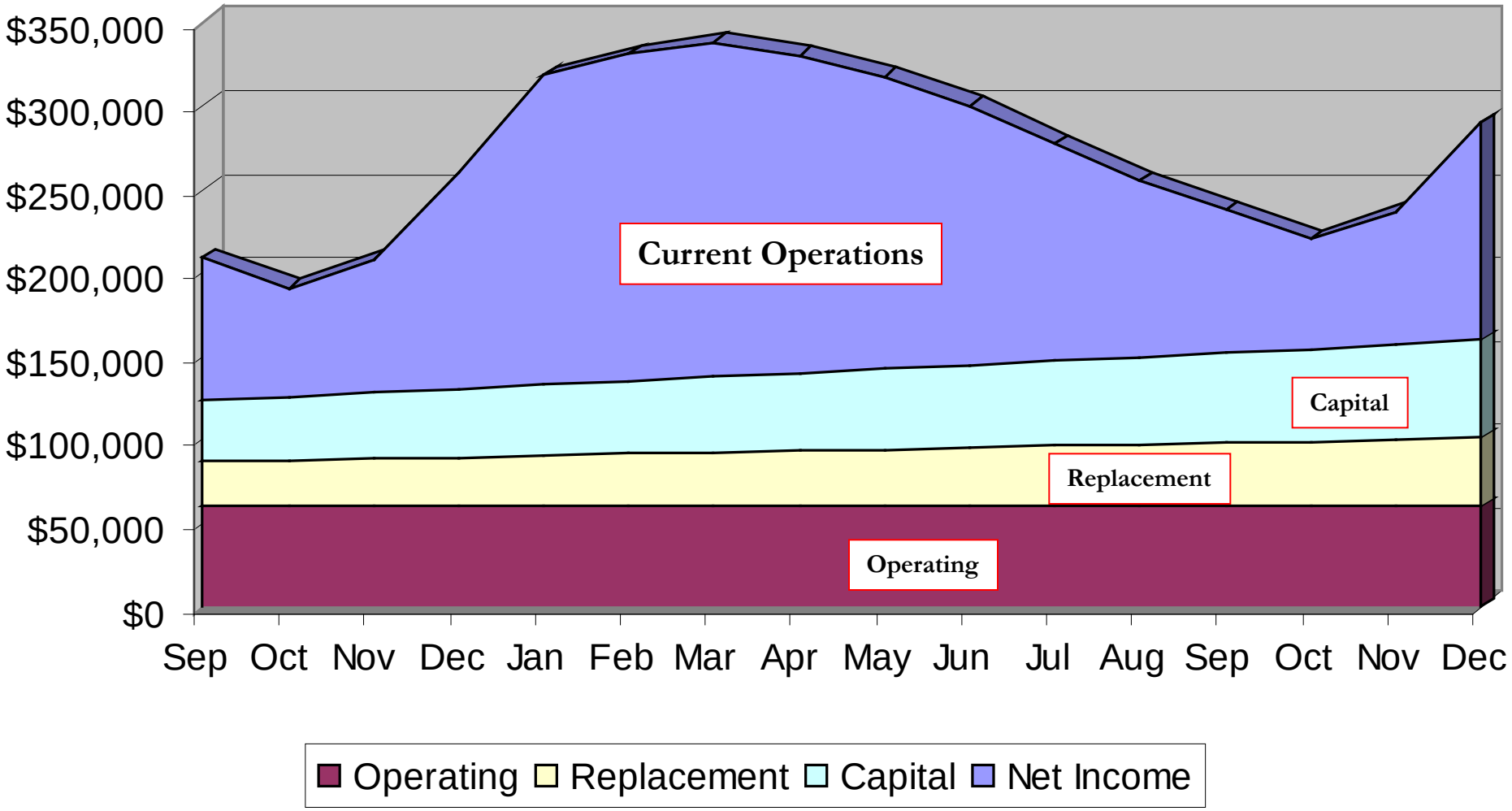
Bank Loan		Capital Fund	
Construction year	2006	2011	Construction year
Construction cost	$100,000	$113,141	Construction cost (at 2½% inflation)
Total principal payments	$100,000	$103,450	Fund contributions
Total interest on loan (at 9%)	$24,550	$9,691	Interest on funds (at 3%)
Total 5 year cost	$124,550	$113,141	Total 5 year accumulation
$/year from assessments	$24,910	$20,690	$/year from assessments



Fund Trends



Cash in Bank versus Fund Balance



Funds on the Balance Sheet

LIABILITIES AND EQUITY		05/31/04	06/30/04	07/31/04
ACCOUNTS PAYABLE				
2010	A/P - ACCOUNTS PAYABLE	0.00	0.00	0.00
2199	A/P - C.I.A. SERVICES	603.70	358.37	659.81
2410	ASSESSMENT OVERPAYMENTS	221.67	472.28	727.32
2420	ASSESSMENTS PAID IN ADVANCE	0.00	0.00	0.00
		825.37	830.65	1,387.13
DEFERRED REVENUES				
2400	UNCOLLECTED ASSESSMENTS	24,970.24	22,359.28	19,819.97
		24,970.24	22,359.28	19,819.97
FUND BALANCE				
3100	OPERATING FUND BALANCE	18,769.38	18,769.38	18,769.38
3200	REPLACEMENT FUND BALANCE	2,083.35	2,500.02	2,916.69
3250	CURRENT REPLACEMENT PROJECTS	0.00	0.00	0.00
3300	CAPITAL FUND BALANCE	20,833.35	25,000.02	29,166.69
3350	CURRENT CAPITAL PROJECTS	(1,000.00)	(1,000.00)	(1,000.00)
----	CURRENT YEAR NET INCOME	60,797.32	46,480.64	25,556.07
		101,483.40	91,750.06	75,408.83
TOTAL LIABILITIES AND EQUITY		**127,279.01**	**114,939.99**	**96,615.93**

Cash on the Balance Sheet

ASSETS		05/31/04	06/30/04	07/31/04
CURRENT ASSETS				
1010	PETTY CASH - Treasurer	150.00	150.00	150.00
1021	CHECKING - Southern National	5,651.33	2,799.51	1,976.16
1025	LOCKBOX - Southern National	10,458.69	3,382.81	2,731.74
1028	MONEY FUND - M Stanley 0.56%	15,109.26	15,129.08	5,133.24
1060	MONEY FUND - Sm Barney 0.62%	5,930.24	5,932.56	66,077.38
1070	MONEY FUND - Legg Mason 0.59%	4,787.58	4,714.47	0.12
1130	CD - SM Barney 07/21/04 0.95%	60,000.00	60,000.00	0.00
		102,087.10	92,108.43	76,068.64
		101,483.40	91,750.06	75,408.83

Notice the total “cash” is similar to but not equal to the total Fund Balance from the previous slide

The Answers

- **How much money should we have in the bank?**

  We need to have $30,640 in our Replacement Fund according to our reserve analysis. We need to have $42,567 in our Capital Fund so we can do our four entry and park projects on schedule. And we want to have $54,000 in our Operating Fund which, by Board policy, is set at 4 months operating expenses. Therefore, we should ideally have $127,207 in our Fund Balance. We currently have $105,000 or 83% of our ideal balance.

- **What is the right assessment for our community?**

  Our assessment has been set at $340 to meet all of our operating, replacement and capital goals and to get us to our ideal funding levels within two years.

Questions & Answers