<u>**Reserves Fund – Design and Implementation**</u>

The following guideline is an addition and expansion of the more general data presented in the existing "Heritage Grand Financial Administration Overview" guideline; this guideline provides additional *detailed* information on the specifics of reserve funds design and management. Our purchased Reserve Study, routinely restudied every five years starting in 2015 through Reserve Advisors, LLC, is in compliance with and exceeds the National standards set forth by the Association of Professional Reserve Analysts (ARPA).

As is consistent with all other Heritage Grand funding/spending, *the reserves funds are administered under the fiscal authority and responsibility of our elected Board of Directors (Board).*

Typically, the expected expenditures that <u>*regularly occur* each year</u> will be funded through the January through December <u>annual budget</u>.
Three line items included in the annual budget (discussed following) are the necessary cash input needs (called "transfer funds" within the annual budget) for reserves fund projects.

The <u>*non*-annual but reasonably anticipated</u> future spending (future meaning over the upcoming 30-year period) is addressed through the "<u>Reserves</u>" program as further defined below.

Each reserves study is inputted with a fixed-over-30-years (a) inflation rate and (b) return on invested holdings percentage values that hopefully reflects current real-world situations.

Line items included in the Reserve Study include those elements with: (a) Heritage Grand responsibility; (b) limited useful life expectancies; (c) predictable remaining useful life expectancies; and (d) a replacement cost above a minimum threshold (currently $9,500).

> *Note: since projects estimated to cost less than $9,500 are programmatically excluded, this infers that Maintenance Committee reserve spending recommendations approved by the Board even though not specific reserve line items are nevertheless acceptable reserves expenditures.*

<u>Our "Reserves" are actually three separate funds</u>:

This "funding for future projects" program (i.e., the reserves program) is a consolidated presentation of three separate (independent) <u>**funds**</u>:

1. The <u>Core</u> fund is supported equally by <u>all 650 home owners</u> (and this fund applied to things like the streets, clubhouse, general amenity costs, etc.);
2. The <u>Duplex Housing</u> ("Americanas") fund is supported only by the <u>98 residence owners</u> within the 49 duplex buildings; and
3. The <u>Stand-Alone Housing fund</u> is supported only by the <u>552 residence owners</u> in that style of housing.

With respect to actual annual homeowner assessments ("dues") transfers for Reserves holdings:

- Duplex housing owners pay amounts equal to the sum of the calculation of the core fund plus the duplex-specific fund;
- Stand-Alone housing owners pay amounts equal to the sum of the calculation of the core fund plus the stand-alone-specific fund.

Project *expenditures* are debited against the correct fund. (The reserves study includes spreadsheets presenting the design line items.)

Hopefully the following will *not* happen but, in a situation where the expenditure needs of one fund exceeds the holdings in that total fund, the Board can, in open meeting, vote to borrow from another fund to pay for the expenditure. *The contributors of the depleted fund, however, must <u>quickly</u> (2 years? 3 years? a Board decision) replace the borrowed funds due to the various contributors of the three funds.*

<u>Fund Administration Measure</u>:

The primary measurement of reserves management success/failure is comparing the actual reserve holdings dollars for each fund to the "scheduled" (reserves program calculation) holdings at that time. Discrepancies (insufficient holdings/excess holdings) are adjusted by Board action each year when annual operating budgets are approved.

<u>Funds Income</u>:

Three streams of <u>reserves income</u> are collected and segregated by the above three funds:

- Homeowner annual contributions (transfers from the annual operating budget).

  Note: This annual homeowner contribution gives reality to the concept the HOA has utilized long-term: we "<u>pay as we go</u>."

  Annual reserves contributions, in addition to paying fair share amounts to future projects, also greatly minimizes the potential of requiring special assessments from those unfortunate homeowners who might reside here when a major project is implemented.

- Return on Investments (ROI) on previously collected funds (typically interest on CD's or money market accounts) previously collected for designated future project work.

  Currently all ROI is taxable per federal tax code requirements and this tax rate is 30% when filing the (routine for us) Form 1120-H: 'U.S. Income Tax Return for Homeowners Associations.'

- Capitalization Fee (Cap Fees) are contributions received from <u>new</u> property owners as a component of closing costs, and serve as new owner contributions to the reserves at move-in time.

  Cap Fees amounts may be differentiated based on the housing type (duplex or stand-alone housing) being purchased. (This difference is due to different benefits delivered due to the housing type being purchased.)

<u>Restudy Considerations</u>:

When a restudy is made (currently, per Board policy, every five years but the Board could vote to study more frequently if special financial environments are encountered), *the current holdings of the three funds (as reported in our monthly financial cost sheets) are transferred into the restudy program as the beginning balances of each fund.* (This says, for instance, that all previous Duplex owner contributions remain with the duplex fund and are not spread to another fund.)

All project plans (spreadsheet line items) are restudied for the new 30-year period; the spreadsheet calculations or specific fund allocations from the previous study are no longer applicable.

> Assuming the previous study was "fully" funded (our goal), the restudy *might not* reflect significant dues transfer adjustments from study to restudy.
>
> If, however, significant economic changes have occurred since the last restudy – inflation rate increase, ROI return reductions, etc. – there might be *significant* transfer requirement changes.

<u>Historical information</u>:

- For the <u>2015 study</u>, the estimated annual return on invested holdings (ROI) used was 1.2%. The future inflation rate was estimated at 2.0%.
- For the <u>2020 study</u>, the ROI used was 2.0% and the estimated inflation rate was also 2.0%.
- The current <u>2024/2025 restudy</u> proposes using 2.7% for estimated ROI and 3.2% for the estimated inflation rate over the 30-year life of the study (years 2025 through 2054).

<u>Calculation Considerations</u>:

- The ROI calculation generally takes care of itself in that whatever income *actually* received is credited to the proper fund.
- The inflation rate is more challenging (even though "perfectly set" is the program target):
  - If this rate is set excessively *<u>high</u>*, more funds are demanded to perform specific jobs than is necessary.

Excessive rates, however, are also self-correcting to the community as a whole over time: the percentage used in the next restudy five years future will be reset and the funds already generated support future calculations.

- If this rate is *insufficiently* <u>*low*</u> versus actual, inadequate funds are held for the particular job and "step change" adjustments to dues (or, worst case, special assessments) might be required in future years.

Note: the 160% (3.2%/2.0%) change due to projected inflation increases in the 2024/2025 study makes significant "funds-needed" impact over a 30-year study period! See the following examples.

<u>Allocation of ROI:</u>

This activity is currently split based on the percentage of reserve funds held at the beginning of that restudy for each component and the split percentages will be held constant throughout the study's 5-year period.

As an example: Heritage Grand's 5/31/24 Balance Sheet reflected the following:
Core Reserves fund holdings = $1,817,199;
Stand-Alone Housing fund holdings = $516,962; and
Duplex Housing fund holdings = $914,543.
Summing these gives a total reserve = $3,248,704. (This total amount is being invested.)
Based on each fund's percentage holdings of the total, ROI income is allocated among the three funds as follows:
Community = **55.9%** of the received income,
Stand-Alone housing = **15.9%**, and
Duplex housing = **28.2%**.

(These percentages could instead be recalculated (Board decision) either 1) each calendar year based on the cost sheet holdings as of 12/31 of the previous year, or 2) some other defined process.)

<u>Cap Fee Adjustments</u>:

Historically our Cap Fees were set at $500 in 2002 and increased to $750 in 2004; no fee adjustments were made until 2025 when the fee was updated to $1,500.

These fees should see routine inflationary updates (but at the same time kept in alignment with Cap Fees charged by competitive communities).

<u>Examples of reserve program specifics</u>:

Question 1: <u>We hold more than $3,000,000 currently; why is that not enough</u>?

A: A review of the roof shingle replacement project at the duplexes (see line item 7.300) is relatively straightforward and shows certain program component interactions.

History: shingles were last replaced in 2020 for about $815,000 project cost as the result of a hail storm (shingles were about 8-years old at the time).

$1,136,200 = The 20<u>20</u> project cost if the roof shingles were replaced then. This step moves all starting point expenditures into 2024 dollars (the date of the restudy).

Our first replacement is scheduled for 2041 based on 20 years of useful life.

$1,940,929 = the 2024 base cost dollars inflated at a 3.2% yearly inflation rate to year 2041. This is the amount of funds needed to be saved up for this specific project.

Since the reserves program calculates for cost from now to 30 years in the future (the current study calculates until year 2054), funds immediately (starting in 2042) begin being generated in 2042 for the *next* shingle replacement project in 2062 – the time period (this 2042 through 2054 12-year period) is 60% of available time for the next fundraising cycle.

An argument: why do we need to save for this job if insurance is "likely" to pay anyway? (Insurance has paid in the past.)

Response: But what if that hail storm *doesn't* happen, or doesn't happen exactly at the duplexes?
If we "hope" for a hail storm that doesn't happen, then around 2028 or so we acknowledge our financial recklessness of not purchasing "insurance" for a project we don't (can't?) self-insure for, and therefore have to start a crash savings of the $1.9 million needed.
What does an *additional* assessment like this look like for the 98 homeowners who are saddled with the cost?

> $1,940,929 divided by 98 homeowners divided by, say 3 years = $6,600 per year or <u>$550 in increased monthly dues</u> for the 3-year period.

A *possible* impact: those existing duplex homeowners who want to sell their properties near that time period have to disclose this cost to potential buyers, and those buyers may find other duplex properties that don't have this additional cost. Lost sales? Who knows. Potentially lost sales? Extremely likely.

Question 2: <u>Why do expenses reflected in reserve studies continue to go up so much</u>?

A: We can analyze stand-alone housing painting to see the impact of the inflation percentage increase we've had the past 5-year period (between the 2020 restudy and the 2024/2025 restudy).

See line item 8.800 which reflect painting the same 56 homes in 2026 and then again in 2035 – the 9-year repainting cycle.

In 2026 the projected cost is $131,211.

Doing the theoretically exact same work (= same houses) in 2035 costs $174,216, or $43,000 more than the same work 9-years earlier.

Looking at the obsolete 2020 restudy, painting of these very same houses was estimated to cost $107,211 in 2026 ($24,000 lower than the same work when re-estimated in 2024/2025).

Why the difference? Inflation (3.2% vs 2.0%, or a 160% increase).

Why is the 2020 study "obsolete?" Remember that the 2021-2024 period included a 9% inflation spike but, more impactful, a 20% overall cost increase. The 2024/2025 restudy reflects those cost increases whereas the 2020 study did not.

Question 3: <u>Are we stuck with 3.2% inflation for every year between now and 2054</u>?

Answer: No. We will restudy again in 5 years and, if inflation is more under control, the new study will reflect that improved inflation rate. Assuming that the future restudy in five years calculates that less future funding is needed for a particular duplex housing line item, the money is not lost to duplex homeowners. In fact, future dues may be favorably impacted since more money was collected in the previous five years.
A rebuttal: But I don't want to pay a penny more than absolutely necessary!
Pushback to this: If I knew beforehand that I won't have any house damage in the next 10 years, I need no homeowners or flood insurance and I can save, maybe $35,000 in insurance costs. But I *don't* know… and also, I am not rich enough to self-insure for the size of potential losses, so I buy insurance.

The above paragraph speaks to what happens if inflation rates go *down*, but what happens if the inflation rate goes *up* and the next restudy presents the commensurate i*ncreased costs* associated with the inflation increase? If we fail to address the *current* economic situation through our dues now, we would likely find ourselves in an increased financial bind *then* (i.e., need for much greater step-change dues increases) due to not addressing the expected increased cost five years earlier and spread the increase over more years.

This guideline was ratified by Board majority vote at the <u>12/8/2025</u> open meeting.

Arlen Isham
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