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Planning for Renewals: Goodbye Special Levies – Timing Reserve Fund Monies for Scheduled Renewal Expenditures

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This article answers the following questions:
What are renewals? How does reserve fund planning affect strata finances? How are strata finances organized for investing? What are the effects of investment vehicles redemption dates on renewals?

KNOWING YOUR RENEWALS
Renewals: A renewal plan leads to remediation projects – and differs from a rehabilitation or renovation – as the latter two are associated with premature failure due to lack of maintenance, and/or other preventable causes.

Strata corporations need a long-term working plan for the sustainment of the development's common asset component inventory. That is at the core of a strata corporation's responsibility.

The process of undertaking systemic reconstruction and/or replacement work for aging components that have reached the end of their service life is rife with risk – risk that can be managed.

Perspectives on Common Asset Management:
Conventional wisdom has strata corporations focus on the accumulation and verification of source documents – with infrequent on-site monitoring.

This traditional approach provides robustness, but it does not factor-in issues of incomplete data and actual on-site component performance. There is thus a systematic delay-and-lag with this approach.

A strata corporation without active reserve fund planning reacts to emergencies, and relies on trades and engineers for its decision-making. Reactive decisions are based on a short horizon and the prescriptions of workers, rather than on the performance of components.

The Good, the Bad and the Ugly: Until the introduction of depreciation reports (DRs), strata corporations coped with risk by focusing on three fiscal-years – the past, the current, and the next fiscal-year. This led directly to bloated operating funds, and repeatedly to lacking reserve fund monies – thus our history of reliance on special levies.

This common approach has 'you cannot plan ahead' written all over it. The variability of future fiscal-year operating budgets – especially if reserve fund component expenditures are hiding in them – means that short-term planning's usefulness is limited.

Renewals have little to do with operating budgets, routine maintenance, and the short-term.

The Case of Two Strata Corporations: Hiding reserve fund expenditure monies in the 'Repair & Maintenance' line item to take advantage of 50 percent votes has many limitations.

The fear of dealing with restricted monies breeds inertia. A strata corporation without a DR – and an actively managed component inventory –must approve a ¾ vote resolution for all major expenditures, whether unexpected or planned.

For this type of strata corporation, a reserve fund is believed to be a contingency fund, with little planning whatsoever required – renewals are typically afterthoughts or emergencies with this approach.

Limited or Astute Teamwork?: Many overwhelmed strata councils rely on the opinion of a dominant strata council member, or fall back on a property manager's recommendations when its decision-making time..

For an organized strata council, member turnover doesn't matter much, since the strata corporation has documents, renewal plans, models, and timelines in place – that any member can get a handle-on quickly.

Financials, Inspections and Quotes: Astute strata councils review the on-going statements of operations – income statements, and the statements of financial position – balance sheets, each month.

When this type of strata council sits down to review the fiscal-year statements during the preparation of the AGM package, it reviews its investments, and refines the operating and reserve fund needs for future fiscal-years.

If the operating budget has been cleaned-up and limited to daily, weekly, monthly expenses, then the strata council can focus its work on the reserve fund.

Expenditures that occur less than once a fiscal-year migrate to their rightful place in the reserve fund. The immediate result is less strata monies going to the operating fund and more contributions to the reserve fund – assuming that a sound long-term plan becomes part of strata councils' risk-management.

Council thus reviews and updates the DR's component inventory and the benchmark to make sound fiscal-year based decisions.

All facets of reserve fund planning – physical and financial analyses – are reviewed to make sure that the regular contributions from owners are at the right level, and that liquidity will be available for future planned scheduled renewals, above-and-beyond the mandated fiscal-year closing balance guideline.

When a DR is in Play: If the strata corporation procures a DR, then all strata finances are on the same footing. Operating expenses included in the annual operating budget, plus major repairs and replacements to common property or common assets that are recommended in the most recent DR may be approved as contingency reserve fund expenditures, for the next fiscal-year by a majority vote.

RENEWING YOUR FINANCIAL PLANNING

Let's Get Financial: Once your ducks are in a row – document and component maintenance, major repair and replacement knowledge – it is time to review the strata corporation's financial position and standings.

FIGURE 1 – DEPRECIATION REPORT BASED DECISION-MAKING INVOLVES:
☐ Revising on-going operating maintenance efforts based on inventory
☐ Reviewing and scheduling past-current-future reserve fund expenditures
☐ Updating inspections and quotes before expenditures
☐ Re-working projected reserve fund opening and closing balances to make sure they meet SPA and REIC guidelines
☐ Reviewing the redemption year for investments
☐ Making investment choices for future fiscal-years

If a strata council chooses to acquire a DR and to follow the Real Estate Institute of Canada (REIC)'s method, the reserve fund's position is established by subtracting the fiscal-year-end reserve fund balance from the benchmark's cumulative current requirements. Once adjusted each fiscal-year for inflation, interest, transfers, and expenditures, dividing the same closing balance by the same requirements provides the adjusted cumulative reserve fund standings for all fiscal-years in the projection.

The combination of all variables and their analysis in terms of the reserve fund's position and standings allows the strata council to determine how much monies are to be liquid for scheduled major repairs and replacement expenditures in the longer-term, as well as to revise their portfolio of investments.

What does a Strata Council Control?: Construction Cost Inflation (CCI) is active at all times and strata councils don't control it. Strata councils do control their reserve fund investments. Suppose – everything else being equal – that a strata corporation has a historical Investment Income Rate (IIR) of return of 0.50 percent on all of its investments and that at this rate, using a DR's recommended scenario, it is expected to reach a reserve fund standing of 61 percent at the end of a projection's thirty (30) fiscal-years – meaning that in thirty fiscal-years' time the reserve fund will have the equivalent of 61 percent of the cumulative fiscal-year adjusted benchmark current requirements.

With better managed investments, that increases the IIR to 1.80 percent, the strata council is geared to have the reserve fund at a standing of 100 percent at the end of thirty (30) fiscal years. This amounts to a sizable reduction in the number and magnitude of regular and special contributions imposed on the owners over the life of the development.

What's Special about Contributions?: While the SPA mentions Special Levies over forty (40) times, the distinction between monies in a special levy fund and special monies in a reserve fund is not clear to many. Without the benefit of a DR, unanticipated expenditures require a Special Levy that must be approved by a ¾ vote resolution, and these monies must be accounted for separately from all other strata corporation monies.

FIGURE 2 – EXTRACT FROM A DR'S RECOMMENDED SCENARIO:

Age of Development in Calendar Years:		34	35	63
Construction Inflation Rate (CIR):	2.80%			
Investment Income Rate (IIR):	0.50%	**Current**		
Fiscal Year-end:	May 31	**2016**	**2017**	**2045**
RESERVE FUND OPENING BALANCE		$9,076	$17,453	$259,291
Annual Contributions		$18,500	$22,200	$32,861
Special Contributions		$0	$0	$37,000
Transfer From Operating		$3,627	$0	$0
Annual Investment Income		$0	$87	$1,296
Total Cash Resources		**$31,203**	**$39,740**	**$330,449**
TOTAL EXPENDITURES FOR EACH FISCAL-YEAR		**$13,750**	**$2,827**	**$93,262**
Reserve Fund Closing Balance		$17,453	$36,913	$237,187
Reserve Fund Fiscal-year End Adjusted Requirements		$233,581	$265,911	$389,256
Reserve Fund End-of-year Position		-$216,128	-$228,998	-$152,069
RESERVE FUND STANDINGS		7%	14%	61%

The investment vehicles in a reserve fund can be for annual fiscal-year based regular contributions – that are escalated predictably and smoothly over time – as well as for planned special contributions that occur irregularly, and typically in future fiscal-years with large expenditures.

What investments?: Since reserve fund monies can be in a reserve fund for up to the duration of the economic-life of a development – over 100 years is not uncommon – having investment vehicles that mature in five (5) year increments makes sense for a variety of reasons, most of all, to ensure a reasonable grasp on risk-management.

When it comes to managing reserve fund monies, five (5) years happens to coincide with the SPA's maximum mandated time-horizon for the redemption of permitted reserve fund investment vehicles.

Yet for the well managed strata corporation with a DR acquired five (5) years ago – and renewed three (3) years since – its strata council is looking five (5) years back and five (5) years forward, for a moving total of ten (10) fiscal-years of investment vehicles to be managed each fiscal-year.

MANAGING YOUR FINANCIAL RISK

Who and What Affects a Strata Corporation: Owners comings-and-goings, strata council member turnovers, fluctuation construction and interest rates, shifting real-estate markets, trades and engineers, reserve fund planners – all affect a reserve fund's management and performance.

Strata corporations may be non-taxable corporations, with the downside of often being a playground for speculators. The upside is that for owners who consider strata lots their home, permitted investment income is tax-free.

With reserve fund planning, contingencies no longer have a place – no more special levies as remediation costs are at the centre of renewals.

From a strata finances perspective, a fiscal-year focus on having owners pay their fair-share of their use of a development's assets makes sense.

Yet there is no turnstile to measure usage. Are users to abuse developments for their own benefit simply because there are no means in place? With active reserve fund planning all of this changes.

RENEWED RETURN ON YOUR RENEWALS

Parts to the Process: Static, moving and iterative repeated tasks are all part of the process of best-practice management and planning for a strata corporation's renewals.

Reviewing past plans, inspections, quotes and statements has to be done repeatedly. Having in place a sound documented process to measure changes allows any strata council member – and for that matter any stakeholder – to quickly ascertain common asset needs and financial preparedness.

Determining the consequences of these needs on strata finances, and establishing the demand for monies on the owners is possible, with DRs. Having a system in place means that all parts of the process can proceed smoothly towards sustaining renewals, and the value of strata lots and developments.

Best-practice Strategies: A timely fiscal-year based financial management strategy has two parts once a DR is acquired. Since a strata corporation is defined by its operating and reserve funds, a strata council is to fine-tune its operating budget requirements and its need for contributions to the reserve fund on a fiscal-year basis.

Without a DR, most strata corporation base their reserve fund contributions decisions on transferring at least 10 percent of the current fiscal-year's operating budget to eventually reach 25 percent of the current fiscal-year's operating budget.

The SPA makes it clear that with reserve fund planning and DRs, the strata corporation can follow the recommendations of the reserve fund planner above and beyond this guideline.

As the process of planning for renewals proceeds from fiscal-year to fiscal-year, reserve fund planning ensures that scheduled expenditures have the monies they need, and allows for the investment of the rest of the reserve fund monies in vehicles that mature over a longer timeframe to maximize investment income and thus reduce contributions.

We are all for mitigating risk. Basing decisions on the performance of assets and finances facilitates that process.