



RESERVE STUDY AND INSURANCE APPRAISAL HANDBOOK FOR MANAGERS AND BOARD MEMBERS

Dear Community Manager and Board Member,

This handbook shall provide the reader with a quick and convenient reference for insurance appraisals and reserve studies.

Besides the condo declaration and the association's budget, the reserve study and the insurance appraisal are one of the most important documents for the annual financial considerations of the board.

Reserve studies are essential in assisting the board for budget considerations and financial planning in general. A good reserve analyst will identify all the components in a community, which the association will have to replace in the future. Reserve studies should be prepared for a 30-year period and updated on an annual basis.

The insurance appraisal plays a vital role in the insurance process. Without it, the association cannot be sure the buildings are insured at the correct amount. Therefore the Florida legislature has implemented language in the statutes to provide for an appraisal every three years. A well-written report will assist the insurance agent not only with the valuation but also with essential information about the property from flood maps to building sketches.

If you have questions about appraisals and reserve studies, please do not hesitate to contact us for assistance.

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RESERVE STUDIES AND INSURANCE APPRAISALS

Glossary and Definitions

*A Handbook for
Association Managers and Board Members*



*Provided by:
Staebler Appraisal and Consulting*

RESERVE STUDIES

GLOSSARY

Budget Year

The budgetary year for which the report is prepared. For associations with fiscal years ending December 31st, the monthly contribution figures indicated are for the 12-month period beginning 1/1/20xx and ending 12/31/20xx.

Inflation

This figure is used to approximate the future cost of repairing or replacing each component in the report. The current cost for each component is compounded on an annual basis by the number of remaining years to replacement, and the total is used in calculating the monthly reserve contribution that will be necessary to accumulate the required funds in time for replacement.

Annual Assessment Increase

This represents the percentage rate at which the association will increase its assessment to reserves at the end of each year. For example, in order to accumulate \$10,000 in 10 years, one could set aside \$1,000 per year. As an alternative, it is possible to save \$795 the first year and increase that amount by 5% each year until the year of replacement. In either case one arrives at the same amount. The idea is to start setting aside a lower amount and increase that number each year in accordance with the planned percentage. Ideally this figure should be equal to the rate of inflation.

Investment Yield Before Taxes

The average interest rate anticipated by the association based upon its current investment practices.

Taxes on Interest Yield

The estimated percentage of interest income that will be set aside to pay income taxes on the interest earned (differs from state to state)

Projected Reserve Balance

The anticipated reserve balance on the first day of the fiscal year for which this report has been prepared. This is based upon information provided and not audited.

Percent Fully Funded

The ratio between the calculated fully funded amount and the actual amount available.

Monthly or Quarterly Assessment

The assessment attributed to the reserves required, by the association each month or quarter.

Interest Contribution (After Taxes)

The interest that should be earned on the reserves, net of taxes, based upon their beginning reserve balance and monthly contributions for one year. This figure is averaged for budgeting purposes.

GLOSSARY

Total Monthly Allocation

The sum of the monthly assessment and interest contribution figures.

Percentage of Replacement or Repairs

In some cases, an asset may not be replaced in its entirety or the cost may be shared with a second party. Examples are budgeting for a percentage of replacement of streets over a period of time, or sharing the expense to replace a common wall with a neighboring party.

Placed-In-Service Date

The month and year that the asset was placed-in-service. This may be the construction date or the date of the last servicing or replacement. If the placed-in service date is not known, the date can also be used by the analyst to estimate the effective age. For example, if a component is estimated to be 15 years old and we write the year 2013, the components placed-in-service date would be 1998.

Estimated Useful Life

The estimated useful life of an asset based upon industry standards, manufacturer specifications, visual inspection, location, usage, association standards and prior history. All of these factors are taken into consideration when tailoring the estimated useful life to the particular asset. For example, the carpeting in a hallway or elevator (a heavy traffic area) will not have the same life as the identical carpeting in a seldom-used meeting room or office.

Adjustment to Useful Life

Once the useful life is determined, it may be adjusted, up or down, by this separate figure for the current cycle of replacement. This will allow for a current period adjustment without affecting the estimated replacement cycles for future replacements.

Estimated Remaining Life

This calculation is completed internally based upon the report's fiscal year date and the date the asset was placed-in-service.

Replacement Year

The year the asset is scheduled to be replaced. The appropriate funds will be available by the first day of the fiscal year for which replacement is anticipated.

Annual Fixed Reserves

An optional figure which, if used, will override the normal process of allocating reserves to each asset. This method requires "bending" the reserve study to the budget, whereas ideally the study should supersede the budget. Very few associations use this method.

Salvage Value

The salvage value of the asset at the time of replacement, if applicable.

One-Time Replacement

Notation if the asset is to be replaced on a one-time basis.

GLOSSARY

Current Replacement Cost

The estimated replacement cost effective at the beginning of the fiscal year for which the report is being prepared

Future Replacement Cost

The estimated cost to repair or replace the asset at the end of its estimated useful life based upon the current replacement cost and inflation.

Component Inventory

The task of selecting and qualifying reserve components. This task can be accomplished through on-site visit, review of association design and organizational documents, a review of established association precedents, and discussion with appropriate association representative(s).

Funding Options

When a major repair or replacement is required in a community, an association essentially has four options available to address the expenditure:

First of all, the Board of Directors has to ensure its ability to maintain the assets for which it is obligated by assessing an adequate level of reserves as part of the regular membership assessment, thereby distributing the cost of the replacements uniformly over the entire membership.

The community is comprised of past, present and future members and the burden to maintain the association has to be distributed evenly and fairly among the members. Any decision by the Board of Directors to adopt a calculation method or funding plan which would disproportionately burden future members in order to make up for past reserve deficits, would be a breach of its fiduciary responsibility to those future members. Unlike individuals determining their own course of action, the board is responsible to the "community" as a whole.

The second option is for the association to acquire a loan from a lending institution in order to effect the required repairs. In many cases, banks will lend to an association using "future homeowner assessments" as collateral for the loan. With this method, the current board is pledging the future assets of an association. They are also incurring the additional expense of interest fees along with the original principal amount. In the case of a \$150,000 roofing replacement, the association may be required to pay back the loan over a three to five year period, with interest.

The third option, used too often, is simply to defer the required repair or replacement. This option, which is not recommended,

FUNDING OPTIONS

can create an environment of declining property values due to expanding lists of deferred maintenance items and the association's financial inability to keep pace with the normal aging process of the common area components. This, in turn, can have a seriously negative impact on sellers in the association by making it difficult, or even impossible, for potential buyers to obtain financing from lenders. Increasingly, lending institutions request copies of the association's most recent reserve study before granting loans, either for the association itself, a prospective purchaser, or for an individual within such an association.

The fourth option is a special assessment for an amount required to cover the expenditure. When a special assessment is passed, the association has the authority and responsibility to collect the assessments, even by means of foreclosure, if necessary. However, an association considering a special assessment cannot guarantee that an assessment, when needed, will be passed. Consequently, the association cannot guarantee its ability to perform the required repairs or replacements to those major components for which it is obligated when the need arises. Additionally, while relatively new communities require very little in the way of major "reserve" expenditures, associations reaching 12 to 15 years of age and older, find many components reaching the end of their effective useful lives. These required expenditures, all accruing at the same time, could be devastating to an association's overall budget.

What do we reserve for?

Major expenses not covered in the operating budget (and usually do not occur on an annual basis) must be budgeted in advance in order to ensure the availability of the necessary funds in time for their use. Reserve expenses are reasonably predictable both in terms of frequency and cost. However, they may include significant assets that have an indeterminable but potential liability that may be demonstrated as a likely occurrence. They are expenses that, when incurred, would have a significant effect on the smooth operation of the budgetary process from one year to the next, if they were not reserved for in advance.

Examples of reserve expenses include but are not limited to:

- Roof
- Plumbing
- Painting and waterproofing
- Concrete restoration
- HVAC system
- Fire alarm and sprinkler system
- Building machinery (in mid and high-rises)
- Elevators
- Access control
- Lighting
- Furniture, fixture and equipment (FF&E)
- Interior Finishes
- Pool resurface
- Pool equipment and heaters
- Fences and walls
- Asphalt mill and repave
- Asphalt seal coating
- Resurfacing of sport areas
- Landscape, irrigation and lighting
- Insurance deductible

FUNDING OPTIONS

State Mandated Reserves:

Florida Statute 718.112 describes as follows:

In addition to annual operating expenses, the budget must include reserve accounts for capital expenditures and deferred maintenance. These accounts must include, but are not limited to, roof replacement, building painting, and pavement resurfacing, regardless of the amount of deferred maintenance expense or replacement cost, and any other item that has a deferred maintenance expense or replacement cost that exceeds \$10,000. The amount to be reserved must be computed using a formula based upon estimated remaining useful life and estimated replacement cost or deferred maintenance expense of each reserve item. The association may adjust replacement reserve assessments annually to take into account any changes in estimates or extension of the useful life of a reserve item caused by deferred maintenance.

How to properly calculate a reserve component to meet state requirements:

An example for fully funded is a roof with a useful life of 10 years and the expected cost of \$10,000. Assuming the roof is five years old, the association would need \$5,000 to have the roof “fully funded”.

Age of the component divided by the useful life times the current replacement cost:

$$(5/10) * \$10,000 = \$5,000$$

Funding Models:

Current Funding Model:

This model is based on the current reserve balance (funds in the bank account) and the current contribution to the reserves per unit/ per month or quarter. It is a good instrument to show the association the current status of the reserves and how the financial situation would develop over the next 30 years if the association would continue funding at the current level.

Pooling Funding Model, also called Threshold Funding or Cash Funding:

This model is also based on the current amount of reserves; however here we calculate the amount each unit should pay per month or per quarter for the association to be able to pay all future obligations contained in the reserve study. Associations, which pool their reserves, use this model. The pooling model is also a convincing argument for associations who are in financial distress and would have to pay much higher amounts when using the straight-line method. The monetary difference between the assessments for pooling and straight-line funding convinces a lot of associations to make the decision to vote for changing the accounting method.

FUNDING OPTIONS

Component Funding Model, also called Straight-line Funding:

This model is also based on the current amount of saved funds for the reserves and computes every component as fully funded. Calculating "fully funded" for every single component results in the component funding model or straight-line funding model. Associations, which are using the straight-line accounting method, have to use this financing model. The straight-line funding model tends to overfund an association in the long run with funds going over the 100% mark. In general an association, which is funded 70% and up, is in good condition, provided that the annual funding progresses at the calculated level.

What does it actually mean to be fully funded?

If you take for example an AC, which has a life of ten years and will cost \$10,000 to replace, you need to have \$5,000 at the end of year 5, \$6,000 at the end of year 6, etc. If you do this calculation with all components and add all together, you should have the sum of all "time-equivalent-cost" accumulated in your reserve accounts to be considered 100% funded.

What does it mean to fully fund the reserve requirements?

The reserve study calculates a certain amount the association needs to contribute during a fiscal year to the reserve accounts. If the association decides to make these contributions as indicated, they will fund their reserve requirements 100%. If not, they will vote it down to a certain percentage.

A lot of associations say, "we are a 100% funded" or "we are funding our reserves a 100%." Be careful with either statement. Read the two paragraphs above and learn how to distinguish between the two statements.

And just because an association funds their reserve requirements a 100%, does not mean the association is a 100% funded.

Update Frequency

Estimating the remaining useful life of a component can be tricky and with our Florida weather, replacement can occur sooner than expected. Furthermore, construction cost constantly changes. Therefore it is wise to update the reserve study for a community every year.

Other reasons are:

- Has the association added or replaced any significant common element in the last year?
- Has the association deviated from the scheduled replacements?
- Has the association contributed to or drawn on reserve funds other than as scheduled?
- Have there been any technological advances or improved product development that might result in a component change?(Also: law changes, for example sprinkler retrofitting)
- Does the current reserve fund balance match what was projected?
- Have any components reached the end of their useful lives earlier than projected?

In general, once an association made the investment to pay for a reserve study, this investment should be protected by updating the study on an annual basis rather than getting a new reserve study every couple of years.

Working with local consultants ensures consistency and readiness by the consultant to assist with updates of the reserve studies.

INSURANCE APPRAISALS

Florida State Law:

Florida Statutes 718.111 reads as follows:

"Adequate property insurance, regardless of any requirement in the declaration of condominium for coverage by the association for full insurable value, replacement cost, or similar coverage, must be based on the replacement cost of the property to be insured as determined by an independent insurance appraisal or update of a prior appraisal. The replacement cost must be determined at least once every 36 months."

Although state law requires the appraisal only every three years, insurance carriers might require more frequent updates.

In any case, please make sure, that the appraiser who provides the update actually visits the property for an update inspection and provides a new set of photos. Insurance carriers might not accept reports with photos older than three years.

INSURANCE APPRAISALS

Minimum Contents of an Appraisal:

- **Letter of transmittal**
 - o Addresses the property owner with statement of date of inspection and summary of values
- **Certification**
 - o Certifies the report and the work of the appraiser to the subject property
- **Signature, rank and license of the appraiser**
 - o Certifies the appraisal was prepared by a licensed commercial appraiser, whose license is current
- **General and limiting conditions**
 - o Explains conditions and limitations, for example if the appraiser had to make assumptions due to a lack of construction plans, etc.
- **Scope of Work (USPAP requirement)**
 - o Describes the steps the appraiser has to take to arrive at the value requested by the client (insurable value)
- **Description of subject property**
 - o A short narrative, which should give an overview of the property such as number of buildings and related site improvements like pool, garage buildings, etc.
- **Flood map and CCCL map**
 - o The flood map is a must as it will determine if the appraisal needs more than one value (Flood and Wind/Casualty Values)
 - o The CCCL map is needed if the property is located seaward of the coastal construction control line

- **Photos of exterior and interior**
- **Photos of site improvements**
- **Owner of record**
 - o Makes sure the report is in fact written for the subject property
- **Identification of client and users**
 - o Ties the report to the client and explains who else may use the report
- **Date of appraisal and date of report**
 - o Shows the carrier the validity and timeliness of the report
- **Purpose and function of the appraisal**
 - o Describes how the report is used and for what purpose it was prepared (Insurable value to be used to determine proper insurance coverage by the insurance carrier)
- **Improvement Description**
 - o Essential to determining the ISO classification and important for the insurance carrier to understand the construction features of the subject property
- **ISO Classification**
 - o Six ISO classification determine the construction quality and the insurance risk of a property (see later section)
- **Definitions**
 - o Explanation of insurable value and construction definitions

INSURANCE APPRAISALS

- **Excerpts from the construction plans or the condo plat book**
 - o Provides insight on the construction features important for the insurance professional as well as the appraiser
- **Valuation pages from Marshall and Swift/Boeckh (MSB)**
 - o Necessary showing the carrier the proper insurable value was calculated
- **Site Improvement valuation (line-item, no lump sums)**
 - o Site improvements like pool, pool fence, pool deck, garages, carports, etc. should not be added together in a lump sum to allow the client, as well as the insurance professional, to chose which items should be insured
- **Summary of values**
 - o Summary of values should be presented building by building with building numbers and/or physical addresses, no lump sum value should be presented
- **Appraiser's qualifications and copy of license**
 - o Proof for the client and other users that the appraiser is appropriately qualified to prepare the appraisal

Insurable Value and Cost Definitions:

Flood Value:

This value is only needed when the property is located in a flood zone, which requires insurance (usually A, AE, V and VE zones). The flood valuation contains the entire building from the foundation to the rooftop.

However, for an appraiser, it is wise to calculate the flood value even if it is not needed because it represents the entire building. This is the value, which can be compared to local construction cost, to cost comparables in the market area and when discussing cost with contractors and developers.

Wind/Casualty Value:

This value is more or less a derivative of the flood value excluding the interior finishes and the foundation with minor parts of plumbing and electric. The wind/casualty value cannot be compared to local construction cost as it is difficult to understand for individuals not familiar with condominium law.

Value "As-Is":

For the purpose of the insurance policy, the building has to be valued as follows:

"The replacement or repair of the structure with like-kind materials based on preexisting conditions".

INSURANCE APPRAISALS

Value “Up to Code”:

This value includes the current building code, e.g. impact resistant openings. The difference between the “as-built” and the “up-to-code” value is the basis for the Ordinance of Law Endorsement.

New Construction versus Replacement Cost:

Because replacement, reconstruction, and repair is always more expensive than new construction, it is vital for an appraiser to use the correct valuation software, like Marshall and Swift/Boeckh. The difference between the two values can easily reach 15-20%. If an appraiser uses the wrong value this can lead to coinsurance penalties in a case of loss.

The Three D's:

The following items should never be included in an insurance appraisal:

Depreciation:

A building is insured at replacement value (RCV) and not at the depreciated value (ACV).

The difference between RCV and ACV is important for an adjuster and the insurance carrier; however, an appraiser should not compute the depreciated value, as it is not within the scope of work for an insurance appraisal.

Demolition:

Usually an insurance policy will automatically include a certain percentage of the dwelling coverage to provide for demolition. This is an adjuster and insurance carrier consideration and has no place in an insurance appraisal.

Debris Removal:

The same as before is true for debris removal.

INSURANCE APPRAISALS

ISO Classifications

The Insurance Services Office (ISO) is a leading source of information for risk management in the insurance industry.

Insurance carriers depend on ISO classifications when it comes to determine the construction quality of a building and Citizens does not even accept an insurance appraisal without an ISO classification.

There are six ISO classifications:

ISO 1 Wood Frame

Buildings with exterior walls, floors and roof constructed of combustible construction.

ISO 2 Joisted Masonry

Buildings with exterior walls of masonry, but with combustible roofs and floors.

ISO 3 Noncombustible

Buildings with exterior walls, floors and roofs of noncombustible or slow burning material; structural steel, walls and roofs are noncombustible, slow burning fiberglass insulation (for example a warehouse).

ISO 4 Masonry Noncombustible

Buildings with exterior walls of masonry, not less than four inches thick, or buildings with exterior walls of fire-resistive construction with a rating of not less than one hour and noncombustible or slow-burning roofs, regardless of the type of insulation on the roof surface (for example a full masonry building with concrete floors, concrete roof and built-up or membrane roof cover).

ISO 5 Modified Fire Resistive

Buildings with exterior walls, floors and roofs of masonry materials not less than four inches thick or fire-resistance rating less than two hours but not less than one hour. This classification also includes structural steel protection techniques.

ISO 6 Fire Resistive

Exterior walls of solid masonry, including reinforced concrete not less than four inches thick, hollow masonry not less than twelve inches thick; exterior non-bearing walls and wall panels may be slow burning, combustible or with no fire-resistance rating. Floors and roof are cast-in-place and at least four inch thick; the building contains also cast-in-place reinforced beams and columns. All structural steel needs to be protected with proper steel protection techniques. Both, pre- and post-tensioned concrete units have steel cables installed in the concrete to provide tensile strength.

INSURANCE APPRAISALS

Who may prepare an Appraisal Report?

In Florida we have three different appraiser ranks, all regulated by the Department of Business and Professional Regulation (DBPR) and the Florida Real Estate Appraisal Board (FREAB) which functions like as a division of the DBPR.

State-Registered Trainee Appraisers:

- The education requirements include 100 classroom hours of Board-approved courses covering the topics required by the FREAB in subjects related to real estate appraisal. After registering with the DBPR the Trainee Appraiser may only work under the supervision of a State-Certified Appraiser (either residential or general). Trainees are not allowed to sign an appraisal report without the accompanying signature of their supervisors.

State-Certified Residential Appraisers:

- Residential Appraisers can only appraise residential properties up to four units.
- The education requirements include successful completion of 200 classroom hours of board-approved courses covering the topics required by FREAB in subjects related to real estate appraisal.
- Provide proof of satisfactory completion of a 2-year associates degree or higher
- 2,500 hours of real property appraisal experience obtained over a 24-month period
- Pass the Residential National Exam and Florida Supplemental Exam.

State-Certified General Appraisers:

- General or commercial appraiser may appraise both, residential and commercial properties.
- The education requirements include successful completion of 300 classroom hours of board-approved courses covering the topics required by FREAB in subjects related to real estate appraisal.
- Provide proof of satisfactory completion of a 4-year bachelors degree or higher
- 3,000 hours of real property appraisal experience obtained over a 30-month period in real property appraisal. At least 50% (1,500 hours) of the claimed experience must be in commercial appraisal work.
- Pass the General National Exam and the Florida Supplemental Exam.

For your next appraisal report, make sure the person you hire is properly licensed; and remember, buildings with more than four units can only be appraised by a State-Certified General Appraiser.

If you are not sure if the person you will hire is licensed, go to the DBPR website and make a license search.
<https://www.myfloridalicense.com>



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