# Annual Funded Ratio

## When a condominium corporation's reserve fund is adequately funded accountants like the inflation matched approach, which they learned from businesses that are trying to maximize their revenue stream. A "no deficit" approach is often too simplistic, as it aims only to ensure reserve balances meet planned expenditures on an annual basis. What happens when the boilers fail the winter after a wall restoration program has been completed? What is the right approach to funding? How can a corporation and their property manager reduce these risks?

BY JEFF TRUMAN

**What does the Condo Act say?**

The Condominium Act of 1998 was put in place partly to address serious shortcomings in the financial health of condominiums. The condominium stock had reached a point where significant expenditures were being required for building repair projects. Without a mandated reserve fund, many corporations simply did not have one. Special assessments were often required. This unfairly punished current owners, since past owners did not make contributions to cover the use of the building's common elements.

The act simply requires that "the board shall review (the reserve plan) and propose a plan for future funding ... (that will ensure) the fund will be *adequate for its intended purposes.*" The italics are meant to emphasize the non-specific nature of the requirement.

Accordingly, many condominiums may still not be adequately funded, or exposed to risk of special assessment. Other recent factors, such as construction inflation and the HST, have also created concerns.

So how can a corporation do better?

**Risk management: A better way**

A risk-based approach to project planning seeks to identify the potential risks, their impact, and devises appropriate remedial measures that reduce or manage the impact of the risk event.

The primary risk to a reserve fund plan is that expenditure requirements exceed the reserve fund amount in any given year. There are many ways this risk arises, most of them beyond the control of the corporation. If you can't control the risk, you must prepare for it to occur.

One way is to set reserve contributions so high that the reserve fund can accommodate any event. However, a large reserve fund does not translate directly into benefits for the unit owners, and higher contribution amounts can scare off potential buyers.

Meeting the requirement of the act only requires a corporation to have sufficient funds to meet the planned expenditures. If expenditures occur earlier than planned, or the economic climate deteriorates, this level of funding exposes the corporation to the risk of special assessments or deferred maintenance, which increases the future cost.

**Annual Funded Ratio (AFR)**

A measure we use to assess the health of the reserve is the "Annual Funded Ratio" (AFR) -- the three-year moving average of the reserve starting balance to the planned expenditures.

Many industries typically utilize three- and seven–year moving averages when forecasting trends. We use a three-year period, as it matches the reserve study update period as defined by the act. Using a three-year moving average allows the AFR to look forward to the future health of the reserve fund, and acts as a barometer on the relative health of the reserve.

The higher the value of the AFR, the less likely unexpected or sooner-than-anticipated expenditures will have a negative impact on the reserve. A Fully Funded Reserve in accordance with the

minimum requirements of the act has AFR = 1, with the reserve balance just meeting the anticipated expenditures.

We recommend AFR ≥ 2 so that in any given year if that year's planned expenditures have been made, the reserve can accommodate a sudden expense in the amount of the average of the next three year's planned expenditures.

Truman Engineering Services Inc. develops each funding plan to meet the requirements of the act and offers varying funding recommendations the company can adopt to suit their financial requirements, including risk tolerance. When the AFR is greater than 2, there is some risk of over-inflated future-year reserves, depending on economic conditions. Therefore, to ensure the most efficient contribution rate, the funding plan should be reviewed on a regular basis to maintain the corporation's desired level of risk mitigation.

**Conclusion**

Like any financial plan, a well-crafted reserve plan is an asset to the corporation and enhances the value of each owner's unit. It includes an assessment of the risk appetite of the client, which requires input from the board, the property manager, and parties most familiar with the building, including service trades. This also requires a thorough understanding of risk events, their probability and potential outcomes associated with those events. A planned approach that incorporates these aspects reduces the financial risk for the corporation. □

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