Nemo's great uncle (flickrCC/Nemo's great uncle)

How to Analyze a Depreciation Report

A depreciation report involves anticipating and preparing for the major repair and replacement of a strata corporation's common property and assets. It has two integral parts: the physical analysis and the financial analysis. The report is a budget planning tool.

The financial analysis estimates the strata corporation's expected long-term expenditures to determine a recommendation for appropriate reserve fund contributions in the future. Depending on the state of the contingency reserve fund (CRF), there are different methods of raising revenue to meet the expenditures—known as the "funding plan." In BC, the legislation requires three funding plans to address alternate funding scenarios.

This article will focus on determining the strength of the contingency reserve fund, understanding financial responsibilities, and identifying some specific issues to watch for that can undermine the accuracy of the financial analysis employed in a depreciation report.

MEASURING A PROPERTY'S RESERVE FUND STRENGTH

A fully funded balance means that there are enough cash and investments in a CRF to meet spending and saving requirements. North American standards for reserve fund planning use this benchmark to calculate the expenditures. All depreciation reports should indicate this benchmark as one of the three funding scenarios.

The CRF balance grows as building components and other assets age and the financial needs of the strata corporation increase, but shrinks when projects are accomplished and the expenditures of a strata corporation decrease. The balance changes each year; it is a moving but predictable target.

The CRF balance can measure reserves, but the true measure, known as reserve adequacy, is whether the funds are adequate to meet the strata corporation's needs.

The reserve adequacy (or reserve strength) is determined in a two-step process that involves:

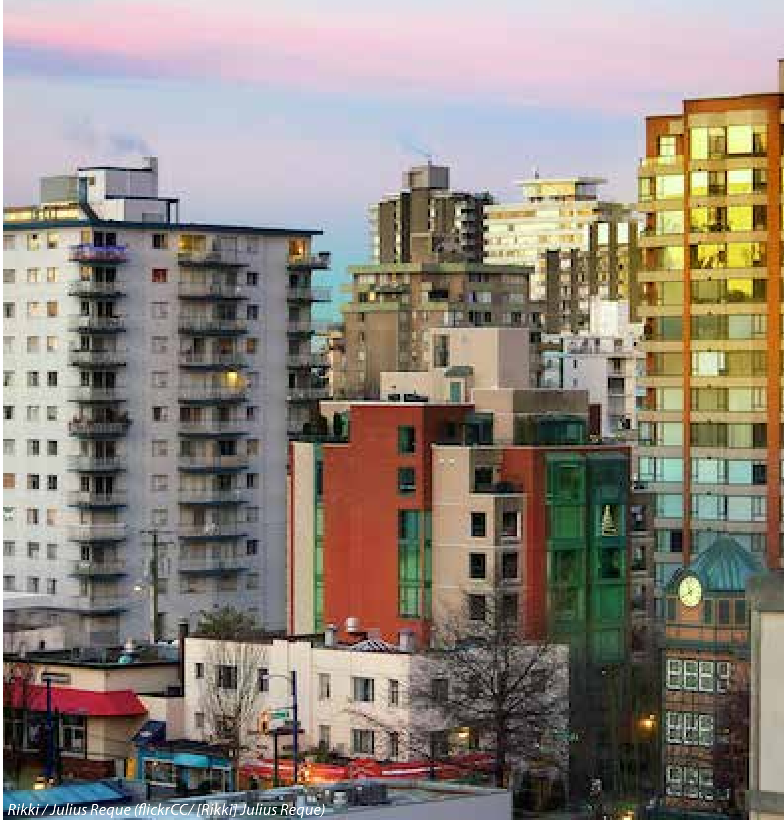
1. Calculating the fully funded balance of the CRF as what would be required in the bank today to cover all future obligations
2. Comparing the current year's CRF balance to the fully funded balance and expressing it as a percentage

Measuring reserve adequacy in terms of a percentage of a fully funded contingency reserve fund reflects how prepared a strata corporation is for upcoming reserve fund expenditures. While a reserve adequacy of 100% is ideal, a reserve adequacy anywhere from 70% to 130% is considered "strong" as in this range cash flow problems are rare. Properties with strong reserve adequacies are highly desirable developments.

A reserve adequacy from 35% to 70% is considered "fair" and strata corporations in this range can expect periodic special levies to meet financial obligations. The 30-year target for most strata corporations is to achieve a fair reserve adequacy.

RESERVE FUND ADEQUACY

Rating	% of Fully Funded Balance	Expectation
Strong	70–100% (or more)	special levies occur rarely
Fair	35–70%	special levies occur occasionally
Critical	0–35%	special levies occur regularly



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When a strata corporation's reserve adequacy is below 35%, it is considered "critical." In this range, strata corporations can expect borrowings, loans, or multiple special levies.

Our research indicates that the majority of strata developments in British Columbia in this first mandated cycle of depreciation reports (years 2012–2017) have a reserve adequacy from only 10% to 25% of a fully funded balance.

Given these findings, a funding plan for a fully funded balance is too onerous for most strata corporations and is usually not recommended. To achieve a fully funded balance a strata corporation would have to pay a special assessment to bring the CRF balance equal to current reserve requirements. It is usually recommended that an alternate funding plan be implemented with a gradual increase in monthly owner contributions to maximize annual interest income and minimize periodic special assessments.

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Bramwell & Associates Realty Advisors Inc. has a Commercial Valuation division and one of BC's largest dedicated Depreciation Report divisions. Jeremy Bramwell holds the Certified Reserve Planner (CRP) designation, which is the only nationally recognized designation for depreciation reports (and reserve fund studies). Jeremy is Chair of the REIC Vancouver CRP Task Force, responsible for promotion of the CRP brand, and is the author of CARSS (Commonly Accepted Reserve Study Standards). For more information, please visit *StrataReservePlanning.com* or the YouTube channel *Strata Reserve Planning*.

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All depreciation reports should indicate the existing reserve adequacy and provide a plan that allows the strata corporation to increase its reserve fund strength to at least a fair position over 30 years.

STRATA LOT CONTRIBUTION

Owners and potential buyers need to review whether the recommended funding plan is financially feasible for them. The best method is to determine the annual average strata lot contribution[1] in the project. Strata lot owners pay contributions, which are the annual budgeted amounts, to the CRF, as well as possible special levies or assessments. Some strata corporations use strata loan payments, but given the rarity of this item it was not included in the example (see table).

The following table provides an example of what a strata lot owner may need to budget over the next five years to maximize the condition, attractiveness, and usefulness of a property's common assets and building components. Strata owners should find this equivalent information, or calculate it themselves, to make sure that they understand the implications and financial responsibilities they will have in the future.

1 *The contribution of the average strata lot (ASL) is achieved by dividing the respective reserve fund variables by the total number of strata lots in a strata corporation.*

STRATA LOT CONTRIBUTION EXAMPLE

	2014	2015	2016	2017	2018
Annual ASL Contribution	$660	$696	$720	$732	$780
Annual ASL Possible Special Levies	$0	$0	$2500	$0	$0
Total	**$660**	**$696**	**$3220**	**$732**	**$780**

UNSUPPORTABLE ASSUMPTIONS UNDERMINE REPORTS

In BC, the new legislation that requires depreciation reports does not provide specific requirements for who can write them—so everyone is now an "expert." The following are three of what I believe are the most irresponsible things in a report that can render the document useless.

Increasing Percentage Rates

To be fair to all owners in all years, the best practice is to have a stable rate of annual increase in contributions by the strata owners, say around 5%.

Some depreciation reports have increasing rates for contributions, perhaps 3% in the first decade, 5% in the second decade, and 8% in the third decade. This method has three main problems:

1. Not only is it unfair to later owners, but it is not realistic that an owner in year 25 will approve high increases to make up for the low fees in the first decade.
2. The deficit in the CRF and on a per unit basis will increase in the period of lower increased rates, thereby lowering market values.
3. Low contributions will create high special levies when they come due, instead of minimizing them.

Construction Inflation Versus Consumer Price Index

The Consumer Price Index (CPI) relates to annual increases in the price of groceries, gas, rent, and clothes. This has been under 3% for several years. All depreciation reports are indexed for inflation, but the rate must be tied to construction costs.

The rate of construction cost inflation for steel, oil, concrete, wood, and labour has no relationship to the CPI and therefore any report using the CPI for construction inflation is irrelevant. Construction cost inflation rates should be based on the construction cost trends for building types that are similar to the subject property. This has been over 3% for most of the last decade. Anything less will underfund the budget as replacement cost savings will be shortchanged.

Grouping

Building components are differentiated by material, use, and life span. For example, in a low-rise building, there are entrance doors, patio doors, suite doors, service doors, and garage doors. Best practice recognizes that each door's purpose, expected life span, materials, and cost are different. As such, each type of door should have a line in the budget and an expense when a repair or renovation is required.

If these doors were grouped into a category called "Doors" or "Non-Window Openings," for example, it would cause two main problems. First, the doors would be given an average life span and component price, which would distort the projections of when money is to be spent and how much would be required at that time. As well, such grouping does not allow for the use of observed physical status from the inspection, instead relying on an average life span, which may or may not be supported at inspection.

RECOMMENDATIONS

Based on these issues, I have several simple recommendations for readers of depreciation reports in order to analyze them.

Look for the fully funded balance of each of the years in the funding plan (or just look at the first few years, the tenth year, and the thirtieth year) and determine the reserve adequacy. Also, calculate the average strata lot contribution to determine if financial obligations can be met, especially special levies. And last, make sure there is nothing in the report that makes the report conclusions unrealistic or unsupportable. Good luck.