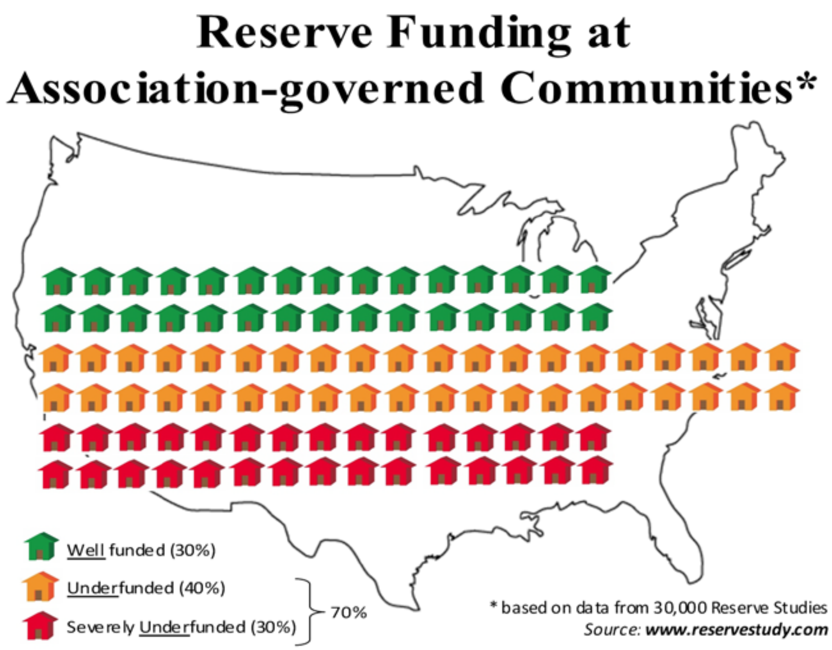
UNDERFUNDING RESERVES – KEEP CALM AND BE SMART: WEBINAR OUTLINE

by Robert M. Nordlund, PE, RS | www.reservestudy.com | March 26, 2014

70% of Associations in the USA are Underfunded. Why?



1) Difficulty Collecting Assessments

The national average 60-day delinquency rate is 5-10%. One of the first things sacrificed when cash flow is tight (due to high delinquencies) is Reserve contributions. In the best associations, delinquencies are 0-5%. What are those associations doing differently?

- They get creative (limit privileges to owners in good standing, or establish lease addendums allowing the association to collect rent from delinquent homeowners)
- Get professional assistance (attorney, collection specialist)
- Develop, adopt, publish, and enforce a collection policy! Show everyone you mean business!

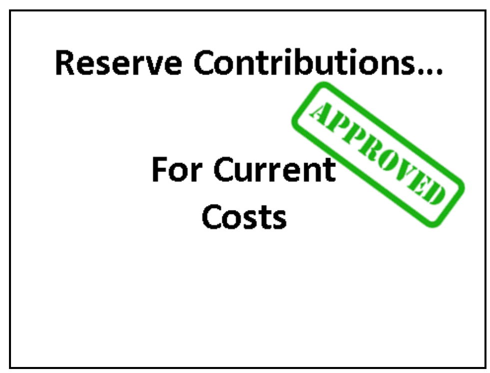
2) Living in a State of Denial

An association needs to take an honest look at their current situation, and assemble the facts. Every successful journey starts with a plan, and a Reserve Study is an association's plan to get successfully to the future. So:

- Face the facts
- Get assistance from a Reserve Study professional
- Update your Reserve Study annually.

3) Letting Emotions Dominate

Most people fear the unknown (the future). They'd rather just deal with the present. So avoid the whole problem of "why do I care about the future of this association – I won't even be here…". <u>Stick to the here and now</u>. Present the Reserve Study as identifying the <u>current cost</u> of ongoing, present deterioration. Totally avoid the emotional baggage when talking of planning for "future expenses" or "saving for a rainy day". Focus on the present. <u>Don't fight human nature – it will be a losing battle</u>!



4) Thinking "We Can't Afford It"

This is just plain false thinking. For one reason, Reserve expenses are not discretionary. You don't have any choice about them. They occur whether you want them to or not. These expenses occur, even if the Board fails to provide funds to offset these ongoing costs of deterioration. And second, <u>someone will bear the cost</u>. In severely underfunded associations, it is the unfortunate set of owners at the time the special assessment is passed who will be forced to bear the cost. And they will not be happy knowing that they are forced to pay more than their fair share, because others paid less than their fair share!

5) **Failing to Make Decisions protected by the Business Judgment Rule**

Boards have insulation from liability exposure if the process they went through to make decisions (like well-documented annual budget decisions!) pass this three-part test:

- They are acting in their area of authority/power
- After having made reasonable inquiry
- Where their decisions were made in the best interests of the association.

If they make willful choices to not fund Reserves, or underfund Reserves, those types of decisions will not be considered “accidents”, so they will not be defended by the association’s D&O insurance policy.

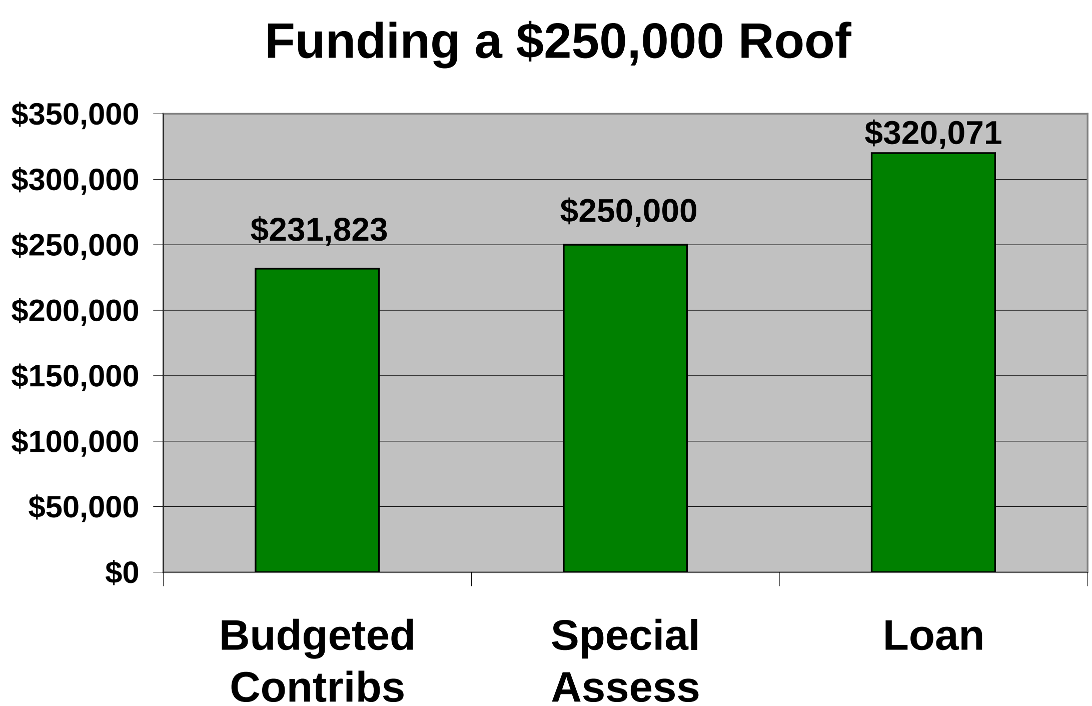
What are the Consequences of Underfunding?

1) **Expensive Deferred Maintenance**

Delayed Reserve projects don’t go away. They often only expand in scope, getting 4-10 times as expensive due to additional damage that occurs.

2) **Need for Uncertain, Unfair, and Expensive Special Assessments or Loans**

See below for what it costs homeowners to perform a $250,000 roof project after 15 years by various funding methods. If you want to save money, fund your Reserves through ongoing, budgeted contributions!



3) Lower Property Values

Home sweet home? Outside of the obvious drop in curb-appeal due to deferred maintenance, having less than 10% of your budget go to Reserves (when 15-40% is typical) means you risk eliminating a large pool of potential buyers. This is because 10% of budget going to Reserves is a minimum standard for FHA, Fannie Mae, and Freddie Mac qualification.

4) Liability Exposure

Budgets and Financial Statements are a wonderfully well-preserved record documenting the decisions made by the Board. Boards who fail to uphold their responsibility to set budgets that maintain the physical and financial assets of the association are highly exposed for lawsuits when future owners are faced with lower property values or special assessments (unless their decision-making process was protected by the Business Judgment Rule).

How do we know if we are Underfunded?

National Reserve Study Standards, published in 1998, give Reserve Study professionals and our clients a consistent set of defined terms and disclosures to facilitate effective communication.

Reserve Studies prepared according to National Reserve Study Standards will have three results:

The Component List is critical, as it forms the foundation of the Reserve Study. It is on the Scope and Schedule of the projects defined in the Component list that the Reserve Fund Strength and Funding Plan will be calculated.

So which Components are appropriate for Reserve Funding?

They must pass this four-part test:

How do we calculate Reserve Fund Strength?

It is a comparison of current Reserve Component Deterioration (the Fully Funded Balance) to Reserve Cash Balance, typically as-of the first day of each Fiscal Year. When they are in balance, the association is 100% Funded. If deterioration has outpaced Reserve contributions, the association is underfunded.

How is it computed?

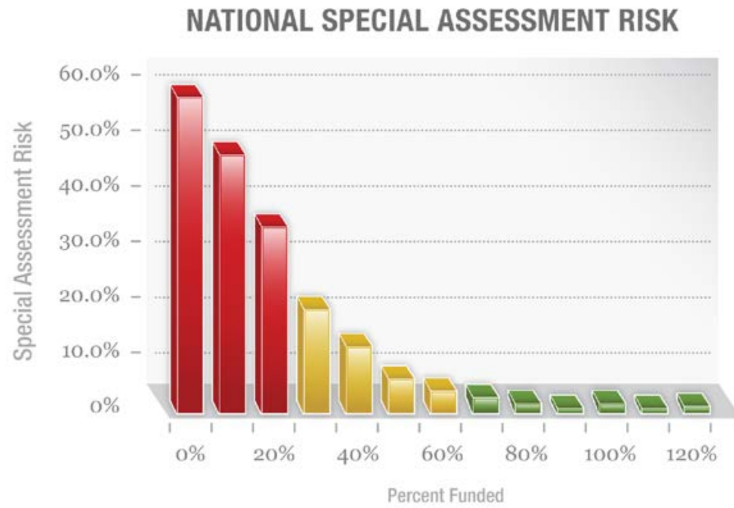
Percent Funded = Actual Reserve Balance / Fully Funded Balance (typically reported as-of the first day of the fiscal year

Note: **Fully Funded Balance** = (Fractional Age) X Current Cost

Where Fractional Age typically is calculated as (UL – RUL) / UL

Why is Reserve Fund Strength significant?

Associations can predict their risk of special assessments and deferred maintenance based on their Percent Funded. The lower the Percent Funded, the higher an association's risk of insufficient funds to perform their Reserve projects in a timely manner.



The Reserve Funding Plan is computed based on the Scope and Schedule of Reserve expenses (defined by the Component List), and in light of the association's starting Reserve Fund strength, designed to most effectively achieve a balance between the following four Reserve Funding Principles.

The bottom line is that an effective Reserve Funding Plan offsets ongoing deterioration, providing sufficient cash when needed, ensuring budget stability from year to year, so homeowners all pay "their fair share" along the way, and so the Board can sleep comfortably at night knowing they have established a fiscally responsible platform for the association.

Audience Questions after the session

Q: What do you do if code changes significantly increase the cost of a Reserve project?

A: Hopefully you anticipated that increased cost as soon as the code was changed, and increased the projected expense in the Component List, giving the association plenty of time to adjust Reserve contributions appropriately. If not, if it was a true surprise, spend the $ and make sure the cost is adjusted in the Component List for the next cycle.

Q: How often should a Reserve Study be updated?

A: The Reserve contribution rate is so large (typically 15-40% of the association's total budget) that it is one of your association's largest budget line items. As such, it deserves annual attention. The condition of your assets change each year, the expected repair or replacement costs change each year, your Reserve Balance changes each year, so after one year it all needs to be updated and re-balanced.

Q: Who should prepare the Reserve Study update?

A: Anyone can prepare a Reserve Study update in all states but Nevada (where a State License is required), but it may be wise to engage the services of an independent, credentialed professional because their expertise and experience lends credibility to the resulting document.

Q: Why should we do a Reserve Study if it's not required in our state?

A: A Reserve Study provides owners with an annual report on the status of the association's major physical and financial assets. In addition, it provides a roadmap to the future, showing the Board and the owners the contributions needed to care for the common area assets. You prepare a Reserve Study update because such information is valuable to the association, not because it's required by State Law.

Q: Where can I find National Reserve Study Standards?

A: The easiest place to find them is on the Association Reserves website, www.ReserveStudy.com, in our "Learning Center. Click here to view.

Q: Why update your Reserve Study annually if your major projects are many years away?

A: Because major projects take years of financial preparation. If a roof project is 10 years away, you'll need all 10 years to prepare. You don't want to wait 5 years and find out that your Reserve interest has been lower than you expected, or you didn't make all your planned Reserve contributions, and labor and material costs have changed enough that you are way off on your cost expectations. You want to be making progress towards your goal each of those 10 years, not spending any of those years drifting away from your objective of getting prepared.

Q: Is the Reserve Study the current state of things at the association, or should it reflect the Board's unique "take" on things?

A: The Reserve Study should reflect the current state of affairs at the association (Component List, Reserve Fund Strength, and the Funding Plan necessary to successfully offset ongoing deterioration). The Board is free to not act on it (execute projects or make Reserve contributions as recommended), but the Reserve Study should always truthfully report the current physical and financial state of affairs at the association.

Q: Can the Board adjust UL or RUL, yielding a higher Percent Funded?

A: If the Board has access to the software, they can clearly do what they want. We applaud and encourage accuracy, so if the adjustments are warranted due to the conditions of the components, great. But misrepresenting the information that appears in the Reserve Study is never a good idea.

Q: What happens to the money if you don't do a scheduled Reserve project?

A: Those funds remain available for that project or any other Reserve project, strengthening the Reserve Fund. Adjust the Remaining Useful Life as appropriate. If the project needs to be done, keep the Remaining Useful life at zero. Otherwise, adjust the Remaining Useful Life accordingly. All just a normal part of the annual Reserve Study update process!

Q: Can you address the difference between "Straight Line" and "Cash Flow"?

A: Both are funding methods. Both provide funds for the exact same set of expenses at the association. Even in a side-by-side comparison where both methods are used to achieve a Full Funding objective, the resulting straight line contributions are typically higher because Reserve funds are used more efficiently in the Cash Flow method because they are not restricted to use on a particular component. That means contributions calculated using the Cash Flow methodology, even with the same funding objective and component list, are more favorable to the association.

Q: What is a good threshold to use to decide between a minor operating expense and a Reserve expense… what cost is too small for Reserve designation?

A: Typically operational expenses are under the Mgr/boardmember signature authority limit. In the absence of that criteria, a threshold in the range of .5 to 1% of the annual budget is often typical.

Q: Is it possible to use an ongoing allowance for a project instead of a total replacement cost?

A: Yes. In situations where total replacement is not expected, but partial replacements or partial repairs are to be expected (sidewalk repairs, plumbing replacements, fence repairs, etc.). These types of projects still meet the National Standard 4-part test.

Q: If I find out something new, or if something changes, should I update my Reserve Study mid-year?

A: No. A Reserve Study is an annual document, prepared for owner disclosure and board budget preparation purposes. We recommend keeping a file of Reserve expenditures and suggested changes (additions or deletions) through the year. Such a file would be used in the process of updating the Reserve Study for the next year.

Q: Aren't Fully Funded contributions too expensive for most associations?

A: No. Fully Funded contributions (directing the association towards being 100% Funded) are, on average, only 13% higher than Baseline Funding contributions (where the objective is simply to keep the association cash-positive, with no margin). <u>Both address the exact same set of expenses at the association</u>. The only difference is that Fully Funded contributions develop some "margin", while Baseline Funding contributions barely keep the Reserve Fund cash-positive. Note that Fully Funded contributions *<u>calculated by the Straight Line method</u>* tend to be a bit higher than Fully Funded contributions calculated by the Cash Flow method, because the Straight Line Method forces a rapid approach to the 100% Funded level. We go into more detail on this point in our Reserve Studies 103 webinar, a recording of which can be found on our website: http://www.reservestudy.com/webinars

Q: Is Percent Funded calculated based on current or future costs?

A: Current Costs, as Percent Funded is a measure of the current financial status of the association. The Funding Plan, on the other hand, is developed based on future costs since it deals with future events.

Q: We are approx 20% funded. Can the current Board pursue former boardmembers for electing not to increase assessments and reserves?

A: In those types of situations, former boardmembers have liability exposure for claims that they failed to perform their duty to create an income stream sufficient to perform the scheduled projects at the association in a timely manner. Hopefully if the former boardmembers can show they acted in their power as boardmembers (not failed to act), made reasonable inquiries to guide their decisions, and acted in the best interests of the association, they will have some liability insulation through the Business Judgment Rule.

Q: If underfunded, how many years is acceptable to improve from Severely Underfunded to Well Funded?

A: With an eye on the cash flow needs of the association, and desiring to not place too high of a "deficit reduction" burden on current owners, often a 5-15 yr timeframe is typical.

Q: What are the remedies for dealing with an owner who refuses to pay any increased monthly assessment and/or special assessment?

A: Proceed with billing that owner their normal, designated share of common area expenses, and handle the delinquency similar to any other delinquency at the association.

Q: If the Reserves get over 100% Funded, is it time to reduce Reserve contributions?

A: Reserve contributions should be calculated and set to offset ongoing deterioration and most effectively pursue all four of the National Reserve Study Standard Funding Principles. If the association climbs over 100% Funded, it means making contributions slightly lower than the association's deterioration rate for a few years may be a successful way to stabilize back down in the 100% range. "Fully Funded" associations typically enjoy some of the lowest Reserve contributions, because they are no longer attempting to build up the strength of the Reserve Fund. They have already arrived!

Q: What is a reasonable life expectancy for road seal?

A: The range is typically 3-5 years, based on road surface, traffic load, slope (its ability to shed water), and the local environment.

Q: What do we do if we didn't make all our budgeted Reserve contributions during the year?

A: Adjust your Operating Budget so that it provides sufficient funds for the needs of the association (so Reserve contributions are not being used for Operating projects), and update your Reserve Study to find how your Reserve contributions need to be adjusted in future years to accommodate the lower projected starting Reserve balance. Typically this results in higher homeowner assessments, as the true cost of operating the association are addressed.

Q: Can you explain what is meant by a "30-yr Funding Plan"?

A: While the Reserve contributions recommendation is for the initial budget year, that initial year forms the foundation for a smooth, 30-yr plan to offset the ongoing deterioration at the association. The result is sufficient funds for all those irregularly spaced Reserve projects that occur through the years. Typically a Reserve Study will have a one-page "30-yr Funding Plan" summary table, showing columns for: years, starting Reserve Balance, the calculated Fully Funded Balance, the resulting Percent Funded (all as-of the first day of the fiscal year), and expected Reserve contributions, any loan or special assessment income, interest earnings, and Reserve expenses through the year.

Q: How do you handle Reserves, and report Reserve transfers?

A: Typically the association collects income from the homeowners into the Operating Account (checking account), then on a regular (monthly) basis transfers the budgeted contribution rate to the Reserve fund (savings account). It is best to make the transfer within the same accounting period (month) in which the funds were received.

Q: We are underfunded because the reserve fund was used to pay for construction repairs that we special assessed for. What should we do?

A: Any time Reserves are spent for non-Reserve projects, it depletes the strength of the Reserve Fund, making it less prepared for the projects it was designed to accommodate. Expect higher Reserve contributions to build back the strength of the Reserve Fund in your next annual Reserve Study update.

Q: Can Reserve Funds be used for Capital Improvements (additional lighting, a new tot lot, etc.)?

A: No. Reserve Funds are for projects that meet the National Reserve Study Standard four-part test. Capital Improvements fail test #1, as they are not yet assets that are the maintenance responsibility of the association. After Capital Improvements have been installed, remember to add repair or replacement of that new asset to the Reserve Study.

Q: Can we spend Reserves for a project not listed in the Reserve Study?

A: Appropriate Reserve expenditures are those defined by the National Reserve Study Standard four-part test. Hopefully all projects that pass this four-part test appear in your Reserve Study. Whether due to human error or unforeseen circumstances, sometimes a "legitimate" Reserve project occurs that does not appear in the Reserve Study. In that case, spend the funds from Reserves, and add the new component to the Reserve Study in the next annual Reserve Study update. If the project doesn't meet the definition of a Reserve project, spending Reserves for a non-Reserve project only depletes the cash available for legitimate Reserve projects.

Q: Is there a difference between "recommended" Reserve contributions and "required" Reserve contributions? Does State Law speak to this?

A: I know of no state distinguishing between recommended and required Reserve contributions. Typically the Reserve Study "recommends" a Reserve contribution rate to responsibly offset ongoing deterioration at the association, meeting the "requirement" stated in almost every set of Governing Documents that the Board "budget adequately for the ongoing care of the association's common areas".

Q: Can an unbudgeted Operating Budget surplus be transferred to Reserves at the end of the year?

A: Yes, as long as the association's Reserves are not in a surplus state (the association needs to maintain its not-for-profit status).

Q: What is the best way to inform the members of the Reserve Budget & its purpose?

A: Distribute the Reserve Study so members can see what their Reserve contributions are going towards, and reinforce at budget time (newsletter, budget meeting, etc.) that the purpose of Reserve contributions are to offset ongoing deterioration, save money by avoiding deferred maintenance, and fairly spread out the contribution burden over those who own homes in the association while those assets are deteriorating. In addition, please encourage them to visit our online Library of resources, or have them view this webinar or others on our webinars page.

Q: How do Reserve professionals estimate replacement costs if that project has not yet occurred at the association?

A: In other words, how do we know how much to estimate for a roof replacement at a new association where the roof has never been replaced? Fortunately, we have experience with a large number of associations, with a wide variety of assets. This gives us familiarity with similar project costs actually executed among our clients. So we are able to use that cost experience. Other resources available to us are the recommendations of trusted association vendors, and national cost-estimating resources.

Q: What is the FHA minimum for Reserve contributions?

A: 10% of the association's total budget. Note that this is typically well below the 15-40% of an association's total budget that is required to offset ongoing deterioration.

Q: Who pays the deductible for an insurance claim? Do you budget for it through Reserves?

A: In general, if the damage can be traced to an individual's willful actions (running into the entry gate), the individual responsible should pay the deductible. If it is a true common area accident, the association pays the deductible. But since insurance is for unknown, unpredictable events, insurance deductibles fail Reserve Component tests #2 and #3, and budgeting for such is inappropriate through Reserves.