TACKLING BUDGETS EFFECTIVELY AND EFFICIENTLY: WEBINAR OUTLINE

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When and where do we start?

Start early, often six months in advance of your Fiscal Year End. Budgeting is a year-round task… review on an ongoing basis, while anticipating adjustments necessary for the next year. You "create the future" with your budget, so give it the appropriate amount of time, energy, and attention.

What is a "Key to Success" in the Reserves discussion?

Focus on the "here and now" – that Reserve contributions are required to offset ongoing, daily deterioration. If you keep up with the "cost" of ongoing deterioration, the future will take care of itself. Totally avoid the "Reserves are for the future" discussion. They aren't. The "cost" of Reserve deterioration is as real as any other bill facing the association. Reserve contributions allow every owner to pay their fair share of deterioration while they own a home at the association.

But what if we can't afford appropriate Reserve contributions?

Reserve expenses (ongoing deterioration) are not optional. Reserve expenses come "with the property". If you choose to not work Reserve contributions into your budget, you have made the choice to pay those same bills (or higher bills when they grow due to deferred maintenance!) at some later point in time through special assessments, loans, or loss of property value.

But we have budget restrictions. We are severely underfunded and can't make that big of a change. What should we do?

Getting into a severely underfunded situation likely took years. It's not inappropriate to take years to get back on track. Start this year by increasing your homeowner assessments $10/mo, with all of it going towards Reserves. We call this "The $10 solution". After 3-5 years of these "do-able" increases, the typical association will find themselves making adequate Reserve contributions, with everyone paying their fair share and minimizing the chance of special assessments, deferred maintenance, and depressed property values at their association.

The $10 solution

How do we know if we are budgeting for all the right things at our association?

National Reserve Study Standards (founded in 1998) indicate repair & replacement projects should be funded through Reserves when they meet the following four-part test. Review this four-part test with your budget committee and Reserve Study professional to ensure no components are missing, and none appear in both Reserves and Operational Budgets. Reserve Components must:

1. Be a common area maintenance responsibility
2. Be Life Limited
3. Have a predictable Remaining Useful Life
4. Be above a minimum threshold cost of significance (often .5% - 1% of annual budget)

Aren't adequate Reserve contributions crippling?

No. Typical contributions for a condominium or townhome association are in the range of $3-$5/day, per home… about the cost of a premium coffee. High-rises and associations with more amenities will require more contributions, Planned Developments and Home Owner Associations (where owners are responsible for the exterior maintenance of their own home) will require lower contributions. You find the size of contributions needed by your association (a combination of the deterioration rate of your Reserve components influenced by the cash-flow needs of the association) in your Reserve Study… it is one of the three standard results of every Reserve Study.

What are the three results of a Reserve Study?

The Component List (the scope and schedule of projects at your association), the strength of the Reserve Fund (typically reported in terms of Percent Funded), and the recommended contribution rate.

RESERVE STUDY RESULTS

What do you do with the Reserve Component List?

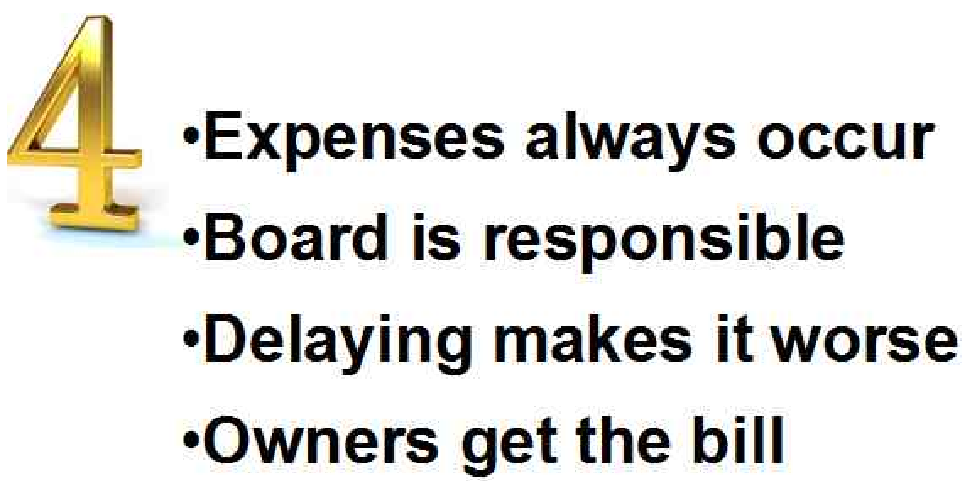
A sharp manager will use it to anticipate upcoming projects… getting proposals in advance, and preparing the Board emotionally and financially for the upcoming expense. Just another way a professional manager can plan ahead and avoid being surprised and painted into a corner.

Reserve Component List

Description	UL	RUL	Cost
Pool Furniture - Replace	5	0	$4,600
Pool - Resurface	10	5	$10,000
Roof - Replace	20	18	$80,000
Asphalt - Seal	5	2	$5,000
Asphalt - Resurface	20	2	$25,000
Building - Repaint	10	1	$50,000
Elevator - Modernize	20	5	$80,000
Hallways - Refurbish	8	6	$24,000

Closing Remarks – Keys for Success:

Understand the Four Reserve Rules: you don't defer any expenses by delaying, you only deal with them later (when they typically get larger), and you've just socked the homeowners with higher fees than if they would have paid a little bit every month, along the way. And, by the way, the blame falls on the Board's shoulders!



Choose the conversation – avoid discussing an uncertain future, choose to stress the "here and now" and the fairness of every owner paying their own cost of deterioration, along the way. Managers – it is your professional duty to guide your association clients towards a successful future. Planning ahead is the key… you've got a full time day-job, so don't try to do your budgeting at the last minute. Budgeting is part of your job year-round! Communicate early and often, it's your job!

Audience Questions after the session

Q: Can we spend Reserve $ on a project not listed in our Reserve Study?

Yes – if it passes the National Reserve Study Standard four-part test. If due to human error or true surprise it doesn't appear in your Reserve Component List, spend the $ from Reserves, and include the new expenditure in your next Reserve Study update, so you'll be prepared next time around.

Q: Aren't Reserve Studies themselves kind of expensive?

The stereotype of being expensive doesn't hold true. In the field of Reserve Studies, there are three Levels of Service:

- Full (do once)
- Update With-Site-Visit (typically over 50% of the cost of a "Full" Reserve Study)
- Update No-Site-Visit (typically well under 50% of the cost of a "Full" Reserve Study)

So the first Reserve Study, your "Full," will be your most expensive (often in the range of 1% of your annual budget). After that, your updates will be <u>significantly</u> less expensive.

Q: If we change Reserve Companies, do we have to start all over with Full Study or can the new company Update our existing Reserve Study?

A: If the prior Reserve Study was prepared according to National Reserve Study Standards (meaning it includes all the required component information and disclosures), it can be easily updated by another Reserve Study firm without starting all over again with another "Full" Reserve Study.

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

A: Approximately 30 states now have some type of Reserve Study requirement. Even so, you update your Reserve Study because such information is valuable to the association, not because it's required by State Law. A Reserve Study provides owners with an annual report on the status of the association's major physical and financial assets and a roadmap to a successful future, showing the Board and the owners the contributions needed to care for the common area assets..

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: 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" (Pooling)?

A: Both are funding methods. Both provide funds for the exact same set of expenses at the association. *In a side-by-side comparison where both methods are used to achieve a Full Funding objective*, straight line contributions are about 10-50% 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 owners with no additional risk.

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: Our association has been doing partial replacements each year, as doing it all at once would be very expensive. Is this ok?

A: You should consider that doing a project a little at a time (window replacement, asphalt or concrete repairs, etc.) will likely cost more money in the long run, as there are probably significant economies of scale in doing the entire project at once. Get a proposal to do all at once, and compare that to your current process. Remember that annual costs will likely increase in the future, the chance of getting matching work done decreases, and the political challenges of deciding who/where things get replaced next is often dicey.

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: 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 (inflated) future costs (and the reality of interest earnings on Reserves on-deposit) since it deals with future events.

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

A: Adjust your Operating Budget for the next year so that it provides sufficient funds for the needs of the association (so Reserve contributions do not continue to subsidize a fictional Operating budget!), 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 is addressed.

Q: 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: 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: Should we budget for landscape replenishment through Reserves?

A: Absolutely. Many significant landscape renovation projects meet the National Reserve Study Standards four-part test.

Q: It's not clear to me why we should be Fully Funded, so long as we have a plan that keeps us well ahead of known requirements for decades into the future?

A: Fully Funded means you have funds on hand, in your Reserve Fund, equivalent to the deterioration at your association. Anything less than that means your success at being able to pay for major Reserve projects will rely on those major projects being spread over a number of years (not all occurring in one year or in back-to-back years), so your Reserve Fund can recuperate from one expense before it is ready to handle another expense. A plan showing you have sufficient cash flow is good, but the future is unpredictable, and it is fiscally responsible to show you are offsetting deterioration with cash.

Q: Does the reserve balance fluctuate through the years?

A: Absolutely. A Reserve Fund will go up and down through the years, since expenditures are usually spaced irregularly through the years. The Reserve Fund will grow in size through "low expense" years as the association approaches a large expense year (roofing!), and the Reserve Fund will drop after one or more large expense years. That's why it's important to measure Reserve Fund strength in terms of Percent Funded, so you can get a more accurate picture of Reserve Fund strength, and do it in light of the association's multi-yr plan (so you don't think the sky is falling after a large expenditure year).

Q: Is a loan an option instead of a special assessment?

A: Absolutely. But it's an expensive option, as the association will be paying interest. The cost of borrowing is not insignificant. In addition, loan payments need to be made in addition to the normal Reserve contributions that are necessary to avoid needing a loan again in another 10 years!

Q: Does Reserve planning apply to our association? They are not required by our State Laws.

A: If you have common area components deteriorating, you need Reserve contributions. You do Reserve planning, and make Reserve contributions, because of the needs of the association, not local State Laws.

Q: Do Members "Ratify" upcoming expenditures, or just Contributions when approving the annual budget?

A: It is the budget (contribution rate) that is ratified, not anticipated expenses through the year.

Q: Recently adding necessary repair and refurbishment projects (left out in prior years) to our Reserve Component List has dropped our Percent Funded down to 17% from 85%. Please comment.

A: Dealing with the truth is always better than in an imaginary world. Prospective owners attracted to your "false" 85% Funded would have reason to sue if they found some pertinent information had been suppressed.

Q: How should a manager such as myself prepare a Reserve Study if the Board doesn't approve the cost of a professional Reserve Study?

A: It is neither the manager's job nor their expertise to conduct a reserve study. They should regularly recommend in writing and in the minutes, the association hire a reserve specialist. Remember - It is not the manager's responsibility to mow the lawn if the board feels it is too expensive to hire a landscaper, and the same goes for preparing a Reserve Study. It is the association who bears the consequence of having no Reserve Study (no budget guidance, no accurate disclosures for members), not the manager.

Q: Our association reserves for roofs and painting of owner-maintained homes (not common property). It has been done this way for years. How should I as a manager react?

A: The association should not be paying for the repair and replacement of private property with association funds (failing the first test of the National Reserve Standards four-part test). Communicate this truth well in advance of the upcoming Fiscal Year, so owners have an opportunity to begin to adjust to this change, and do not be surprised if the "adjustment" takes 2 years (or more). The manager's job is to assist the Board in communicating this change so it is a palatable to the owners as possible. Remember – anything that has to do with money will be a sensitive subject to the Board and to the owners affected. Better to move slowly with much open communication than move quickly and create a toxic political environment for everyone.

Q: In our area there is a 50-50 chance our roofs will be replaced by insurance. Should we still Reserve for them?

A: Yes. It is the Board's job to make sure the association is prepared for upcoming expenses. That is done by making adequate Reserve contributions and paying insurance premiums. If insurance proceeds replace a roof, the association now has more time to prepare (through Reserves) for the next roof replacement project.

Q: Should we Reserve for insurance deductibles (fire, flood, earthquake, hailstorm…)?

A: No. Insurable losses occur unpredictably, so they fail test #3 of the National Reserve Study Standard four-part test.

Q: Can we spend the money for a necessary Reserve project, even though the Reserve Study says it should not happen for a few more years?

A: Absolutely. Reserves are to be spent to maintain the assets of the association. Spend the money, then revise the Reserve Study for the next year.

Q: Can we re-allocate or re-assign Reserve $ from one component to another? Can we add a new component? One scheduled project doesn't need to be done, and one unscheduled project needs to be done a few years "early".

A: See above. Do what needs to be done at your association, and update your Reserve Study annually to reflect the most recent and most accurate expectations for timing and cost of your Reserve projects, and thus your Reserve needs.

Q: Why hire a Reserve Study professional? My board says all they need to do is get a few replacement cost quotes.

A: Any professional saves the board time, provides expertise, and insulation from liability. In many instances, with a credible Reserve Study, current software tools allow volunteers with available time to update that Reserve Study in-between professional Reserve Study engagements without too much risk. See www.QuickReserves.com for such a solution.

Q: Should we send a copy of our Reserve Component List annually to the members?

A: Absolutely (if it is current… don't get into the awkward position of sending out dated information). The Reserve Component List and the association's Percent Funded are important annual disclosures.

Q: Is there a recommended minimum funding level?

A: Yes. "Baseline Funding", where the objective is to keep your Reserves cash-positive, involves a significant risk of special assessment (since there is no margin for the inevitable "surprises" that occur). Baseline contributions are typically about 10-15% less than Full Funding contributions, so it's not a lot more to get peace of mind that comes from freedom from special assessments.

Q: Should we Reserve for replacement and maintenance?

A: You should Reserve for projects that meet the four-part test. Building painting, asphalt seal coating, and tree trimming is sometimes called "maintenance" (or non-capital by IRS standards), but they fit the four-part test and should Reserve for such projects. That said, you should not Reserve for minor, incidental maintenance projects around the association (that are unpredictable, or fall under the .5% - 1% cost threshold of a typical Reserve project).

Q: What is the best way to present our Reserve situation (component status, level of preparedness, and Reserve contribution needs) to our members?

A: Communicate early, often, and in many forms! Newsletter, annual meeting, signage ("Your Reserve Funds at Work… Buildings 1-4 being painted Sept 2014"), messages on the common bulletin board, email notifications, and the annual meeting are just a few ideas. Remember there is good news even in the most dire of situations. Find and emphasize that good news! Example: Let's say the Board cut down expenditures for seasonal planting on the recommendation of the Budget Committee. Everyone wants more flowers, so, it's not all that popular. How to extract a positive message? "Reserve funding increased 2% this year, thanks in large part to the work of the Budget Committee and with the cooperation and understanding of the owners. Thank you all!"

Q: We are currently underfunded. Is it appropriate to have current owners make up the deficit before increasing contributions for next year?

A: One of the principles of Reserve Funding is an "Equitable Distribution" of contributions across the owners. Since it is so difficult to turn the clock back and get current owners to pay what they "should have", we recommend you make adjustments and focus on collecting a more appropriate Reserve contribution rate in the future.