DON'T MAKE THESE MISTAKES!

WEBINAR OUTLINE

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Reduce your Frustration! Avoid making these five mistakes:

1) Confusing your "Day Job" with your "Night Job"

Day Job – vertical chain of command: you have a boss, you have people under you.

Night Job (board member) – chain of command is horizontal - no one person is the boss. You work as part of a team/committee. For profit president role is much different than the role of a non-profit volunteer president.

2) Disagreeing Publicly

Majority decisions are acceptable. Insisting upon unanimous votes puts too much pressure on your board colleagues. You don't always have to decide things unanimously. Expect some disagreement. That is part of the democratic/board process. But remember that you are one Board of Directors. So once the decision has been made, by the majority, support that decision. You are part of the team.

3) Not appreciating Risk vs Reward

You don't get paid. So you shouldn't take risks inappropriate for a volunteer. Keep your risk/liability exposure by adhering to the following:

a) Business Judgment Rule (making your decisions on behalf of the association: in good faith, and in the best interests of the association as a whole, after making reasonable inquiry)

b) Statutory Immunity

c) Following the Corporate Process (go through all the appropriate steps so it doesn't look like "Joe/Mary decided to…")

d) Errors and Omissions insurance

e) Having your vendors and experts do the work (not thinking you have to do it all yourself!

4) Working outside your area of strength

Directors make decisions and "Direct", let your manager carry out board decisions. You pay your vendors, from the manager to the gardener, to do a job - insist they do it, don't do their job for them.

5) Overly Long Board Meetings

People are most effective in their first 60-90 minutes. After that, concentration and effectiveness deteriorates. So:

- Prepare in advance
- Have a "consent" calendar
- Don't over-discuss or over-argue
- Don't insist on unanimity
- Better to have two 90 minute meetings than one three hour meeting
- Convene a follow-up meeting, or delegate to a committee when something is clearly going to take a lot of time

An ideal Board Meeting length is 60-90 minutes. You can do it! The 75 minute Board meeting is <u>not</u> fiction! It is achievable!

Save money – avoid making these common Reserves mistakes:

1) Not doing Reserve projects when needed.

Delaying typically increases the scope of work and total cost, offsetting any "savings" due to not spending the funds on time.

2) Not maintaining your Reserve components.

Failure to perform timely maintenance can shorten the component's life, or expand a projects scope of work. Both increase an association's overall Reserve expenses!

3) Ignoring your Reserve Study.

Ignoring your Reserve Study puts you on the defensive. You lose your opportunity to proactively prepare for upcoming projects, prepare your homeowners for upcoming projects or expenses, and dooms your association to always trying to "catch up" – physically and financially.

4) Not making adequate Reserve contributions.

The roof is going to fail, the carpet is going to deteriorate. These obligations are growing every month, and if the association is not making adequate Reserve contributions, a deficit is growing that will be addressed by future owners. Ongoing Reserve obligations are as real as any other bill the association faces. And remember – Reserve contributions at the typical association are not "too expensive"! For condominium homeowners, Reserve contributions are typically about as much as a premium coffee per day. Millions of people across the country effectively choose to afford that expenditure, so it's not too expensive for your homeowners!

Another way to avoid making key Reserve mistakes is to understand the "Four Reserve Rules":

1) Expenses always happen
2) The Board is responsible to provide for the expenses of the association
3) Delays usually get expensive
4) Homeowners get stuck paying the bills

You can appreciate that homeowners don't like when a Board, through indecision, good intentions, or by mistake, fails to provide for the predictable financial needs of the association, causing predictable expenses to become "surprises" and go over-budget. Don't make life expensive for your homeowners!

For additional resources, see:

www.ReserveStudy.com

and

www.RHOPC.com

You can view the recorded webinar by clicking on this link:
https://www.youtube.com/watch?v=wzXhW-L7-JQ

Post-webinar Q&A session:

Q: Our BOD insists on funding the reserve plan exclusively through special assessments. Their reasoning is that this funding method does not increase the monthly dues and makes future property sales more attractive. Does this policy violate the 'good judgment rule'? Consequences?

A: Planning to act in a reactionary way, instead of a proactive way, is risky and possibly irresponsible. Repeated special assessments rather than a normal budgetary item will lead to confusion among current owners, and especially when transitioning through a unit sale (seller and buyer each claiming the other owes payment). For individual owners living in an association like this, it is wise to set aside your own Reserve contributions to prepare for the inevitable special assessments: $60 or $90/mo ($2 or $3/day) is a good starting point.

Q: Is the Business Judgment Rule a law, or just a guideline?

A: The Business Judgment Rule is a general legal principle that is recited in many association governing documents, but is also found in the California Corporations Code in several places. California Corporations Code Section 5231 contains the rule as applied to non-profit mutual benefit corporations … and common interest developments are non-profit mutual benefit corporations.

Q: How often should you update your Reserve Study, especially if your major projects are many years away?

A: Major projects take years of financial preparation, and since Reserve contributions are such a large portion of the association's annual budget (often 15-40%), it's wise to update your Reserve Study regularly. In our experience, we find that annual updates are one of the best indicators of lack of Reserve cash flow problems. Check with local legislation – in many states there are requirements to update your Reserve Study annually or every X years, or update your Reserve Study on the basis of a diligent visual inspection every Y years.

Q: If not all of our homes have balconies, and they need work, can we charge just the balcony owners (or do we charge everyone)?

A: It depends what your Governing Documents say. If they are "common area", they are the financial responsibility of all owners, not just owners with balconies. You would need to amend your HOA Governing Documents if you wish to specially allocate some common area expenses to some but not all homes.

Q: Do we need to follow the advice of our manager or our consultants (our attorney, our Reserve Study provider, etc.)?

A: That is one of the tenets of the Business Judgment Rule. If you have doubts about the correctness of the advice you are receiving, first make sure you are getting it from the correct expert. For example, your lawyer is not the best person to give you advice about financial statements - that would be the accountant's role. If the correct expert is giving dubious advice, do not just ignore the advice- get a second opinion. If the second opinion differs, you may be able to disregard the first.

Q: How much money should you have in Reserves?

A: Every association has different needs, and those needs are different each year. Reserve Fund strength is measured by the association's Reserve Percent Funded, not its Reserve cash balance. Percent Funded is an important parameter defined in national Reserve Study Standards. It is the comparison of an association's Reserve needs to its Reserve cash balance. 100% Percent Funded is ideal, showing the association has cash set aside equivalent to its Reserve needs. Most associations have some degree of a Reserve deficit (their Percent Funded is under 100%), but associations with a very low Percent Funded (0-30%) often have special assessments and deferred maintenance.

Q: Is it a law to have 10% of your budget going to Reserves contributions?

A: Not a law, but FHA, Fannie Mae, and Freddie Mac all REQUIRE at least 10% of the association's budget going towards Reserves in order for a condominium association to be "approved" by the FHA or FannieMae for loans. Most associations need 15-40% of their budget going to Reserves to offset ongoing deterioration, so 10% is a pretty low standard. Being above that minimum will make loans more affordable (meaning it boosts home values), and it will increase the chance your owners will be able to get desirable refinancing terms. So it is an overall good idea. See additional articles on the subject here and here.

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

A: The Reserve Study should reflect the current state of affairs at the association (Component List, Reserve Fund Strength, and the recommended Funding Plan). The Board is free to not execute projects as recommended, and they are free to not make contributions as recommended, but the Reserve Study should reliably report the current physical and financial state of affairs at the association.

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. We recommend keeping a file of Reserve expenditures and suggested changes (additions or deletions), a file that would be used in the process of updating the Reserve Study for the next year.

Q: What are the most common Reserve Funding mistakes?

A: The most common is presuming that last year's Reserve Study, or one from a few years prior, is still "valid". Reserve Studies are one–year documents. They expire each year. The next is assuming that if you want to be 50% Funded, you make Reserve contributions 50% of the Full Funding contribution amount. That is a big mistake. It takes a lot of money to keep your Reserve fund cash-positive. Being 50% Funded means you have sufficient cash for all your Reserve projects, but only half the "margin" you enjoy if you are 100% Funded. Dropping your Reserve contributions only about 13% will typically eliminate all your "margin", typically causing your Reserves to be barely cash-positive (0% funded). So Reserve contributions to get your association 50% Funded will typically be only a little bit less (5 to 10% less) than Full Funding contributions.

Q: Unforeseen expenses such as water or earthquake are not Reserve-able, but can be paid by borrowing from reserve funds. Are there any general guidelines on how to repay? Specifically, do we special access or increase monthly dues?

A: Reserve Funds were collected for a particular purpose, and are dedicated towards specific projects. Repayment of borrowed Reserves can be done via special assessment (reimbursing the Reserve Fund), or spread out over years by increasing homeowner assessments to cover increased Reserve contributions. An updated Reserve Study is a great way to find out which suits your budget best.

Q: Our condo association has never had problems collecting assessments. Our average unit is valued at $171/sf with $11.60 in reserves and no major outside repairs forecast for 7 years. Why should we not stop funding reserves & borrow on owned land or assessments, if ever needed.

A: Reserve contributions offset ongoing deterioration. If you fail to make contributions, you are letting this "bill" get way ahead of you. It is fiscally responsible to pay this "bill" on an ongoing basis.

Q: Siding of buildings is the largest component in our reserve study. Is it industry standard to reserve for siding? If siding is routinely repaired and well maintained, why would it need to be replaced, and therefore, isn't it unnecessary to include in the reserve study?

A: National Reserve Study Standards have a four-part test that dictates which components/projects are to be funded through Reserves. If a component meets all four tests, it should be funded through Reserves:

1. Is the project a common area maintenance responsibility?
2. Is the project life-limited?
3. Does the project have a predictable Remaining Useful Life?
4. Is the project above a minimum threshold cost of significance?

Presuming exterior siding is a common area maintenance responsibility at your association, it is reasonable to expect that it meets the other three tests, so is appropriate for Reserve funding. In many associations, siding is a very normal Reserve component. The exception would be if ongoing routine maintenance is significant enough to entirely prevent complete replacement in the future.

Q: We currently do not have facility utilities such as electrical wiring or plumbing within the interior walls as components in our reserve study. Is it industry standard to reserve for these items?

A: Please see the above. If a component meets the National Reserve Study Standards four-part test, it should be funded through Reserves. Wiring and plumbing are typically not funded through Reserves because they fail test #3, since timing and scope are often not predictable.

Q: A Reserve Study Policy is required by state law to include when it will be prepared, whether there is a funding plan, the projected sources of funding and whether it will be based on physical and financial analysis. It specifically states an internally conducted reserve study shall be sufficient. We are in the process of updating this policy. Although it is not legally required to be prepared by an independent expert, we understand the benefit and had one done a few years ago. We also have the resources to internally update our reserve study with competent financial individuals. Any advice on the frequency of the two methods?

A: It would be helpful to know your state, as 30 states now have some form of Reserve Study or Reserve Funding requirements. As Reserve contributions regularly comprise 15-40% of a typical association's budget, it is wise to engage outside, independent expert counsel on this matter, than the board making such decisions, that require a particular expertise, in-house. Perhaps you're a compromise is that your policy could state that the more significant With-Site-Visit Reserve Study updates be prepared on intervals consistent with State Law by an independent credentialed individual (look for someone with a PRA or RS credential), and that the association must update their Reserve Study annually, but that the updates in-between With-Site-Visit updates may be done internally.

Q: A Reserve Fund Investment Policy is required by state law. It only says we need to have a policy and does not state what it should be included. We are in the process of updating this policy and questions on the types of investments.

A: Not knowing your state law, we can only comment generally. As fiduciaries for the association, it is typical that rather than articulate a specific short list of appropriate investment vehicles, clearly require that your investments be held in vehicles where there is no chance of loss of principal. Please see a sample investment policy here.

Q: In general, our Board does not like to have special assessments. But in what situations might they be appropriate? We have a large component ($700,000) scheduled in a few years and have been significantly increasing reserves based on recommendation from a reserve specialist. If we fund more than half from reserves at the time of the project, does our declaration language prohibit us from funding the remainder from a special assessment provided we get the required votes?

A: National Reserve Study Standards list four Funding Principles:

- that the contributions provide adequately for anticipated needs
- that the contributions provide budget stability
- that the contributions are equitable over the owners
- that the contributions are part of an overall fiscally responsible plan.

This means, in actual practice, that it is appropriate to fund for anticipated projects through ongoing, budgeted contributions, not intentionally deferring some or all contributions to a future point in time, when an unfortunate set of homeowners will have to bear a disproportionate cost of a project that should have been paid by other owners, over time, who enjoyed the use of that asset. Creating a situation reliant on a future special assessment could be described as irresponsible and unfair, because one set of Boardmembers chose to have future homeowners (others) pay for expenses that current homeowners should have funded.

Q: Is it legal to set up (have homeowners vote on) a special assessment that would run for 4 years with the assessment being $1,000.00 for each year? In addition to the legality, I wonder about the potential problems with collections should a homeowner sell their property during those 4 years.

A: As in the preceding question, "is it appropriate" is usually the issue, not "is it legal". If an association is coming to grips with a major expense 4 years away, it is more stable and equitable to spread contributions to that large expense over 4 years, rather than all at once. Typically we see associations offering a slight discount to owners who are able to pay in advance, while many associations offer payment plan alternatives (6 months, 12 months, 48 months). Remember to include a clause that if there is an ownership change at any point in time, the entire balance due becomes immediately due and payable.
(Kelly): The assessment should state when each payment becomes due, so there is no dispute between a current or former owner as to who owes a payment on the assessment.

Q: What is your opinion about volunteer committees as compared to hiring experts as mentioned earlier?

A: Volunteer committees can be great training grounds for potential directors. However, they should never be a substitute for qualified experts. For example, some large associations have legal committees, with lawyer volunteers on the committee - but they don't analyze legal issues, they liaise with the HOA's legal counsel. Whether with construction, or finance, or other topics, committees do not relieve the board of the responsibility to obtain the appropriate expert input.

Q: When you repair or maintain a reserve item, is it an operating expense or reserve expense?

A: If the repair serves to <u>extend</u> the Remaining Useful Life of the component, it is a Reserve expense. If it is just a minor ongoing maintenance expense necessary to maintain "status-quo" of the asset, it is an Operating expense.

Q: Should minutes contain the task list for the management company. Not as part of motions, just a long list of the management company action items?

A: No. Minutes should reflect just a few items: Which directors attended, what reports were received, what motions were made (and what happened to the motions).

Q: When approaching projects and coordinating bids, meeting with vendors onsite etc., it's hard to get other board members involved to meet or research etc. How do you as president get things accomplished when you can't get help?

A: Most of those tasks can be handled by a competent manager. As a volunteer director, you should be making decisions. Your manager should be doing the work and gathering the information for you to make good decisions.

Q: Please explain what a "Consent Calendar" is and how it operates.

A: A consent calendar is a list, prepared by the manager, which contains the various items which require board approval but which are expected to be so non-controversial that no discussion is necessary. One motion then provides blanket approval for such items, saving time for the board to focus on items which do need discussion.

Q: Are you finding that more HOA board members are hiring constructions consultants prior to investing in major deferred maintenance issues?

A: I have been for years recommending this, because a consultant can often protect the HOA and save it money.

Q: If we don't check to make sure the vendor is doing his job, who does? Vendors come on property and say they've done whatever work he was contracted to perform (for instance – cleaning our drains), but how do we know it was actually done? Do we expect our manager to come onsite and check?

A: A primary role of the manager is to make sure the right vendors are working for the HOA and that they are doing a good job. If individual homeowners give the manager reports, they can sometimes help alert the manager to problems. But let the manager handle things, unless the manager is “financial only” management, in which case the board is stuck with property issues, including vendor performance.

Q: I would like to make it clear that there is absolutely no reason all board meetings have to be at night. They are business meetings and should be during business hours. Comments?

A: (Robert) My association’s board meetings are held during the day. (Kelly) This really depends upon the association. Some associations have members who are more flexible - retirees, for example. It may be unreasonable to expect that all your neighbors miss work to attend board meetings - fit your meetings to your association.

Q: If time allows: Please review IRS 60-704, how it relates to 1120 vs 1120H and the election needed if an HOA chooses to file 1120 (often *after* an election is possible). In particular - what are the risks should an HOA choose (or be advised to) NOT hold the election, and then later knowingly or unknowingly file 1120 anyway - and what is the likelihood those risks will actually come into play?

Follow-up - does failing to do 60-704 properly put that year's reserve contributions at risk?

A: This is a question for your accounting professional.

Q: How unfair is funding reserves through special assessments ONLY to present and future members?

A: Unfairness always has two sides. Funding Reserves through special assessments is unfair to past members, but they snuck away without paying their fair share so they're keeping quiet and not complaining about it. Reserve expenditures are inherently irregular, but Reserve deterioration occurs on a very steady, ongoing basis. It is appropriate to offset the cost of steady, ongoing deterioration with steady, ongoing contributions, or the cost of that deterioration will be unfairly shouldered by future owners.