TIGHT BUDGETS, TOUGH CHOICES

WEBINAR OUTLINE

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What is a Boardmember's Responsibility?

- To Protect, Maintain, and Enhance the assets of the association.
- To collect funds from the members
- To conduct a Reserve Study as one of the many necessary tasks involved in running the association (tax preparation, procure insurance, retain vendors, solicit bids, etc.).
- To spend association money effectively to maintain the assets of the association and run the affairs of the association.

How can a Boardmember do their job well enough to avoid significant liability exposure?

By measuring their actions and decisions against the Business Judgment Rule.

Business Judgment Rule Overview:
Boardmembers are not held to a *perfect* standard, but they need to act professionally and confidently to run the affairs of the association. Boards have reasonable insulation from liability exposure even if it is later revealed they made a "mistake", if their actions and decisions have three characteristics:

1. In a good faith
2. In the best interests of the association (duty of Loyalty)
3. After prudent, reasonable inquiry

How does this differ from a Manager's Responsibility?
A manager is more of a coach, offering guidance and encouragement to the board. The manager has a tremendous opportunity to help the board make wise decisions with their professional training and experience (knowledge of "best practices", State Law, etc.). The board has ultimate authority, but managers wield power and influence. Use it for the good of the association!

Know your Obligations: Providing sufficient income to pay the bills of the Association

<u>Operating Budget</u> (the daily/weekly/monthly recurring expenses) vs <u>Reserve Budget</u> (contributions to offset ongoing, predictable deterioration of the association's major components)

Where is there flexibility?
Level of service: amount or frequency of janitorial, pool care, or security service, level of management assistance, or size of insurance deductibles. In the Operating Budget, it is often readily apparent the difference when service is downsized to save money. If the board goes "a step too far", they can easily scale the service back up to a level appropriate to the needs/expectations of the owners.

In the Reserve budget, the effect of reducing Reserve contributions (or not raising them as necessary!) is not so readily apparent. Deterioration is still ongoing whether the association sets aside sufficient Reserves or not. Getting "behind" will only lead to special assessments and deferred maintenance in the future. Properly sized Reserve contributions will offset ongoing deterioration, will ensure fairness of contributions over the years, and will minimize the association's exposure to special assessments.

So how to safely save Reserves? Avoid being "penny wise but pound foolish" by eliminating maintenance projects that will end up <u>costing the association significantly more</u> at a future point in time.

Remember that not all Reserve projects need to be done when they are scheduled in the Reserve Study. If they have to do with association security or would have catastrophic consequences (no hot water for the entire building!), be proactive and do the project on time. Some projects can be delayed if there are minimal consequences (the lobby or rec room looking outdated, a perimeter fence that is still sturdy, or a pool heater that fails right at the end of the swimming season). Appreciate that some projects are fundamentally best done on schedule, as that <u>timely maintenance project</u> (painting, deck sealing, asphalt sealing, etc.) will prevent expensive deterioration!

So: Minimize Reserve expenses by performing timely preventive maintenance. Spend money as necessary to keep the association's assets well maintained, with the effect of extending the Useful Life of components, delaying costly replacements.

Important: There is no money saved if/when you underfund your Reserves. The ongoing cost of Reserve deterioration is as real as any Operating Budget bill, and it will some day come due and need to be paid. You might as well pay it now on an ongoing basis, rather than wait and dread the inevitable special assessment.

Overall Counsel:

- Run the association for the majority of owners, not the vocal minority. Remember that the board's responsibility is not to make people happy. The board's job is to run the affairs of the association (see first paragraph on Board responsibility). Running the association effectively (protecting, maintaining, and enhancing the assets of the association), maximizes property values, has the important side effect of making the majority very happy!
- Managers – wield your power effectively. Don't condone or enable poor or foolish behavior.
- Don't be constrained by perceived homeowner limitations. Homeowner assessments are only one of an owner's many expenses. Most people can make adjustments here and there if one of their mandatory expenses increases. It may sound callous, but most people have the flexibility to cut back on a few restaurant meals, premium coffee drinks, their extended list of cable channels, or delay purchase of that new car until next year instead of this year.
- Deal with the truth of the matter. Wishful thinking is never a wise plan. For the good of the association, expenses (Operating and Reserves) need to be balanced by sufficient income. Assessments regularly need to be raised in our inflationary economic environment. If some of your owners claim they can't afford the cost of assessments, that is their problem. They need to consider moving to more affordable housing.
- A budget is not just a static document. Employ your salesmanship skills when presenting the budget. Tell the owners how you've saved money by cutting back on X, or retrofitting your incandescent lights with fluorescents, changing insurance companies, etc.
- If a big increase is warranted, one that you feel is crippling or unpalatable, consider taking a small step towards the solution, not getting there all in one giant step. Remember that the Business Judgment Rule allows you flexibility in your decisions if you've made them in good faith, after making reasonable inquiry (and exploring your options), and in the best interests of the association. Don't just give up!
- Understand the important difference between "can't" and "won't". Can't implies real limitations, which rarely exist. Won't is usually the more accurate description of a board who chooses to not make necessary changes to homeowner assessments. Those types of decisions often increase Boardmember liability exposure.

Every decision you make as a Boardmember is measured, and Meeting Minutes and annual budgets are amazingly good records of the decisions made while in office. Let the record show you were wise, not foolish!

Bottom line – as a Boardmember (or a manager guiding and encouraging Boardmembers), pursue your objective, and show courage. Do what needs to be done. Don't be penny wise and pound foolish. Focus on the big picture, maximizing home values and quality of life at the association. Move your association in the right direction!

To view the recorded webinar, click this link:
https://www.youtube.com/watch?v=NoyEQcJiSCg

See more webinars on related Reserve Study topics at:
http://www.reservestudy.com/webinars

Webinar Questions Asked by Attendees

Q: Not wanting to find itself accused of "deferred maintenance"(in spite of a nosediving budget), a majority of our Board often chooses to go ahead with projects at the expense of having to increase annual homeowner dues. What should we do?

A: Maintenance expenses are often very appropriate expenditures. If those expenses are necessary, perhaps an increase in homeowner dues is appropriate and necessary.

Q: Replacing a standard component with an upgraded one: Eg. Standard front lobby doors if upgraded to automatic doors. Is the difference ok? Increase the reserve study at will or does it become a special assessment whether from operation surplus or homeowner special assessment?

A: If the component is a natural evolution/upgrade of an existing component (a newer technology access-control system), or an enhancement of an existing component, that project meets the four-part test as an appropriate Reserve expense. For the next Reserve Study update, make sure the component description, Useful Life, and Replacement Cost has been updated.

Q: Our HOA has always been one of the best funded in our city. A new Board member has taken charge, and the Board is now spending our reserves at an alarming rate. Our reserves have gone from 85% funded to a projected 23% in 2018. What advice could you offer to protect our HOA finances?

A: You don't provide enough information to answer completely. Were they scheduled Reserve projects? Was there one or more unfortunately expensive but necessary Reserve projects? If not, vote in a new majority Board next year!

Q: Can you spend Reserves for a capital improvement, like a landscaping upgrade (to address water conservation)?

A: Yes, possibly. Look for a landscape renovation/replacement line item in your Reserve Study (or create one in your next Reserve Study update). See here for an article on the topic.

Q: How often should you update your Reserve Study?

A: As Reserve contributions are typically one of the association's largest budget line items (often 15-40% of total assessments), and since the condition of the components changes each year, their replacement costs change each year, the size of the Reserve

Fund changes each year, and the association's economic environment changes each year (interest and inflation), annually updating your Reserve Study is a good choice.

Q: What is the requirement for updating your Reserve Study? Annually? Every two years? Five years?

A: Annual updates are recommended (see above). No matter the minimum frequency required by different states, we find that when an association waits three years between Reserve Study updates, our work effort is a significant adjustment. When five years has transpired, it is better described as a rescue effort.

Q: Our reserve and operating accounts are linked at one bank. I've heard our manager ask "Would you like us to transfer money from reserves for this?" No check, no two signatures. Is this appropriate?

A: Err on the side of rigorous accounting. Strong accounting checks and balances (well documented withdrawals and transfers) are appropriate. Note that separate accounts are often required by your Governing Documents.

Q: What can you do when board members use reserve funds to pay for large (non-reserve) items with no open vote and no statement on how the "loan" will be repaid?

A: State your concerns for explanations and clarity, and run for the board next year.

Q: What is a manager's exposure if they allow HOA boards to not follow the law (eg, not holding membership meetings, not conducting reserve studies) and not bringing this up at every opportunity?

A: A manager's best defense is to have their recommendations clearly recorded in meeting minutes.

Q: Our situation is that our 34-year-old building has cedar-shingle siding that badly needs replacement. The estimate for replacement came to $1.2M. As an alternative, the Board investigated painted, cement-fiber siding, which came in less at $450K. It was determined that the work would require a $40K special assessment to augment the reserves. Certain Association members demanded an advisory vote as to whether to do anything. The result of the vote was the majority of the members voting did NOT want to replace the siding, even though it is deteriorated. Can the Board go ahead and replace the siding anyway?

A: It is the board's responsibility to care for the assets of the association. They don't need to ask permission to do their job. They may be limited in their ability to pass a special assessment on their own authority, however. Look to what is stated in your Governing Documents, what is allowed in State Law, and check with association legal counsel as appropriate.

Q: Presuming roofs are mechanically deficient and a professional recommends immediate replacement. Does board have authority to initiate replacement?

A: See above. Yes.

Q: Regarding the mechanically deficient roofs, presume there is insufficient $$$$ in reserves. Can the BOD initiate a replacement project without approval?

A: It depends. If the special assessment qualifies as an emergency, the board does not need membership approval. If the assessment is 5% or less (California law), the board does not need membership approval. If the special assessment is more than 5% (California law) and it does not qualify as an emergency, the board cannot raise the funds needed to replace the roof without membership approval.

Q: My recommended "Seven Steps of Reserves Management"

1. Reserve Study
2. Establish Annual Reserve Assessment
3. Develop Current Year Reserve Plan
4. Develop Current Year Reserve Budget
5. Approve Reserve Projects
6. Track & Manage Budget for Approved Reserve Projects
7. Investment Management
The whole picture needs to be explained as a system

A: Very nice! Thank you James Fortney (Boardmember) from CA!

Q: We borrowed from the reserve to fix a major road and sewer repair, does that have to be repaid?

A: Those sound like they are likely legitimate Reserve projects (see the National Reserve Study Standards four-part test). If a major repair extends the life of a Reserve project, it is a Reserve expense. If it is a Reserve expense, it is not "borrowing". Of course, adjust and update the Reserve Study the next year reflecting the benefit of those major repairs. If it is not a Reserve expense, the funds should be repaid in a timely manner.

Q: What are your views on lowering the maintenance fee? For example, our association budgeted more money for insurance based on an expected increase this year but the increase did not occur. For next year, we can actually lower the maintenance fee and still meet all operating and reserve funding. Is it wise to lower the maintenance fee or kept it high and find a project for the extra?

A: Don't look for expenses where you can spend money. Plenty of expenses will find you! If your budget appears largely surplus, by all means reduce income to match the expenses.

Q: At times Board members ask about pricing, - for current reserve pricing, what are good resources to go to?

A: Current pricing should appear in your current year Reserve Study. Absent that information, a good source for current pricing is from the vendors currently serving your association, familiar with your assets.

Q: If we have a big repair, should we spend down the entire reserves? We will need a special assessment too.

A: Check with your Reserve Study provider. The Reserve fund may already be prepared for such a series of expenses.

Q: We have a lot of low ticket items that only need doing every 2-3 years. e.g., reseal pool deck is $1000 every 3-4 years. Is this Reserve Budget or Operating Budget?

A: It depends on the size of the association. For many/most associations, a $1000 expense is significant, appropriate for Reserve designation. If these are predictable, they would be easily budgeted through Reserves. On the other hand, for a large association, $1000 may be trivial, more appropriately handled through the Operating budget.

Q: What percentage do you recommend for a reserve payment?

A: It depends on the needs of the association. Appropriate Reserve contributions are often in the range of 15-40% of total budget.

Q: When there is an excessive amount of retained earnings sitting in the operating acct., i.e. 6 figures, do you recommend transferring most of this into the reserves/restoration acct?

A: Most accountants I've spoken with recommend retaining 2-3 months of income in the Operating account on an ongoing basis for cash-flow management purposes.

Q: Our Prop manager says to record only motion passed in minutes. He does not include info gathering, unless a professional presents to us. That doesn't reflect our considerations. Is this a problem?

A: Minutes should reflect decisions and reasons for those decisions, not conversations. "The minutes should never reflect the secretary's opinion, favorable or otherwise, on anything said or done." (Robert's Rules, 11th ed., p. 468.) However, summarizing information that formed the basis can certainly be included since it shows the board did its due diligence.

Q: Our CC&Rs have a provision that says the association is to provide annual inspections of the roofs. We replaced all the roofs several years ago and they are still under warrantee. In contacting the roofing company they stated that they do not complete annual roof inspections, especially to roofs that are under warrantee. Where does this leave the Board with respect to the requirement in the CC&Rs?

A: Hire a roofing consultant.

Q: A component needs to be replaced but is not on the list in the reserve study, can it be added and reserve money be used for that item?

A: Absolutely. If a legitimate Reserve expense for some reason does not appear on your Reserve Study, spend the funds from Reserves, and add that component in your next Reserve Study update. See more here.

Q: We have had the luxury of having years of annual surplus after the final expenses are tabulated. As a non profit in FL, what are we to do with the surplus? Return it? Use it to offset future expenses?

A: It is common in cases like this to officially transfer the "surplus" to Reserves (check with your CPA on how to properly designate this transfer), strengthening your Reserve fund and possibly lowering future Reserve contributions.

Q: Is it OK for a California HOA to deposit reserve funds in an out of state bank? How about depositing funds in an instate California bank which then deposits the funds in an out of state bank through the CDARS program?

A: Unless an association's governing documents restrict deposits to California institutions, the monies may be kept in out of state institutions. The only exception is found in Civil Code §5380, which requires managing agents who for compensation exercise control over the assets of the association who receive funds belonging to an association must deposit them into: (i) an escrow account with a bank, savings association, or credit union in California, which is insured by the federal government, or (ii) an account under the control of the association, or (iii) a trust fund account maintained by the managing agent in a bank, savings association, or credit union in California.

Q: The association is undertaking major Reserve renovations. The Board has engaged an experienced construction manager for oversight of the contractors doing the work. Is this a Reserve Expense or an Operating expense?

A: A Reserve expense. Reserve projects should be all-inclusive: construction management, permits, shipping, materials, installation, disposal, etc.

Q: What process would you recommend in reserves budgeting, when looking at "potential" major expenses that are perceived as "possibilities" vs "probabilities"?

A: We use the term "reasonably anticipate". If the project can be reasonably anticipated, where the timing of the project and its scope can be identified, it is likely a Reserve project (not just a "nice idea").

Q: We do not have a drainage reserves line item, but we need to have about $20K in repairs done to stop flooding behind townhomes and in the streets. Is it appropriate to use road reserves for all of this work? (Condo Assn)

A: If a project meets the National Reserve Study Standard four-part test (Common Area Maintenance responsibility, Life Limited, Predictable Remaining Useful Life, and above a minimum threshold cost of significance), spend the $ from your Reserve Fund. Add a line item for a periodic drain repairs and re-allocate Reserve funds as appropriate in your next Reserve Study update

Q: How do you feel about lowering the owner contribution?

A: In the rare cases where assessments are too high (income exceeds Operating expenses and appropriate Reserve contributions), that is appropriate.

Q: Would an association be better off increasing the assessment based on a recent Reserve Study all at one time?

A: Homeowners should expect minor annual assessment increases. Boards need to act wisely to not raise assessments faster than the homeowners can successfully support those increases. Sometimes getting "on pace" with respect to an appropriate assessment structure may take multiple years of medium-sized increases.

Q: Shouldn't Reserve Study providers present an in depth evaluation of the completed Reserve Study at a board meeting?

A: A presentation of results is a very effective way for a board to gain an accurate understanding of the Reserve Study. Check with your Reserve Study provider to find if a presentation of results is included in the Reserve Study scope of work, or if such a presentation will incur extra charges.

Q: What can you do if you have a board member convincing everyone that a reserve study is not needed - no matter if it's required by law or not or needed for budgeting purposes?

A: Be better at convincing everyone than that board member, or simply out-vote that board member! A Reserve Study identifies the association's current Reserve obligations, the Reserve fund's current level of preparedness, and the size of contributions necessary to offset ongoing deterioration and prepare for the timely repair or replacement of Reserve projects. Without a Reserve Study, a board is forced to guess. And guessing is never a very responsible way to run an association (it breaks the third leg of the Business Judgment Rule… lack of prudent inquiry)!

Q: Is there a reasonable dividing line on what is an operating versus reserve expenses (dollar amount, useful life, percentage of operating costs?

A: Typically, the crossover is somewhere in the range of .5% to 1% of an association's annual budget (or the manager or Board member's "signature authority").

Q: How do I answer a Board member who stated they didn't want assessments raised (though they're severely underfunded) because it scares away prospective buyers?

A: It is always safer to live in the truth. A Board's job is to raise assessments to meet the financial needs of the association. Prospective homeowners should be told the true costs of living in the association, not a false number that the board knows in advance will need to be supplemented with special assessments.

Q: Same question as above, but how to answer <u>owners</u> who don't want new buyers to be scared away by higher assessments (due to Reserve contributions)?

A: Everyone is responsible to pay their fair share of the very predictable cost of ongoing deterioration. It is unfair and irresponsible to "kick the can" of those expenses on to the shoulders of unknowing future owners, misleading prospective buyers with false claims for what assessments to expect.

Q: What happens when the Board passes a budget with increased dues, but the Members override/veto/reject the budget, so we fall back to the previous year budget? Meaning, the Board is trying to do the right thing (with gradual increases), yet enough members eventually disagree with the Board.

A: In areas where the members have a say in the budget process, the board needs to do what it can to "sell" the value of taking care of the association, maximizing home values and owner enjoyment. Typically, a few dollars a month makes thousands of dollars difference in home values and pride of ownership.

Q: What are the implications of a Board not managing spending to the budget ratified by owners?

A: The membership has the power to remove the board via recall or replaced them at the next annual meeting.

Q: Should the budget reserve amounts be deposited regularly to the reserve account or once per year?

A: Regularly. Show discipline: get those funds out of the checking account (where they appear tempting to spend), into the Reserve Fund where they begin earning interest.

Q: Do you have any more information on "standards" of performance (how much Reserves are "good", how much the average association has, appropriate levels of maintenance…)?

A: See articles here and here. In summary, special assessments and deferred maintenance are rare among associations above 70% Funded, while those Reserve cash flow problems are common among associations in the 0-30% Funded range. Most associations are in the middle 30-70% Funded range.