



ON THE ROAD WITH RESERVES

The road to a successful community is paved with good intentions AND a good reserve study. You may just have to navigate a few roadblocks.



by Robert M. Nordlund, PE, RS
CEO/Founder
Association Reserves, Inc.

March 2018

www.reservestudy.com

Reprinted with permission from the March/April 2018 issue of Common Ground™ magazine, the flagship publication of Community Associations Institute (CAI). www.caionline.org

THE RESERVE STUDY WAS UPDATED by a credentialed Reserve Specialist (RS). The community association board set the monthly assessments to accommodate operating budget increases and provide for the recommended reserve contributions. The manager distributed the annual budget to all the owners. Everyone breathed a sigh of relief at having survived another budget cycle. And that's when the financial trouble began!

A map is extremely helpful when departing on a journey, but if there are unexpected roadblocks, even the most experienced traveler needs help arriving at the intended destination. A reserve study is a map to the future, but what's a manager or board to do when roadblocks arise while trying to follow the directions?

How should a board handle a major project that doesn't appear on the reserve study's component list? When does a maintenance project turn into a reserve project? What if the reserve expense is significantly larger (or smaller) than budgeted? Does the board always have to execute the project when the reserve study says to? What if we fail to make the recommended contributions? Can we ignore some of the really long-term repairs? Questions like these show how trying to follow the reserve plan can get complicated.

It is important to establish a balanced reserve budget that provides the funds needed to protect, maintain, and enhance the physical assets of the association. It is equally important to know how to navigate the blockades that get in the way of executing the plan.

Here's how to navigate around six common roadblocks:

ROAD BLOCK #1: IT'S NOT IN THE RESERVE STUDY.

CAI's National Reserve Study Standards contain a four-part test to define reserve components: a common area maintenance responsibility; a limited useful life; a predictable remaining useful life; and above a minimum threshold cost of significance. But what about an association that received an unexpected notice from the fire marshal requiring expensive hillside brush clearance? Or what about buildings that surprise even the most experienced reserve professionals with projects—electrical, plumbing, or decking issues—that couldn't have been anticipated from a visual site inspection? And, of course, managers, board members, and reserve specialists all could make mistakes and overlook a significant component. So what do you do?

Remember: The board's primary obligation is to protect, maintain, and enhance the assets of the association. The first step is to consult with your reserve study provider to determine if the project is covered somewhere else in the reserve study, as it could be bundled in with another line item. Any “newly discovered” component still needs to pass the reserve study standard four-part test. If it does, and the missing component needs to be repaired or replaced now, it is a reserve expense. Spend the money from reserves and add the component in the next update. In that update, expect recommended reserve contributions to increase as a result of the expense and the addition of the missing component.

ROAD BLOCK #2: MAINTENANCE OR REPAIR? SOMETIMES IT'S HARD TO TELL.

Managers and boards may be called to navigate the fine lines that often exist between maintenance, repairs, and replacements. This leads to confusion about whether certain work should be paid for from the operating or reserve budget. A good example is a perimeter fence with a useful life of 20 years. The reserve study projects a cost of \$25,000 to replace the fence this year. But the fencing contractor believes the life of the fence can be extended by another 3-5 years by replacing a few central supports and a large panel for \$2,000. So, is the \$2,000 considered maintenance or a replacement? Is it an operating or reserve expense?

Here's a useful decision-making point: If the repair changes the reserve study by extending the remaining useful life of the asset, consider it a reserve expense. Be sure to add a note in the budget file to report this work in the next reserve study update.

ROAD BLOCK #3: WHAT IF THE PROJECT'S COST IS VERY DIFFERENT THAN ESTIMATED IN THE RESERVE STUDY?

There are many reasons why the actual cost of a repair or replacement could differ from the amount estimated in the reserve study. Let's use the wood fence example again.

The reserve study says \$25,000 to replace every 20 years. But the manager tells the board about a new fencing material that should last 30 years, doesn't require painting, and costs \$40,000. There are two questions at play here: Is the association permitted to overspend? And, is this “upgrade” a legitimate reserve project? The answers are yes and yes.

Overspending and underspending are to be expected since the figures in the reserve study are estimates. Be sure to keep a good record to share with your reserve study professional. Hopefully, your association only gets surprised once with unique circumstances that make a project surprisingly expensive. At every reserve study update, your association's actual cost experience should be incorporated, improving the reserve study projections.

With respect to upgrading the component, reserve expenditures are not limited to like-for-like replacements. Consider that \$25,000 for a fence that lasts 20 years is \$1,250 of deterioration per year on average. The newer, 30-year fence, costing \$40,000 will deteriorate at \$1,333 per year but will save the association \$5,000 in fence repainting every five years (\$1,000 per year). The true cost of your existing fence was \$2,250 per year (\$1,250 + \$1,000). So financially, the new material is a wise decision as it will save your homeowners money for the next 30 years.

ROAD BLOCK #4: CAN WE POSTPONE SOME PROJECTS?

Reserve study professionals recognize five types of component failures:

Inconsequential. These aren't critical and mostly create an inconvenience. One example is residents having to tolerate a few days of cold water after a pool heater failure.

Watch and reassess. This refers to components like roofing and fencing. The gradual approach of the failure may be apparent (i.e., fence becomes wobbly), but the actual failure point may be delayed or accelerated due to weather or maintenance.

Obsolescence. This refers to items that are functional but may be aesthetically or technologically outdated like lobby furniture or intercom systems.

Protection. Components in this category include wood painting and asphalt seal coating, protecting and sustaining the underlying asset.

Catastrophic. This category includes central water heaters, entry gates, and elevator systems. These are components with functions that are essential to the association.

Delaying projects that fall into the first three categories requires a judgment call on the part of the board. In contrast, "protection" or "catastrophic" projects should always be accomplished on time, as scheduled in the reserve study. Squeaking out a few more years of useful life for repainting and asphalt sealing usually comes at the cost of a significantly shortened useful life and higher than normal repair or replacement costs downstream.

Catastrophic projects that are delayed (yes, even while the elevator is still working fine) can result in significant disruption for the association when the component finally fails (at the most unwelcome time!). And untimely catastrophic failures are usually significantly more expensive than the originally scheduled repair or replacement. Since there is usually a higher cost for failing to spend in a timely manner, ask your reserve study professional for counsel if you need extra guidance in making decisions of this nature.

ROAD BLOCK #5: WHAT IF WE DON'T MAKE ALL THE BUDGETED RESERVE CONTRIBUTIONS?

Unfortunately, failing to make budgeted reserve contributions “to save a bit of money” won't stop the clock on ongoing common area deterioration. Each month that passes without a corresponding contribution to reserves causes the association to fall behind the relentless continuing cost of deterioration and weakens the reserve fund. Associations with weak reserve funds have an increased risk of special assessments and depressed property values. You never “save money” by skipping reserve contributions.

ROAD BLOCK #6: WHAT IF WE SIMPLY IGNORE THE REALLY LONG-TERM RESERVE PROJECTS?

Certain reserve projects, like roofs or elevator replacements, occur as rarely as once every 20 or 30 years, which could be long after a board member's voluntary service has ended. But the deterioration that leads to those inevitable repairs and replacements is steady and predictable. The cost of that deterioration is as real as any other bill the association will face. Every owner has a responsibility to pay their fair share of the deterioration bill while they own a home in the association. So associations should strive to build a culture of paying the annual “deterioration bill,” even if it is a bit vague and far away. Making appropriate contributions toward that inevitable project, and adjusting expectations as it gradually draws closer, will mean the association will be financially prepared when the date finally arrives.

THE INEVITABLE AND PREDICTABLE

A balanced reserve budget based on a well-prepared reserve study that sits on a shelf all year long is a useless guide for an association. Reserve studies by their very nature should improve with age as they are regularly updated to reflect the association's current reality. They also should provide current guidance that managers and boards need to navigate reserve-related decisions throughout the year. Boards should commit to making budgeted reserve contributions and spending reserves wisely on reserve projects in a timely manner.

Reserve planning is rarely a straightforward journey. It is full of minor roadblocks along the way. With an updated reserve study as a guide, and experience dealing with the most likely roadblocks, managers and boards can make wise reserve planning decisions throughout the year.

©Community Associations Institute. Further reproduction and distribution is prohibited without written consent. For reprints, go to www.caionline.org/reprints. CAI is the world's leading provider of resources and information for homeowners, volunteer board leaders, professional managers, and business professionals in community associations, condominiums, and co-ops. Visit us at www.caionline.org and follow us on Twitter and Facebook @CAISocial.