

UNDERFUNDING RESERVES – KEEP CALM AND BE SMART: WEBINAR OUTLINE

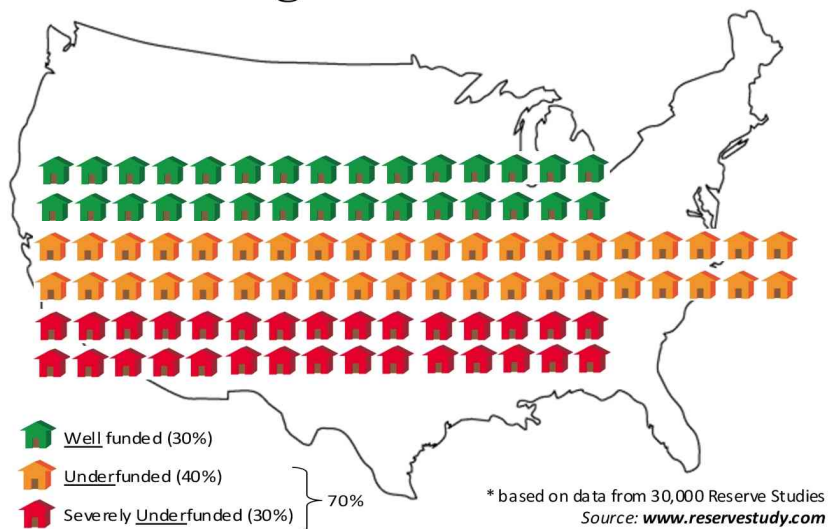
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www.reservestudy.com

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

Reserve Funding at Association-governed Communities*



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)
- Get professional assistance (attorney, collection specialist)
- Develop, adopt, publish, and enforce a collection policy!

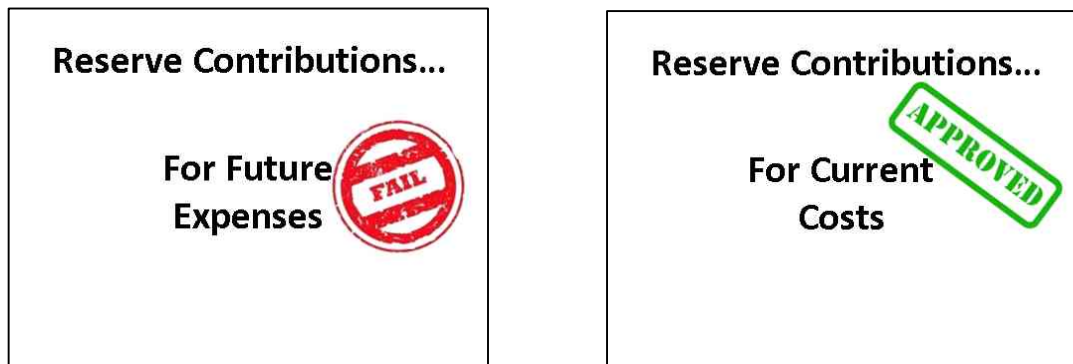
2) Living in a State of Denial

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...". Stick to the here and now. Present the Reserve Study as identifying the current cost 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. Don't fight human nature – it will be a losing battle!



4) Failing to Make Decisions protected by the Business Judgment Rule

Boards have insulation from liability exposure when 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.

What are the Consequences of Underfunding?

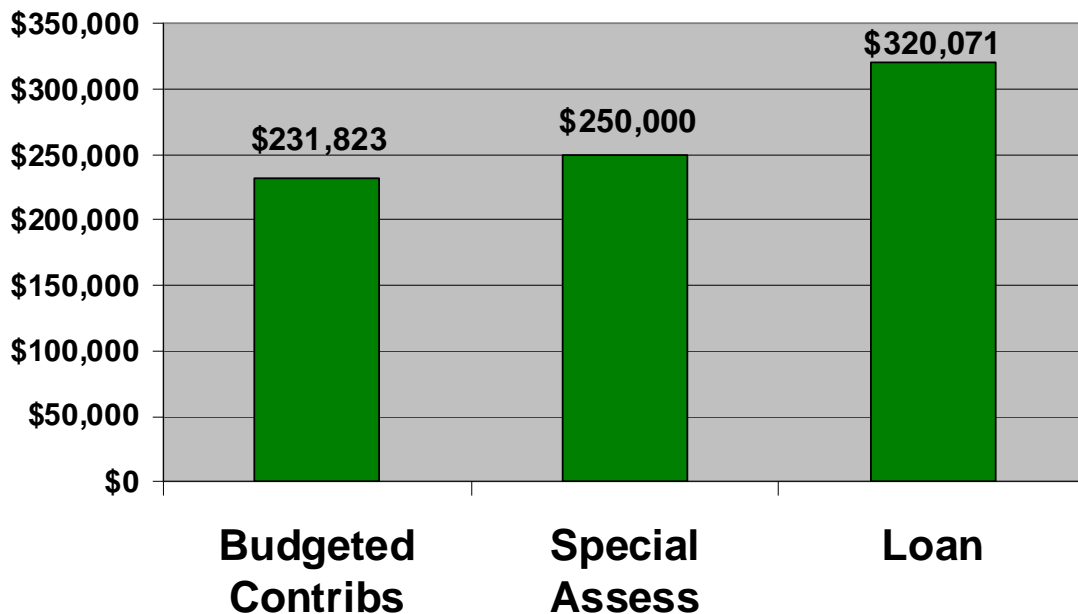
1) Expensive Deferred Maintenance

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!

Funding a \$250,000 Roof



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:



RESERVE STUDY 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:

RESERVE COMPONENT “FOUR-PART TEST”

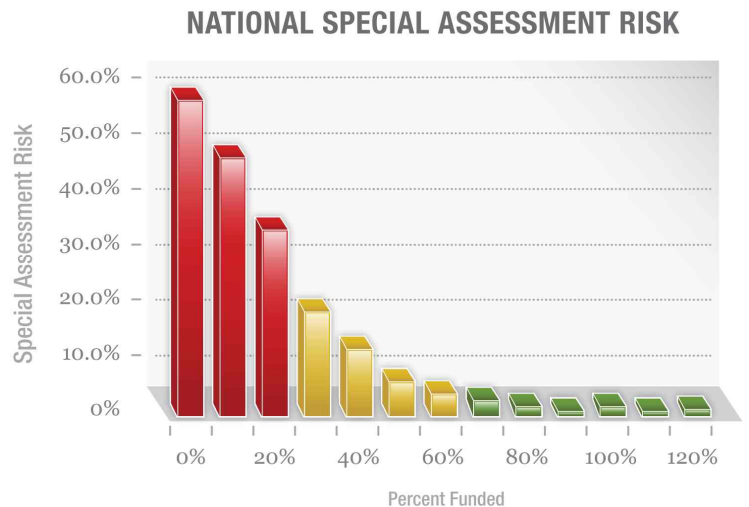
How do we calculate Reserve Fund Strength?



It is a comparison of Reserve Component Deterioration at the association (the Fully Funded Balance), compared to Reserve Cash Balance. When they are in balance, the association is 100% Funded. If deterioration has outpaced Reserve contributions, the association is underfunded.

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.



RESERVE FUNDING PRINCIPLES

Audience Questions after the session

Q: Why do you suggest an annual Reserve Study update?

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. It deserves annual attention. Contributions are based on physical and financial information, both which change over the course of the year.

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 what needs to be done financially to care for the common area assets. You can't expect to get to the future successfully if you don't have a map.

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."

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 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: 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). In addition, Fully Funded contributions calculated by the Straight Line method tend to be a bit higher than Fully Funded contributions calculated by the Cash Flow method because it 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 it 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 30% 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 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. Doing so will give them 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.

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: 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.