PLANNING YOUR RESERVES TO AVOID DISASTERS

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We know a few things about the future: that it will come, and that it will probably not be exactly what we expect. In order to minimize the number of these future "surprises", we counsel associations to prepare for the expenses that are predictable. Expenses that can be anticipated fall into two categories: the Operating Budget (for daily/weekly/monthly expenses), and the Reserve Budget (for large expenses that occur annually or less frequently). The larger expenditures, and thus the larger opportunities for failure, fall into the realm of the Reserve budget.

The objective of the Reserve Study is to anticipate and prepare the association financially for the major common area repair and replacement expenses it is likely to face. When these major expenses are identified and funds are being set aside towards those eventual expenses, the association has minimized its exposure to financial disasters (special assessments). If done well, major budget surprises can be reduced to cases of "true emergencies", not expenses that could have (and should have!) been anticipated. But doing a Reserve Study well is easier said than done.

There are two conflicting schools of thought that create dramatic tension in our industry. One school of thought is that homeowner assessments (Reserve contributions included) should be low, to make the association more attractive to prospective homeowners. On the other hand, Boardmembers have a fundamental responsibility to budget accurately for the corporation, avoiding fiscally irresponsible behavior by setting assessments at a level that sufficient funds are collected to take care of the property's demonstrated and anticipated needs.

This means that while the Board has a responsibility to establish Operating and Reserve contributions that will provide sufficient funds to maintain the association's major common area assets, the Board needs to be sensitive to the financial needs and interests of its members (and future members) by not taking too conservative a stance on the matter.

Fortunately, most expenses are predictable. The key to proper preparation is that most expenses are predictable to those who are looking for them! While it is generally pleasant to surround oneself with optimistic people, when it comes time for budgeting, you need a "realist", not an optimist. The expenses will occur, whether you are ready or not.

Even disasters will come in due time. They may be man-made (a truck crashing through an entry gate, or a break in an irrigation line that causes a hillside to gradually slip into someone's backyard pool), or they may be "acts of God" (an earthquake, fire, or torrential rains). They may come as a surprise in the middle of the night, or may be gradual such as when the Board gradually comes to grip with the undeniable reality that the building needs to be replumbed or the roof needs to be replaced.

We cannot prevent true disasters. What we can prevent is disasters caused by being overly optimistic or by being cavalier. They key, from our point of view dealing with thousands of associations nationwide, is to be well prepared but not over-prepared. A well-prepared association is strategically positioned to take care of the known expenses, and in good enough financial health that it can absorb an unexpected financial blow without being knocked out. Fortunately, being “well-prepared” is measurable. Reserve Fund “strength” is generally defined as being in the 70% Funded to 130% Funded range.

The Reserve Fund is generally the first place Boards look for help when a disaster occurs. An association in need of emergency funds can take out an immediate 0% interest loan from itself, from the Reserves to the Operating fund. Note that some states regulate how this can be done and when it needs to be paid back, so be careful! If the expense can be rightfully defined as a Reserve expense that had previously been unidentified, it may be in the best interests of the association to re-classify it as a Reserve expense, adjusting the Reserve Study and delaying/spreading “repayment” over a number of years along with all the other Reserve projects. In these cases, if the Reserve Fund is strong, only slightly higher Reserve contributions are needed to rebuild the strength of the Reserve Fund over many years to return to its prior position of strength. If the Reserves are “weak”, generally defined when the Percent Funded is under 30%, most often an unanticipated expense or an expense that happens earlier than anticipated results in a special assessment.

Without current Reserve Study information (Percent Funded, Funding Plan, Component List), a Board is exposed to more potential surprises (disasters). With an annually-updated Reserve Study, a Board is armed with appropriate expectations regarding near-term expenses, and what strategies they have at their disposal to deal with surprises. Having current-year Reserve Study information is a key tool Boardmembers can use in preparing to avoid financial disasters. Using that tool to establish a strong Reserve fund takes years of fiscal discipline, but it rewards association members with maximized physical appearance of the property, maximized home values, and minimized exposure to financial disruptions and disasters.