Avoiding Reserves Quicksand!

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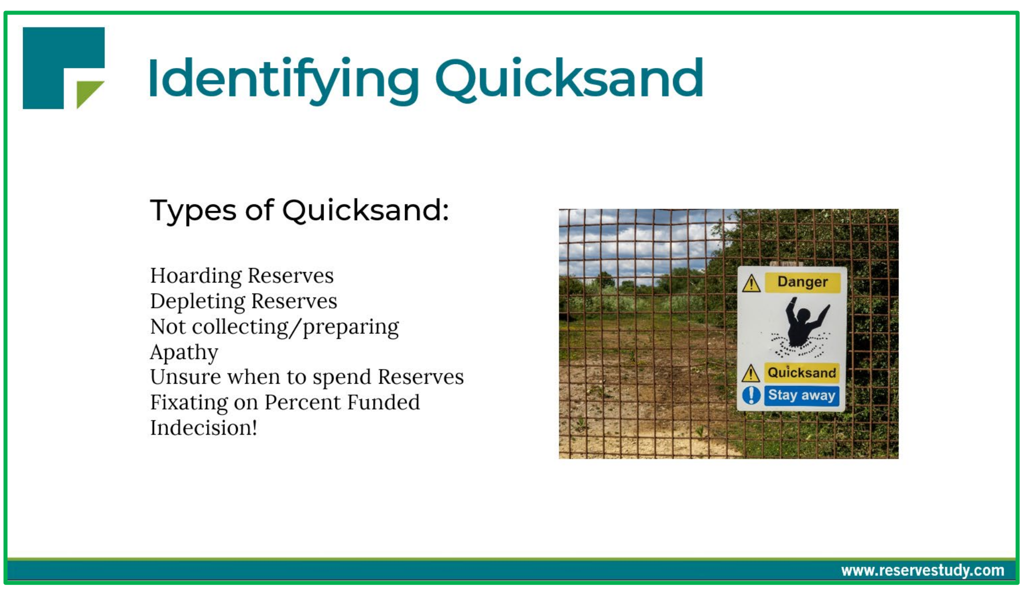
Avoiding Reserves Quicksand is a webinar we created to address the common problems boards and managers face in navigating their associations successfully to the future. If you or your association are unsure how much to set aside in Reserves, if your board doesn't even care about Reserve contributions, if your board struggles with hoarding Reserves or spending Reserves too freely, then your association is stuck in some Reserve Quicksand issues.

In this webinar, former manager and consultant John Cligny joins Robert in helping attendees identify Reserves quicksand, get out of Reserves quicksand, and finally avoid getting into Reserves quicksand in the future. In an environment where recent events have heightened concern about the Reserve decisions boards are making, identifying quicksand, getting out of it, and avoiding it are critical to a successful future where the association has sufficient Reserves to perform projects on time (no deferred maintenance, no special assessments) and where property values are maximized.

Identifying Quicksand:



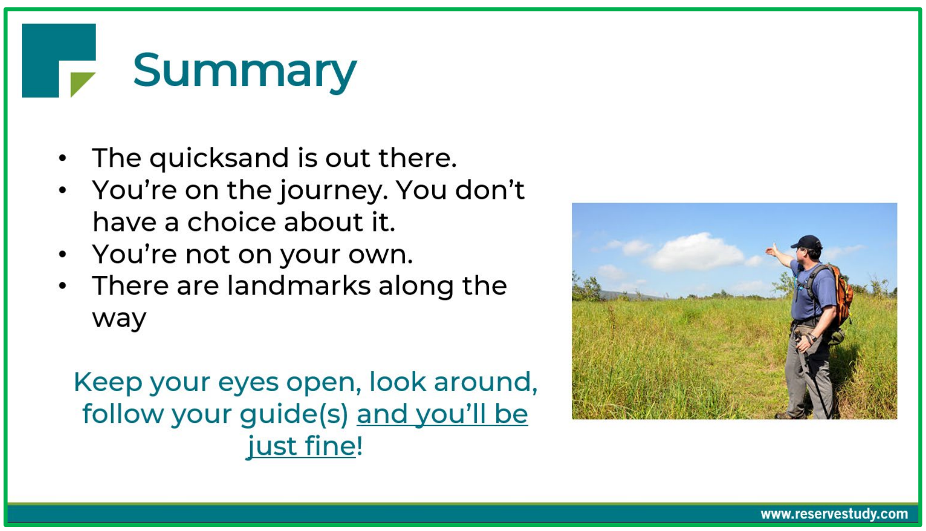
Getting out of Quicksand:

Get help from an experienced manager or credentialed Reserve Study professional, and always follow the three-part Business Judgment Rule (Duty of Care, Duty of Loyalty, and Duty of Inquiry). Adjust your budget as necessary, and make those contributions as recommended and spend those Reserves as recommended! The objective is caring for the property, not minimizing monthly assessments or amassing a "large" Reserve fund.

Avoiding Quicksand:

It's all about sustainability. Make Reserve contributions that offset the ongoing cost of deterioration. Rely on your trusted guides and update your Reserve Study regularly.

Remember:



For additional information, please visit:
www.ReserveStudy.com and www.MyAssociationAdvisor.com

WEBINAR QUESTIONS ASKED BY ATTENDEES

Q: In this low interest rate environment, where do you recommend large $ Reserves be invested? Wouldn't it be better to rely on periodic assessments until interest rates get more attractive?

A: This is an appropriate and interesting questions, especially the 2nd part. Best practices for investing reserve funds are as follows. 1) safety of invested capital, 2) liquidity of invested capital and 3) the rate of return on the invested capital. The reserve dollars need to be safe, available, and make a modest return. Regarding the 2nd part of the question. An emphatic "no". Reserve contributions should be budgeted expenses from the operating account and transferred or deposited into the reserve account monthly. Interest rates may be low, but "low rates" is a poor excuse for failing to Reserve adequately. It is far more important that the funds exist to perform projects on time, than to be failing to set aside adequate Reserve due to the excuse that those funds are not earning a "high" rate of return.

Q: What to do about investing reserve funds to keep up with inflation so that the buying power of reserve funds do not decrease appreciably?

A: Do not expect that Reserves on-deposit will ever keep up with inflation. Let that go. That is not the objective of Reserve contributions. The primary goal is that they exist, so the board can perform the necessary repair and repair projects in a timely manner. Just set your Reserve contributions appropriately, enjoying the little you get in interest, and you will be fine. If you have a significant amount of reserves (commonly described as "over $500,000), it may be appropriate for the Board to utilize an investment firm to manage the reserve accounts. Your investment advisor will know what appropriate investments to use to meet the priorities of 1) safety of invested capital., 2) liquidity of invested capital and 3) the rate of return on the invested capital

Q: Considering the "four-part test", is there in general, any issue using reserve funds on a component that meets the test but does not appear in the reserve study?

A: No. Reserve components are defined by the four-part test, not "does the project appear in our Reserve Study". It is common that with the passage of time, we find new projects that should be added to the Reserve component list. Do so, spend the Reserves, and update your Reserve Study to offset that expenditure and adjust your Reserve contributions for the upcoming years.

Q: **What if a Board disagrees with a predictable useful life from a reserve study?**

A: They should contact the Reserve Study provider with clarifications (that tennis court belongs to the neighboring property, not our association). Or "we replaced the roof in 2018, not 2020". That is great information. We incorporate that information and revise the report. If the board just plain disagrees (we do not plan to repaint the ironwork, we think it is just fine…), and we feel painting the ironwork is wise and appropriate, the Reserve Study will stand "as-is". The board has asked for our professional counsel on the matter, and that is what they will get. If they wish to test and see what happens if they diverge from our recommendations, that is what our uPlanIt online Reserve calculator tool is for.

Q: **Is it appropriate to fund reserve expenditures out of operating funds rather than reserve funds?**

A: No. An association should have a budget line item for Reserve contributions. The ongoing cost of deterioration is predictable and real, and it should have a dedicated budget line item, not a casual "if we have a little left over now and then, we'll spend it…".

Q: **Is it appropriate to use Reserves Funds for repairs to Reserve components? When do you use operating for repairs versus reserves?**

A: Minor repairs should be accomplished with Operating funds. It crosses from a minor repair (Operating fund) to being a legitimate Reserve expense when that "repair" project extends the Useful Life or Remaining Useful Life of the project. Fixing a loose board on a fence is a maintenance project. But touchup-painting all the horizontal top rails of a fence to extend the entire fence repaint a couple of years could be a legitimate use of Reserves. Just remember to update your Reserve Study for the next year!

Q: **Why do you consider special assessments a bad thing?**

A: They are unfair to current owners (burdened with the entire cost of assets that deteriorated over many years, unsettling to the association, unsure if they will pass (and provide necessary funds), and they are generally untimely (it takes quite a while to collect sufficient funds to do necessary projects, often resulting in expensive deferred maintenance). From a property value perspective, special assessments indicate unfunded liabilities and can be a red flag to realtors who point out the drawback of prior or pending special assessments to prospective buyers.

Q: **How often is it recommended a reserve study be done; be it a full onsite, or just a paper update from the previous reserve study date?**

A: Best practice is to update annually. Remember that Reserve contributions are commonly your largest budget line item (or one of your top three), so it deserves that kind of scrutiny. A pattern of With-Site-Visit updates every third year, with No-Site-Visit updates in the in-between years, is a good and economical pattern. Smaller or simpler associations may even dispense with professional No-Site-Visit updates, doing those updates in-house.

Q: **You present a Reserve as including operating expenses and capital expenses. Please comment on separating the Reserve into 1. Capital and 2. Operating Expense Reserves so there is clarity/separation in where the Reserve(s) dollars are planned for?**

A: Operating expenses are the (normal) daily, weekly, monthly recurring expenses at an association. Reserves are those major common area repair and replacement expenses, budgeted through the Reserve Fund. Pay for Operating Expenses from the Operating (checking) account, pay for your Reserve expenses with Reserve funds.

Q: **We are a small, self-managed association of 12 units. We do not have a lot of common area expenses. No pool. No clubhouse, etc. One issue is that for obvious reasons homeowners would like the association to pick up the bill for things that are borderline in terms of responsibility. How do you determine expenses that are in the gray area? As an example, we let everyone treat the gated area in front of their unit as their own where they can plant a garden, put in brick for a small patio, etc.**

A: Governing documents should clarify what is common area and what is not. Good practice is to have a "responsibility matrix" showing who is responsible for what (owner vs association). Then you get into aesthetic issues (even of individually owned assets, or limited use common area), which should be controlled by the Architectural Review committee. I (Robert) live in an association with stand-alone homes. I own my home and my land. But I still need to ask the association for approval prior to painting my home. The expectations should be clearly laid out, so no owner is surprised or treated unfairly, and all home values in the community are maximized.

Q: **In your experience, does the amount of HOA monthly dues or is it periodic assessments that have the greatest negative impact on property values?**

A: Special assessments by far harpoon property values. People can tolerate and adjust for ongoing monthly assessments. But periodic, unsettling special assessments are things that cause prospective buyers to be wary of joining your association. Expect a history of special assessments to prevent buyers from paying top dollar to join your association.

Q: **You mention to rely on an experienced managers to avoid quicksand… What about smaller associations that are self-managed? We are self-managed -- it is not that we enjoy doing this, but it's the best option. Many in our area are self-managed as well because they are too small to get quality management interested in small complexes. In our case, we tried some management companies and had bad experiences. We do recognize the need to update the reserve study and have used your do-it-yourself one.**

A: The point of the discussion was to get help. Experienced managers are only one way that Boards can ask for help on how to avoid the quicksand. I agree that small associations are at a disadvantage. However, small association Boards can still comply with the sound business judgement rule, by seeking the advice of experts be it a consultant, reserve specialist, attorney, or CPA.

Q: **When you already have a reserve study, do you have to stay within the %'s in the study or can you increase or decrease where the board deems necessary?**

A: A Reserve Study is a budget guide. It is your association, so you still have the freedom to set your budget what you feel is best. But do not stray too far from a professional recommendation without good (documented) reasons!

Q: **I am a real estate attorney. I am also an owner of a condominium unit in a building that is 66 years old. Our HOA Board chronically underfunds the Reserve Fund and ignores the recommendations in the Reserve Study. The Board also ignores letters and emails from owners who point out issues that constitute warnings about preventive maintenance. The Board President, a lawyer, says the Board members understand their fiduciary responsibility. But nothing gets done. What can an owner do?**

A: Create your own Reserve Fund for the inevitable special assessment that will occur or look for a condominium in another association that is run in a more fiscally responsible manner. Or a third option is to run for the board yourself!

Q: **How to deal with owners living only on Social Security, who can't pay an increase?**

A: Remember that the board's job is to run the affairs of the association. Owners get to choose if they can afford to live in the association or not. You (board member) take care of your responsibilities, let individual owners make their own decisions about what they feel they can afford (staying or moving to less expensive housing). You are under no obligation to keep it “affordable” at some arbitrary level.

Q: We have extra uncommitted funds available in our operating account. If we have an upcoming expense that qualifies as a reserve expense, is it ok to pay the expense from the operating account rather than the reserve account?

A: Certainly!

Q: What would you suggest as an inflation rate to be used for future year planning?

A: Since a Reserve Study is a multi-decade plan, we use a backward-averaged inflation rate that we feel has “stood the test of time” and should be a good reflection of average rates into the future. That said, something in the range of 2.5% - 3% should suffice.

Q: What interest rate do you recommend?

A: We recommend something very close to current interest rate. If your interest earning rate is less than 1%, we recommend using 1%. We fully expect interest rates to come back up in the not-too-distant future.

Q: There are so many "experts" the Board is prompted to consult and should listened to, but volunteer Board members have difficulty settling onto positive decision-making in this ever more rapidly developing "need toward action" and it becomes "chaos" toward indecision. How does one jump-start a stagnant Reserve Fund program?

A: Hire a Reserve Study professional to provide wise counsel, and/or hire a consultant to help the board with their decision-making and planning responsibilities. That’s where consultants like John Cligny fit it… helping associations through rough patches.

Q: Do you know how much a reserve study cost for a small 24-unit condo complex?

A: It depends on your location, the complexity of your common area components, and your Fiscal Year End (what time of year you need the Reserve Study accomplished). Please click here for a free, no obligation proposal.

Q: **Regarding assessments: Do you recommend loss assessment insurance?**

A: Currently, that is a very inexpensive product that provides peace of mind. If I owned a home in a condo, I would have it.

Q: **If we are not your client, will you be able to update our prior Reserve Study?**

A: If it was prepared according to National Reserve Study Standards, yes. Depending on your circumstances, you can choose from an Update-With-Site-Visit or Update-No-Site-Visit. If it was not prepared according to National Reserve Study Standards, we will recommend starting over with a "Full" Reserve Study.

Q: **Is it proactive to distribute a reserve study or engineers report?**

A: We recommend transparency. Many of our clients make those documents, which may also include the annual Audit, readily available to existing homeowners (through an owner portal on the association's website, for example). You may wish to consult your attorney on this matter, to make sure private/sensitive issues are not disclosed, constituting "notice" and awareness on the Board's part.

Q: **We carried out a reserve study at the end of last year but not in time to include in the budget. None of the board members are still on the board member. How do we make sure the new board carries out the decisions made last year when budgets come up this year? We did have a member vote to switch from straight line to pooled budgeting. To make it even more confusing, the new board got rid of the management company we had last year.**

A: Wow! Much has changed at your association. Hopefully, the new board will use that information as they begin the budget planning process this year. Remember, you have an opportunity to run for the board to contribute to wise decision-making.

Q: **We are in the process of replacing our roofs and need to take out a loan. Our reserves do not cover the total amount. Do you recommend depleting the reserves to reduce the size of the loan, or is it ok to take a half of your reserves in order to keep money in the reserves for emergencies?**

A: Check with your Reserve Study provider, who is likely able to run some scenarios to help in your decision. It is usually unwise to (significantly) deplete your Reserves. Your solution may end up being a combination of special assessment, loan, Reserves, and raised assessments.

Q: **Regarding the four-part test: Common Area & above a minimum cost seem easily discernible. Useful life and Predictable remaining life seem "greyer". Can an item have too long a useful life to be considered a reserve item? What minimum costs are common?**

A: National Reserve Study Standards do not define a maximum Useful Life. If a project is "reasonably predictable" (and meets the other three tests) it should be funded through Reserves. Common examples may be a 40-yr roofing system, or a 35-yr elevator modernization. The minimum threshold of significance is often board member or manager signature authority, which varies with association size. For smaller associations that may be $500. For larger associations that may be $20,000. The "threshold of significance" is often in the range of .5% to 1% of an association's annual budget.

Q: **I think another quicksand is "if it isn't broke, why replace it?" If things have useful lives, when they reach the end of those but are not broken, is it wiser to replace them or to "extend" their lives since they aren't broken?**

A: Good suggestion! See a recently published cover article in the Hawaii CAI chapter newsletter here. Maybe we can create a webinar on that topic for next year.

Q: **We were looking for a financial planner, but our current management company suggested that was not necessary and they can provide us with financial assistance to plan how to pay for the project in the recent reserve study. Is that typical?**

A: Good advice is worth the cost. Do not sacrifice wise counsel by being cheap.

Q: **So, should we add building inspection by engineer periodically as a reserve item? How often should this be done?**

A: Yes. Frequency depends on the age of your building and construction style, but that is a valuable inspection that can be paid through Reserves. Without other guidance, "every 10 years" is a good starting point.

Q: **How does one address the opposition to sufficient Reserve Funding that seems more predominant in an age restricted community (Average age 75+)?**

A: Continually reframe the Reserve contribution discussion as "to offset current deterioration". Never characterize Reserves as "for the future", or "for a rainy day". All you are asking with Reserve contributions is for owners to pay their fair share of deterioration that occurred while they owned a home in the association. It is very hard to argue against that.

Q: So, if we have a three-year plan for treating our trees for some nasty bug, should that be a reserve component? It is a significant $$.

A: Yes! If the trees are common area (✓), if they need to be treated on a regular basis (✓), if you can see the cost approaching (✓), and if the cost is significant (✓), you have met all four elements of the four-part test. Sounds like a Reserve component to me!

Q: If we have a decorative water fixture (large entry fountain), shouldn't that be a Reserve component?

A: If it meets all four elements of the National Reserve Study Standard four-part test.

Q: Would it be advisable for the board to invite our reserve study professional to an owners meeting, or do you find online meetings or webinars are a better tool to convince the support of both the board and the overall owners in the community?

A: I like your thinking. Check with your Reserve Study provider to find their availability to appear in person or "virtually". Check here on our website to see if there is a webinar, or portion of a webinar, that might prove insightful. Feel free to contact one of our offices for a recommendation.

Q: Is it acceptable to include routine maintenance expenses such as vehicles and other equipment that require frequent maintenance as a subcategory of the primary reserve item in lieu of the operating budget?

A: No. Ongoing maintenance should be accomplished from the Operating budget.

Q: Should money for hurricane clean up be a reserve study item?

A: No. A hurricane fails the "predictability" part of the Reserve Study four-part test. That is unfortunately a "surprise" expense that may force a special assessment. Note that if there are no short-term demands on your Reserve Fund at the time of such an unfortunate event, you may manage a short-term (interest free!) loan from your Reserve fund to avoid a special assessment, restoring those "borrowed" Reserves over a short period of time. Check with your manager or attorney for Reserve borrowing restrictions or procedures in your state, and check with your Reserve Study professional to run some scenarios for you to contemplate.

Q: Thoughts on whether an owner resolution could hold current/future boards to following a reserve study? Obviously, future owners could amend the resolution.

A: Great idea. Reserve Studies guide the association forward over a multi-year planning horizon. A "policy" statement would help to guide the board over the years. See a sample policy document here that could serve as a starting point template.