Avoiding Reserves Quicksand!

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by Robert M. Nordlund, PE, RS
& Julie Adamen PCAM

www.ReserveStudy.com
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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 now national consultant Julie Adamen joins Robert to help attendees identify Reserves quicksand, get out of Reserves quicksand, and 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:

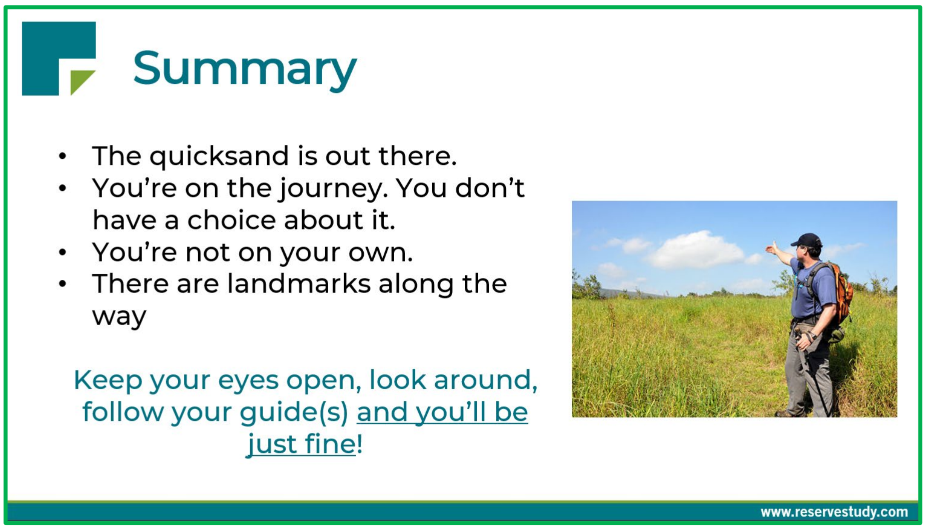
Getting out of Quicksand:

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, making recommended contributions and spending 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.Adamen-Inc.com

WEBINAR QUESTIONS ASKED BY ATTENDEES

General Reserve Questions

Q: Can you provide any resources that show the funds put into reserve are an asset that increases the value of the property - from a sales standpoint not a literal accounting principle of an asset? Convincing the board and owners that the funds are an investment is very difficult!

A: No problem! See here and here.

Q: How dangerous is having a Zero reserves?

A: It depends on upcoming expenses. If the property is brand new and has zero Reserves, they are technically 0% Funded, but their "current needs" are so low that they can quickly start accumulating a reasonable Reserve Fund before cash flow problems arise. If the property is mature, it means they have significant deterioration and no cash to care for the property. That's special assessment time!

Q: Why should we have confidence in a recent reserve study as a reasonable estimate of funds required to sustain the property? We had a reserve study just done that recommended a current funding level that was 4 times greater than a prior reserve study which was 2 years old. Costs haven't gone up that much and there weren't any line items identified as having deteriorated faster than expected.

A: I'd love to figure out the answer to that question! Was it a different Reserve Study provider (taking a more conservative view in the second report), were there some significant additions to the component list in the updated report, and did the updated report include recent Reserve Study Standards recommendations for additional inspections or maintenance projects? I'm sure the answer is in there somewhere.

Q: Have you heard of associations lowering their reserve funding and deferring maintenance?

A: Unfortunately, all the time. They tend to believe that "mother nature and father time" bypass their association, not causing any deterioration, that the inflation that affects our entire country skips right by their association, and that "just because they say it" means it will come true. Crazy!

Q: **We cannot get the board to obtain a reserve study. We are a simple, small (50 unit) association, with no pool, or anything else. They feel we only need to worry about roofs. What to do?**

A: Some boards are frankly short-sighted. Start saving up for the inevitable special assessment. Figure about 1/3 of your monthly assessments should be set aside towards Reserves. So if yours are currently $300/mo, start setting aside $100/mo.

Q: **How often should a reserve study be updated?**

A: Best Practice is now to have your Reserve Study updated every third year on the basis of a diligent visual site inspection, with inexpensive no-site-visit updates in the in-between years.

Q: **How do you deal with a board member who thinks the reserve funding recommendation is overstated and the prices (costs) should be less than stated?**

A: Everyone is entitled to their opinion. That boardmember can use our uPlanIt tool to reduce all the costs and find out how much less the Reserve transfers should be, sign their name on the resulting budget, and be prepared to be sued in a few years when the homeowners stage a revolt because of the resulting special assessment. We prepare Reserve Studies. We don't have a vaccine that prevents foolishness.

Q: **How do you address the common statement "I'd rather have the money in my pocket and just assess me when needed"? When assessment time comes, then they argue about how much it is. Can't win.**

A: That's an absolutely valid homeowner point of view. It's not wise, because not all owners are able to shoulder the financial burden of a special assessment, which means there will be delays getting the project done (making it more expensive), or the association will pursue a loan (making the project more expensive). Besides, it's the board's job to follow the Governing Documents and set assessments appropriately to offset the expenses of the association. It doesn't matter what the homeowners think. That's the tail wagging the dog. They are not in power, and they are not the ones that will be sued for ignoring the Governing Documents or operating in a fiscally irresponsible manner.

Q: **I have a Board member that has said "We don't know what is going to happen in the next 10 years, let alone 30 years, so why not readjust as and when the time goes on." How do I explain through appropriate documentation (civil codes, etc.)? We drop off the cliff in year 10 of the 30 year study.**

A: I don't know what's going to happen in the next 10 years either. That's why every Reserve Study is a one-yr document. That's why Reserve Studies need to be regularly updated. Martians may invade the earth, or we may be hit with a meteorite, etc. But knowing what I know about the legal system and the responsibilities boardmembers carry, they need to plan to care for the association. Acting responsibly means planning ahead. If no planning occurs, that boardmember can expect to be "surprised" by special assessments and claims of fiscal recklessness while serving on the board. One thing leads to another. We all learned that in kindergarten. That's why we plan ahead. And that's why we are extra careful when someone else gives us something valuable of theirs to hold (which is what boardmembers are there to do… caring for the Real Estate assets co-owned by other people).

Q: **The Governing Documents for our HOA require 2/3 approval for any assessment increase as well as special assessments. So it is literally the homeowners that have full control and they have voted "no" year after year despite the information given to them. Thoughts?**

A: A) Do a better job of explaining to the homeowners that the cost of roof deterioration (etc.) on an ongoing basis is real, not fantasy and that not funding it "now" will only lead to special assessments later. In other words, they're not saving any money. B) Get your Governing documents revised. C) Consider moving out of an association that is so dysfunctional.

Q: **At your firm, after you complete 30-year study for a HOA, does your firm come back to present it to the BOD?**

A: Sometimes that is stipulated in the scope of work, and in those cases "yes". Regularly we provide a phone consultation or short online meeting (or recorded video) to explain the completed Reserve Study. Usually, an on-site presentation at a scheduled meeting is an extra expense to the association, as only a few associations make that request.

Q: Our property manager says “we don't prepare a budget for the reserves”, and “the homeowners don’t have to approve reserve budgets”. Management will only help us with the operating budget. But Reserves are the biggest expenses. How can we <u>not</u> be budgeting for those expenses this year and future years?

A: Management companies regularly don’t venture outside their expertise, meaning they usually don’t prepare Reserve Studies. That’s fine. Most associations hire a specialist for Reserve planning. And it also may be very true (as commonly is the case) that homeowners don’t need to “approve” the budget. Commonly, the board sets the budget and tells the homeowners what it’s going to be (and if they don’t like it, they can run for the board or move out of the association). Reserve expenses are very real. Every association should budget for that reality.

Reserve Component Questions

Q: How to handle large but unpredictable expenses such as an elevator breaking unexpectedly?

A: First, elevators usually don’t “break” unexpectedly. They usually break down, or break down more regularly, when they are old and need to be modernized. But the bottom line is that Reserves are for the predictable expenses in an association’s future. There is no reason to be surprised by a major repair or replacement project that failed on schedule and on budget, over a 20 or 30 yr timespan. Reserve planning prevents you from being surprised by predictable expenses. You have plenty of exposure to true surprises in this world, you don’t need to add being surprised by something that was predictable.

Q: What about organizations that decide to spend reserve funds on something new that didn't previously exist and was not in reserves?

A: Depleting Reserves on non-Reserve projects only means that higher Reserve transfers will be needed in the future, to “catch up” and replenish the Reserve fund (preparing it for the projects it is planning to fund). If that doesn’t happen, special assessments will be the result. The “double whammy” is often that the new expense (not budgeted from Reserves) will also need Reserve funding of its own, further increasing Reserve funding requirements.

Q: Can weed abatement {trimming} be in a Reserve Study? Seems like it should be part of the Operating Budget expenses.

A: Weed abatement usually falls below the standard of significance that is required to be funded through Reserves. That is often in the range of "manager or board signature authority", which is commonly in the .5% to 1% of annual budget range. But… more associations are performing significant fire and brush removal projects to minimize their fire exposure and their insurance costs. Those "fire break" expenses can be high enough to be regular Reserve projects.

Q: How do AR's estimated cost numbers reflect region to region differences?

A: By being different in different regions! Each of our Reserve Studies is designed so that projected costs will be similar to what it will cost to get the project accomplished. That is higher in some areas and lower in other areas. Our Project Managers are sensitive to cost factors of the clients in their region.

Q: Where do you obtain your information for how much each project should cost? Being in central Washington, I have some Boards that sometimes feel the numbers are not entirely accurate.

A: Most of our costs come from similar projects incurred by other clients in your region. Those tend to be very reliable "actual" costs that benchmark our projections for other properties.

Q: How do you determine what is an operating expense or a reserve expense? (Lifting the canopy of trees over the street, a drainage issue, painting the HOA fence)

A: There is a national standard three-part test that you can read about here, and an article on "Operating vs Reserves" that you can read about here.

Q: Is the Reserve Study an operating expense or a reserve expense?

A: Generally the cost of a Reserve Study, especially updates, falls below the threshold of significance required to be a Reserve component. Therefore a Reserve Study is typically handled as a periodic professional service expense, paid from the Operating Fund.

Q: **We are in the Southern Arizona desert. Our builder put in a lot of lush landscaping with high watering requirements. We want/need to redo much of the landscaping to desert friendly low-water usage plants. This is an upgrade but water friendly – saving money with reduced water costs. Can we do this as a Reserve project?**

A: There are two ways this can be done. As a regular "landscape refurbish" project (every 10, 15, or 20 years), or as an internal "loan" from the Reserve Study to the Operating Budget. In the latter, the expense can come from Reserves, with the payback of the expense to Reserves coming from lower water expenses for the next 5, 10, etc. years. Speak to your Reserve Study provider about how such a project can be handled at your association.

Reserve Funding Questions

Q: **What are the pros and cons of reserve funding vs. special assessments? Our HOA is resistant to having a large reserve fund and prefers special assessments when there is a certain expense.**

A: Special assessments (generally) require a vote of the ownership, so their passing is never "for sure". Delays get expensive, and loans (an alternative to special assessments) get expensive. So you're not doing owners any favors by failing to accumulate necessary Reserves. Besides, usually, boards are required by Governing Documents to budget adequately for all expenses. And Reserve expenses are very real. Boards can get into trouble when they don't follow their own Governing Documents.

Q: **Our plan covers a number of expenses less than $150K over the next 15 years and one $1M expense more than 25 years out. Our Reserve funding covers the first 15 years comfortably. We have differences of opinion on how much weight to put on the possible large expense 25 years out. Comment?**

A: Fund for it. Time is your friend… funding a $1M project over 25 years is a lot easier than funding a $1M project over only 15 years.

Q: **What precisely do you mean by "fixating on percentage"? Do you mean complacency because it's a good percentage (say, 45-55% funded), or do you mean agitation because it's low (35%)? Please explain.**

A: In the webinar, I was referencing clients who feel their goal is a particular Percent Funded, and they lose sight of the true goal being to provide for the needs of the association. In these cases, they fail to spend Reserve funds on necessary projects in order to speed their progress towards an arbitrary Percent Funded goal that they set for themselves. In other words, they sacrifice taking care of the property to hit an arbitrary technical goal. That's foolish.

Q: Could an organization take out a loan to cover reserve expenditures?

A: You could, but that's an expensive way to fund Reserve projects. Rather than earning interest by putting your cash into Reserves (offsetting ongoing deterioration), that forces the association to pay interest to the bank. The difference is truly thousands of dollars over the years.

Q: Is there an average % for funding reserves (as a percent from reserve study) specific for condominiums?

A: Most associations of all types need to be funding their Reserves by setting 15-40% of their total budget towards Reserves to offset ongoing deterioration. Regarding Reserve Fund status/size, most associations are in the middle range, having a Reserve Fund that measures to be 30-70% Funded.

Q: Is pooled reserves or line item better?

A: Pooled. That method (officially called the Cash Flow method) uses cash more efficiently than the "straight line" (officially called the Component method). The result is lower costs to the homeowners and less administrative overhead to manage the process.

Q: Our recent reserve study found we're 31% funded and suggested a special assessment of $10,000 for the next 3 years. Would it be a problem if we spread the $30,000 over 5 years instead or must we do it in 3 years?

A: Please ask that question of your Reserve Study professional.

Q: If your reserve account is underfunded and there are a lot of fairly immediate current improvements that need to be addressed, can you ask the owners to approve a multi-year special assessment to reach your goal, or do you have to get approval of a special assessment each year? (in CA)

A: Boardmembers in CA have authority to pass "small" special assessments without owner approval. Please check with your attorney and your Reserve Study professional to develop a plan that fits the needs of your association.

Q: If we set our Reserve transfers to be greater than the rate of ongoing deterioration, depreciation, and both increase annually at the same rate (annual increases to the funding, and annual inflation on the expenses), will we eventually get to 100% funded?

A: No. That is because the growth of component expenses due to inflation will always be larger than the growth of funds growing towards that future expense. The target keeps getting bigger, faster than the funding grows to meet that future expense. This "lagging effect" is an even larger problem when the association's Reserves are low. The way to solve this issue is to increase reserve funding faster than inflation's effect on expenses. Your Reserve Study professional does this naturally, or you can use our "uPlanIt" online calculator to see for yourself.

FL Specific Questions

Q: There continues to be confusion on when FL 4-D requires SIRS elements to be fully funded. Is the date by Dec. 31, 2026 if the budget is approved in 2025?

A: There is no need for FL associations to be Fully Funded. The absence of "waiving Reserves" is not equivalent to "Fully Funding" or being "Fully Funded". Please see here for clarification.

Q: Are insurers now more likely to look at reserve studies? In FL

A: Absolutely.

uPlanIt Questions

Q: Is uPlanIt only available for the first year after the study?

A: uPlanIt is designed to assist the board and management in testing adjustments to their recommended Funding Plan. It is accessible throughout the association's budget season, and three months into the beginning of the next year. If access is desired longer than that period, the association can commission another Reserve Study update, or pay for another budget season of access to uPlanIt for $399. See more here.

Miscellaneous Questions

Q: Is there a law on how much and how you invest your reserves? 50% in a 3-6 month money market for example.

A: This is controlled by your Governing Documents, State Law (in some cases), and the principles of fiscal responsibility. Make sure your funds are not only safe from loss, but also insured. Please consider retaining a community association Reserve Fund investment expert to give you wise counsel. See this webinar from earlier this year featuring a Reserve Fund investment expert.

Q: I would love to hear your recommendations on how to fund the reserve, in part, through investments. We have a CD ladder but we're never sure how much to keep liquid and how to best tier the CDs.

A: Work with an investment counselor familiar with community associations. They will examine your recently updated Reserve Study to learn your upcoming cash needs and design a plan to ladder your investments effectively while keeping sufficient funds liquid.

Q: Could you speak to the need for Building Envelope/Structural and Plumbing investigations

A: Updated Reserve Study Standards recommend the use of outside experts to evaluate structural, building envelope, plumbing, roofing, HVAC, asphalt, etc. issues. A Reserve Study provider is just a "generalist", expert in budgeting and cash flow. The insights from an expert will inform anticipated short term and long term expenses found in the Reserve Study. Younger (10-20 yrs) buildings benefit from structural inspections in order to stop or minimize the effects of building aging, and older buildings benefit from structural inspections to navigate the way forward safely and cost-efficiently.

Q: How do you plan for the insurance market in Florida? My condo that has been assessed for rising insurance in Florida and it's 15k back per unit! Due to the tragic collapse of Champlain Towers South many providers have left Florida. Can you have a line item for insurance in reserves?

A: Expect higher homeowner assessments. Insurance is an ongoing service, not a Reserve project. Pay for it from higher homeowner assessments. Reserves are dedicated to major repair and replacement projects.

Q: Our townhomes are 5 yrs old. Because of some shoddy construction, we are having very expensive leaks behind the siding and leaking through basement walls and roofs. We need a solid source to help us decide what we are required to fix since we are out of warranty. These exterior repairs are killing us. What to do?

A: Retain an attorney familiar with original construction defects. They will have an expert team that can assess your situation and craft a plan to move forward.

Q: If Reserves are not for capital upgrades, then how do we fund capital upgrades?

A: Special assessments or temporarily higher homeowner assessments.

Q: We are a 61 year old Non Equitability Cooperative and unfortunately we fell into "Quick Sand" about 5 years into our existence and have remained in it until this year's board on which I am the President. We are nonprofit in our state and have heard there are resources to help with improvement projects by being sponsored by 501c-3 agencies. Deferred maintenance was the law of the land for more than 50 years and now we need to replace Electric and Plumbing property wide but don't need a mortgage. We are pulling in rebates from Utility companies etc. What grants are out there for us?

A: Unfortunately, I am not familiar with grants for private property. Typically, owners are responsible to fund the care of their own property.

Q: We live in a 242 unit (50 building) condo community in Florida. Our community is 11 miles from the beach and also is only 1 and 2 stories high. Our problem is condo insurance. It has gone up significantly each of the last 3 years. We were told last year that the broker would not be able to renew our policy UNLESS we got new roofs. So we did at over $2.3M. Part came from Reserves, and part came from a loan. Our community was new in 2006 (currently 17 years old). What do we do?

A: Real Estate is expensive to own and maintain. It is not more complicated than that.

Questions asked in prior "Quicksand" webinar sessions

Q: Can you discuss the efficacy of obtaining a bank line of credit?

A: Bank funding is an expensive way to pay for Reserve projects (paying interest to the bank). So, it shouldn't be your first choice. Reserve projects are predictable, so it's always best to set the funds aside on an ongoing basis, earning compound interest. If your association's Reserves are weak, a line of credit may be a good idea to ensure you have sufficient cash to perform your projects on schedule. Delayed or deferred projects often get very expensive!

Q: What are the drawbacks to being over 100% funded for multiple years?

A: First, your association is a non-profit organization so it's not a good idea to ask for more money from your owners than is necessary or appropriate. Second, it's not fair to ask current owners to pay more than their fair share of deterioration, creating a net surplus of funds that will likely mean lower Reserve contributions for future owners.

Q: What do you do when the board doesn't want to complete projects when they are due? The money is there, they just keep delaying which now is going to cost us more because of high inflation.

A: (Julie) Tough one, and not an unusual circumstance. Some people just can't wrap their minds around spending large dollar amounts, even when the money is there. Bring in your professionals to discuss with the Board the virtues of completing reserve projects on time, and the downsides (there are many) of not doing so, i.e., reserve study specialist, manager, general counsel or insurance agent (depending on the issue(s)).

(Robert) Reserve funds have one purpose, and that is to be spent on necessary projects. Do it, to minimize the chance of expensive deferred maintenance, maximize owner enjoyment of the property, and maximize home values.

Q: Do we need to keep the full amount of our townhome property insurance deductible in the Reserve Fund if there is a loss to all buildings?

A: No. Reserves are for predictable projects. Special assessments are for surprises (meeting the insurance deductible for a catastrophic loss). In fact, there are "special assessment insurance" products out there that are currently rather inexpensive, that owners can individually obtain to minimize their exposure to a special assessment <u>that is not due to normal deterioration</u>.

Q: **We are a community of 1274 single-family units - oldest part at 20 years, youngest part 2-3 years. My question is about measuring adequate levels of reserve. We are working towards fully funded - and we are now at about 56%. I have heard 70% but also heard that if we dip to 30 percent that is ok. Any guidance?**

A: Aiming towards the 100% Funded mark is the bulls eye. Special assessments are common when the association is in the 0-30% range. Special assessments are almost non-existent when the association is above 70%. These ranges are true whether the association is large or small, new or old.

Q: **At what point do you feel like you have a well funded Reserve. Is 70% to 80% a reasonable target?**

A: See the above. 100% is the bulls eye, but you can begin to relax when you cross the 70% line. In the world of making projections about future events, don't aim for the edge of the target. Aim for the bulls eye.

Q: **We have a long-time board member who has strong opinions and influence over the board. While he may know that we are under contributing to our reserves, he states that we have a lot of people on fixed incomes as to why we can't raise our assessments more. Other board members follow his lead, including our president, who sees us paying our bills, therefore there's no problem. No comment on the 26% Funded that we learned after last year's reserve study. It's as if the reserve studies are ignored. The property manager also doesn't understand the purpose of reserves. How can we bring understanding? Can our reserve study specialist help?**

A: We can help, you can help, and the manager can help by reminding that board member that the duty of the board is to the association, not to one or more owners or owner types. Let each owner decide if they can afford living in the association. That is not the board's responsibility.

Q: **How do you answer a Board member who wants to stop assessment increases because people are on a fixed income?**

A: Board members are Trustees of the corporations, which means "*a person or firm that holds and administers property or assets for the benefit of a third party.*" That 3rd party is the corporation, not individual owners. All decisions should be based on what is good for that corporation not only in the here-and-now, but into the future. The reality is that not everyone will be able to afford the community in which they live in perpetuity. Decisions cannot be made for an owner or an owner-type at the expense of the organization as a whole. Doing so is a breach of fiduciary duty.

Q: **With the new Structural Integrity Reserve Study (SIRS) requirement in FL, will we have to do two reserve studies?**

A: No. The SIRS just means that a "normal" Reserve Study will need to incorporate fresh information from an engineer and architect at least every 10 years. Best practice is still to update your Reserve Study on the basis of a diligent visual site inspection at least every third year (each year including the results from your latest structural evaluation).

Q: Are there any special issues for Florida?

A: See above. We are actively involved in encouraging appropriate revisions to the SIRS legislation, because as currently written it is difficult to implement for clients.

Q: How do you determine the component number for each listing in the Charts?

A: We have a company-specific numbering system. It means something to us, but in reality they are just numbers that help separate one Component from another, maintaining order.

Q: Where did you get your inflation rate from?

A: In projecting years and decades into the future, we look backwards in time. Please see more information here for how we are planning for lower long term inflation while at the same time dealing with higher short term inflation. For current inflation rates, see here.

Q: The company that performs our Reserve Study has been using 3% as the inflation factor in estimating future funding requirements. With the current high inflation rate, do you expect a higher inflation rate being used in Reserve Studies?

A: See above.

Q: Recently, the replacement costs for some of the components specified in our reserve study has been significantly higher than the costs estimated in our RS. How do you recommend handling these cost gaps? Special assessment? Increase future reserve fund contributions to make up the disparity?

A: Updating your Reserve Study on a regular basis is your first step in making sure your Reserve Fund is "well prepared". Many associations relying on a Reserve Study from three years ago (or longer) are finding themselves under-prepared. So update your Reserve Study, and find out if you can catch up with higher contributions or if you are in a cash flow jam and need a special assessment.

Q: It seems like quicksand has the upper hand, as board members have finite terms (if they serve them out) and human nature is to deal with the present and not think about the future. For instance, if a fence needs replacement this year, pay for it. They don't think about if 10 years from now we will have a $2 million asphalt project, as they figure they'll have moved out by then, perhaps no longer be amongst the living. In other words, they see it at someone else's problem. Comment?

A: Indeed, this is human nature. Quicksand DOES have the upper hand, and all we can do is fight the good fight of communication, education, and long-term thinking. We do rack up some wins, but it's a never-ending battle. Just keep providing comments and information, have sources you can cite, bring in experts: Management, counsel, insurance and reserve study experts, etc. You may lose the little battles but focus on winning the war. Keep good humor, and remember, when they fight you the most, you're right on target.

Q: What is an effective counterpoint to a Board member who states that reserve study professionals want Boards to put too much money into reserves?

A: (Julie) My question to that member would be: Why? What would be the specialists motivation? They have no vested interest in taking this action that I can see.

(Robert) All we do is balance income against predictable expenses. We never touch association money… there is no motivation for us to ever recommend any more than is necessary to effectively sustain the assets of the association.

Q: If an association does not have any reserve component items scheduled during the next year, and it is not the third year when an on-site reserve study is required by CA law, can you skip a reserve study update for that year?

A: In CA, a With-Site Visit update is required at least every third year, no matter if you have planned Reserve projects or not. In the in-between years, it is always wise to consider a very inexpensive No-Site-Visit update, especially now in a time of rapid inflation.

Q: Our association has planned well and thought we were in good shape on roof reserves, but our roof now needs to be replaced much sooner than we had originally thought, and with inflation, we are seriously short of the funds. Is it better to borrow money or assess in this case?

A: Difficult to answer without more information. Your first call should be to your Reserve Study provider. Also - what does your manager say, or know about banks that lend to associations? Check with your general counsel with respect to your borrowing options.

Q: Is there an advantage of straight line reserves vs pooled reserves?

A: Calculating your Reserve Funding Plan is always advantageous with the Cash Flow (pooled) methodology, as it fundamentally uses cash more efficiently than it all being identified in separate funds (Component method, also called "straight Line")

Q: Are reserve funds considered a bucket of money?

A: When using the Cash Flow methodology, Reserves are one "bucket of money". When using the Component methodology, each component essentially is treated as having its own little bucket of money preparing for that individual expense.

Q: What should be an average monthly contribution (%) to reserves?

A: You learn what is appropriate for your association in your updated Reserve Study. In general, most associations find they need to be contributing somewhere between 15%-40% of their total budget towards Reserves.

Q: **How much do Reserve Studies cost? We have only 37 homes and very few common areas but one serious sewage vault that is a financial drain.**

A: Reserve Study costs are custom to each association, as they vary with size and complexity. Yet size and complexity also defines the association's annual budget, so a starting point idea for an initial "Full" Reserve Study is often in the range of 1% of an association's annual budget. All Reserve Study update products are significantly less expensive.

Q: **Recently, the CA law firm of Berding-Weil published a rather concerning article about funding reserves and for building components that are not included within the typical study. What is AR doing to include more components in studies, if anything? For example, there is most often no funding included for pipes! When these fail and require replacement, Boards are often financially unprepared for the expense.**

A: We are involved in updating National Reserve Study Standards to minimize the potential for "surprise" expenses outside of Reserve planning. Our job is to eliminate surprises from projects <u>that are predictable</u>. Only the projects that are truly surprises (which we sometimes need to remind our attorney friends are indeed part of life on this planet) should cause special assessments.

Q: **We have a reserve study that is 2+ years old from firm A and just received a new reserve study from firm B…both are credentialed. Issue…there is a huge difference in the amounts that we need in our reserves. Which one is correct?**

A: I would expect minor to significant differences even from the same company with the passage of over two years of time. But not all credentialed companies actually follow National Reserve Study Standards. The updated Standards being proposed will include testing and continuing education, which should minimize differences between credentialed companies.

Q: **Are Reserve Study inspections done by licensed engineers? if so, can those reserve inspections replace our annual building inspection?**

A: No. Reserve Studies are budget and cash management endeavors. For building infrastructure inspections, you need a specialist in that field commonly with an engineering or architectural background.

Q: **Is the Finance Committee able to recommend 8-12% operating (inflation 8%, reserves 4%, 4% emergency)?**

A: Finance committees can make whatever recommendations they believe are correct. It doesn't have to be wise… people can do crazy things. That doesn't make it a good thing.

Q: How often do you recommend updating your Reserve Study?

A: Best practice is to update your Reserve Study on the basis of a diligent visual site inspection at least every third year. Statistics also show that inexpensive No-Site-Visit updates in the in-between years significantly drop an association's risk of a special assessment. So with components, costs, Reserve balance, and economic forces in a constant state of change, annual is always best.

Q: Is uPlanIt available to customers with the first draft of a Reserve Study, or only after the report is finalized for the year?

A: When the report is "finished" on our end (before receiving any client feedback).

Q: What do you think about loans vs reserves since our roofing need is imminent?

A: Loans are an expensive way to pay for Reserve projects! But because we have yet to invent a time machine, if you don't have the cash for an imminent roofing project, you will need to choose between a special assessment and loan. Consider the pros and cons of each.

Q: In lieu of a special assessment, is a long-term (10 year?) loan an option?

A: Yes. Just remember… while you're paying off that loan making up for sins of the past, you should also be making larger Reserve contributions to keep up with the cost of ongoing deterioration and avoid from being in exactly the same position (needing a loan) in another 10 years.

Q: How do you tell the community that we will be increasing reserves without getting shot?

A: Communicate, communicate, communicate. Send out frequent information on what the Board is considering, and why. Start EARLY. This process may take months to get the buy-in you're looking for. Explain what experts you relied on to get this information (and recommendations). Hold a town hall, and be very open and transparent. Perhaps bring in your expert (Reserve Study provider, counsel, roof expert, etc.) – whoever is appropriate to the situation.

Q: Can you be so far behind in reserves that you must raise dues to "catch up" and subsequently the units become unsellable?

A: No. Typical Reserve contributions are 15%-40% of total budget. There's nothing "unsellable" about that.

Q: Can you elaborate on the intervals of updating assessments comment made earlier? Looking for info on the interval and the kinds of things to factor in and the best way to educate owners.

A: Not sure if I am answering this correctly (meaning, understanding what you are asking for), but as an industry we like to see assessments go up a little every year. Keeps your budget more realistic, and gets the owners used to assessments (like everything else) going up every year, even if it's small.

Q: If the current inflation rate is plugged into the reserve study it will result in a significant increase in annual assessments. This will result in a great deal of owner dissatisfaction. Any suggestions?

A: Communicate, communicate, communicate. Send out frequent information on what the Board is considering, and why. Everyone knows what inflation is doing to their own budgets, the association's is no different.

Q: How do you differentiate what money should be used for? For example is our pool reserve fund ok for like a pool heater replacement or just like a MAJOR pool repair? What is a guideline?

A: It starts with the National Reserve Study Standards four-part test, which defines appropriate Reserve projects. Those should be listed in your Reserve Study, helping you separate between what is paid through Operating and what is paid through Reserves. Check with your Reserve Study provider for guidance and see our Reserve Studies 101 webinar, which is all about component selection.

Q: You have said home values go up with a higher % funded. Is that true for Orange County, CA?

A: Yes.

Q: Can you speak to a reserve study and how it relates to the association's ability to guarantee its obligations? Is a study a solid way for it to show its guarantee? Are there other ways to guarantee?

A: There are few guarantees in life (death and taxes?), but a well funded Reserves certainly stacks the odds significantly in your favor of having sufficient cash to provide timely repairs and replacements to your property. A good conservative goal is to strive to be 100% Funded.

Q: What would be a legitimate reason/situation to decrease monthly assessments?

A: (Julie) If it were legitimate that more money is being collected than needed to fund the operating and reserve accounts and have some margin for uncollectable assessments, and not just a couple of hundred dollars. Something relatively substantial. Honestly, I've never seen it.

Q: There are some Board members that will not raise the assessment because they are loyal to owners and not the corporation. Do the remaining Board members have a duty to bring someone in like an attorney to inform the remaining Board members of their obligations to fund the reserves?

A: Yes, that’s a great idea.

Q: Our association has a long history of changing the reserve fund to tilt in the direction of pet projects, often cosmetic. With CA mandated balcony inspections, huge infrastructure projects, etc. we find ourselves funded under 25% and asking for special assessments to “right the ship.” How do you convince people that righting a ship that has a history of being helmed by irresponsible captains that you will be different… especially with term limits?

A: If you are running for the Board, simply be honest about your position and why, and that of the association, drawing a clear difference between “the way we’ve always done it” and the way it should be done. Be upbeat and professional and avoid finger-pointing and personal attacks. You may suffer a few of those, though….

Q: What are the guidelines or any restrictions on investing the reserves for maximum income?

A: Those funds are not your own. They belong to the corporation. Never put them at risk of loss. That is a safe starting point. Watch our “Investments and Inflation” webinar for more information.

Q: Your Reserve Study categorizes % funded into three groups: less than 30%, 30% to 70%, and more than 70%. You assert that there is a difference in special assessment risk in these groups, resp. High, Medium, and Low. Question: Where is the data that supports this classification of risk?

A: We track the results of all our completed Reserve Studies (now over 70,000). That informs our findings. Because of the significance of this data, and because we don’t reveal any client identifiable information, we’ve shared the redacted dataset with the CAI Research Foundation.

Q: Do you have any companies that provide reserve studies for New York Co-operative buildings?

A: Association Reserves!

Q: We had a reserve study done 4 years ago. It has been an invaluable tool in helping us raise reserve funds for a lot of deferred maintenance. Do you feel that a Board is able to assess future projects and reserve needs without having a professional update done?

A: Because all the elements on which a Reserve Study is based are in a continual state of change (conditions, costs, Reserve balance, economic conditions), Best Practice is to perform a With-Site-Visit Reserve Study update at least every third year and consider inexpensive No-Site-Visit updates in the in-between years. Reserve funding is regularly your largest single budget line item. Check it annually.

Q: What do you do if your documents won't let you raise dues more than 5% per year, but that doesn't meet what the inflation level is in today's world? Planning for a large expense in the next two years.

A: First, ensure that your state law doesn't supersede (overrule) your documents with regard to the raising of assessments. If not, call your attorney and get going on updating your Governing Documents to eliminate that clause. Then start communicating immediately with the owners on what is coming down the road, and what options the Board is considering and why, which may include a special assessment just to provide essential cash flow. Don't be "one and done" or give up easily, the future of your association is at stake. Don't assume that most folks don't read or don't read all that is sent them – keep communicating. Be transparent and open, send out the information of what you are basing your considerations. Get in front of this now – you have a better chance of encouraging owner buy-in.

Q: How are you dealing with the high current inflation and minimum wage increases on future reserve project funding?

A: It's an interesting combination of high inflation now, but an expectation for more "normal" inflation for the long term future. See what we're seeing, doing, and recommending here.

Q: What is the difference in reserves between single residence HOAs and Condominium HOAs?

A: Sorry, not enough information to answer specifically. It likely boils down to a difference in the amount and type of common area responsibilities.

Q: Is your historical data "sliceable" so that those associations with units impacted regularly with sea/coastal weather conditions can develop more realistic reserve budget plans? Can our analyst help with that?

A: Our overall client data collection knows the zip code of the property but doesn't categorize them by "coastal exposure". Your credentialed Reserve Study provider should be making adjustments in Useful Life, Remaining Useful Life, and cost particular to your association to help you set a realistic Reserve Funding Plan.

Q: Any comments on how to make progress on accurate financial planning when it's incredibly hard to get estimates at the moment (and the estimates expire well before estimated project start dates)? It took us 10 months to get one deck rebuild estimate.

A: To perform effective financial planning, have a credentialed Reserve Study provider update your Reserve Study. It is not your job to "do it all" yourself.

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 <u>no obligation</u> 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.