Avoiding Reserves Quicksand!

Aug 13, 2025

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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 transfers, if your board struggles with hoarding Reserves or spending Reserves too freely, then your association is stuck in some type of Reserve Quicksand. Remember – community association living has been described as "carefree", but it is anything but "free"! There are significant unavoidable costs (driven by Mother Nature and Father Time), and it takes hard work and diligence (and plenty of cash) to stay "on the trail".

In this webinar, former manager and national consultant Julie Adamen joins Robert to help attendees identify Reserves quicksand, get out of Reserves quicksand, and then avoid getting stuck in Reserves quicksand in the future. In an environment where Reserve-budget issues have grown to include legitimate safety concerns, effective Reserve planning is serious business. It takes skill to navigate to a future where there are sufficient Reserves to perform projects on time (no deferred maintenance, no special assessments) and where property values are maximized.

Identifying Quicksand:

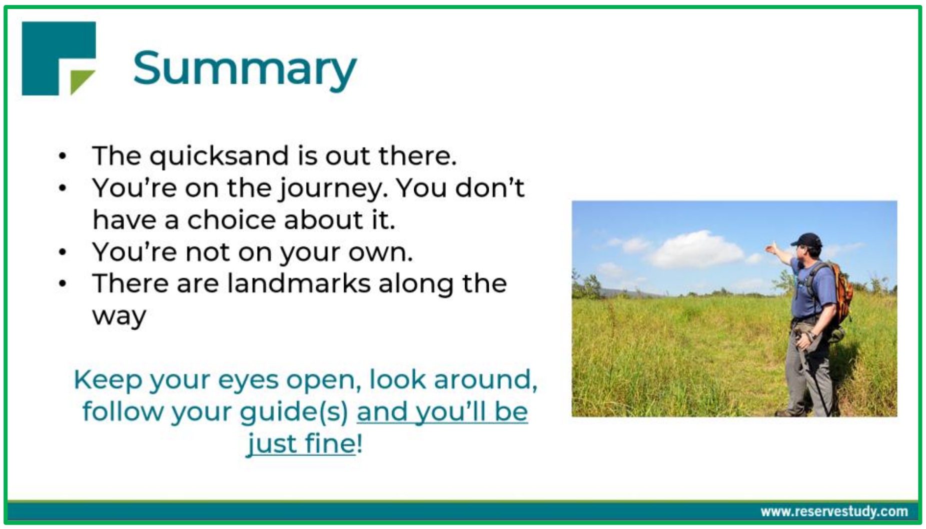
Getting out of Quicksand:

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 overall budget as necessary (increasing assessments), making recommended Reserve transfers 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 transfers that offset the ongoing cost of deterioration. Rely on your trusted guides and update your Reserve Study regularly.

Remember:



Additional information:

National Reserve Study Standards (updated 2023) [here]

Free chapter 1 download of "Understanding Reserves" book [here]

Free Reserve Study proposal request from Association Reserves [here]

More information on our speakers here: www.ReserveStudy.com and www.Adamen-Inc.com

FAQs

Disclaimer: We're grateful for all the questions shared during our live webinar sessions. Due to the high volume of inquiries, similar or duplicated questions may already be addressed in the FAQ section below. If your question requires a more detailed explanation or if you're seeking further information on the topic, we encourage you to contact your local reserve study provider — you can find their contact information [here].

Q: What is the difference between an Operating expense and a Reserve expense?

A: Most attendees seek clarity on this. The key rule: a Reserve expense must be a common-area responsibility, with a reasonably predictable life expectancy, and a cost that is "material" (significant) to the association, meaning commonly above 0.5% to 1% of the annual budget.

Q: What is the 3-part test for including something in the Reserve Study?

A: See above. Per national Reserve Study Standards, it must:

- Be a common-area maintenance responsibility
- Have a reasonably predictable life expectancy
- Have a cost that is "material" (significant) to the association, meaning commonly above .5% to 1% of the annual budget.

Q: How often should we update our Reserve Study?

A: National "Best Practice" is a With-Site-Visit update at least every third year, with No-Site-Visit updates annually in between. That's because all Reserve Study information (Reserve balance, conditions, costs, interest, and inflation) all drift from "the plan" within a year's time.

Q: Is 70% funded "good enough"?

A: Yes. Your target should be the 100% Funded level (Fully Funded), where the cash in Reserves is equal to the dollar value of deterioration at your property. But studies show that there is essentially no further reduction in special assessment risk once an association is above 70% Funded.

Q: What if our Reserve Study doesn't include a component we know we need?

A: Reach out to your local credentialed Reserve Study provider. It may be added if it passes the 3-part test. Timely updates ensure your plan is accurate through the years, helping you plan effectively for the care of your property.

Q: How do we convince reluctant board members or homeowners to fund Reserves?

A: In most cases, you don't need to "convince" the homeowners. It's their duty to pay the rate of homeowner assessments that the board sets. For board members (and in the associations where homeowners vote to "approve" the budget"), remind everyone that deterioration is real, maintenance and replacements are expensive, and it is the board's <u>responsibility</u> to budget for the sustainability of the association. Frankly speaking, remember that you have no control over the expenses. Mother Nature and Father Time ensure that everything is in a <u>constant state</u> of deterioration. Your only choice is if you pay the cost of that deterioration evenly, on an ongoing basis, or in periodic unsettling special assessments.

Q: Can we use Reserves for preventive maintenance?

A: Yes—if it significantly extends the life of the component and passes the cost threshold. Routine care still belongs in the Operating budget. Discuss further with your local credentialed Reserve Study professional.

Q: What happens if our Reserve Fund is over 100% funded?

A: Do not pause contributions. Your provider may recommend a slightly reduced rate of Reserve funding in order to gradually deplete that surplus over time.

Q: Can Reserve funds be borrowed or used for emergencies (like insurance premiums)?

A: Sometimes. Check with your legal counsel to see if it is prohibited by your Governing Documents or State law. If borrowing is allowed, ensure all borrowed Reserves are restored in a timely manner. Some states (e.g., CA & WA) require any borrowed Reserves to be repaid within a specified (relatively short) period of time. It is inappropriate to use Reserves for Operating expenses (like insurance premiums). Operating Fund shortfalls are an indication that your assessments need to be raised.

Q: Why are actual project costs sometimes higher than what's in the Reserve Study?

A: Often the culprit is an old Reserve Study (not for the current year). Reserve Study costs are estimates prepared to the best ability of the provider. If you find some costs in your Reserve Study were understated, challenge your Reserve Study provider with that news and request a revision or commission an update.

Q: What is Percent Funded and how is it calculated?

A: Percent Funded is a relative measure of Reserve Fund strength:

(Actual Reserve balance / Fully Funded Balance) × 100

Note that the Fully Funded Balance is the cash value of all the Reserve component deterioration at the association.

Q: Can we delay Reserve projects or substitute alternatives like patch repairs?

A: Yes—but with caution. It may lower costs short-term but often leads to higher future expenses or safety concerns. It is best to discuss with your local credentialed Reserve Study provider to discuss phasing, delays, or interim repairs.

Q: Do different vendors produce different Reserve Study results?

A: Yes, even under national standards. Differences may arise due to assumptions about maintenance, cost sources, professional judgment about the amount of deterioration, and the selection of a Funding Goal (Full Funding is a conservative goal, Baseline Funding is an aggressive/risky goal, and Threshold Funding can be any level in-between). Please discuss differences and strategies with your local credentialed Reserve Study provider.

Q: How should boards handle underfunded Reserves without alienating homeowners?

A: Transparency and clear communication are key. Explain that prior underfunding has created a "legacy burden" that needs to be confronted. Explain that the ongoing cost of deterioration has exceeded Reserve Funding, and the association needs to increase Reserve Funding to prepare for upcoming projects. Homeowners may have enjoyed lower assessments for years, but that assessment structure was unsustainable.

Q: Can a homeowner or board member prepare a Reserve Study themselves?

A: In most states, they can. But it's never recommended. Lack of expertise and lack of independence are significant obstacles. Reserve Funding is commonly 15-40% of an association's total budget. For a budget line item that large, an understated funding recommendation can result in deferred maintenance or special assessments that cause home values to drop <u>far in excess</u> of the cost of a Reserve Study. Boards should rely on credentialed professionals.

WEBINAR QUESTIONS ASKED BY ATTENDEES

General Reserve Questions

Q: **What are your thoughts on having, CDARS? What is the best term and safe choice options for weeks 13-26-52?**

A: Regarding CDARS (Certificate of Deposit Account Registry Service), CDARS are considered a low-risk investment due to the fixed interest rates and the FDIC insurance coverage. They are considered an investment where "protection of principal" is ensured, but it's important to be aware of potential early withdrawal penalties. Please discuss with a qualified Reserve investment counselor if and how they may be appropriate for your association, in light of your financial assets and upcoming Reserve projects.

Q: **Is it advised to share the first draft of our Level 1 Reserve Study (first EVER) with all Owners prior to any official vote at an annual meeting for a vote? Or best to keep with the Board for a more coordinated review prior to release of the Final Draft for vote? Any tips for best educating our 45-member Owner Community is welcome.**

A: No. A first draft is a working document. Wait until the Reserve Study is refined and published. Regarding your community, the important points are that owning Real Estate is expensive, Mother Nature and Father Time see to it that Reserve projects are inevitable (and predictable), and that Reserve Funding only offsets current (ongoing) deterioration. When every owner pays the cost to offset ongoing deterioration, future takes care of itself.

Q: **What is the potential impact of an HOA loan on resale value, buyer perception, mortgage approval rates (including FHA/VA lending guidelines), and community attractiveness vs the nearly 100% risk of litigation regarding a special assessment? For context, our townhome community of 157-unites is 25-years old, 41% funded (per our latest Reserve Study), and faced with a potentially $750K asphalt project to replace the asphalt throughout the entire community. Although at 41% funding, we have $1.5 million in Reserves, draining $750k to pay for this project outright, would drastically underfund us. Not to mention, we have 23 buildings in our community approaching 30-years old, at which point roof replacement comes into play.**

A: My experience is different regarding "risk of litigation" with a special assessment. Deterioration costs are what they are. Effective ongoing communication with your homeowners means they're not surprised about the physical and financial status of your association, and they're aware months or years in advance when a special assessment is coming. Please discuss your Reserve funding and spending options with your local, credentialed Reserve Study professional to choose the best path forward. Note that both a special assessment and a loan send a message to prospective buyers that the association is not prepared for its own future, making buyers cautious and causing them to underpay (reserving some of their cash for a future special assessment they'll have to pay).

Q: **Our association just had a reserve study done and our Funded percent is 96% so we are in good shape currently but have many items in the Component List. When it comes time to initiate a component project and pull money from reserve to complete a component project, what is the best way to do this and record it in the association financials? Since the component project will not be in that year's budget (or should it be?) yet when payment for project is complete and paid due funds will come from operating account and will show in financials and budget to actual report. Our reserves are held in multiple certificates of deposit with a few that have very flexible withdrawal terms so easy to pull money when needed for component project payments. Looking for recommendations on how best to handle the money aspect.**

A: Your Reserve Fund liquidity should match your upcoming projects. It is best to not have Reserves needed for a project tied up in a long term investment. It is best to keep enough cash liquid (in a Money Market account, not a time-dependent investment) to pay for upcoming projects. That way the cash can be transferred to your Operating Account on a day's notice when the bill is due to be paid, without early withdrawal penalties. For further details, please discuss with your accounting representative.

Reserve Component Questions

Q: **In our reserve study, we have some large assets like walls around the community, that have million-dollar replacement costs. How do you plan for these? It may have a 100 life.**

A: Long-life components like perimeter walls are often challenging. Regularly it is best to model them with "partial repair/replacement" intervals. For instance, $x of repairs every 5 years. We know nothing lasts forever. Partial repair/replacement projects can be adjusted over the years to suit the needs of the association, always providing the cash needed to sustain the assets. Please discuss with your local credentialed Reserve Study professional.

Q: **What about establishing reserves for unpredictable items such as hurricane damage? Clean up can be several times more than annual landscape maintenance.**

A: Reserves are for predictable, inevitable expenses. Hurricane damage is neither—it's unpredictable in timing and magnitude. That's why it's best handled through proper insurance coverage and perhaps a disaster response plan or "contingency" or "emergency" fund, not reserves.

Q: **I have a community with a substantial number of trees. Their reserve study doesn't allow for the tree removal/replacement program to be considered in part of their**

expenses, but the program is at least $25-$30K a year. Is there any way to have this be reconsidered (as I know they are not the only community to experience this)?

A: Absolutely. Landscape projects (especially tree care) regularly meets the national Reserve Study Standards three-part test to be considered a Reserve project: a common area maintenance responsibility, reasonably predictable life limit, and above a minimum cost of significant to the association. Challenge your Reserve Study professional to reconsider their position on tree trimming.

Q: I read the IRS doesn't consider painting/staining as a legitimate reserve (capital) project. How do we save for it? How much for initial and monthly?

A: Prepare your taxes per IRS standards/definitions and prepare your budget per national Reserve Study Standards. Painting/staining, tree trimming, asphalt seal coating, etc. may all be legitimate Reserve projects (passing the three-part test). Expect your local credentialed Reserve Study professional will Include such components in your Reserve Study. Your tax preparer may care (or not), your tax preparer may wish to see your Reserve Study (or not). This issue is immaterial if your association files the common 1120-H tax form.

Q: Why would a reserve specialist expect a manager to determine replacement costs for a fire sprinkler system, for example?

A: They shouldn’t. Your reserve specialist should determine replacement costs using industry data, vendor input, and their own expertise. A manager can assist by providing access to vendors or historical costs (or referencing a similar project at another adjacent property), but the burden of estimating belongs to the Reserve Study professional.

Reserve Funding Questions

Q: If a board ends the year with a surplus in operating, is it better to carry that over to operating in the next year, or transfer it to reserve?

A: If reserves are underfunded, transferring surplus operating funds to reserves is almost always the wiser choice. Operating surpluses should be viewed as a “one-time” gain—perfect for catching up on long-term needs, <u>not</u> for lowering next year’s assessments.

Q: What is the best way to consider how a large expenditure should be funded? Part reserve, part assessment. All assessment, all reserve?

A: Ideally, the reserve fund should cover the entire cost of predictable projects. Splitting costs often indicates reserves are underfunded. That said, for unplanned or scope-expanded projects, a cost-sharing approach can be a fair compromise. Best to discuss with your local credentialed Reserve Study professional for your unique circumstances.

Q: **At the end of the year, should we aim to have 2-3 months of operating expenses in our Operating (checking) account, and carry it forward to the next year?**

A: Correct. Having a healthy operating cushion—usually 2–3 months of expenses—is a common and smart business practice. Just keep in mind that anything beyond that cushion (see above) may be better utilized in reserves.

Q: **How do you feel about pooled reserves vs. line-item reserves? We have line-item reserves that have been sitting around for several years which we can't touch.**

A: I'm a strong advocate of the Cash Flow Method (aka "pooled reserves" method). It very simply uses your Reserve cash more efficiently, not having significant portions tucked away untouchable for large periods of time. For underfunded associations, this makes Reserve funding much more tolerable while they gradually build the strength of their Reserve Fund. Utilizing the Component Method (aka "Line-item reserves") yields unnecessarily high Reserve funding requirements for the common underfunded association.

Q: **We are currently making Reserve transfers in pursuit of a "Fully Funded" goal. But we expect next year we won't be able to sustain those transfers, because they will push us higher than our current "5% annual increase" limitation to our assessments. Can we safely shift down to "baseline/minimum" Funding?**

A: First, I'm not comfortable with your question. If you are currently making Reserve transfers pursuing a Fully Funded goal, I don't see how 5% assessment increase limit threatens your ability to continue. Remember that Reserve transfers are just a portion of your budget. Most of your costs (typically 75%) are from the Operating side. Discuss with your local credentialed Reserve Study professional. Lowering your Funding Goal, falling behind the rate at which your Reserve assets are deteriorating, just exposes your homeowners to future special assessments. There's no avoiding the high costs driven by Mother Nature and Father Time. Perhaps you can get the homeowners to approve a budget with <u>more</u> than a 5% increase for next year (above what the board can do automatically).

Q: **Do you have a contingency line item in your reserve expenses? This would only be used for undefined expenses.**

A: Generally, no—reserves are for predictable projects (meeting the national Reserve Study Standards three-part test). A "contingency" for "possible" expenses does not pass the test. If you want a "cushion" on the side for the unknown (insurance deductibles, storm cleanup, unusually high snow removal costs, etc.), create a new savings fund for that purpose and call it a contingency fund. Reserves are for known, predictable projects.

Q: **If you add a new component to Reserves, do you have to initially purchase it using operating funds? Or can you use the existing reserve funds and then add it to the reserves list?**

A: If it's a brand-new asset, the purchase should come from operating or a special assessment. Once it exists, however, it's added to the reserve study for future replacement funding. Note that quite often we add a new component to Reserves simply because it was in plain sight, but either was "missed" or its life expectancy was indeterminate (it needed to get a bit older before we were able to predict its deterioration trajectory).

Interest/Inflation Questions

Q: **Inflation is currently estimated at 7 to 10%. Is there any insight into that amount going back down?**

A: I believe your estimate of current inflation is a bit high. But I expect the appropriate government/financial authorities are making adjustments to interest rates and spending to try to bring it back down to a "healthy economy" rate of inflation. History shows inflation moves in cycles. We have some level of control over it. For reserve planning, assume a conservative long-term rate (3–4%) but keep an eye on short term actuals to ensure your "current costs" are appropriately benchmarked.

Q: **Should interest earned on Reserve accounts go back into Reserves? Does interest count towards the budgeted Reserve Transfer or is it extra?**

A: Because interest is earned from Reserves on-deposit, it is common to include those (after tax) earnings as part of Reserve funding. Some associations siphon it off to the Operating Fund, but that just forces their Reserve transfers to be higher.

Q: **When the Reserve transfer is listed in the budget, is it just the money moved from Operating to Reserves each month/quarter/year? Or should that number also reflect the interest the Reserve funds earn over time?**

A: See above. The budgeted transfer is the planned movement of cash from operating to reserves. Interest comes from the bank and is typically reinvested in the Reserve fund (and included, after tax, as part of Reserve funding). Please discuss with your local credentialed Reserve professional to be clear how it is handled at your association.

State Specific Questions

Q: **Are the principles of Reserve Funding the same for SIRS funding and Regular Reserve funding, and how are they connected?**

A: Yes—the principles of identifying components, projecting costs, and funding appropriately are the same. SIRS just brings a statutory framework and a specific list of components, for which a minimum level of Reserve funding cannot be waived by the homeowners.

Q: My association completed the SIRS in March 2024 and used the SIRS for the 2025 budget. Actuals of course are different than the Study estimates for 2025. What adjustments, if any, are needed to budget for 2026? Can the association make such adjustments without using a consultant? The underlying assumption is that the reserve assessments will be equal to or greater than the Study annual funding requirements.

A: Please discuss with your local (FL) credentialed Reserve Study provider. There are some new requirements in the recent 2025 legislation that affect who updates your Reserve Study, and when. Please be reminded that State Law requirements are minimal requirements… your job is to fund to sustain the association. Make sure you don't focus too much on "just what the law says".

Q: Can we ask our reserve study specialist to incorporate borescope findings we've had done in our CA condominium by a construction company since the SB326 (Civil Code §5551) inspections? We wish to ensure these findings are included in the reserve study summary.

A: Absolutely. New, credible data—like borescope inspection results—should be integrated into the study so your funding plan reflects current realities. It is best to discuss and share these findings with your Reserve Study professional.