

APPENDIX 3: QUESTIONS & ANSWERS ABOUT COMMUNITY ASSOCIATION RESERVES

1. "We keep hearing about 'adequate' reserves. What does this mean—how do we know what's adequate?"

For financial experts and reserve specialists, the answer rests on financial concepts that have been much debated. For many years the concept was based on the assumption that each reserve component must be fully, or 100 percent, funded for the overall reserve balance to be adequate. For example, if a component has a 20-year life and a \$100,000-replacement cost, the association would need to set aside \$5,000 annually ($\$100,000 \div 20 \text{ years} = \$5,000$) so that, at the end of the 20-year period, 100 percent of the "replacement cost" had been accumulated.

For this component to be 100 percent funded at the end of three years, the association should have accumulated \$15,000 ($\$5,000 \times \text{three years}$). But, if only \$7,500 has been accumulated in three years, then this component is only 50 percent funded. In this example, 100 percent funding is the same as adequate funding.

The concept becomes more complex when the reserve study includes numerous components. In this situation, if each component is 100 percent funded, as described above, the actual reserve balance may never approach \$0 and may always have a significantly higher than needed balance. In this case (see Figure 8), an association could be adequately funded *without* being 100 percent funded.

Associations should review their long-term cash-flow projections and evaluate the funds that will be in the fund over a 20- to 30-year cash-flow period. Based on this review, the association can then establish the yearly contributions at a level that allows for an adequate reserve balance without over funding. (See Chapter 1, Establishing a Reserve Fund.)

2. "Sometimes our accountant mentions 'full funding' and the Reserve Specialist talks about 'proportional funding' Are these the same thing?"

No. The term proportional funding is preferred over full funding because full funding is a little misleading. The word "full" implies that no further increases in contributions to a fund are necessary, which usually isn't the case. Full funding also suggests that anything less isn't adequate, which can actually result in over funding. A more accurate term is proportional funding—a term suggesting that adequate funds are available at specific points in time for major repairs, replacements, and refurbishments of all common area items. If you're saving for these items, you're setting aside a proportional amount of money for each component on an annual basis.

3. "Our board was presented with several options for funding our reserves—full funding, threshold funding, and baseline funding. How do we know which one to use?"

Each funding option has its pros and cons. Depending on your association's needs and circumstances, one method may be better than another. Part of your fiduciary duty to the members is to understand the implications of each method and to make an informed choice. Work closely with a certified Reserve Specialist and document your decision-making process.

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4. "If our reserves are replacement funds, what are maintenance funds? What type of items should be in each?"

Replacement funds are used to pay for common area components that will be completely replaced in the future. Maintenance funds are used to pay for maintaining common area components until it's time to replace them. For example, a wood siding replacement reserve would pay to completely replace the siding in 35 years, and a painting fund would pay for painting the siding every four years to ensure that it lasts for 35 years.

5. "Is it possible to determine our reserve contributions as a percentage of the operating budget?"

Association members often wonder what percentage of their budget should be devoted to reserves. According to a recent survey, most reserve professionals find percentages to be poor indicators of appropriate reserve fund size because of the vast differences in association sizes, budgets, amenities, architectural styles, etc. For example, the state of Michigan mandates a minimum reserve contribution of 10 percent of the operating budget. But if the operating budget includes association employee salaries and benefits, the association could easily become over-funded. Consult a professional before deciding how much to put in reserves.

6. "Our association has always managed to pay for whatever it needed to replace or repair. So, why should we undertake a professional reserve study?"

For most people, a home represents the largest single investment of their life. In community associations, the board has a fiduciary responsibility to protect that investment through proper planning, prudent investing, and preventative maintenance. Few boards have the expertise needed to undertake the type of planning and investing needed, so a professional reserve study is essential to fulfilling their duty. You've been lucky up to now—further lack of planning may expose you to claims of liability or negligent in certain circumstances.

7. "OK, we're convinced that we need to do some formal planning and investing, but why can't we do it ourselves? Would we still be exposed to liability if we prepare our own reserve study?"

Yes. If you prepare your own reserve study and neglect to include items that may need repair, replacement, or refurbishment in the future, you may be found negligent in a court of law and held personally liable for any shortfall of funds needed to repair, replace, or rebuild these common area items. Even though there are laws that protect volunteer board members from liability, if the board willfully removes certain items from the reserve study to lower amounts earmarked for reserves, it may be found liable if problems arise.

8. "Our association just took over from the developer. Included with the initial governing documents, the first board received a reserve study prepared by the developer. Since the developer in many instances does not use a professional reserve study preparer, and since the developer's interests and ours are a little different, is there anything special we need to know?"

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Yes. The reserve study included in the initial governing documents is prepared by the developer before construction actually begins, based on estimates from the architectural and engineering design drawings. Since a completed community is unlikely to match the design drawings exactly, the reserve study is unlikely to reflect the needs of the community exactly. Changes made during construction are common, and unless the initial reserve study contained major omissions, this is not a cause for concern or a claim against the developer.

It's important to understand that initial reserve studies are based on estimates and proposed, not as-built, construction. This can be mitigated by updating the reserve study at some time near the end of construction to reflect what has actually been constructed, and periodically updating all reserve studies since the condition of common area assets change constantly.

9. "Our board president wants his stock broker to handle the association's funds, is that OK?"

No. Even though the president is unlikely to garner any personal benefit from the relationship between the association and his broker, the possibility of a perceived conflict of interest exists. In this case, association members might infer that the president will enjoy some sort of preferential treatment, if not outright kickback, from his broker as a result of the referral. The safest course of action is for board members to avoid even the implication of a potential conflict of interest.

10. "The board treasurer believes that a formal investment policy will protect the board from liability. Is this correct?"

No, but it increases the likelihood that this board and future boards will perform more effectively and consistently. A formal investment policy provides important guidelines that help board members and managers protect and maintain members' assets. Although any board can rescind, modify, or even ignore the policy, most prudent boards will follow it assuming it's in the best interest of the association and it allows for reasonable returns and realistic processes over time.

11. "Why should we hire a professional company to do our reserve study, and where do we find one?"

A reserve study is a complex document that projects when numerous major components will need to be replaced and what they will cost. Preparing it requires a unique combination of specialized engineering knowledge and a keen understanding of financial investing.

Professional reserve study providers, or RS designated specialists, are qualified to perform competent reserve studies tailored correctly for each community. These professionals have met stringent requirements, and they're held to high standards. They have a thorough knowledge of common interest developments, HOAs, and community associations, and can provide a board with sound guidance. Boards that hire professional reserve study providers greatly reduce their liability for a possible breach of fiduciary responsibility.

To locate a professional reserve study provider, visit www.caionline.org/directory/index.cfm or contact

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your local chapter of Community Associations Institute.

Also, when selecting a reserve study provider, prepare a request for proposal that outlines the scope of work to be done and that specifies the reserve study must conform to the National Reserve Study Standards of the Community Associations Institute and statutory requirements. Inquire whether a certified Reserve Specialists will be directly involved in your engagement.

12. "We're a self-managing board, and although we can do our own accounting, we want professional guidance on investing. Before we decide who to hire, how do we check references on a financial advisor?"

There are several regulatory and government agencies that maintain records on financial advisors, banks, brokers, and other financial service providers. These include the National Association of Securities Dealers (www.NASD.com), the New York Stock Exchange (www.NYSE.com), United States Securities and Exchange Commission (www.SEC.gov), and the Federal Deposit Insurance Corporation (www.fdic.gov).

13. "A couple members of the board have high tolerance for risk, and they're encouraging us to be more aggressive with the association's investments. Is this OK since we're investing other people's money in stocks, bonds, or mutual funds?"

No. Homeowners entrust their money to the elected board. If that board loses money in aggressive—that is, risky—investments, it can expect to be sued for breach of fiduciary responsibility. Speculating and taking risks with association funds is never appropriate, no matter what the potential reward. Industry standards and the best practices of many communities nationwide have shown that a conservative approach is warranted for any and all funds entrusted to a governing board.

14. "Our reserves are under-funded, and we need to build them up as quickly as possible. How can we double our reserves with no risk?"

You can't. To earn above-average returns on investments, you must take above-average risks. The board has an obligation to protect the association's assets, and pursuing risky investments is contrary to this responsibility.

15. "The association treasurer found an investment that pays 10 percent; however, this 'annuity' requires that the treasurer and the president be named as owner/beneficiary. Should we consider this option in order to reap the high return?"

Absolutely not. You wouldn't sign over your personal bank account to your neighbor, and putting control of the association's investments in the hands of one or two board members is equally unacceptable. Besides being a breach of the board's fiduciary responsibility, it's a risky approach with inherent potential for abuse or malfeasance.

The practical implications are that if anything were to happen to either officer—death or incapacitation,

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for example—the board would have to deal with family, heirs, or an estate attorney who knows nothing of the arrangement with the association.

16. "Our local bank has both our operating and reserve funds. They're in two separate accounts, but the combined total is greater than \$100,000. Are we exposed?"

Yes. The FDIC delineates the insurance coverage for each institution by the Tax ID or Social Security number of the customer. If you have more than \$100,000, including interest, in any one bank or FDIC insured institution, your funds are at risk. Never maintain more than \$100,000, including accrued interest, in any one bank.

17. "Our association bought mutual funds that have declined in value and now we need money to replace the roof. What options do we have?"

Very few. You can keep the mutual funds or sell them, either way you still need to fix the roof, which may mean levying a special assessment. If you sell the funds, you'll take a loss. If you keep them you could borrow against the value of the fund, but you also risk further losses in value and additional special assessments.

Some states have laws that stipulate the length and types of investments that may be held by associations. Check with your attorney about the suitability of investing reserves in mutual funds.

18. "Will the annual audit catch problems with the reserve funds?"

Not necessarily. Auditors have two responsibilities when auditing association financial statements that include replacement reserves.

First, they must specify whether information on future major repairs and replacements is disclosed in the financial statements, that the presentation and methodology for it is appropriate, and that it has been subjected to a limited review, but not audit. This limited review would list the components to be included in the replacement fund, their remaining useful lives, and their estimated replacement costs. The auditor does not audit this information, but instead determines that it has been presented in accordance with standards established by the American Institute of Certified Public Accountants. There is no requirement to reference the amount the board is funding or how it compares to the engineering study, unless, in the auditor's judgment, it warrants mention, as explained below.

The second responsibility of the auditor is to ensure that the financial statements adequately disclose how the association is setting aside funds for future repairs and replacements. The auditor will look for the date the engineering study was prepared, who prepared it, the methodology for funding, and the degree to which the association is funding the replacement fund as recommended in the engineering study. If disclosure is complete, there is no requirement for the auditor to specify the level of funding or shortfall in the reserves. Nonetheless, if the reserves are significantly under-funded, the auditor may elect to mention it.

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19. "Our maintenance expenses are significantly over budget this year due to unanticipated bad weather. Can we borrow funds from the replacement reserve fund to cover this?"

In certain states, associations are allowed to borrow from reserves to cover operating shortfalls. Ask your association attorney what your state's statutes or civil code allows.

The important thing to remember about borrowing from reserves is that the amount must be repaid within a reasonable period.

20. "We'd like to enhance our community. Is a reserve fund appropriate for a general upgrading?"

Replacement reserve funds are specifically designated for the replacement of existing components. In many instances new technologies or materials may be available to use as the replacements, and there is no reason why this cannot be done.

However, it isn't appropriate to use reserve funds for a new component that wasn't previously part of the reserve study. After the new component is added, it should be included in the reserve study for future maintenance.

21. "Our reserve study projects what it will cost to replace various components, but what about inflation? Won't it affect our reserve balance?"

Changes in the rate of inflation and in interest rates, plus changes in the condition of your common elements are the reasons reserve studies must be regularly updated. An updated study will have a new beginning balance that may include interest earned and replacement costs that have been adjusted for the effects of inflation.

Don't assume that interest earned will offset the effects of inflation because the third variable—the aging of the common elements—will also offset interest earned. This is because the interest earned is generally based only on the monies that have been accumulated while the estimated inflationary increase in replacements will be applied to the full replacement costs.

On the face of it, including inflation and interest seems logical and would appear to provide level funding of reserves into the future. However, a case can be made for factoring neither inflation nor interest in future replacement funding because it's too speculative. Rather the update would reflect changes in accumulated balances and adjusted costs of specific common elements.

22. "Our reserve study estimated that the boiler wouldn't need to be replaced for another four years, but we have to replace it now. We weren't expecting that outlay this year. What should we do?"

You need to do two things. First, you need to cover the expense of replacing the boiler. Talk to an association financial specialist about how to use your existing investments without incurring penalties. If this can't be done, you may have to increase fees, impose a special assessment, or possibly borrow funds.

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Second, talk to a Reserve Specialist to find out why the reserve study projections were off, and make whatever changes are necessary. Update the study to reflect the new beginning balance and the current conditions of all components. It should be kept in mind that while a reserve study does include projections for when replacements will become necessary, these time frames are generally estimated based on visual observations and may not reflect the actual time of replacement. This is one of the factors which must be considered when the association is deciding which funding plan to use and how much risk to take in regards to the ongoing fund balance.

23. "We just had the roof replaced, and it cost ten percent more than the reserve study called for. Why did this happen and what should we do?"

Your reserve study is a budgetary tool, not a cost guarantee. Actual costs rarely match a reserve study's projections exactly, but they should be close.

A ten percent variance—in your case, an increase, but it could also have been a decrease—probably resulted because the costs of many components were averaged.

A reserve study is generally not looked at on a line-by-line basis. For example, let's say your total fund has \$500,000, \$100,000 was earmarked for the roof, and the actual cost was \$110,000. You don't need a special assessment or a loan to cover the \$10,000 shortfall because the overall fund has enough money to cover the cost of the roof.

Go ahead and pay the entire \$110,000 for the roof from the reserve funds. Then update the reserve study to reflect the new roofs, the condition and age of all of the components, and the new balance—\$390,000—remaining in the fund.

24. "We need to replace a retaining wall, but it wasn't included in the reserve study. Can we use reserve funds to pay for this?"

Maybe. Generally, replacement funds should only be spent on items listed in the reserve study as scheduled. While there is no specific prohibition against this, it's discouraged because it depletes the funds prematurely and skews the funding plan.

Some professionals believe this is acceptable in certain circumstances—for example, for a component that was inadvertently omitted from the reserve inventory—provided that:

- The reserve funds are adequate to cover cash flow in the short run.
- The reserve fund will be adjusted immediately to replace the funds used and to add the previously omitted item to the overall funding plan.

Any time the board discovers that a component has been omitted from the reserve study for any reason, it should immediately have the study revised to include it.

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25. "We just had our reserve study reviewed by a Reserve Specialist who said that our reserves are significantly under-funded? What should we do?"

The board and manager should meet with the reserves study preparer and a professional financial advisor to develop a plan for adequately funding the reserves. Evaluating the reserve study in detail with the Reserve Specialist, combined with evaluating the association's cash flow and budget with the financial advisor, should identify ways to increase contributions over time until the reserve funds are in line with the reserve study.

26. "We need about \$2 million to renovate our aging building. Although we have \$3 million in reserves, we don't want to deplete those funds so drastically. Would it be appropriate to obtain bank financing for this replacement project? How will this affect our assessments?"

Bank financing (borrowing) is an acceptable alternative to a large special assessment. Associations can borrow money if their governing documents allow borrowing, if the funds are needed to maintain or repair common area components, and, in some cases, if the association members approve. Assessments will need to be adjusted accordingly to repay the principal and interest.

27. "Our community is still in development and won't reach build out for another year. How should we fund our reserves during this time?"

The answer depends on how many capital components have been completed, the size of the community, and the developer's obligation during the build-out period. In most instances, the association budget is based on full occupancy, and unit owners' contributions are based on their percentage ownership interest at the time the community is completed. The developer makes up any shortfall until all homes are built and sold.

In larger communities being built over many years, the budgeted reserve contribution will vary. Reserves for common elements that have been completed should be fully funded regardless of the number of units sold. As the community is built, other common elements like roads and sidewalks will increase, and the reserve funding should increase accordingly.

28. "Why is it important for the builder or developer of a community association to understand reserves?"

Developer have the same interest in protecting assets—the development—as any homeowner. A well-formulated reserve funding strategy contributes to the value of the development and makes the process of turning control of the community over to homeowners financially less burdensome. A developer's goal is to sell all homes as quickly as possible. Establishing a sound reserve fund promotes sales because it reduces the possibility of a special assessment after build out. In many instances developers are now using Reserve Specialists to help prepare the initial budgets which are included in the governing documents.

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29. "I'm not going to live here very long, why should I worry about reserves for items beyond the next few years?"

This question can be answered best by citing an example. You've been living in your condominium for the past 12 years, and you plan to retire and sell it in seven years. The roof has a 20-year life, and will be replaced the year after you leave. If you don't contribute towards the roof during the 12 years you live under it, the new owner will have to pay the full cost of the new roof after living under it for only one year. This clearly isn't an equitable method for homeowners to pay a proportionate share for the use of the roof.

30. "We have quite a few resident owners on fixed incomes in our association. Are they exempt from contributing to reserves?"

No. All owners are responsible for paying an equal portion of all common expenses—including repair and replacement funds, i.e., reserves. They were notified of this requirement when they purchased a home in an association and received their governing documents.

31. "The association's budget is very tight this year. Is it OK if we don't contribute monies to the replacement fund?"

It would be a breach of fiduciary responsibility for a board to not budget for ongoing maintenance, repairs and upkeep of the association's common area components. However, if the board has disclosed the fact that it will not budget, reserve, or set aside funds—and the owners have agreed to this approach—it may be acceptable. A more responsible approach would be to consider raising assessments.

32. "The association's budget is very tight this year, but we're able to contribute a limited amount. Can we leave out a few items like tile roofs, concrete slabs, or water pipes from our reserve study in order to lower the reserve contribution?"

No. The best course is to include everything. Don't leave anything out of the reserve study that the association would have to pay for later by imposing a special assessment or by borrowing. If, however, you elect to exclude some components, let the association members know that they may have to pay for these items later through a special assessment. Add the excluded items to the reserve as soon as possible.

33. "Our board is making arrangements to have our reserve study updated, and we were asked whether we want a site visit? Is this necessary?"

There are two basic types of update, an update with a site (or field) visit and one without a site visit. The update without a site visit is used primarily for budget analysis. For example, the association may want to see how much the annual contributions would increase if a swimming pool was built.

A site visit is necessary if the condition of the reserve study components has changed for any reason—the passage of time since the last reserve analysis, weather damage, new construction, remodeling,

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and so on. Also, if you're making arrangements with new or different reserve study provider, a site visit is necessary.

34. "We just had a reserve study done 18 months ago, and our accountant is already suggesting it's time to update it. Why do we need an update?"

Reserve studies are always subject to change depending on the condition of the common area assets, which are affected by various factors like location and weather, and the condition of the association's finances.

Updating the reserve study adjusts for additions or upgrades to the common area like a new or refurbished tennis court. Updating adjusts the projections of the remaining useful lives of components based on their actual conditions, and it adjusts for altered fund balances that may have resulted from spending more money than anticipated, or if common elements are replaced earlier than originally scheduled.

35. "OK, I understand now why we need to update the reserve study. How often should we plan to review and update it?"

Once a year. The reserve study is an integral part of an association's overall financial plan, and it should be considered as part of the annual financial review.

Although the reserve study should be reviewed annually, how frequently it should be updated by a qualified professional varies based on the size and age of the community. In many instances, larger communities update their reserve study annually, while smaller associations update it every three to four years. The need to update more frequently increases as the community ages. A good rule of thumb would be to have the study updated, including a field visit, every third year until the association is ten years old and then every other year after that.

The type of funding plan an association is using is another consideration when determining how often to update a reserve study. For example, the baseline funding method is the least conservative, so annual updates may be warranted. On the other hand, an association that uses the proportional funding method and has established a large threshold amount in the fund would most likely find it acceptable to update a reserve study less frequently than once a year.

36. "OK, the reserve study is complete. Now what?"

Your reserve study is a planning tool—use it. Use it when you develop the annual budget. Confirm that you made the appropriate fund contributions during the past year, and make sure this year's contributions have been factored into the assessments.

Use the reserve study to plan the work that must be done in the coming year. Undertake replacements according to the schedule in the reserve study; otherwise they may cost more than the fund has accumulated.