community resource

Insight and Education for Community Associations

Community Associations Institute / Central Arizona Chapter / www.caicommunityresource.com Issue 3 / 2009

SAFEGUARDS: Protecting Your Organization from Itself – Financial Issues

RESERVES: If You Fail to Plan, You are Planning to Fail

Assessment Increase: One Size Does Not Fit All

How to Borrow and What Impact Does a Reserve Study Have on the Process

PLUS...

2009 CAI Casino Night
Myths and Misconceptions
2009 CAI CAC Event Calendar

CENTRAL ARIZONA CHAPTER
community
ASSOCIATIONS INSTITUTE

RESERVES: If You Fail to Plan, You are Planning to Fail

By Kerry-Lynn Goto, CMCA, LSM, PCAM, RS

Eventually, a community's major assets, such as streets, building roofs, and recreational amenities will "retire," requiring major repairs or replacement. However, unlike individuals who don't properly plan for retirement, associations can't rely on Social Security.

Community associations function as businesses. Although the business is generally non-profit in nature, a board of directors has a fiduciary obligation to the association, and is elected by the membership to protect, preserve, maintain and enhance its community's common elements. This fiduciary obligation requires community association boards to adequately prepare for anticipated future expenses. So, what happens when association boards don't plan ahead? Essentially, an association that has not properly funded for replacement reserves faces three scenarios: borrowing from a bank; special assessment; or, deferred maintenance.

While obtaining a bank loan to pay for necessary replacement or repairs may be an option, the financing charges associated with borrowing add to the cost of the primary expenditure. Even if a bank loan is available, some association governing documents prohibit borrowing, while others require approval of a large percentage of homeowners in order to proceed. In many cases, regular assessments must be increased to meet the loan payment obligation; and the bank will require a lien against future association assessments to secure repayment.

The second option is the dreaded special assessment. Special assessments are frequently unfair, as they place financial responsibility for worn-out components on the current homeowner, regardless of how long they have owned property within the community. They can also create an economic hardship on homeowners who may already be struggling to meet their regular assessment payments, as special assessments usually have a very short time-frame for payment. Additionally, as with the borrowing scenario discussed above, obtaining membership approval for a special assessment can be difficult.

The third alternative is to defer the necessary maintenance or replacement until the association has sufficient funds to meet its obligations. However, deferred maintenance can have a snowball effect, leading to a deterioration of common area appearance and functionality, a decline in property values, and a potential breach of fiduciary duty claim against the association's board of directors causing increased insurance premiums.

The most prudent course of action for an association's board is to avoid the foregoing scenarios by preparing for component retirement through a long-range reserve funding plan. A well-executed reserve funding plan distributes major repair and replacement costs over a period of several years, helping to ensure that funds will be on-hand when needed, thereby avoiding the need for loans, special assessments or deferred maintenance.

Association boards can employ various strategies to meet their reserve funding goals. These include baseline funding, threshold funding, and full funding:

- Baseline funding establishes a reserve funding goal of keeping an association's reserve cash balance above zero. Various plans are tested against the anticipated reserves expense schedule until a desired funding plan is achieved;
- Threshold funding maintains an association's reserve fund balance above a specified dollar amount, or percentage funded. This method could be more or less conservative than full funding, depending upon the threshold amount; and,
- Full funding is designed to attain and maintain reserves at or near 100% of funding. This method is sometimes referred to as "component" funding, as reserve funds are separately allocated for each component to achieve 100% funding for future expenditure.

Planning for an association's asset retirement makes good business sense, as it helps to ensure that sufficient funds will be available to meet future replacement costs. If you are unsure, or know that your association's reserve funds are inadequate, a professional reserve study provider can assist with long-range reserve planning and funding strategies.

Kerry-Lynn Goto, CMCA, LSM, PCAM, RS, is 30+ year veteran of the community association industry. She is a community association consultant and the owner of Great Boards, LLC; a consulting firm that provides professional reserve studies for common interest developments.