Do You Have an Elephant in the Living Room?

The Power of Reserve Studies for Community Associations

by Robert Nordlund and Joel W. Meskin, Esq., CIRMS

Do you have an elephant in the living room? That is a way to describe something that everyone knows about, but nobody talks about because it is too awkward. Community Association budgets, and particularly Reserve contributions and disclosures, are such a thing. Although most of the governing documents for the over 300,000 associations throughout the country and many of the 50 states require that community associations have reserve studies, the reality is that most do not, or if they do they are not regularly updated, and if they do, they are not properly funded.

Community Associations are created because the members have chosen to live in a community where they have a common interest with the other members. The basic notion is that the common interest creates enhanced value to the community by providing common amenities and services or a protection of a certain lifestyle. Inherent in this common interest is the need to manage and maintain this enhanced value. This process is the foundation of a community association's management team – and is the board of directors or trustees' fiduciary obligation.

The Reserve Study is potentially the greatest tool to comply with this fiduciary obligation. Many of the challenges for an association and complaints for a board arise from the fact that the board does not have its finger firmly on the pulse of the physical aspects and assets of the association. Two key excuses raised by associations are that they "cannot afford a reserve study" or it is too late. Both of these are week excuses. The board of directors may be breaching its fiduciary obligation by taking no action. As we all know, knowledge is power and a reserve study gives the board knowledge that could lead to the power to protect member investments.

Some associations have budgets designed to create problems with income less than expenses. Even more associations skimp on their Reserve contributions (normally afraid to increase assessments). But Reserve expenses typically average out to be 15-40% of an association's total budget. If the contributions aren't going in slow and steady on a regular and long term basis, than what results is a big community association nightmare. There will be special assessments. As we all know, the special assessment may be limited to what is allowed by the governing documents and/or state regulation, forcing special assessments going on for years. The result is the requirement to disclose to future purchasers, which will have a direct impact on home values.

It's just expenses higher than income, all over again. Many associations don't know their Reserve status, going years without evaluating their Reserve needs, calculating the size of Reserve contributions they should be making, and reporting to the owners the state of their Reserve Fund. The result? Budgets are based on wishful thinking, the owners are confused and uninformed, and due to lack of cash there are instances of deferred maintenance or special assessments. Fortunately, it doesn't have to be that way.

Imagine an association where budgets are balanced (income matches expenses) and distributed to the owners each year. Imagine an association where the Reserve contributions are re-evaluated each year. Imagine an association where every year the Board communicates to their members how they are dealing with the reality of funding future Reserve expenses. Imagine an association where the Board communicates the relative size and strength (Percent Funded) of the Reserve Fund to the members each year.

Would regular ongoing assessments be higher? Probably, but remember that Reserve contributions are typically less than a premium coffee, per unit, per day. Would there be future special assessments? Less likely. Would owners be surprised by the financial status of the association? No. Would Real Estate values be maximized? Most likely. Would owner enjoyment of the association be maximized? Most likely. What is further accomplished is the board and the association have created a very strong risk management tool which should have an impact on insurance costs and may very well eliminate a number of different types of claims and will result in less complaints by association members.

Running your association in a fiscally responsible manner is not as hard as it would seem, based on the high number of associations running themselves into financial trouble! Simple management tools like a "budget to actual" report throughout the year helps a Board know the truth about income and expenses at the association. New tools periodically arrive on the market that make preparing budgets and disclosures easier. Association websites are assisting and sometimes replacing mailings and newsletters in keeping members regularly informed. Novel free web-applications like QuickReserves place remarkably easy and powerful Reserve budgeting and disclosure tools into the hands of board members and managers everywhere. It is simply not that hard to be fiscally responsible and earn the rewards of shorter board meetings, less (threat of) litigation, and higher property values.

It boils down to being <u>your</u> community. You get to choose how it is run. You can choose to ignore some of the big issues like balanced operating and Reserve budgets, or you can choose fiscally responsible behaviors that bring peace and order. Continuing down the path of wishful thinking and hiding information from the owners leads to special assessments, disappointment and disarray.

So is there an elephant in your living room? Start your association on the path to a better future by annually preparing a balanced Operating and Reserve budget, and making clear annual disclosures to the members. Being financially responsible is not that hard to do.