Reserves

One of the primary duties of the board is protecting property values. Boards accomplish this by planning ahead and reserving money for future big-ticket expenses in funds called reserves.

- Knowing what the big-ticket items—roofs, asphalt, seawalls, boilers—will cost and when to replace them is a specialty that requires the expertise of engineers and investors. These experts—called Reserve Specialists—prepare reserve studies that tell associations how much they need to put aside, or reserve, in each year's budget so they can pay for a new roof in 20 years. To locate a qualified Reserve Specialist, boards should visit www.caionline.org and consult the National Service Directory and/or the Credentialed Professionals Directory.
- The board and manager cannot develop a realistic budget without a reserve study.
- Because prices and conditions change from year to year, boards should have the association's reserve study updated at regular intervals.
- Reserve funds build up over many years. Therefore, investment strategies are an essential component of any reserve-funding program. Boards have a fiduciary obligation to protect the principal while maximizing the return

on the investment. This requires sound financial guidance from qualified advisors.

- Maintaining adequate reserve funds eliminates unexpected fee increases, special assessments, and borrowing. And by saving instead of borrowing, the association earns income instead of paying interest. In fact, the income from reserve accounts can help keep fees low by supplementing assessments.

STEPS IN ESTABLISHING A RESERVE FUND

1. Get the owners on board. Owners sometimes think reserves are costing them extra money or wonder why they should pay now for something that may not have to be replaced for several years. To help owners understand the importance of reserves, boards can inform them of these important reasons:

- A reserve fund may be required by law.
- Reserve funds provide for the planned replacement of major items that must, at some point in time, be replaced.
- Major items deteriorate over time. Although a roof will be replaced when it is 25 years old, every owner who lived under it should share its replacement cost.
- Reserves minimize the need for special assessments.
- Reserves enhance resale values.

2. Conduct a reserve study. The board should work with its manager, accountant, engineer, and Reserve Specialist to conduct a reserve study. Reserve studies have two parts: the physical analysis and the financial analysis.

3. Setup a component schedule. A component is a part of the common elements, like a roof or boiler, and the schedule is the date when the experts think it will need to be replaced. A components schedule is therefore a list of all common area components and the dates when they are likely to need replacing.

TOOL 12.1: See the Flowchart for Selecting Preventative Maintenance Schedule Components at the end of this section.

4. Select a funding plan. There are four primary reserve funding strategies, and the board must decide the one that's right for the association based on funding goals.

- Full funding means that reserves are funded and maintained at or near 100 percent.
- Baseline funding means that associations keep the reserve cash balance above zero.
- Threshold funding means that the fund's minimum balance is set at a predetermined dollar amount.
- Statutory funding means associations set aside the minimum amount of reserves required by statutes.

5. Decide how often to conduct a reserve study. Experts recommend that studies be reviewed or updated every one to five years, but this can vary according to the age and needs of the association.

INVESTING

The board has a legal responsibility to all owners to make sure reserve funds are invested properly and that the funds are available when needed. For these reasons, board members must consult with professional advisers, decide on a strategy that is in the best long-term interest of the association, and prepare a written investment policy.

ESTABLISH AN INVESTMENT POLICY

An investment policy will provide boards with the structure, consistency, and continuity necessary for any investment decision they must make. The policy should take into consideration safety, liquidity, and yield of principal as well as investment risks like inflation or interest rates.

TOOL 12.2: See the Sample Investment Policy at the end of this section.

GUIDELINES FOR INVESTING RESERVES

Boards are guided by their bylaws as to how to invest their funds. Typical guidelines might state:

- If the association needs to use reserve funds within six months, it should invest in a money market fund.
- If the association needs money within six months to one year, it should invest in a six-month CD or a six-month treasury bill.
- If the association needs the funds after one year, it should utilize a laddered portfolio of CDs or treasury notes based on the future liquidity needs of the association.

Associations benefit from prudent investing that focuses on reason and foresight—not on high rates of return. The board has a fiduciary duty to protect, maintain, and enhance association assets, not to speculate with funds. Any variance from this safe and secure approach may constitute a breach of fiduciary duty.

TAX CONSIDERATIONS

Associations can invest their funds in a variety of ways. However, different types of investments are subject to federal and state income taxes, such as:

- Interest income
- Rental income (if the association owns and rents a unit)
- Capital gains

The effect of taxes on the association's investments will need to be factored into the overall reserve funding strategy.

FINDING A RESERVE SPECIALIST

A qualified Reserve Specialist has years of experience and education, and he or she can ensure that your community association prepares its reserve study as accurately as possible. To locate a Reserve Specialist, go to to CAI's website at www.caionline.org and peruse the Credentialed Professionals Directory and/or National Service Directory.

Cautions

Reserve accounts have a bearing on whether prospective buyers can get financing in your association. It's important to allocate sufficient funds for reserves in the annual budget.

Setting aside funds for the future is an extremely important part of the board's financial responsibility. It's important to remember that boards that fail to adequately fund their reserve accounts have breached their fiduciary duty to the association.

Reserve studies are technical documents requiring specialized expertise. The board should hire a qualified, experienced person to prepare its study.

If board members prepare the reserve study, they should be aware of the risks since they will expose themselves to liability if they don't set aside sufficient funds.

An association's reserve can easily become over-funded as well as under-funded. It's important for boards to consult a professional before deciding how much to put in reserves.

Check your state's laws; reserves in your state could be dictated by statute.

FOR MORE HELP

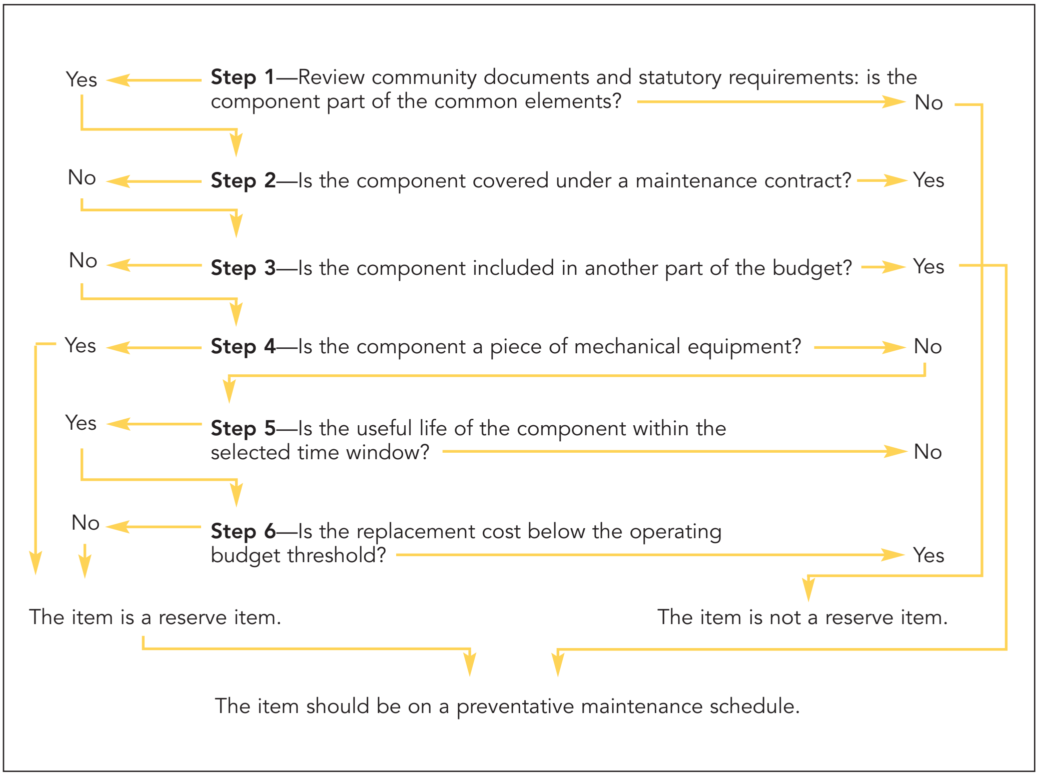
Available online at www.caionline.org/bookstore.cfm or call (888) 224-4321 (M–F, 9–6:30 ET).

Reserve Funding and Reserve Investment Strategies, Guide for Association Practitioner #24, by M. Frumkin and C. Juall. (Community Associations Institute, 2003.)

www.caionline.org/about/designations_finding_professionals.cfm

To download a PDF of the entire Board Member Tool Kit, go to www.caionline.org/toolkit.

Flowchart for Selecting Preventative Maintenance Schedule Components



Sample Investment Policy

Approved by the Riverview Condominium Board of Directors on [date].

The Riverview Condominium

Rockville, Maryland

BE IT RESOLVED that the replacement reserves shall be invested in such amounts as may be authorized by the board in accord with the following policy.

A. No funds shall be deposited or invested except in authorized investments. Authorized investments are those that are in accordance with the Maryland Condominium Act and with the declaration and bylaws of the Riverview Condominium and that are obligations of, or fully guaranteed by, the U.S. government.

B. All accounts, instruments, and other documentation of such investments shall be subject to the approval of, and may from time to time be amended by, the board of directors as appropriate, and they shall be reviewed at least annually.

C. Investments shall be guided by the following goals, listed in decreasing order of importance:

1. **Safety of principal.** The long-term goal is safety of the replacement reserves.

2. **Liquidity and accessibility.** Funds should be readily available for projected and unexpected expenditures.

3. **Minimal costs.** Investment costs (redemption fees, commissions, and other transaction costs) should be minimized.

4. **Professional management.** Funds should be invested with professional managers who have good reputations and sound credentials.

5. **Return.** Funds should be invested to seek the highest level of return that is consistent with preservation of the purchasing power of the principle and accumulated interest.