BUDGETS, RESERVE FUNDS AND FINANCIAL PLANNING 101:

Building a Powerful Financial Future for Your Managed Community
INTRODUCTION

If you are on the board of a condo, co-op, high-rise or HOA, you know that the value of your property and the satisfaction of fellow homeowners are directly tied to the financial strength and stability of your association. Well-managed, financially healthy communities can consistently deliver essential quality services while strategically pursuing long-term capital improvements that allow them to compete in a changing landscape—one that increasingly features amenity-rich communities and buildings.

Fiscally sound properties are also notable for what they do not provide: surprises. Their annual budgets reflect the importance of efficient operational approaches and ongoing preventative maintenance designed with cost effectiveness in mind. Their reserve fund planning is based on hard data and an accurate assessment of future capital needs directed toward community enhancements. Finally, their financial planning methods are engineered to maximize investment benefits, simplify complex banking processes and deliver financial security.

By minimizing unexpected expenses, controlling operating costs and safeguarding investments, you are helping to preserve not just the value of your property, but the lifestyle that you and your fellow residents expect. Getting your financial house in order across all areas—budgeting, reserve fund forecasting and financial planning—takes time and a commitment to understanding the smallest details of your association’s accounting and management policies.

Fortunately, you need not approach the challenge alone. A strong and experienced professional management company—along with highly specialized financial and engineering consulting services—can provide the foundation for superior financial performance. With the right management and technical support, your community can thrive now and into the future.

In the following pages we will review specific steps that you and your board can take to achieve financial management success. We will also illustrate just how much fiscal responsibility can be realized by consistently paying attention to the connection between your annual budget, your reserves and your overall financial plan.
PART ONE
GETTING YOUR ANNUAL BUDGET OFF THE GROUND—AND RIGHT ON THE MONEY

A TIME TO REFLECT

Preparing your association's annual budget is not just a financial necessity, but an opportunity to assess your overall management strategy and gauge its relative success.

For instance, when analyzing current and past operational expenditures for maintenance and repairs—and projecting next year's needs—you can gain insight into the effectiveness of your association's approach to managing these critical functions. Is your maintenance program adequate to help prevent costly infrastructure issues, such as HVAC equipment failure? If the previous spending and projected budget reveal large swings in infrastructure costs, it is time to look at how your infrastructure is actually managed and how it can be improved.

During the budgeting process, you should also review current vendor lists and determine which among them are planning fee increases or service changes in the year ahead. This is an excellent chance to appraise the status of working with your current vendors:

» Are they reliably providing quality service?
» Are their fees and terms reasonable?
» Do they offer new capabilities that you can bundle in?

Depending on the answers, you may want to shop around for new vendors, or at the very least, renegotiate for better fees and service terms.

With a vast network of vendor relationships and the ability to evaluate and negotiate for quality services, an experienced management company can help. At FirstService Residential we understand that quality and cost are equally critical factors in the vendor selection equation. We not only have access to top vendors, but the purchasing power and knowledge to arrange more favorable contracts. For instance, Andy Larkin, CMCA, a general manager with FirstService Residential, was able to save a total of $264,000 annually by carefully re-evaluating vendor contracts for a 404-unit, mid-rise community.
BUDGET WITH THE FUTURE IN MIND

While it is technically an “annual” budget, the process should drive you to think long-term and to consider how planned expenditures in the coming year can actually help you save money down the road.

A budget is meant to optimize the revenue stream from monthly dues toward the overall operation of the community. Quite simply, it tracks how, when and where the money coming in is going to be flowing out. Strategic budgeting, on the other hand, should form the basis for longer term financial decisions. Every community should have a 1-, 3- and 5-year plan, and your annual budget should reflect your long-term financial planning. It should also anticipate any large projects that cannot be funded from your reserves or which may require levying special payment assessments.

To make sure your approach to budgeting is on track, here are some key considerations:

1. Prepare and Plan

The budget process is, at times, arduous and time-consuming. In order to meet the challenge and ease the burden, you must be prepared. An experienced property management company, such as FirstService Residential, can help you through the process and ensure that the budget is followed strictly throughout the year. Members of our financial management team often attend board meetings to present draft budgets, address questions and provide insights on how to improve the operating budget. Our goal is to provide the highest level of financial guidance to board members and to the association’s finance committee.

PAY ATTENTION TO THE DETAILS

When unforeseen shortfalls occur during the year, your reserve funds and your long-term capital improvement plans may pay the price. Keep your eyes open in these areas that are often overlooked when planning the budget:

» Accounts payable. A building or community that carries accounts payable on a month-to-month basis requires special care to understand how this element impacts the budget. When properties are facing cash-flow challenges, they will often recommend new annual budgets that deliver only modest increases in spending. But in the quest to minimize increases, these budgets sometimes overlook the need to carry accounts payable into the new year.

» Bad debt. Budgets generally anticipate 100 percent collections of fees and dues from owners. The reality is that some owners will carry arrears balances, and the difference between the ideal budget and this reality can cause cash-flow problems. A bad debt expense line item in your budget can help anticipate this issue.

Failing to consider year-end accounts payable will prevent the annual budget from generating enough revenue to pay all invoices, leaving your community in the position of having to use reserves or levy a special assessment. Similarly, if there is a deficit in the current year, this must be carried forward to the subsequent year being budgeted.
2. Approach Conventional Operating Costs from an Unconventional Perspective

Understandably, the routine number-crunching nature of budgeting and accounting exercises can lead to routine decision making. The “if it ain’t broke, don’t fix it” justification springs to mind. But this can also lead to missed opportunities to find new solutions that can positively enhance the community and improve the effectiveness of the operating expenses.

Many homeowners look for inspiration and ingenious ways to make their household income stretch further. The same should hold true for associations. Boards and managers should challenge themselves to look beyond just the numbers and reconsider how objectives can be achieved, not just how much it will cost to do so.

At FirstService Residential, our nationwide team of management experts have developed innovative cost-saving methods tailored to communities to help lower their operating expenses. Some of it starts with what we can do to deliver results and reduce costs, such as adopting new management practices, improving strategies for hiring staff, offering energy use and cost management solutions, just to name a few.

BUDGETING SOLUTIONS THAT WORK OUTSIDE THE BOX—AND BEYOND THE FARM

In California, the Orange County Fire Authority notified FirstService Residential community manager Brian Taylor that the community he managed had 30 days to thin out 40 acres of nearby wild brush because it posed a fire hazard. Although Brian put the project out to bid with landscape contractors, he expressed concern about manpower costs and liability in hiring a landscape company with such a tight deadline looming.

Brian and FirstService Residential understand the incredible value in creative planning and cost-control solutions. Brian had heard of employing farmers to provide herds of goats to clear brush in steep areas, and put that plan to work for his board. He hired a local farmer to bring a herd of goats to graze their way through the wild brush, which they did at 1/5 the cost of landscapers who were charging $5,000 an acre. The goats cost only $1,000 an acre—resulting in a cash savings of $180,000, and no additional costs in manpower or the gas and power consumption from using landscaping equipment.
3. Understand the Role of Reserve Funds in Order to Budget Properly

An annual budget is prepared with the intent to break even. As a result, any unfavorable variances created throughout the course of a year will generate an operating deficit. It’s at this point that many associations may be tempted to dip into their reserve funds to cover the shortfall—an action which is actually not allowed by most states per their statutes.

The fact is that your reserve funds are designed to save for future repair, replacement or additions to major components or infrastructure of your community. Variances in your budget will either put your capital plan at risk or require you to seek a special assessment. While you may not be able to avoid the financial impact of a natural disaster, there are steps you can take to minimize unexpected costs and avoid accessing reserve funds for anything other than their intended use.

The most important step to protect reserve funds is to adequately budget for maintenance costs. Your repairs and maintenance budget should provide sufficient funds for routine and preventative maintenance of equipment and infrastructure from HVAC systems to roofs. The goal is to prevent deterioration and allow your infrastructure to meet or exceed its “useful life,” or the expected lifespan of a system, piece of equipment, paint job or other component.

To ensure that your infrastructure is being properly cared for, you must invest now to save later. At the same time, your reserve funds must account for the fact that at various points some elements of your infrastructure will need replacement. As we will discuss later, your reserve funds and capital plan should integrate with your approach to annual repairs and maintenance budgeting, and a comprehensive program of asset management can help accurately diagnose your future capital needs.
4. Stay Engaged All Year Long

If there is only one caveat that every association board and community manager must recognize in order to wisely manage funds, anticipate costs and achieve efficiency, it’s this: *the budgeting process is non-stop.*

Although the annual budget has a start and end date, the process does not end once there is an approved document. You need to stay on top of how expenditures are being managed month-to-month to truly assess if your budget is working effectively. If the board and property management team do not operate within the confines of the budget, the document becomes meaningless.

On the financial management side, you must also have strong internal controls in place. Separating duties like recording receipts and making deposits will help to guard against financial misappropriation, which will ultimately help protect your budget as the year progresses.

Ultimately, your approach to budgeting and day-to-day management are closely intertwined. To make your budget work, you must ensure your management is in top form. A deep and ongoing awareness of your community’s current and past finances will help you greatly when creating the new budget for the year ahead. A professional property management organization will bring resources and experience into the equation, offering oversight and budget-conscious strategies for success.
Budget and financial planning are not just about the here and now, but about the future and the unexpected. Through the preparation of the annual budget, you have considered your community’s more immediate needs, and you have worked to determine how those needs relate to your long-term plans.

Now it is time to turn your attention to, and accurately budget for, your association’s reserve funds, which is specifically designed to anticipate those larger future plans. The fund’s purpose is to fuel infrastructure improvements and maintain quality in the community by allowing for projects that are critically necessary—and generally expensive. Future roofing projects, pool refinishing and paving projects are all examples of potential reserve fund spending. Reserve funds can also be used to cover unanticipated expenses such as emergency repairs from storm damage or project cost-overruns.

Establishing and maintaining your association’s reserve fund is a complex process, and many managed buildings and communities struggle to determine exactly how much they will need down the road for emergencies and capital improvements. The best way to make sure your fund is properly set is to have an accurate reserve study completed, and to supplement this with an asset management program and engineering consulting services.

WHY CONDUCT A RESERVE STUDY

A reserve study aims to analyze and detail future needs at a property, and to minimize surprise expenses. The study identifies an association’s upcoming common area repair and replacement projects. By predicting when capital expenditures may need to occur, and using statistical models to account for the emergencies, it allows for strategic planning.

To maximize the value of your reserve study, consider implementing asset management programs that use specialized tests of major components at your property—HVAC, roofs and pool equipment—to measure the likely life expectancy of infrastructure. By comparing the
actual state of your infrastructure with the useful life prediction of the reserve study, asset management can continually ensure that your reserves match with future needs.

As part of an asset management program you will be guided to establish comprehensive preventative maintenance programs to keep your community's equipment in good shape. Accurately allowing for this level of maintenance in your annual budgets will ensure that your reserve needs are managed and properly tracked, and more important still, properly utilized.

Here is a closer look at key steps to take to plan and protect your association’s reserve funds:

1. Select the Right Firm to Ensure an Accurate Reserve Study

Reserve studies are not always perfect, and they certainly are not all created equal. To make sure you receive an accurate, data-driven reserve study, it is critical to partner with a reserve study firm that is proven and experienced. A top property management company will be able to work with you to select the best firm for your circumstances, starting with providing a list of qualified candidates and assisting with examining the details of their approach, comparing proposals and checking references.

HERE ARE SOME ISSUES THAT BOARD MEMBERS SHOULD CONSIDER WHEN SELECTING A RESERVE STUDY FIRM:

» Make sure your reserve study specialist has an engineering background. A deep understanding of infrastructure and equipment will allow the specialist to correctly diagnose your community’s future needs.

» Understand the level and degree of assessment and testing that your reserve study specialist will actually do to determine the current condition and life expectancy of components. All too often, study firms will make judgments and assumptions based on general information, without truly investigating your specific infrastructure and needs. If the study results were ever challenged in court, would they be considered opinion, or would the reserve specialist have hard, proven data to justify recommendations?

» Make sure your reserve study specialist is recommending a preventative maintenance plan to help ensure maximum life expectancy for your community’s components. We will talk about this in greater detail later.

» Confirm your reserve firm will employ replacement cost estimates based on actual costs from your local area, not national averages.

» Ensure that the specialist’s funding plan will meet your board’s expectation of maintaining a 70 percent or higher funding level. If an association is underfunded, will a plan be recommended to help the property catch up while maintaining current needs?
2. Consider an Asset Management Program

Most association management companies only provide community management services, leaving the actual asset—your physical property—out of the picture. While you budget for day-to-day services, plan for capital improvements, and determine your reserve needs, shouldn’t you also take care to actually preserve and manage your infrastructure? The physical structure or structures that define your community are your most valuable asset: they determine what your own residence will be worth when you go to sell and they inform every aspect of how you live.

A comprehensive asset management program, administered by management and engineering experts, will protect your equipment and infrastructure, saving your property in repair and replacement costs.

3. Prioritize Preventative Maintenance

As mentioned, a comprehensive and adequately funded preventative maintenance plan is essential for the health of your reserve funds. Understanding how long your infrastructure components should last, and making sure they meet these goals will keep your reserve funds intact for their intended purposes: planned future replacement of components, capital improvements and emergency uses.

All too often, maintenance is conducted reactively rather than proactively. Investing in preventative maintenance may initially require you to increase your maintenance budget, which you can do during your annual budgeting. It can also help extend the life of your equipment to help avoid costly repairs and unplanned capital spending.

Board members overseeing residential properties of all types should ensure that their assets are fully protected and that their ability to fund future projects is strong. Expert property management companies offer the foundation for strong operational efficiency, while specialized engineering knowledge and asset management services provide complementary avenues to further maximize such efficiencies. Be sure to partner with a property management company that can thoroughly assess the needs of your community and connect you with the right people to manage your assets before emergencies occur.
ASSET MANAGEMENT IN ACTION

FirstService Residential was able to connect the board of The Austonian, a towering 683-foot tall, 56-story condominium building in Austin, Texas, with one of its asset management consulting partners to put its comprehensive services to work. The company delivered a full building inspection, reported on the condition of the structure and infrastructure, provided recommendations and proposed a preventative maintenance program for the board.

K.C. Williams, a board member at the Austonian and an engineer himself, had high praise for the assessment firm:

“One of the highlights for me this year was meeting and witnessing your assessment techniques. Your final report was very helpful in developing final recommendations. I can assure you that your work and influence in such a limited time will be long-lasting and will help our engineering team improve their attention to detail.”
PART THREE
MAKING SMART FINANCIAL PLANNING A PRIORITY

As a board member, you have a fiduciary duty to protect the financial interests of both the association and your fellow homeowners. That includes ensuring that operating and reserve funds are properly managed, invested and protected to achieve ongoing financial health and stability.

The opportunities to maintain or grow account funds, or even create new revenue streams, are varied and plentiful. Whether investing association funds, accessing or refinancing loans, restructuring insurance policies and premiums or securing investments that accrue interest, your financial decisions as a board member have far-reaching implications for your association’s bottom line now and into the future.

Association treasurers must understand the right vehicles to invest in, how to increase yield while maintaining liquidity, what the optimal allocation of funds should be, and more. In addition, each state has unique requirements for the management of association reserve funds, all designed to protect homeowners and ensure financial stability.

Consequently, rather than managing their financial planning themselves, many community associations opt to partner with financial management companies—especially those with deep experience with homeowners associations and strong banking relationships. FirstService Financial, the proprietary financial services division exclusive to the FirstService Residential portfolio, works closely with the treasurer and board to review the association’s investments and craft tailored solutions to help it achieve its goals.

This hands-on, dedicated approach to helping communities maximize their finances is what sets FirstService Residential apart. Our highly trained in-house team of financial professionals provides a full range of cash management, treasury and investment solutions designed to help you navigate the complex association banking landscape.

With billions in administered funds across North America, FirstService Financial leverages our scale to eliminate unnecessary bank fees while providing increased interest yields. With an integrated approach to long-
term reserve fund management, FirstService Financial provides multiple investment options through various institutions and products to ensure that our clients' liquidity needs are met while maximizing interest yield and protecting principal.

Whether you choose to work with a financial services company or go it alone, it is important to understand some of the fundamental principles of good financial planning. By keeping these tenets in mind throughout the year, board members can ensure they are fulfilling their responsibilities and improving the financial outlook of their building or community.

Here are some key considerations for your financial planning strategy:

1. **Understand the Basics for Investing**
   Operating funds and reserve investments are analyzed differently, therefore your strategy for managing each will differ accordingly.

   For your **operating funds**, consider maintaining three months of budgeted expenses in a checking account and investing the excess in interest-bearing accounts. If there is more than one year’s worth of budgeted expenses, then the excess over that amount can be invested in longer term vehicles. Typically, anything less than one year of budgeted expenses should be kept liquid.

   For **reserve investments**, the board should develop an investment policy if one is not already in place. Based on this policy, and based on a reserve study and any anticipated capital improvements or replacements you can determine the ideal amount of liquidity that should be maintained for your reserves. Liquid funds should be set aside for one year’s worth of projected expenses, along with a 10 percent cushion to account for cost variances. The remainder should be invested in longer term vehicles.

2. **Know Your Options and Obligations**
   There are, of course, a range of investment types for your operating and reserve funds. These investment products, and the requirements that govern them, differ from state to state. For example, some states do not impose any restrictions on associations, while others require that investments be insured.

   Since board members have a fiduciary duty to safeguard the assets of the association, most invest primarily in money market accounts for liquid funds, and CDs for longer term funds. A financial services partner can help you choose the right investment products based on your investment policy and your reserve fund expenditure requirements.
3. Choose Your Bank Wisely

Finding the right banking partner can make the entire process of managing your finances easier and safer. Below are some factors that boards should consider when selecting a financial institution:

» **Stability**: By examining a bank’s ratings from multiple sources, you can determine just how predictable and stable its offered rates will be.

» **Experience with community associations**: Institutions that have worked regularly with condo/co-op associations and HOAs will be familiar with your needs and will be able to easily work with your in-house management or professional management company.

» **Account opening requirements**: It is critical to understand the exact requirements a bank has for opening accounts. You should determine how easy it is to open an account, conduct transactions and whether directors need to physically visit a branch to sign paperwork—an issue that is relevant because some boards have regular turnover.

4. Review Regularly

One of the best ways to ensure that your financial planning strategy is on track is to review your investments regularly. At least once a year, conduct a thorough examination of returns and assess your investment strategy. The best time to conduct your review is prior to your annual budget preparation.

**Ultimately, your association’s financial planning strategy should align closely with your annual budget and should reflect the health of your operating funds. Finally, consider all of your capital improvement plans and the strength of your reserve funds.**
FINANCIAL PLANNING THAT DELIVERS RESULTS

At 201 West 21st Street, a 130-unit co-op in Manhattan, FirstService Financial delivered powerful results in the form of a comprehensive mortgage refinancing strategy. Guiding the association’s board through the process, FirstService Financial developed specific steps to help achieve the association’s key financial end-goal: to fund significant capital improvement projects on the horizon.

After analyzing the property’s current mortgage situation, FirstService Financial was able to identify a hybrid loan product that would offer the co-op a way to avoid short-term cost increases with a new loan, gain access to significant loan proceeds, and switch from an interest-only to an amortizing loan—all without having to raise maintenance dues or impose a special assessment. In the end, the association locked in a lower interest rate, along with net proceeds in excess of $1.2 million to fund capital needs.

Greg Reed, 201 West 21st Street Tenant Association President, had high praise for FirstService Financial:

“FirstService Financial’s professional guidance throughout the process was a fantastic benefit offered through FirstService Residential as our management company. We were able to meet our refinancing objective and achieve favorable new loan terms.”
SUMMING IT ALL UP

True stability within any managed property or community requires that every aspect of the association’s finances work toward a united goal. Your annual budget, your attention to reserve funds and capital planning and your approach to financial planning and investing must all be in sync. So remember:

» Your annual budget must adequately account for daily operational management and preventative maintenance, which will help ensure the integrity of your reserve funds.

» Your annual operating funds and your reserve funds provide opportunity—and responsibility—for careful investment, which can enhance your community’s overall operational health.

» Strong financial planning will ensure that you are making the most of your funds, your insurance plans, and your assets.

» An accurate reserve study and a professionally delivered asset management program can protect your reserve funds from unexpected equipment failures and infrastructure decline, saving your association significant dollars in the long run, and leaving room for capital improvements that will enhance your investment and your lifestyle.

The best way to get your integrated financial program on track is by talking to the experts at FirstService Residential. For more information about our exceptional services and solutions, visit us at www.fsresidential.com today.
About FirstService Residential

FirstService Residential is North America’s largest manager of residential communities and the preferred partner of HOAs, community associations and strata corporations in the U.S. and Canada. FirstService Residential’s managed communities include low-, mid- and high-rise condominiums and cooperatives, single-family homes, master-planned, lifestyle and active adult communities, and rental and commercial properties.

With an unmatched combination of deep industry experience, local market expertise and personalized attention, FirstService Residential delivers proven solutions and exceptional service that add value, enhance lifestyles and make a difference, every day, for every resident and community it manages. FirstService Residential is a subsidiary of FirstService Corporation, a North American leader in the property services sector. For more information, visit www.fsresidential.com.