

Updating Your Reserve Study

Some winters remain unforgettable in many regions of the country because of record snowfalls. Minefields of potholes, torrential rains from spring or fall hurricanes can leave a lasting impression on an associations common elements.

Upon close inspection of your community, you'll likely see the damaging effects of ice, wind, and snow on pavement, driveways, roofs, gutters, and exterior paint. Paint may be prematurely peeling; roofs may be missing shingles or showing unforeseen tears. Thunderstorms may have knocked down trees or damaged portions of the common areas.

Repairing or replacing these elements will affect the financial profile of your association - and lead to many questions. How much will these repairs and replacements cost? Do we have enough money in reserves to pay for them? Did we plan in our Reserve Study to make these repairs and replacements? Did we plan to make them so soon? Are our homeowners still contributing the appropriate amount for sufficient reserves?

To answer these questions, you need to *update your Reserve Study*.

SNAPSHOTS IN TIME

A Reserve Study consists of two key components:

- A physical or engineering analysis of the association's common elements
- A financial analysis that determines a long range funding plan to repair and replace the association's common elements

A Reserve Study identifies the association's future capital needs as of a specific date. Think of a Reserve Study as a snapshot in time. Imagine, for example, that you could photograph the future. You could take a picture of a roof and see if it will still be intact in two years-or if it will be leaking. A Reserve Study acts just like that futuristic camera by estimating the remaining life of the common elements and the future cost to replace them.

So why should you update your Reserve Study? Additions and deletions to the association property, fluctuations in construction costs, and unpredictable events-such as harsh weather-can all significantly affect the accuracy of reserve funding levels.

Your association is constantly changing, and continues to change after the Reserve Study is conducted. The engineer or architect based the Reserve Study on certain assumptions which also can change over time. For example, a board may change its philosophy - particularly from board member turnover - on the timing of repair or replacements. Many boards also make discretionary replacements, such as remodeling a clubhouse. Or, a Reserve Study firm may have

recommended that the association replace its roofs in three years. If, three years later, the roofs do not leak and still look good, the board may decide to delay replacing them for one or two years.

Reserve Studies can be affected by other factors as well, such as new labor saving techniques that reduce capital project costs or a greater return on fund investments than anticipated at the time of the Reserve Study. As these and other conditions change, Reserve Study recommendations can gradually steer off course.

Any Reserve Study more than two years old should not be relied upon with complete confidence.

UPSIDES TO UPDATES

There are two primary benefits to updating a Reserve Study:

1. Updating ensures accuracy. An update ensures that the timing and costs of future capital projects are accurate. To do this, the reserve analyst reviews the property and incorporates information provided by the association. Examples of this information include:

- Weather conditions that extend or diminish the remaining useful lives of the common elements.
- Age, condition, and rate of deterioration of the common elements.
- Preventive maintenance steps implemented by the association, which extend the life of certain components.
- Technological advancements in product design, construction methods, and materials that directly affect the replacement cost of a particular common element. In the future, for example, associations will use construction materials not yet invented.
- Additions and deletions to the property, such as new homes or the addition of a pool clubhouse, fences, or even signage.

2. Updating helps maintain the correct level of funding. To update the Reserve Study, the reserve analyst incorporates changes in the remaining useful lives of the common elements and the estimated future costs of replacing them.

The analyst also considers certain financial conditions, such as:

- Changes in inflation that affect local market rates for materials and labor. The inflation rate of construction costs will vary over time, due to the supply and demand of housing. As demand for housing increases in a particular area, a shortage of labor and materials results, causing prices - and the inflation rate - to rise.
- Actual interest earned from invested reserves versus estimates made in the last Reserve Study. Variances from earlier projections are

common. For example, if reserve funds invested in certificates of deposit are earning greater interest than projected in the initial Reserve Study, the reserves may be overfunded. As a result, homeowners may not have to contribute as much as originally expected.

Any board's biggest fear is that the funding plan no longer meets the association's needs. Overfunding means that current owners are contributing more than their fair share. Under funding inevitably leads to such unpleasant options as bank loans, large increases in assessments, or special assessments, which can be particularly painful to homeowners on fixed incomes.

Or, to put it more simply, *overfunding penalizes current homeowners, while underfunding penalizes future homeowners.* The purpose of a Reserve Study is to determine reasonable reserves and reasonable reserve contributions that treat current and future homeowners fairly.

UPDATE FREQUENCY

Updates are typically conducted on a two-to four-year cycle. Some state statutes require more frequent updates. The American Institute of Certified Public Accountants recommends that associations annually evaluate their replacement costs and funding estimates.

The appropriate time frame is determined by how significantly the property has changed. For example, the actual cost of any major replacement project can affect the amount of future reserves. Other factors that affect the frequency of an update include changes in the replacement schedule, such as postponing a repaving project, and financial considerations, such as changes in interest rates and construction cost inflation. These all change the funding requirements or the level of assessments paid by owners. For example, a rapid unforeseen increase in the construction inflation rate causes the reserves to be insufficient for future capital projects. The affects of these changes in the property and marketplace can only be determined through a Reserve Study update.

DO WE NEED A SITE VISIT?

As mentioned previously, a Reserve Study includes a physical analysis and a financial analysis. For the physical analysis, the engineer or architect conducts an on-site inspection. He or she scrutinizes the property's age and condition, the dates and costs of repairs or replacements, and future costs of capital repair projects. The financial analysis examines changes in the inflation rate of construction costs, any adjustments to the capital repair schedule, and actual interest earned from the reserve investments.



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Updating Your Reserve Study

An association with a two-year-old Reserve Study may not need a physical inspection, which can save the association money. An update without a site visit is possible if the association:

- Adheres to the replacement schedule
- Has not undertaken such major projects as roof, siding, or street replacements since the last Reserve Study

An Update without a site visit is less expensive because the engineer or architect does not revisit the property, which saves time and money. A site visit can be beneficial, however, because the engineer or architect can more accurately determine the extent of future replacement projects and when they'll be necessary. If the association has just completed a major replacement project or added new property, it should consider an Update with a site visit. It's also a good idea when repairs and replacements occur at times different from the Reserve Study schedule, the maintenance schedule or practices have changed, the association has endured harsh weather conditions, or the reserve analyst has not inspected the community in more than four years. The engineer or architect closely scrutinizes the current condition of all of the common elements during the on-site inspection and adjusts the

remaining useful lives, based on observations and other information. For example, if the inspection takes place shortly after a major capital project is completed, the specialist can determine the quality of materials used and, in some cases, whether proper installation procedures were followed.

Quality of materials, installation procedures, and maintenance practices all play a critical role in determining when replacement will be necessary. With an on-site inspection, the reserve analyst can more accurately determine the common elements' rate of deterioration.

The important thing is this: periodic updates will account for variations before the board finds itself faced with unpopular decisions, such as hurriedly repairing the common elements and raising assessments.

After an on-site inspection, the reserve analyst adjusts the remaining useful lives of the common elements and, accordingly, the replacement schedule. Finally, the reserve specialist determines appropriate reserve contributions based on all of the new information.

The analyst and the board should discuss the association's reserve philosophy. This insures that the funding plan is consistent with the association's long-term objectives. Changes to the

funding plan are often so subtle that most owners are unaware of them. Yet Reserve Study Updates position boards to better fulfill their fiduciary responsibility with minimal problems, while strengthening property values and maintaining the quality of life that the homeowners have come to expect.

Accountants, community managers, and Reserve Study professionals agree that updating the Reserve Study is essential for the financial well-being of an association. Updating keeps the funding and repair/replacement schedule plan on track. Current and future homeowners benefit from equitable reserve contributions, and the board can rely on an accurate business plan for effectively managing the association. In a sense, the association can plan for a rainy day, (or a snowy one!)

*by John P. Poehlmann
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Reserve Advisors, Inc. is the leading provider of **Reserve Studies**, **Transition Studies** (defect analysis at developer turnover), and **Property Insurance Advisory Services** in nearly 50 states and Canada since 1991.

Clients benefit with a customized, thorough analysis that's based on our noninvasive, visual inspection and is easy to use. Understanding the needs and issues that are specific to client objectives helps ensure satisfaction.

Clients comply with national standards because many of our engineers and architects hold the Reserve Specialist (RS) and Professional Reserve Analyst (PRA) designations from the *Community Associations Institute* and *Association of Professional Reserve Analysts*.



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Our principals are at the forefront of education and professional standards. Theodore Salgado, P.E., PRA, serves as President of the *Association of Professional Reserve Analysts (APRA)*. John Poehlmann, RS, serves on the *Community Associations Institute (CAI)* national Board of Trustees. Both are founders of CAI's *Reserve Professionals Committee*, which developed national standards for Reserve Study providers.

Our focus is to help clients preserve and maintain their property in excellent condition.