WHY WOULD ANYONE UPDATE A RESERVE STUDY ANNUALLY?

by Robert M. Nordlund, PE, RS
CEO/Founder
Association Reserves, Inc.

December 2013
(updated from August 2011)
www.reservestudy.com

At this time of year, many Boardmembers and Managers are asking themselves this very question. With Reserve contributions making up **15% to 40%** of the typical Association's budget, there are a number of issues involved in formulating an answer.

But before we can talk about updating a Reserve Study, let's look at the various ways a current Reserve study becomes "outdated".

The three key results of every Reserve Study (according to National Reserve Study Standards) are shown below:

RESERVE STUDY RESULTS

And each of the three results can easily become outdated.

#1. Outdated Component List (changes to Remaining Useful Lives & Replacement Costs)

#2. Outdated Reserve Fund Strength (changes to % Funded)

#3. Outdated Funding Plan (changes to how much needs to be set aside from now on)

The term "Current" in Reserve Study jargon refers to the information being tied to the start date of the Association's Fiscal Year (FY). It is necessary to tie the information to the FY starting date because of the time-dependent nature of Reserve Studies. Let me demonstrate one-by-one how these results become outdated:

#1. Outdated Component List

Let's say a Reserve Study dated January 1, 2011 included a Roof component with a Remaining Useful Life (RUL) of 3 years and a Replacement Cost of $245,000. If the study was updated for January 1, 2012, the current Roof RUL at that time would likely drop to 2 years and you would expect the estimated Replacement Cost to be a bit higher. If the Reserve Study was updated for January 1, 2013, the current Roof RUL at that time would probably drop to 1 year and you would expect the replacement cost again to be a bit higher. If the original 2011 Reserve Study was never updated, homeowners and prospective homeowners reading the report in 2013 could be under the mistaken impression that the Roof had a RUL of 3 years and a replacement cost of $245,000. They would have to take a close look at the report date, and do their own manual subtraction/inflation calculations for the number of years since the Roof information became outdated. Of course this exercise would have to be repeated for every component on the Component List.

#2. Outdated Reserve Fund Strength

Let's say a Reserve Study dated January 1, 2011 measured the Association's Reserve Fund Strength at an "average" 60% Funded with a low risk of Special Assessment. Let's assume that the Board does not follow the recommended Funding Plan for three consecutive fiscal years (2011, 2012, and 2013). It is not only possible, but highly likely (especially if there were major reserve expenditures) that the Reserve Fund Strength would drop from 60% Funded to a "weak" 30% Funded with a high risk of Special Assessment. Homeowners and prospective homeowners in 2013, relying on the outdated report, could be under the mistaken impression that the Association was financially stable instead of financial unstable. They would have to take a close look at the report date, and do their own due diligence about what had transpired in the three years since 2011.

#3. Outdated Funding Plan (how much needs to be set aside from now on)

Let's say an Association raised homeowner dues January 1, 2011 to cover steep Operating Budget increases, but because of that held Reserve contributions constant at the 2010 rate (even though their January 1, 2010 Reserve Study recommended an increase in Reserve Funding from $50 per unit per month to $60/unit/mo. And through that political turmoil, a new Board gets elected in 2012 on the platform of "no assessment increases", so Reserves remain underfunded through 2011, 2012, and 2013. It is not only possible, but highly likely that a Reserve Funding Plan in 2013 or 2014 would require a Special Assessment. If the original 2011 Reserve Study was never updated, homeowners and prospective homeowners reading the report in 2014 could be under the mistaken impression that the Funding Plan was free of special assessments, and it would be easy to miss that their actual Reserve contributions were less than the amount recommended way back in 2011. They would be surprised in 2013 or 2014 to learn that scheduled repairs were being deferred and that the Board needed to levy a special assessment to make up for the three years of under-funding reserves.

Reserve Studies expire for a simple reason. The information contained within is no longer valid after a year! The physical condition of the roof (and asphalt and paint and hallway carpet) has changed. The Remaining Useful lives have changed. Replacement costs have changed. The strength of the Reserve Fund has changed. The size of the Reserve Fund has changed. The economic environment and the Funding Plan have changed. I hope by now that that it's obvious it only takes one year for a "current" Reserve Study to become outdated.

Now I'd like to pose a different question: "How did we ever adopt the mindset in this industry that it is acceptable <u>not</u> to update the Reserve Study annually?" I believe there are two explanations:

- Misconstruing the concept of a multi-year forecast

  Reserve Studies that comply with National Reserve Study Standards contain a projected Funding Plan (reserve income) and Spending Plan (reserve expenses) over a minimum 20 year period. Many people have misinterpreted these "projections" to mean that the Reserve Study is valid for 20 years. The actual intent of the multi-year forecast is to give Associations a one-year plan with a 20-year window on the future.

- Legislative Misinterpretation

  Certain states have legislation that requires a Reserve Study "Site Visit" Update every two, three, or five years. The actual intent of the verbiage was to emphasize the importance of periodic inspection-based updates to validate the interim annual no-site-visit updates. It seems to be an unintended consequence that many people have misinterpreted this verbiage to negate the need to perform annual "No Site Visit" Updates in the intervening years.

Finally, let me conclude by answering the question originally posed: Why Would Anyone Update a Reserve Study <u>Annually</u>?

Budgeting Usefulness

A <u>current</u>, credible Reserve Study is extremely helpful to Boardmembers in determining how much of the homeowner assessments need to be set aside to fund Reserves so that all required repairs & replacements can be completed in a timely manner.

Crisis Avoidance

When a Reserve Study is updated annually, it is typically a matter of mostly minor revisions and tweaks. Compare that to a situation where an Association wants to update a Reserve Study that expired 3-4 years ago. In these cases, the Reserve Study update process becomes a “rescue operation”, where the Association’s Reserve Fund strength has diminished significantly and the new Funding Plan needs to compensate for years of under-funding. Perhaps a special assessment is now necessary. That kind of crisis could have easily been avoided with minor annual adjustments.

Disclosure Purposes

Homeowners (and prospective homeowners) expect and deserve to have access to “current” reserve disclosures. As of 2013, 30 different states specifically require Reserve Studies for budget preparation or owner (and prospective owner) disclosure purposes. Boardmembers can only rely on a current-year Reserve Study to make accurate disclosures about the Association’s largest financial asset.

Sound Business Judgment

For a budget line item as large and significant as Reserve contributions, an annual evaluation of Reserve contributions complies with the "sound business judgment" rule for non-profit corporations. In addition, most Governing Documents require an "appropriate" amount of Reserves to be collected each year to offset ongoing deterioration of the common area components. That amount needs to be adjusted annually in light of inevitable changes to the Association's physical and financial circumstances.

Generally Accepted Accounting Practices

In August 1991, the American Institute of Certified Public Accountants (AICPA) modified their Generally Accepted Accounting Principles (GAAP) for Associations by recommending annual Reserve planning as part of the budget planning and financial reporting process. By contrast, it is unacceptable to rely on outdated information or ignore such a large budget line item for years at a time.

In all other areas of our lives, we expect current information. Just as you would never expect your bank to resend you last month’s bank statement, when you step back from the situation, it seems foolish to rely on an outdated Reserve Study. Why Would Anyone Update a Reserve Study Annually? A better question might be: **Why wouldn’t they?**