WHY IS ACCOUNTING FOR INTEREST AND INFLATION (ESPECIALLY INFLATION!) IMPORTANT?

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Interest earnings bring income to the association, and inflation takes it away. Interest earnings are good, as they provide income to the association, supplementing owner contributions. Inflation means that your projected Reserve expenses get more and more expensive in future years. But do interest and inflation offset each other? No. Not even close!

Inflation is unfortunately far more significant to an Association than interest, because inflation works its effect on the entire value of all your Reserve components. Interest, on the other hand, is only earned on the much smaller amount of Reserve cash actually in the bank. Associations that assume interest earnings will offset the rising costs due to inflation are flat out wrong.

So -avoid these three common Reserve Study mistakes:

- Ignoring them both – (i.e., assuming they are both zero)

  Although interest rates are low now and some associations fail to keep their Reserves in interest-bearing accounts, inflation is not zero. Inflation doesn't go away if you pretend it doesn't exist. Even an incorrect estimate (don't worry, all projections about the future are likely to be incorrect!) for interest and inflation will be closer to reality than guessing that both will be zero.

- Counting on interest to "offset" inflation

  Remember, inflation affects the entire "value" of your Reserve expenses, while interest is only earned on the much smaller amount of Reserve cash actually in the bank. Interest earnings will never offset the larger influence of inflation.

- Relying on frequent (i.e., annual) Reserve Study Updates to offset the effect of inflation

  Ignoring the very real effects of inflation means you are doomed to a future of under-funding for future expenses. Annual Reserve Study Updates will allow you to make refinements and corrections along the way, but the Association will always be “falling behind” when the effects of inflation are ignored. Actual Repair & Replacement costs will always be higher than the Reserve Study predicts, and the Reserve Fund will never catch up or grow to a position of strength.

Associations that ignore the real effects of interest and inflation are making a significant Reserve Funding mistake. These associations find that even if they update their Reserve Study each year, they are continually under-funded. This is because their Funding Plans were designed for unrealistically low future expenses. So take a look at your bank statement to get your interest earnings rate (perhaps reduced 30% to account for taxes), and use a stable multi-yr estimate for future inflation (the average over the last 10 yrs was 2.27%, the average over the last 20 yrs was 2.55%). In Hawaii, it is required that associations use an inflation rate no less than the Honolulu Consumer Price Index for All Urban Consumers for the prior year (which was 3.7% for 2011).

An accurate and useful Reserve Study has, as its foundation, a realistic Reserve Component List, detailing the Scope (current replacement cost) and Schedule (Remaining Useful Life) of the items that will eventually need to be repaired or replaced. Don’t undermine the credibility of the report by excluding realistic estimates for both interest and inflation. Your current and future homeowners are counting on it!