

## **Condo Insights – Reserve Studies – Part 3**

### How a reserve study can affect property values in your association

The final installment of this three-part column will discuss the relevance of a reserve study to the association financial position, how mortgage companies view reserve planning and additional implications and benefits of a reserve study and adequate reserve funding for an association and its members.

Reserve studies identify future repairs and replacement of common property that accounting principles require to be presented to supplement an association's basic financial statements. Although not part of the basic financial statements required by the Financial Accounting and Standards Board, a reserve study is an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, and historical context.

Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimate is the inability to assess the adequacy of accumulated savings intended to fund the future replacement costs of the common elements. Accounting principles do not project liabilities for estimated future replacement costs or their discounted present value. However, the association's reserve study provides a credible measure of the projected replacement costs and dates.

Associations are required to contribute at least ten percent (10%) of their annual budget to fund reserves to maintain Fannie Mae project eligibility. Ten percent is also the minimum contribution now required by most mortgage companies. Freddie Mac will continue to allow newer associations with less than 10% annual reserve funding to secure loans if the association has a professionally prepared current reserve study and if the association is following the recommended funding schedule in the reserve study.

Failing to conduct a reserve study and regular updates can be argued as a breach of a board's fiduciary duty. Physical assets will deteriorate over time, and your association will need to replace or repair them. The reserve study identifies these assets and includes a schedule to fund the association's reserve account to cover the cost of these major replacements or repairs. If its reserve fund is underfunded, an association runs the risk of falling short on funds when the need for major repairs or replacements arises. In turn, this will put all members of the association at unnecessary risk. A reserve study identifies these hidden liabilities thereby eliminating this risk.

The most effective way to know whether your association is underfunded or adequately funded is to perform a reserve study. Reserve studies help your association circumvent financial crises. By ensuring funding for major projects, the board will have no need to impose special assessments or take out a loan. Both those alternatives are not popular choices among homeowners.

When planning for the future of your association, you need to have objectives. The reserve study documents what the association needs to set aside to maintain property value and quality of life as the community matures. Expenses and circumstances change, so an association should update its reserve study on average every 5 years.

Because every property is unique, there is no one set answer as to how much your association needs to have in reserve. There are multiple factors involved, such as the age and size of the property, the amenities offered, expected use/wear and tear of assets, etc. As stated in the previous column, industry guidelines suggest an acceptable level of funding is to have 70% or more of the property's calculated deterioration be covered by the reserve fund. This will lower the risk of any future board having to level a special assessment.

Board members have a responsibility to prioritize the association's needs above all else. That means making the tough decisions required to maintain annual reserve account funding when there are always many competing items that require financial attention. If an association gets off track and under-funds its reserve account, it becomes exceedingly difficult to catch up.

Unlike the operating fund, the reserve fund can be set aside for investment opportunities. Of course, when investing reserve funds, capital preservation is imperative. An association must guarantee the safety and liquidity of its reserves and consider yield last.

One caveat and limitation of reserve studies: Buildings at the shore are exposed to severe environmental conditions. A high chloride environment, weather extremes and water infiltration can cause havoc. The exterior façade is the first line of defense to protect structures. Exterior façade inspections should be conducted on a regular basis because problems tend to start from the exterior façade and if left untreated, migrate into the structure. Exterior façade inspections and rehabilitation projects to address the building envelope to protect the structures and avoid more serious and complicated problems are typically not included or considered in a reserve study.

Unless there is an immediate issue in need of structural analysis, reserve studies naturally precede more detailed and costly inspections. This is not to say one is more important than the other, but that invasive testing may not always be necessary. In the case that a structural analysis is conducted first, those findings can be incorporated into the reserve study report.

Buildings benefit from professional inspections by structural engineers, mechanical engineers and exterior envelope experts inspecting multi-family buildings from different points of view. In this harsh coastal environment, our buildings need more inspection, maintenance and care compared to mainland structures.

A reserve study is an essential component of an effective management plan for every association.

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