Reserve Planning Fundamentals for the Board of Directors

What is a reserve study?

Isn't the manager responsible for the reserve study?

How can you tell if you have a good reserve study?

How do you select a reserve study provider?

What should a reserve study cost?

How is the reserve study incorporated into the governance process of a homeowner's association?

Surprising as it may seem these are not unusual questions to have someone ask, when speaking to community association members and in many cases industry professionals as well.

What is a Reserve Study?

Simply put a reserve study is an analysis which results from "studying" the common area components (assets) of the association. The purpose of this analysis is primarily to establish four subsets of information:

1) **Component Inventory** – this inventory identifies the assets which are commonly owned by the association membership, and which are expected to require replacement or a major expenditure of association funds for maintenance and repair, one or more times over the course of the next thirty years. The development of a Component Inventory is critical to the success of the reserve planning process. If you don't accurately identify all of the assets the association is responsible for the reserve funding schedule which results will not be complete and will not achieve the association's financial goals.

2) **Expected Useful Life** of common components - this part of the analysis is critical as well. If the Component Inventory is the "foundation" of a good reserve study, then these

Expected Useful Life projections may be said to be the "framework" of the structure, as this data will become the basis for the scheduling of reserve fund expenditures. If you don't have a realistic understanding of how long the various components should be expected to last, then your funding schedule becomes little more than guesswork.

3) **Remaining Useful Life** of common components – Remaining Useful Life differs from the Expected Useful Life. The difference concerns the remaining period of time, from the current date, until a major repair or replacement expense is expected to occur. The Expected Useful Life is the total period of time a component should be expected to last from the date it is first placed into service as a new component, until replacement is required. Therefore if a component has an Expected Useful Life of thirty years but it is already ten years old at the time the reserve study is performed, then the remaining Life Expectancy would be twenty years. The determination of Remaining Life Expectancy is the single most subjective part of the reserve study analysis. The older an association is, the more important it is to have a reserve study performed by someone who possesses the expertise to formulate credible and reliable remaining life expectancy estimates.

4) **Replacement Cost Schedule** for common components, based on the current cost of replacement – the operative concept here is *current* replacement cost. All of the replacement cost projections contained in the reserve study should be based on the estimated replacement cost at the time the reserve study was prepared. These cost estimates are then subjected to an adjustment for inflation, which in most cases will be a fixed percentage applied across the board to all component replacement costs. With most analytical software used for preparing reserve funding projections the inflation rate cannot be adjusted from one component to the next; rather the same percentage is applied to all components. This is an important distinction as many components will in fact increase in cost at dramatically different rates.

In its most essential form it is this data which is at the core of all good reserve studies. The more accurate and thorough the data, the better the reserve study will be. Various principles and parameters are incorporated into the process in order to preserve the integrity of the analytical process, but in all cases the analysis must produce accurate, reliable information in order to be of meaningful benefit to the association.

Reserve Planning is Not the Manager's Responsibility-

Perhaps the single most important concept which needs to be understood by all owners and managers is that the ultimate responsibility for long range financial planning (reserve planning) is that of the Board of Directors (BOD). The manager may assist in this process to one degree or another, but it is a mistake for any BOD to assume the manager should handle the reserve planning and financial management issues which go hand in hand with any long range financial planning process.

A second and perhaps equally important concept which seems to have been lost on the industry as a whole - including most Boards - is that the long range financial plan, and the reserve funding plan which results from setting long range financial goals, is the <u>single most important responsibility of every BOD, every Board member and the association as a whole.</u> Over the life of the community no other single issue will impact the association to the degree reserve planning and funding or the lack thereof, will impact the community, and the quality of life of association members.

Thirty Years is the Tipping Point-

Think of it as a retirement plan for your community. On average this retirement plan will need to achieve the financial goals of the community within thirty years. If an association is diligent in the stewardship of their property over this thirty year period, you may be able to prolong the inevitable until the community is thirty-five or forty years old.

For the majority however, thirty years will be the tipping point at which major repair and replacement expenditures can no longer be avoided without having an adverse impact on property values within the community. Inability to complete these repair and replacement projects due to a lack of funds is considered a breach of the Board's fiduciary duty to the community.

Look After Your Own Money-

There is an old saying among professional money managers that no one will ever manage your money as well as you do. This is good advice and it is entirely true. The BOD should not expect, nor should they allow, their manager – or anyone else - to take control of the reserve planning process for any number of reasons.

This is not an attempt to disparage managers and the hard work they put forth on behalf of their clients. Most managers are overworked and underpaid even if they don't end up being the defacto reserve advisor for the associations they manage. What is important to understand, as a board member or concerned owner, is that the most important responsibility the BOD has to the community is to manage the long range planning and financial affairs of the association.

What are the arguments against having your community manager take responsibility for you reserve planning efforts? Considering the following points:

- It is unlikely the manager is being paid enough to do the job correctly, even if they possess the necessary expertise to act as a reserve advisor. If they do possess the needed expertise, it is highly unlikely they would have the time to undertake a proper reserve study, given that even the simplest of studies is going to take thirty or more man hours to complete.

- It is unlikely you will have the same manager over the twenty-five to thirty year period during which the reserve funding plan will play out. If you do rely on the services of your manager, especially when an association is relatively young, it is highly unlikely you will have an opportunity to discuss the deficiencies in your reserve funding program with the person who was responsible for producing the plan.

- One of the most important principles of reserve planning is *independence and objectivity*. Your manager, because they have an established prior relationship with the community, is not considered an independent and objective third party, from a conflict of interest standpoint. It is for this same reason that the BOD itself should never undertake to perform its own reserve study.

Managers and the management companies they work for are generally best served by tending to the short term interests of their clients. In such circumstances many managers (and board members) will concede to the demands of current owners, who almost always seem more interested in minimizing their *current* out of pocket expenses, than they are in doing what may be best for the community over the long run.

This type of thinking and the motivation which drives it is the kiss of death for any homeowner's association; in particular condominiums and other attached housing arrangements where the association is responsible for the exterior of the homes within the community.

Perhaps most important of all is the immutable fact that from a legal standpoint it is the BOD who is accountable to the association membership. If your association fails to execute proper planning and you end up being faced with insurmountable expenses after twenty-five or thirty years, and no money to pay for them, it is the BOD who must answer to the membership, not the manager.