

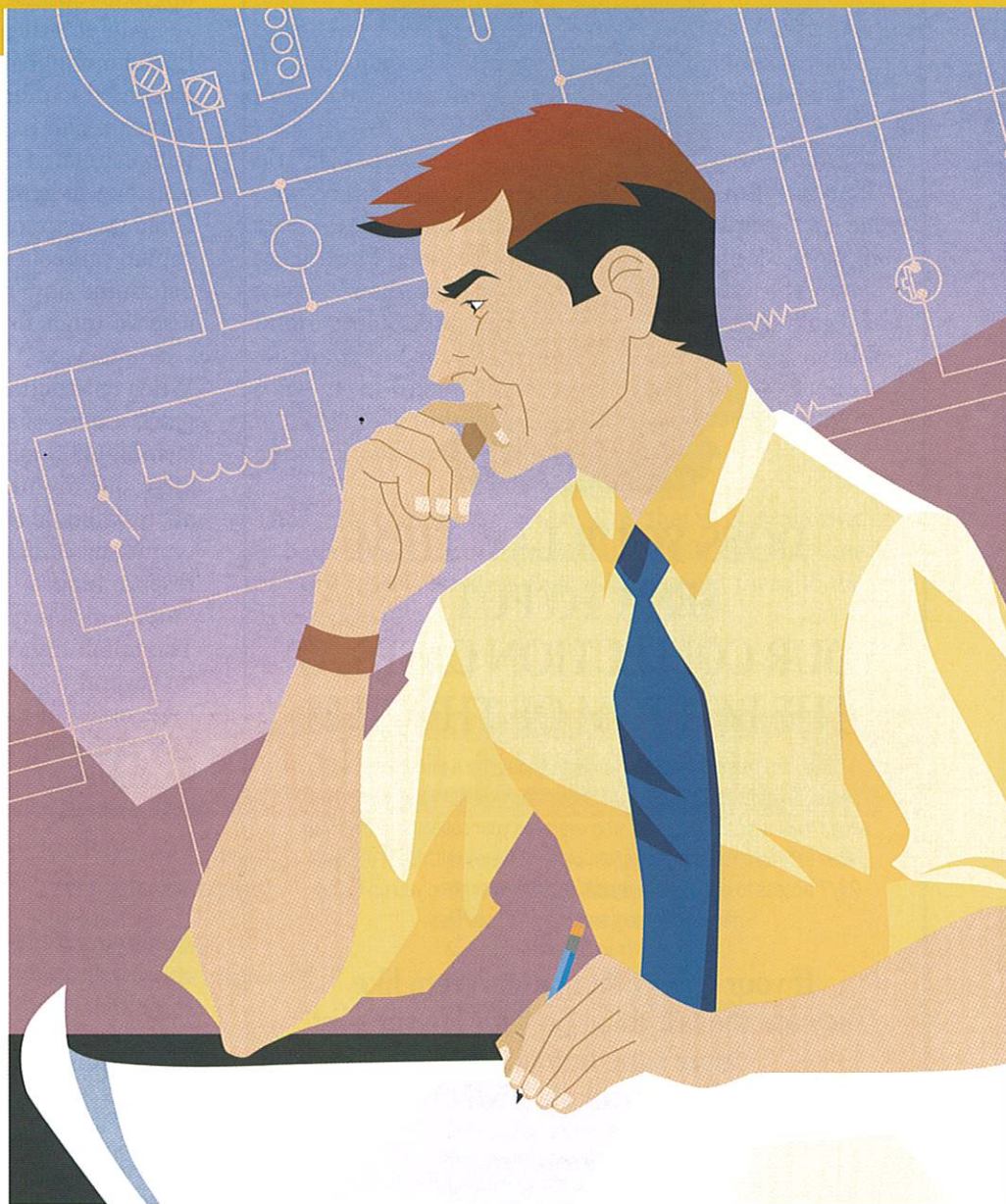
Reserve Studies, Their Benefits & Short Falls

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Reserve studies are excellent tools for community associations to plan for the long-term repair and replacement needs of their common elements. They have been used by many community associations to forecast funding needs for major repairs and capital improvements and assess the need for financial reserves.

For condominium associations, the Illinois Condominium Property Act (the "Act") requires establishing a "reasonable reserve for capital expenditures and deferred maintenance for repair or replacement of the common elements." Although the exact meaning of "reasonable reserves" is subject to some debate by legal experts, a prudent board of directors should seriously consider establishing a reasonable reserve even if not required by the governing instruments in order to discharge their fiduciary obligations. Without the benefit of a reserve study, the board members will not have any reliable information to help forecast major expenditures, and to determine the amount to save to pay for them. Therefore, a reserve study is a needed tool to "guide" the board of directors in the long term financial planning of the association. Merely planning to pay for the next project will not protect the association from large fluctuations in needed funds. Such large fluctuations can lead to the need to impose special assessments on a frequent basis to pay for various replacement projects.

Reserve studies are designed to provide a long-term forecast of



upcoming major repair or capital projects. That information is then used to calculate how much the association should save in its reserve fund on an ongoing basis to be able to fund those projects.

The reserve analysis should include all major common element components (limited common elements and other components are excluded since

the association is not responsible to pay for their repairs). Examples of such elements are roofs, facades, balconies, sidewalks owned by the association, windows (only if they common elements), parking garages, mechanical systems, electrical systems such as fire alarms, etc., elevators and domestic hot water heaters. However, the ongoing repair and maintenance of those



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components should be accounted for in the association's operating budget rather than the reserve funds. Examples of ongoing repair and maintenance include routine inspections of roofs, and maintenance agreements for elevators. However, roof replacement and major elevator upgrades should be accounted for in the reserve study.

Each component included in the reserve study should be evaluated to determine its remaining service life and the cost to repair or replace it. Those costs are then tabulated with estimated inflation to provide the association with a schedule indicating the required funds to pay for them. Once the required funds to pay for long-term repairs and capital projects are determined, calculations are made to determine how much money should be saved in the reserve funds to pay for those projects.

When calculating estimated replacement/repair costs, the reserve analyst should consider inflation. If a repair would cost \$50,000 in 2009, it will cost significantly more in 2016 due to inflation. On the other hand, the reserve analyst should also account for the interest earnings on moneys that the association saves and deposits in its reserve fund.

The reliability of a reserve study will primarily depend on several factors:

- Accuracy of the estimated remaining service life for each covered component
- Accuracy of the estimated replacement/repair cost
- Accuracy of the assumed inflation rate
- Accuracy of the assumed interest the association earns on its reserve funds

Achieving a high degree of accuracy on each of the above factors is nearly impossible. However, even with some balancing of over and under estimating, large inaccuracies in estimating the above can lead to reserve studies that fall far short of providing for adequate funding for future needs.

Inaccuracies in estimating the remaining service life of building components is inherent to reserve studies. Reserve studies are typically based on a cursory review of the building components. Such cursory review may not uncover underlying problems that can severely reduce the service lives of many building components. In some cases, reserve studies merely assume average service life for building components such as roofs, facades, parking lots, etc. As such, if underlying problems with building components are not detected, assumptions of service life and longevity of building components used in the reserve study may be false and result in unrealistic time lines for repair/replacement. This will lead to major unexpected financial problems when repairs and replacement of

building components are needed a few years earlier than predicted by the reserve study.

Another issue with reserve studies is the method of estimating repair/replacement values. In most cases, industry average unit prices are used to estimate such costs. However, particular building configuration and specific needs of the project may result in significantly different costs. As an example, replacement of a roof on a high-rise building in downtown Chicago can cost several times more than a similarly-sized roof on a three-story suburban building. Often reserve studies do not appropriately account for such major variations. In addition, project costs such as design and oversight fees are typically not factored in.

Proper estimation of inflation and interest rates can also make a significant difference in the accuracy of the reserve analysis. If the assumed inflation rate is lower than actual inflation rate, the reserves will end up being underfunded. Conversely, if the assumed interest rate is too low, the reserves may be over funded. In today's economic climate these numbers are almost impossible to predict.

The combination of the above factors can result in major difficulties in financial planning for major repair/replace-

ment projects. With any luck, the estimates that are too low will be offset by ones that are too high; however, that cannot be relied upon. Reserve studies are still needed to get a baseline for required work. In order to compensate for inevitable inaccuracies in the reserve projections, each reserve study should be re-evaluated and updated once every 2 to 5 years. These frequent updates will help adjust for such inaccuracies before they cause large deviations from actual expenses and available reserve funds.

It is also important to note that most reserve studies will provide the baseline funding needs for a fully-funded reserve. This means that all future capital projects (major repairs and replacements) will be fully funded from the reserve funds. However, it is possible to pay for some future projects through special assessments and/or loans. Although this practice is not typically recommended, in some cases when large amounts of money are needed in the short term for projects, it may prove the only practical option.

Thus, any community association that is endeavoring to behave in a fiscally prudent way will take the time to explore reserve studies and to implement them to the extent possible.

CAI-ILLINOIS 2009 CALENDAR OF EVENTS

April 24 — Friday
Policy Seminar
(Property Managers Only / Continental Breakfast)
* NEW DATE *
8:00 am - 11:30 am
Location: University Center - Chicago, IL

April 25 — Saturday
ABC Essentials
8:00 am - 4:00 pm
Location: To be determined

April 29 — Wednesday
Homeowners Forum - FREE
7:00 pm - 9:00 pm
Location: Rob Roy Country Club - Prospect Hts., IL

May 7 — Thursday
Finance Seminar (Board & Homeowners / Appetizers)
5:30 pm - 9:00 pm
Location: DoubleTree Hotel - Arlington Heights, IL

May 14 - 15 — Thurs & Fri
M-203 Community Leadership
8:30 am - 5:00 pm
Location: Downers Grove, IL

May 27 — Wednesday
Homeowners Forum - FREE
7:00 pm - 9:00 pm
Location: Lakeside Lodge at Grand Dominion - Mundelein, IL

June 2 — Tuesday
2009 CAI Golf Outing
* NEW DATE *
7:00 am - 6:00 pm
Location: St. Andrews Country Club, W. Chicago, IL

June 4 - 5 — Thurs & Fri
M-204 Community Governance
8:30 am - 5:00 pm
Location: DoubleTree Hotel - Arlington Heights, IL

June 12 — Friday
Financial Seminar
(Property Managers Only / Continental Breakfast)
8:00 am - 11:30 am
Location: DoubleTree Hotel - Arlington Heights, IL

July 9 - 11 — Thurs - Sat
M-100 The Essentials of Community Assn. Mgmt.
8:30 am - 5:00 pm
Location: Downers Grove, IL

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