

RESERVE FUNDING

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Over the years reserve studies have changed and adopted various terms meant to explain how the study was prepared. They include terms such as: fully funded, component funding, cash flow method, pooled funding, threshold funding, partial funding, reserve contributions, etc. The list of confusing reserve study terms goes on and we haven't even considered all the accounting terms used in the reports such as inflation, initial depreciation, expected useful life, remaining useful life, deferred maintenance, etc. This can be a lot to wrap your head around. It's probably why I have never prepared a reserve study where the association didn't request a presentation or meeting to discuss the report after they received it.

Associations have lots of questions about reserve funds and unfortunately very few people know how to answer them. I recently read an article on the website of a major firm that specializes in reserve studies and they stated that the component funding method is the same as the fully funded method which sets the reserve contribution rate to achieve a fully funded balance of 100 percent. Among other reserve analysts this statement isn't wrong per se. That is because the terms mean different things to us than they do to the layman. An association or property manager reads that same statement and believes that unless they adopt a component funding method, they will only be partially funded and thus require a majority vote of the association in order to adopt anything but the component method. This way of thinking isn't only wrong but very expensive. I've seen component method contribution rates 60 percent higher than pooled method contribution rates. Would you rather have a \$320 per month reserve fee or a \$200 per month fee?

So, what's the difference? Why the confusion of terms? And why do reserve analysts have so many terms to say all the same thing? I can't answer the last question, as I have been asking the same thing for years. But I can attempt to shed some light on the terms used so that you can be more educated and understanding when your board is reviewing your plan, no matter who prepared it.

First let's start off by explaining all the terms, pointing out which ones are duplicative and which ones are unnecessary. A reserve fund is designed to put cash away in order to cover the expenses related to repairing or replacing common elements such as the roof, painting, paving, and other common elements over \$10,000. These are the kind of items which individual unit owners are not responsible for but the association as a whole is. When an analysis of all these common elements is prepared, the association is left with two choices. Either fully fund the reserves or partially fund them. Partially funding the reserves is not allowed by statute unless approved by a majority vote of the association at a duly called meeting. Partially funding implies that the association is deliberately under funding the reserves with the full knowledge that they will have to perform special assessments in the future to cover expenses related to the common elements. Fully funding the reserves implies that the association is attempting to put

enough money away that they will not have to levy special assessments in the future for reserve expenses.

That's it. Those are your two options: fully funded or partially funded. Note that the above definition I gave for fully funded is the layman's definition and not the reserve analyst definition. This is where most of the confusion comes into play. Reserve analysts have read fully funded and component funding as synonymous, but in fact, based on the layman's definition, component funding is just one method for fully funding the reserves. This confusion is perpetuated by the fact that analysts continue to use these terms in their reports and are themselves often confused about the terms. My firm has been guilty of the same thing in the past and we have recently chosen to adopt a more reader-friendly choice of layman's terms when presenting our studies.

So now we have our starting point. Let's assume for a moment that the association chooses, as most do, to fully fund. We will set aside partial funding for the remainder of this article and look at the choices available for fully funding the reserve account. Remember, fully funded means that the association is intending to fund the reserves such that they will not have to special assess or borrow to cover reserve related expenses. It doesn't mean they won't have to special assess or borrow, it just means they are following a plan intended to avoid that. Sometimes costs come in unexpectedly high or expenses arise that the analyst could not foresee.

The reserve fund is not for the repair or replacement of just one expense, but involves multiple building and property components. This brings up an accounting question. Should each component be accounted for separately or all together in one big account? If your roof costs \$100,000 and needs replaced in 20 years, then you need to put away \$5,000 per year for its eventual replacement assuming no inflation for simplicity. If you reproduce this calculation for each component, then add up the yearly amounts, you will end up with your total yearly contribution. Seems simple enough right? This is called the component funding method. It is easy to calculate and easy to understand. Most property managers and savvy board members can create this plan assuming the useful life and replacement cost estimates are accurate. In fact, this is what most property managers who prepare reserve budgets do for their associations.

As property managers and board members receive more training, usually via seminars and such, about reserve studies they begin to hear "component method" and "fully funded" used interchangeably. They follow this logic and assume any method other than the component method is not going to be fully funded. I have even prepared studies for associations who outright reject any other method because of this misunderstanding. It is disappointing because one hates to see associations charging higher reserve fees than they have to. They aren't wrong to follow the component method, but it is better that they make this decision after they fully understand all their options.

The other accounting method for funding reserves is called the cash flow method. The cash flow method does not account for each component separately as in the component method. Instead, the cash flow method looks at the actual expenses over the study duration—typically 30

years—and calculates a smooth formula for contributions such that the overall reserve funds will never fall below zero. This method satisfies our layman's definition of fully funded because it plans for not needing any additional funding in the future. The cash flow method typically has a significantly lower contribution rate than the component method which means lower reserve fees for each unit owner. The ultimate benefit is also a lower bank balance than the component method. The question I often ask my clients is this: Fifteen years from now would you rather have tens of thousands of your own dollars sitting in a reserve account doing nothing for you or in your retirement plan? The answer is obvious, but so many associations still choose the component method.

There are many reasons why an association would choose the component method over the cash flow method. The first and most common one is the one we have already discussed. It is because someone has informed them that the cash flow method is not fully funded, which is technically incorrect. Another reason is because they did not hire a professional analyst to prepare a cash flow method plan. They are relying on their property manager or board members to prepare the plan and the complex calculus used in the cash flow method is beyond their ability, thus, a component method is presented and adopted because it was the only one anyone knew how to prepare. The final reason for choosing the component method over the cash flow method is because of the inherent risk of the cash flow method being designed to never fall below zero. One tiny mistake or unexpected expense and the account dips below zero and then special assessments get levied or money must be borrowed.

That last reason is valid. But the cash flow method can always be adjusted. Instead of designing the plan such that the reserve balance never falls below zero, the plan can be designed so that the reserve balance never falls below some set figure. This “set figure” can act like a cushion, if you will, to absorb unexpected overages. For example: Let's say you budgeted \$100,000 for your roof but the lowest bid came in at \$120,000. With a cushion in place, you can pay for the \$20,000 overage and absorb that cost by adjusting the contribution rate slightly the next year. The rate changes are often miniscule and the association avoids special assessments and borrowing. This cushion is called a threshold or an amount greater than zero which the account is designed to never fall below. When this threshold is incorporated into the cash flow method it is called the threshold method. So just remember, the threshold method is just the cash flow method with a buffer added.

Cash flow method plans or threshold method plans are synonymous with pooled plans because all the components are grouped together and accounted for as one. The threshold plan is the one most associations choose to adopt once they have met with an expert who has explained all of these nuances to them. Threshold funding plans typically require 30 percent to 60 percent lower contribution rates than component funding plans and the fund as a whole is 100 percent funded.

The threshold method and cash flow method plans also allow the association to pay for that \$20,000 roof overage in the example above without any special votes or assessments, because the roof does not have its own account but shares the pooled account with all the

components. The analyst has no personal stake in which plan the association chooses; there does not seem to be any financial advantage to choosing the component method over the threshold or cash flow method. The component method used to be required by Florida Law but is not any longer. It has much higher contribution rates, much higher minimum account balances—money just sitting in a bank doing nothing—, and requires votes to move funds from one component account to another. It is an antiquated accounting method which is unfortunately still used by many associations today.

A high-quality, professionally-prepared reserve study will include the component method and threshold method for comparisons sake. But all this discussion between component method and threshold method is for naught if the initial data is incorrect. This data includes the repair/replacement cost, total useful life, and remaining useful life of all common elements as required by Florida Statute. And this initial data is only as good as the analyst obtaining it.

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