

Reserves Plan

Debating funding options

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Popular management consultant Peter Drucker famously stated, “The best way to predict the future is to create it.” With that in mind, what future do you want for the association you manage? Will there be sufficient cash to maintain curb appeal and maximize owner enjoyment, or will there be scarcity, deferred maintenance, special assessments and tension among owners? Though the goal isn’t always achieved, every manager and association board wants the former. How you get there is a matter of choice.

The options, of course, include baseline funding and full funding of reserves. According to CAI’s National Reserve Study Standards (first published in 1998), baseline funding defines the objective of keeping the cash balance above zero in light of all anticipated

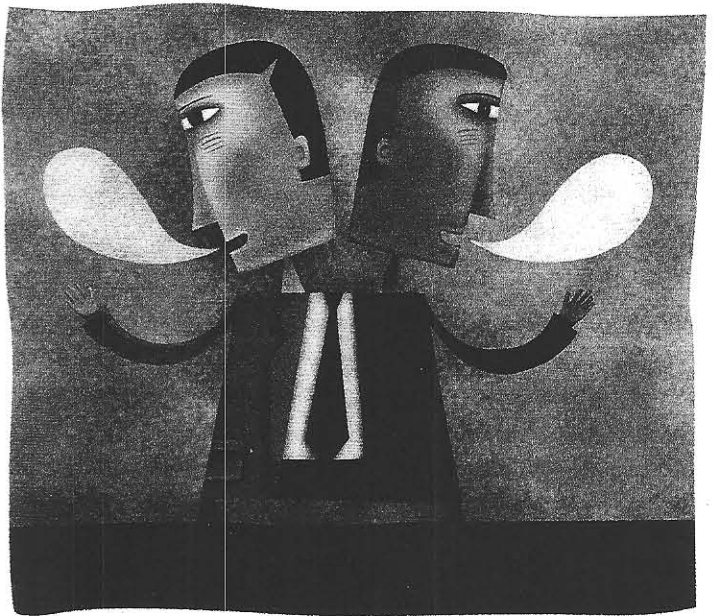
Percent funded

Managers need to help dispel a pesky misconception about reserves. Some board members mistakenly think that 50 percent funded means making reserve contributions 50 percent of what has been recommended. The first problem: percent funded is an evaluation of reserve fund size—actual cash compared to the deteriorated value of the reserve assets—not a measure of reserve contribution size. In addition, does 50 percent funded refer to baseline or full contributions? Contributing only 50 percent of baseline funding means the association only puts away half of what is needed to meet planned reserve expenses. Such an association soon will run out of money and need a special assessment.

expenses for at least the next 20 years. Full funding is the goal of reaching and maintaining the reserve fund at or near the 100 percent funded level, the objective being to keep the association’s reserve balance equal to the value of asset deterioration.

Stereotypically, we know full funding as a conservative objective with higher contributions, while baseline funding has the reputation of being an aggressive funding objective with lower contributions. So what could be wrong with planning to have enough cash for all anticipated reserve expenses (baseline funding)? Nothing! Unless, of course, you argue it’s appropriate to offset an asset’s ongoing physical deterioration by gradually accumulating reserve cash (full funding). Generally, the higher full funding reserve balances provide some margin of protection against the inevitable reserve expenses that occur earlier than expected or larger than expected. This sets the stage for a classic debate between the conservative position and the aggressive position, similar to how an association chooses the size of its insurance deductible.

To see the exact size of the gap between these theories, we examined the numbers. Instead of focusing the evaluation toward or against associations starting with more or less reserves, which may have compromised the data, we concentrated on percent funded status. We looked at 60 different cases: 20 randomly selected from a



pool of associations that were in the 0 to 30 percent funded “weak” range to start with, 20 from a pool of associations starting in the 30 to 70 percent “fair” range, and 20 associations with a “strong” reserve fund—more than 70 percent funded. After double-checking all our figures and analyses, we found that within 1 percent in each grouping, baseline funding contributions averaged only 13 percent less than full funding contributions. Further minimizing this difference, remember that reserve contributions are typically 20 to 25 percent of the total budget. So a 13 percent difference in this one line item means the entire debate about baseline funding versus full funding boils down to 2.6 to 3.25 percent of an association’s total budget.

In addition, a repeatable fraction of baseline funded associations require special assessments when things don’t go exactly according to plan. With these special assessments added to the budgeted baseline funded reserve contributions, the “lower contributions” advantage shrinks further. Considering these eventual special assessments, the average difference between baseline funding and full funding contributions drops to approximately 7 percent or 1.4 to 1.75 percent of total budget. >>>

Component Method Example

Reserve Component Inventory	Total		Cost	Beginning Balance	Funding Required
	Estimated Life (Years)	Remaining Life (Years)			
Roof Replacement	30	8	\$14,000	\$0	\$1,750
Building Painting	5	2	\$6,000	\$0	\$3,000
Pavement Resurfacing	20	3	\$10,000	\$0	\$3,333
Pool Re-Marcite	10	4	\$8,000	\$0	\$2,000
Annual Required Funding				\$0	\$10,083

Cash Flow Method Example

Reserve Component Inventory	Total Estimated Life	Remaining Life (Years)	Cost	Projected Cash Outflows																
				Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10							
Roof Replacement	30	8	\$14,000																	
Building Painting	5	2	\$6,000		6,000															
Pavement Resurfacing	20	3	\$10,000			10,000														
Pool Re-Marcite	10	4	\$8,000				8,000													
Total Projected Cash Outflows:				\$0	(\$6,000)	(\$10,000)	(\$8,000)	\$0	\$0	\$0	(\$6,000)	(\$14,000)	\$0	\$0	\$0	(\$6,000)	(\$14,000)	\$0	\$0	

Beginning Cash Balance: \$0
 Annual Reserve Requirement: \$6,000
 Ending Cash Balance: \$6,000

