An Explanation of Condo Association Reserve Funding: Straight Line Method vs. Pooling Method

As requested by the Board and Members at the Feb.11th 2014 budget meeting we are providing an explanation of Reserve Funds. Within this summary we will provide examples and details to help determine the right course for the LBT Association.

Both Florida statute and your association governing documents require Reserves. The only way to bypass these requirements is to annually waive the requirements by a majority vote of the members.

FLORIDA STATUTE

Chapter 718.112(f)(2) of the Florida Statutes requires that in addition to annual operating expenses, the budget must include reserve accounts for capital expenditures and deferred maintenance. These accounts must include, but are not limited to, roof replacement, building painting, and pavement resurfacing, regardless of the amount of deferred maintenance expense or replacement cost, and for any other item that has a deferred maintenance expense or replacement cost that exceeds $10,000. The amount to be reserved must be computed using a formula based upon estimated remaining useful life and estimated replacement cost or deferred maintenance expense of each reserve item. The association may adjust replacement reserve assessments annually to take into account any changes in estimates or extension of the useful life of a reserve item caused by deferred maintenance.

Chapter 718.112(f)(3) of the Florida Statutes requires that reserve funds and any interest accruing thereon shall remain in the reserve account or accounts, and may be used only for authorized reserve expenditures unless their use for other purposes is approved in advance by a majority vote at a duly called meeting of the association.

LBT CONDO DOCUMENTS

Article 6 of the Bylaws states that the receipts and expenditures of the Association shall be credited and charged to operating and reserve accounts in accordance with state law, and generally acceptable accounting principles, including, but not limited to, the following classifications.

(a) Current expense, which account, if applicable, shall include, but not be limited to the following items:

1. Administration of the Association
2. Management fees
3. Maintenance
4. Rent for recreational and other commonly used facilities
5. Taxes upon leased areas
6. Insurance
7. Security provisions
8. Other expenses

9. Operating capital
10. Fees payable to the Division

(b) Reserve accounts in accordance with Section 6.3 hereof.
Article 6.3. Reserves- The Association shall maintain separate ledger accounts for roof replacement, repaving, building exterior, pools and for any other item of capital replacement or deferred (that is, not annual) maintenance which will exceed ten thousand dollars ($10,000), together with any other reserves designated in the annual budget. Each reserve account shall be fully funded each year as provided in the Condominium Act unless the members for a budget year determine otherwise in the manner provided by that Act. Such vote shall be taken (if at all) each year, for only one year's reserves. Funds in any reserve account may not be used for any purpose which is not appropriate to that account, unless approved by the members as provided in the Condominium Act.

Straight Line Method vs. Pooling Method

Now that we have established the requirements for reserve funding we can discuss the methods. There are currently two different methods used to account for reserve funds.

The first method is called the Straight Line Method. Here are several important things to consider about this method:

1) Each reserve project has its own reserve account. The reserve accounts are funded annually through contributions to each account. The contributions are determined by taking the current year's project cost, subtracting the current value in the reserve account, and dividing by the remaining useful life of the item.

2) The money that is allocated to a reserve account must remain in the account and the Board cannot utilize those funds for any purpose other than for that particular project without a majority vote of the homeowners deciding differently. For example, if the Board has allocated $200,000 to the buildings roof replacement reserve account based on the expected cost, and the project's actual cost only ends up to be $150,000, the residual funds that have been collected cannot be used for any other purpose. The remaining $50,000 in the reserve fund would become the initial value of the roof reserve account for the next time the buildings need to be reroofed. Likewise, if the project's actual cost was $250,000, the Board cannot use reserves from any other reserve account to cover the additional $50,000 without a vote of the majority of the homeowners approving.

3) Interest earned on reserve funds is kept separately and can be used for any reserve project.

4) By using the current year project cost, as opposed to the expected project cost at the

time of completion, this method does not take inflation into account. For projects that are expected to be completed in 1 or 2 years, this has a limited effect; however, for projects that are not expected to be completed for 15 or 20 years, this can cause an underestimation of the project cost.

5) Expected interest that the reserve funds will earn is not taken into account in the association's budget. If your association has reserve funds, annual interest earned can be a material amount of money which, when using the straight line method, cannot be included in the reserve contribution calculations. Therefore, in essence, homeowners have to contribute more (the amount of interest earned annually) to the reserve accounts annually under the straight line method than they would if interest could be taken into account.

The second method is called the Pooling Method. Here are several important things to consider about this method:

1) This method is similar to the straight line method; however, instead of having individual reserve accounts for each project, there is one pool of funds that can be used for any reserve project.

2) Inflation is taken into account. For example, if a project is scheduled for two years from now, the current estimated cost of the project is $100,000, and annual inflation is expected to be 1%, then this method would require that the reserve pool have $102,010 available two years from now to complete the project.

3) Earned interest is included in the reserve pool and anticipated future interest is taken into account. For example, let's say that the reserve funds are held in a money market account with a .5% annual interest rate. If the pooled reserve account currently is $300,000, annual interest could be roughly estimated at $1,500. This is $1,500 that does not need to be contributed to the reserve pool from maintenance fees.

4) Reserve studies anticipate property projects as far into the future as the longest life span of a given item and provide a schedule of annual reserve contributions for each of those years. These schedules are set up to increase by no more than the estimated rate of inflation annually. LMC always recommends a reserve study be prepared by a professional company in the business of providing reserve recommendation.

Illustration of Straight Line Method vs. Pooling Method

Here is an example of how the straight line method and pooling method would work under the same situation.

For this example we will use some hypothetical numbers for illustration. We will assume the time has come to replace the roofing on all of the property's buildings and the reserve account for this project contains $150,000. We will assume that the association has a total of $550,000 available for ALL reserve projects.

If the actual cost of the roof project is $175,000($25,000 more than is in the roof reserve fund), under the straight line method, the Board has several options. (1) The Board can delay the project until there is $175,000 in the roofing reserve account. If the roof replacement is urgent due to leaking or other issues, this may not be a feasible option. (2) The Board can issue a special assessment on the unit owners to make up the $25,000 deficit. (3) The Board can wait until the following year and increase maintenance fees substantially to make up the $25,000 deficit. (4) The Board can have a homeowner vote to take $25,000 from a different project reserve fund. This 4th option would require at least 51% of the homeowners to vote favorably for this option.

Under the pooling method, the Board would be able to pay the $175,000 out of the $550,000 total reserve funds to complete the project in a timely fashion. The Board would then need to determine how to earn back the extra $25,000 that was used for the roofing project over future years. This could be done through an increase in reserve contributions in future years or possibly another reserve project(s) might cost less than estimated. The savings from one project can be used for the overages of another.

Final Decision

So, is reserve funding the right choice for the LBT condo owners association? If so, which method is the right choice? Answering these questions is the next step since the decision is up to the homeowners through a vote at the annual meeting on April 24th 2014 at 4:00pm with at least a majority approval needed to pass.