

# FUNDING YOUR RESERVES - MAKING STRATEGIC CHOICES

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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 your association? 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? It’s your choice.

First, let me clarify your choices. According to CAI’s National Reserve Study Standards (first published in 1998), “Baseline Funding” defines the Reserve Funding Objective of keeping the Reserve cash balance above zero in light of all anticipated expenses (for at least the next 20 years). “Full Funding” is defined in the same National Standards as having the goal of reaching and maintaining the Reserve Fund at or near the 100% Funded level. The objective here is to keep the association’s Reserve balance equal to the value of Reserve asset deterioration.

Full Funding has the stereotype of being a conservative Funding 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 that it is appropriate to offset an asset’s ongoing physical deterioration by gradually accumulating Reserve cash (Full Funding). These generally higher Full Funding Reserve Balances have the effect of providing some “margin” for 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.

We looked at 60 different cases: 20 randomly selected from a pool of associations that were in the 0-30% Funded “weak” range to start with (relatively little money in Reserves), 20 from a pool of associations starting in the 30-70% “fair” range, and 20 associations with a “strong”

Reserve fund (over 70% Funded). We felt it important to not bias this evaluation towards or against associations starting with “more” or “less” Reserves. After double-checking all our figures and analyses, we found that within 1%, in each grouping *Baseline Funding contributions averaged only 13% less than Full Funding contributions*. To further minimize this difference, remember that Reserve contributions are typically 20-25% of the total budget. So a 13% difference in this one line item means the entire debate about Baseline Funding vs Full Funding boils down to 2.6 – 3.25% of an association’s total budget!

The truth is this: whether Baseline Funding or Full Funding, it takes a lot of money to offset Reserve expenses. These two philosophies only differ in the degree of “margin” the association has for their Reserve expenses. Both plan to provide for all anticipated Reserve expenses (without reliance on future special assessments). These funding strategies differ only in how much margin the association retains in Reserves to minimize their chance of special assessments or deferred maintenance. All those associations thinking they have plenty of “margin” so they can make only a fraction of their Reserve contributions (“because our Reserve Fund is so large” or “because our Reserve contributions are so large to start with”) are ignoring the reality that you can’t safely slash your Reserve contributions. If you were Fully Funding your Reserves, you’ll find you can only safely shave your Reserve contributions.

Think of it this way. It will take many tanks of gas to drive across the country. Whether you allow the tank to just about hit fumes before you fill up and never fill the tank more than halfway (Baseline “Fueling”), or whether you conservatively fill up any time you get down to a ¼ tank and end up at the other coast proudly with almost a full tank (Full “Fueling”), you’ll purchase just about the same amount of gas along the way. The only difference between the two will be the half tank (or so) that one car has at the end, compared to the many tanks purchased along the way.

Full Funding and Baseline Funding sound worlds apart, but the bottom line is that in light of total Reserve expenses, the real, dollars and cents difference between the two is very small.