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DECIDING BETWEEN "CASH FLOW" AND "PERCENT FUNDING" YOUR RESERVES

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Hawaii state law (Section 514A-83.6) requires associations to update their Reserve computations each year as part of their annual budget, and include a specific statement about whether the budgeted Reserve contributions were developed using a "Percent Funded" or "Cash Flow" funding plan. What does this mean and what are the distinctions between these two options?

Hawaii is the only state (as of this writing) that requires compliance with respect to funding Reserves. In National Reserve Study Standards terminology, Hawaii managers and boardmembers needs to choose between two Reserve funding objectives:

- Threshold Funding: keeping the Reserve Fund at or above a specific cash or Percent Funded (in this case, a minimum of 50% Funded)

  Percent Funded refers to the "strength" of the Reserve Fund as of a particular date, typically the first day of the association's Fiscal Year. It is a ratio that measures how close the Reserve Fund balance comes to matching the deteriorated portion of the common areas. As such, it fluctuates and needs to be re-computed each year. For instance, if the life of the $400,000 roof is one quarter used up this year, the deteriorated portion this year is $100,000. If the association's total common area deterioration is $250,000, to be at least 50% Funded means the association has to have $125,000 (minimum) in their Reserve fund. Being a minimum of 50% Funded does not mean the association has on hand at least 50% of the total replacement value of the common area assets. Being at least 50% Funded does not mean the association is making at least 50% of the budgeted reserve contributions

- Baseline Funding: where the association's objective is to have sufficient Reserve "Cash Flow" over at least the next 20 years so as not to need a special assessment or loan

  When an association chooses Baseline Funding of their Reserves, the Reserve Balance is lower, on average, than with other more conservative funding objectives. This is because Baseline Funding allows an association's Reserve Fund to theoretically drop to $.01, as long as it never becomes completely depleted. On one hand, this means more money is in the bank accounts of the homeowners and less in the bank account of the association. On the other hand, the association is at more risk of a special assessment because the association has no "margin for error". Note also that the association's income from outside sources will be lower due to lower interest earnings on the Reserve fund.