FUNDING PLAN CALCULATION METHODOLOGY – WHICH IS MORE ACCURATE?



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Someone who attended one of our recent webinars asked an interesting follow-up question worth sharing. His association manager had recently told him that a Funding Plan based on the Straight Line methodology (also known as the Component Method in National Reserve Study Standard terminology) was more accurate than a Funding Plan based on the Cash Flow methodology, and he wanted my opinion on the matter.

While both the Straight Line and Cash Flow methodologies are calculations to find the appropriate Reserve transfer rate for an association, neither is *more accurate* than the other. The choice between the two is one of risk management.

The Straight Line (Component) methodology divides the cost of replacing an item, minus any funds already on deposit, by the number of years remaining. The same calculation is done for each component, with the sum being the recommended Reserve transfer rate. Slight variations in results are possible, depending on how the existing Reserves are distributed among the components. With this methodology, each component is prepared for its next expenditure without any expectation to share or borrow funds allocated "to another component" through the years. With each component standing on its own, this methodology tends to be yield higher recommended Reserve transfers in the first few years.

The Cash Flow methodology provides funds for each project, but from a single Reserve fund "pool". If used in a manner that allows the pool to be largely depleted, this calculation methodology is risky or aggressive. But the key word is "if". If the Cash Flow methodology is used to pursue the same "Full Funding" Goal that every Straight Line calculation pursues, it allows the association to pursue that goal in a smoother manner due to temporary sharing of funds between

components. Basically, it uses cash more efficiently because funds are never tucked away in a little pocket, unavailable for use by other scheduled Reserve projects.

Funding Plan choices are strategy choices and risk choices, not accuracy choices.

In any Funding Plan methodology, the underlying data (the Reserve Component List) is always the same – Changing Funding Plans has nothing to do with Reserve Component List accuracy or Reserve Study accuracy. This means the resulting expenses are the same. These are simply two different ways of calculating the multi-yr Funding Plan, with pros and cons to either, with both providing sufficient Reserves to accomplish all scheduled projects. Neither Funding Plan methodology is more accurate than the other. The only difference is how much "cushion" of cash the association accumulates above projected expenses, and the shape of the Reserve Funding Profile over the years (the even spread that is a hallmark of the Cash Flow method, or the higher initial Reserve Funding requirements that are typical of the Straight Line method). That is an issue of risk management, not accuracy.

Accuracy comes from the Reserve Component List – ensuring that all your major, predictable, common area projects are on the list, with reasonable estimates for Useful Life, Remaining Useful Life, and the current Repair or Replacement cost.