FUNDING PLANS AND ACCURACY

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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 that can be used to make reserve contributions, neither is more accurate than the other - It is more a question of risk management and whether the association is taking on a conservative funding objective or an aggressive funding objective.

The Straight Line methodology divides the cost of replacing an item by the number of years remaining, then subtracts the reserve funds available. The result is the amount to fully fund the item for the next fiscal year. Slight variations in results are possible, depending on how the Reserves are distributed among the components. With this methodology, each component is prepared for its next expenditure without any sharing of money between components. It tends to be considered a conservative objective.

The Cash Flow methodology individually funds each item, but the funds for all items are held in the same account. This calculation tends to be considered an aggressive objective.

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. They are simply two different ways of calculating the data, neither Funding Plan methodology is more accurate than the other. Mathematical calculations are mathematical calculations and therefore all should be accurate (unless one can't reliably add, subtract, multiply, or divide). The only difference is in how much cash is going into your Reserve Fund (the recommended Reserve contributions). That is an issue of risk management, not accuracy.

Presuming your Funding Objective is identical (to become Fully Funded), computing your contributions using a Cash Flow / Pooled Funding Methodology will typically result in lower contributions, since it can be crafted in a smoother manner that eliminates the jumps and bumps typical with contributions calculated using the Straight Line method.

The Cash Flow Funding Methodology also opens up the possibility of different (lower) Funding Objectives, such as Threshold Funding or Baseline Funding (barely maintaining the Reserves cash-positive). A weak Reserve balance obviously increases the association's risk of a special assessment, if or when the Reserve Fund is found to be inadequate. Even so, pursuing those lower objectives typically only drops the contributions another 15%-25%.

Therefore, choosing between funding methods is not an issue of accuracy. It is an issue of contribution smoothness through the years, and how much risk of special assessment the association wishes to take on. If the association wishes to avoid special assessments, they should pursue a Fully Funded objective. The risk of a special assessment is measured by Percent Funded. That Percent Funded calculation is the same, no matter which contribution methodology is chosen.

I tend to think of accuracy as having to do with the Reserve Component List - is everything included that should be included on the list? Are the life and cost estimates on-target? The Reserve Funding Plan has to do with smoothness, fairness, and risk management.