THIS ARTICLE APPEARED IN THE ECHO NEWSLETTER – NOVEMBER 1995

Percent Funded Calculations

What Are They? What Do They Mean?

by Roy Helsing

Since January 1992 Section 1365 of the California Civil Code has required specific disclosures concerning the financial position of a community association's Reserve Fund. In part (and simply stated), the law requires the association to determine the amount of money expected to be on hand in the Reserve Fund as of the end of the upcoming fiscal year; the amount of money "necessary to be on hand"; and the percent the former is of the latter. This concept is often referred to as the association's "Percent Funded" calculation. Since that time, increasing emphasis has been put on that number by lenders, real estate agents, homeowners, boards of directors, attorneys, and virtually everyone else associated with the community association industry. Unfortunately, this simplified approach to disclosing the relative health of an association's reserve posture can be very misleading and can result in an unwarranted depression of property values.

As a basis of explanation, we are going to use an actual association in the San Francisco Bay Area. It is a 29 year old, 58 unit condominium, with slightly underfunded reserves. This particular association is underfunded because they decided to establish reserves only a few years ago when they replaced their roof, although there are numerous other reasons why an association could (and most likely will) from time to time become underfunded. This association has a portfolio of major components which, on a straight line basis, requires an annual assessment of $25,152 ($36.14 per unit per month) and should have $130,214 on hand at the end of their fiscal year. The association will have $50,000 in the reserve fund at the end of the fiscal year, and is therefore only 38 percent funded using the typical straight line calculation. Clearly the association will run out of money at some time in the future. A cash flow analysis shows that this will happen at the eleventh year (2006), if they collect only the straight line assessment of $36.14 per unit per month.

[This article assumes the reader is already familiar with the differences between straight line and cash flow funding calculations, but a brief review follows in this paragraph. The straight line method of calculation essentially says that if you had a $100,000 component with a ten year life you should be collecting, and should have collected, $10,000 towards that component. Therefore, if the component were 3 years old the association would have $30,000 in the Reserve Fund toward it. Similarly, the contribution and balances are calculated for each component and then added together to get the total calculation and the total amount of moneys which should be on hand. This is an easily understood approach, but when applied to the real world always results in an incorrect calculation (usually too high an assessment, and too high a "desired balance" once the effects of interest and inflation are considered.) As a result, most reserve analysts use a cash flow methodology which, simply stated, takes these factors into account.]

This of course is devastating news! Only 38 percent funded! Buyer, WATCH OUT! But what does this really mean? In the case of this association, a further analysis reveals that if the association merely collects $38.94 cents per unit per month they will not run out of money. In fact, they will even maintain a 10 percent balance in their worst year. Wait a minute! Only 38 percent funded but the impact is only a $2.80 per unit per month increase in assessments! Less than eight percent over what might be expected in even the best of circumstances! In fact, this association's total budget was $150 per unit per month—so it is less than a 2 percent increase in the total assessment. Certainly if the year of depleted funds was next year, we would have a much greater impact. On the other hand, if that year when funds are depleted is 20 or 30 years out, the impact might be only pennies a door. In like regards, if there are more homes to share the burden, the impact may well also be minimal. The bottom line is that you cannot look at the percent funded figure alone. Associations can appear to be grossly underfunded as measured by "Percent Funded" with minimal impact. Conversely, they can, in some cases, be fairly well funded and still require significant assessment increases. As a result, the percent funded figure is a meaningless disclosure of the relative health of the association's Reserve Fund because it is in no way reflective of the financial impact on current or future owners.

If you really grasp the pitfalls of straight line calculations, you might realize at this point that part of the problem is using a straight line calculation to determine the "amount of money necessary to be on hand." Without going into the mathematics involved, if we calculate the amount of money necessary to be on hand by allowing for interest, inflation and taxes (a "cash flow" approach), we find that only $72,500 needs to be on hand. With $50,000 on hand the association is 69 percent funded. This methodology is certainly a better reflection of the "amount of money necessary" and helps solve the problem of some CPAs who want to indicate any shifting of responsibility as a part of their review. It also is more palatable and accurate than 38 percent funded for the same association. Again,

however, this disclosure does nothing to indicate the impact of the reserve funding level on current or future homeowners. It is one thing to indicate that the association is underfunded and only has 38 percent to 69 percent of the cash that is "necessary" at some point in time, and quite another to say that this has less than a $3.00 per unit per month impact on owners.

Unfortunately, the uninformed come quickly to the conclusion that a high percent funded means a financially healthy association, while a low percent funded means that current and future buyers may be affected by special assessments or significant increases in regular assessments. While to some extent this is true, as with most attempts to generalize, the exceptions to this rule are both normal and numerous. A rather normal example of a somewhat underfunded association with minimal impact was discussed above. Clearly the fact that the association is significantly underfunded is not a major concern. Except of course for the fact that property values could become depressed because buyers and real estate agents may not understand that there is virtually no negative impact on assessments or the association's ability to meet its obligation. On the other hand, an association can be 90 percent funded or better and still be faced with significant short term special assessments. For example, 90 percent of a $1 million dollar roof job due in the next year is a significant impact!

Until such time as we can get lenders and real estate brokers to understand this concept and to look at the future cash requirements and its impact on current and future owners rather than the "Percent Funded" disclosure, we are in danger of allowing property values to be depressed through misinformation and misunderstanding.

What can we do? First of all, make sure you are using a method of calculating the "amount of cash necessary" in your percent funded disclosure which is appropriate. Secondly, consider stating the impact of the underfunding as part of your disclosure. Just because the law says you must disclose the "percent funded" calculation does not mean that you cannot supplement that disclosure. Which disclosure do you feel is best: "The association is 50 percent funded." or "The association is 50 percent funded, and the impact of this underfunding is an additional $1.25 per unit per month for the next eight years." How about this situation: "The association is 95 percent funded." Or "The association is 95 percent funded but must levy special assessments of $1,200 per unit during the next year in order to pay for the new roof." (By the way, in this last example the special assessment situation is a required disclosure.)

If the impact of underfunding is minimal, help everyone involved realize this by stating the impact. On the other hand, if the impact of relatively high funding is greater than what may be normally anticipated, you have a fiduciary responsibility to disclose that fact also. Remember, it is not what "Percent Funded" your association is that is important – it is the impact of that underfunding on current and future owners. The percent funded figure by itself does not, in many cases, adequately disclose that situation. When that situation occurs, you should consider supplementing that disclosure.

Roy Helsing is president and CEO of The Helsing Group, Inc., a consulting firm specializing in community association matters. He is a member of the ECHO Reserve Analysts Resource Panel.

This reprint is provided courtesy of the author and ECHO. It appeared in the November, 1995 issue of the ECHO Newsletter.