Reserve Funding

Myths and Misconceptions

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In this article we will seek to define and deflate a couple of persistent misunderstandings surrounding reserves for community associations.

Myth #1: Funding reserves for projects that will happen many years from now isn't important for owners living in an association today.

One of the biggest misconceptions about reserve contributions we hear, even more than "they're too much" or "we can't afford them," is that they are for the future. To be clear, reserve contributions are not for the future. It is much more appropriate to characterize reserve contributions as offsetting ongoing deterioration, which takes place in the present.

Monthly (or quarterly, or annual) reserve contributions offset the deterioration that is occurring each month while the current owners are enjoying those assets. The owners using these assets should pay for their use. It's only fair. If every owner pays their fair share of deterioration on an ongoing basis, the future takes care of itself. While the actual reserve expenses are in the future, those expenses arose due to slow and steady deterioration that occurred on a daily, predictable basis, often in plain sight, for years.

Reserve contributions are not charity for future owners. The ongoing cost of reserve components' deterioration is as real as any other bill the association faces. Associations should set themselves up for success by making appropriately sized reserve contributions that pay the "deterioration bill" on an ongoing basis. If done right, when the

“balloon payment” for that gradually growing obligation occurs, everyone who benefited from those components in prior years will have paid their fair share, and the funds will be available for the expenditure.

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Myth #2: Pooled reserves will lead to abuse and wasteful spending.

This article is obviously intended for a Florida-based audience, but it’s written from the perspective of having worked with associations around the country. Our firm has prepared reserve studies for clients in all 50 states, but it is only in Florida that we encounter associations still using the outdated, inefficient “straight-line” method for reserve funding. Most often the associations using the straight-line method (also known as the “component method”) have been doing so for many years, especially if the association was created prior to 2002. (Although the pooled reserve funding methodology had been in existence for many years prior, it wasn’t until 2002 that the Florida Administrative Code was amended to allow its use.)

The argument against pooled reserves basically amounts to a concern that if all of the reserve funds are held in one “pot,” then a rogue board of directors could spend it foolishly, if not recklessly. For instance, critics may worry that an expensive, unnecessary lobby renovation project would be prioritized while vital spending on a more important component such as a leaking roof is ignored or delayed. In our experience, this fear is largely unfounded. Of course, there are surely anecdotal examples where poor decisions have led to regrettable outcomes, but these are rare cases and are usually the result of ignorance, not ill intent. (This also supports the argument that board members should be obtaining professional reserve studies or other guidance if they’re unsure of what to address first.)

The specific details of how the method works—and the many advantages it has over the straight-line method—are beyond the scope of this article, but the simple fact is that using pooled reserves has been the default method for funding in community associations for decades. If it were as dangerous or prone to abuse as some claim it is, there probably would have been legislation developed by now to specifically prohibit it, based on clear evidence from a multitude of situations. There isn’t. But, for argument’s sake, let’s consider the possibility that a board of directors did knowingly and willfully intend to make irresponsible financial decisions while in control of the association. In

that event, a prosecuting attorney would be able to build a case around a possible breach of fiduciary duty by invoking the “Business Judgment Rule.” If the board really did abuse their position by using reserve money in such a manner, then they could be held personally liable for their actions, as directors and officers liability coverage typically does not protect them in that type of scenario. It seems that that should be reason enough for board members to tread carefully when it comes to making financial decisions, and luckily the vast majority of board members are doing so just fine.

Myth #3: Because of Senate Bill 154 and the new SIRS requirements, associations must have the entire replacement cost for all “structural” components saved in reserves by December 31, 2024, or else they are not “fully funded.”

Since the passage of SB 154 and the creation of the new SIRS requirements, our office has been fielding daily calls and emails asking about the specific obligations facing condominium associations going forward. The most anxiety-laden question that comes up in these conversations is about what must be done, budget-wise, in the immediate short term. So, let’s spell it out. After December 31, 2024, any budget adopted by a condominium or co-op that is subject to the new requirements must contain “full funding” of reserves for the specific items listed in the bill. What does that mean? It simply means that the proposed funding schedule must demonstrate that the property will have accumulated the replacement cost of each such component by the time it reaches the end of its useful life. That’s it. In other words, there’s no need to “make up for lost time” (i.e. collect funds that would have been budgeted in prior years but for the fact that they were waived or “partially funded.”)

As a simple example, let’s say a building has a roof with a 20-year useful life and a replacement cost of $100,000. Ideally, the association should have been budgeting $5,000 each year from the time the roof was put on so that they could gradually, evenly distribute the cost over all 20 years of its lifespan. (We’ll ignore inflation for this example.)

Let’s say the roof is currently 10 years old, or halfway through that useful life, and the association has actually been waiving reserves up until now, meaning they are starting from $0 in the bank. First of all, “fully funding” does not mean collecting the entire replacement cost up front; that would be silly when the component still has quite a lot of life left to go. There’s also no need to capture the collective amount of $50,000 that they waived over the course of the prior 10 years. Instead, they would just need to show that 10 years from now, they will be able to pay $100,000 for a new roof. That means that they must collect $10,000 annually for the next 10 years. Sure, that might sting, but at least it’s not $50,000 (or $100,000) all at once.