COMMUNITY ASSOCIATION RESERVE FUNDING:

POOLED METHOD VS. COMPONENT METHOD

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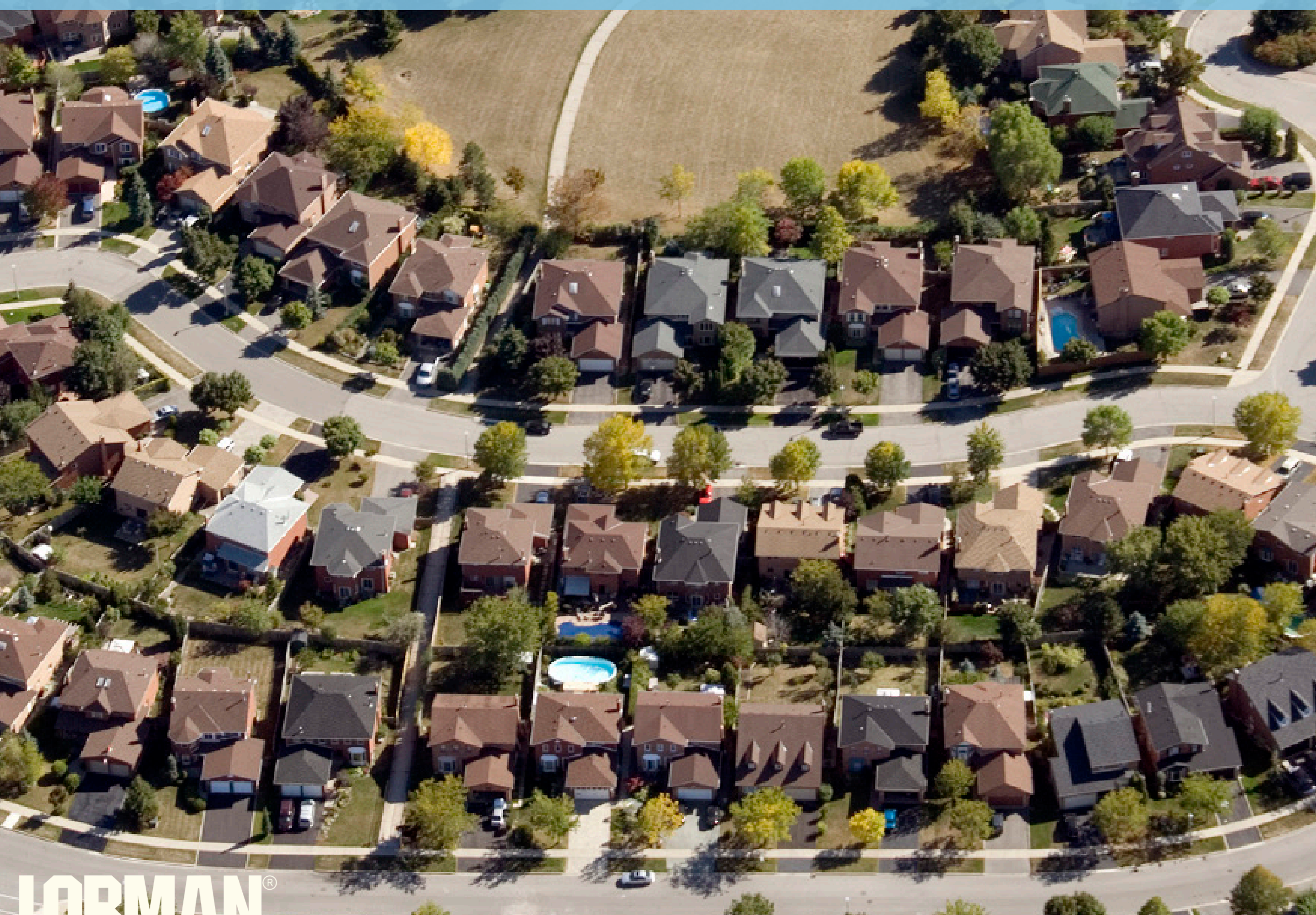

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Community Association Reserve Funding:
Pooled Method vs. Component Method

Written by Hans C. Wahl, Esq. – 4/14/17

Reserve funding for certain common element items is required for community associations under Florida law. Specifically, condominium associations must fund reserves for roof replacement, building painting, pavement resurfacing and any other item that has a maintenance expense or replacement cost exceeding $10,000. Fla. Stat. § 718.112(2)(f). For homeowners' associations, if the developer initially established reserve accounts or the members affirmatively elect to provide for reserves, then the association must fund those reserve items in future budgets. Fla. Stat. § 720.303(6)(b).

Florida law allows for two types of reserve funding, one of which is the pooled method (also referred to as the "cash flow" method) and the other is the component method (also referred to as the "straight-line" method). This means reserve funding can either be based on a separate analysis of each of the reserve assets (the component method) or a pooled analysis of two or more of the reserve assets (the pooled method). F.A.C. 61B-22.005(3). The required funding for each reserve item is based on a calculation using the replacement cost less the current reserve balance divided by the remaining useful life of the reserve asset. Fla. Stat. § 718.112(2)(f). There are companies that will provide community associations with a reserve study that will include these calculations.

When using the component method, the Association must establish a separate account for each reserve asset. Each component reserve account must be fully funded each year based on the reserve study, unless the members vote to reduce or waive the reserves. Funds that are set aside in each component reserve account can only be used for that specific reserve asset unless the members vote to use the funds in one component account for another purpose. Fla. Stat. § 718.112(2)(f).

The biggest advantage to using the component method is knowing that the funds in each component account can only be used by the association for that specific reserve item. An association cannot use those funds for any other purpose without holding a vote of the members and receiving an approving vote of a majority of the members. The biggest disadvantage to using the component method exists when a component account for a specific reserve asset is severely underfunded and that asset needs to be replaced immediately. In that situation, the Association must either (1) delay the replacement/maintenance of that reserve item until that component account is fully funded (which may not be practical); (2) levy a special assessment on the members to cover the deficiency in that component account; or (3) hold a vote to move funds from another component account to the underfunded component account.

A pooled account simply means the Association has one single reserve account (as opposed to several separate component accounts) to pay for all of the Association's reserve assets. When using the pooled method, the amount of annual cash inflows into the pooled account each year of the reserve study, combined with the expected beginning pooled account balance each year, must be enough to cover all projected cash outflows each year. Stated another way, the annual pooled account reserve assessment must be at an amount to ensure the pooled account will never have a negative ending balance during any year of the reserve study analysis. The pooled account calculations can never include a planned future balloon payment.

The biggest advantage to a pooled account is the flexibility that comes with how the reserve funds are spent. Funds can be drawn from the pooled account to cover expenses for any of the reserve assets at any time without member approval. Thus, the pooling method provides significantly more flexibility than component reserve accounts and allows for projects to be completed in order of need at the time the need arises. Member approval is required to use the pooled funds to pay for any item not included within the reserve pool.

The biggest disadvantage to the pooled method is that a future board of directors may not be prudent or cost-sensitive and overspend on a certain reserve asset just because it has access to a large pool of funds. For example, let’s say an association has a $300,000 pooled account balance and needs to replace a common element item such as a dock or boardwalk. With a large pooled account balance at its fingertips a board may be tempted to include unnecessary “upgrades” and “additions” that may result in overspending by thousands of dollars. Unnecessary overspending could severely deplete the pooled account balance and result in a substantial increase in reserve assessments the next year. This may also result in the need for a special assessment if another reserve asset needs replacement later that year or the next year.

If you are concerned that your association is not properly funding reserves then you should consult with your licensed manager or seek the advice of an experienced attorney. If it has been awhile since your association last had a reserve study then you may want to schedule one in the near future. For most associations, a reserve study should be performed every 3 – 5 years depending upon the types of reserve assets involved.

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