

Reserve Balances – Executive Summary

The white paper that follows reviews recent changes to the calculation of reserve balances and some of the consequences of those changes. Based on a review of Board minutes, those changes to the calculations were never formally approved by the Board. The most noticeable of the consequences from the unapproved changes is that the 2021 RCL reserve study assigned a categorization of “high risk for potential future special assessments” to the Cape George Water Reserve.

The changes that started in late 2019 resulted in what we will refer to here as an “Alternative Method” for calculating reserve allocations and balances. This Alternative Method is a material departure from the historical, previously approved method (hereinafter “Approved Method”) employed for nearly a decade and the Alternative Method does not appear to be consistent with the existing Bylaws and Rules.

The changes are a result of a number of complicated factors. None of the changes is known to be required by any regulatory groups.

As is explained in more detail in the five-pages of narrative and two-pages of detailed display that follow, the Alternative Method changes resulted in a significant redistribution of reserve balances among the three accounts.

The balance in the Water Reserve was effectively decreased by nearly half a million-dollars while the other two reserve balances were increased.

Comparison of Reserve Balances as of December 31, 2020

	General	Water	Marina	Total
12/31/2020 reserve balances calculated using the Approved Method	\$321,127 24%	\$909,613 69%	\$81,217 7%	\$1,321,957 100%
12/31/2020 reserve balances (unaudited) per Treasurer’s Report published March 2021*	\$560,537 47%	\$460,356 39%	\$171,739 14%	\$1,192,632 100%
Difference Alternative Method to Approved Method	\$239,410	\$(449,257)	\$90,522	See the two detailed displays for reconciliations of the Total Balances

* As calculated by Treasurer by applying original 2014 RDA pro-rata percentages to GL balance.

The Finance Committee recommends that the Board approve recalculating the three reserve account balances based on the Approved Method, as set forth in our current Rules and Bylaws.

The background and suggestions for the way forward are provided in the following pages.

Reserve Balances

The 2021 RCL Reserve Studies, especially that of Water, raised concern over the adequacy of the Water reserves and the potential future need for special assessments. It is positive that more individuals are paying attention to all three reserve studies and to their importance to the long-term financial health and operations of Cape George.

Risk potential for Special Assessment

Provider & Year	General Reserve	Water Reserve	Marina Reserve
2014 RDA – Level 1	No risk assigned	No risk assigned	No risk assigned
2015 & 2016 RDA Updates	No risk assigned	No risk assigned	No risk assigned
2017 – RCL Level 1	Adequate	Adequate	Adequate
2018 – RCL Level 3	Moderate	Moderate	High
2019 – No update	N/A	N/A	N/A
2020 – RCL Level 2	Moderate	Moderate	High
2021 – RCL Level 3**	Moderate	High	Moderate

Source: Published Reserve Studies

Reserve studies and the results they produce are highly sensitive to basic data inputs. Several of the most critical input elements are supplied by management and include the beginning reserve balances, the remaining current contributions, whether or not additional income is to be considered and of course the dollar value and timing of expenditures from those reserves. Reserve consultants take management’s input and apply a series of mathematical computations projected over a 30-year time frame to come up with potential outcomes.

Working with reserves i.e., what to call them, how to account for them, how to spend them and how to keep Member/Owners informed is a complex area. Past approved methods (“the Approved Method”) were designed to provide Members with a way to actually “see” where their money was going and how it was spent.

Background

Between late 2019 and 2020 tracking and reporting of reserve accounts were made more difficult by Cape George’s efforts to simultaneously (1) transition to a partial Fund Balance accounting system and (2) attempt to have financial reporting mirror the audited financial statement. There are no known regulatory requirements for those changes.

Cape George has since at least the 1990s, maintained three distinct reserves accounts – General, Water and Marina. Prior to 2015, the three reserves were funded entirely through year-end excess cash from the respective operations of each cost center. Expenditures from those reserves have generally followed capital asset guidelines.

In 2014, Members approved a specific Reserve Assessment that was to be distinct from the General Assessment. The Members were also told that the distribution of this new assessment would be dispersed into the three reserves using the Approved Method that

had been in place for nearly a decade. In response to the Members' approval, changes were made to the Bylaws and several finance rules, all of which remain unchanged today.

Funding for the new Reserve Assessment started in January 2015. The process is as follows:

- Start with the prior year's audited balance,
- Add the respective excess cash income for each cost center and interest for the year,
- Add the respective allocated portion, or pro-rata, of the Reserve Assessment for the year as recommended by the reserve consultants,
- Reduce the reserve for respective Board approved expenditures, and
- Finally, add or subtract for things like loans, pay-backs and corrections.

The pro-rata reserve allocations have historically been based on the most recent Level 1 reserve study and used the recommended funding percentages from that study to calculate the percentage distribution of the reserve assessment to the three reserve accounts. The first external professional study was completed in 2014. The pro-rata was to change once every three years with the new Level 1 study. There has not been a Level 1 study completed since 2017.

The table below provides cumulative values of the major funding and expenditures activities for the three reserves over slightly less than a decade.

Cumulative Major Reserve Activities *

	General	Water	Marina	Total
Excess cash income contributions - 2012-June 2019	\$335,335 30%	\$566,017 50%	\$219,627 20%	\$1,120,979 100%
Pro-Rata reserve allocations 2016-June 2019	\$205,837 43%	\$205,717 43%	\$71,561 14%	\$483,115 100%
Reserve expenditures 2013-June 2019	\$(244,193) 47%	\$(51,569) 10%	\$(224,617) 43%	\$(520,379) 100%

*2012 thru June 2019 from Treasurer's Annual Reports. Loans, pay-backs and corrections not included in the above.

The emergence of the Alternate Method

Sometime during the last half of 2020, the method for calculating and allocating reserve balances changed materially. The change was first published in a summarized, restated December 31, 2020 Treasurer's Report in the March 2021 Board material. No documented formal Board action or discussion has been found approving the Alternate Method of distributing reserve balances. There is no known regulatory or audit requirement for the changes and the changes appear inconsistent with existing Bylaws and Rules.

The difference between the two methods is due to a simultaneous series of changes including the adoption of a form of Fund Balance accounting and an attempt to mirror the presentation of audited financial statements. It also appears that the distribution of excess cost center income and the pro-rata reserve assessment was treated as fully discretionary which, again, is inconsistent with existing Bylaws and Rules.

The summary table that follows compares the reserve balances as of December 31, 2020 if they had been calculated using the traditional Approved Method and how they actually now appear in published reports. The summary table is accompanied by two very detailed displays included at the end of this white paper that provide a detailed comparison view of the reserve activities of late 2019 and 2020.

In the detailed displays, the comparison between the two years provides very different results and balances. This is due to the multitude of simultaneous changes mentioned above. The two balances can be reconciled, as shown in the notes included at the end of each comparison year.

Understanding the different values generated by the two methods and the reasons for those differences is not easy. *The major differences in the two methods comes down to the attribution, or lack thereof, of excess cost center income to its respective reserve balance and the distribution, or lack thereof, of the pro-rata share of the reserve assessment to the respective reserve balance.*

Comparison of Reserve Balances as of December 31, 2020

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12/31/2020 reserve balances (unaudited) per Treasurer's Report published March 2021*	\$560,537 47%	\$460,356 39%	\$171,739 14%	\$1,192,632 100%
Difference Alternative Method to Approved Method	\$239,410	\$(449,257)	\$90,522	See the two detailed displays for reconciliations of Total Reserve balances

* A calculated by Treasurer by applying original 2014 RDA pro-rata percentages to the total GL balance.

Clearly there is a major disparity between the reserve balances calculated by the traditional Approved Method and the Alternative Method. It is the nearly half a million-

dollar difference in the calculated Water reserve balance, coupled with management inputs for future funding levels that are the primary causes for the risk assessment category currently assigned to the Water Reserve.

The Alternative Method reserve balances, labeled “as of December 31, 2020”, that were first presented in March 2021, have remained unchanged in the prior Treasurer’s Reports through October 2021. No reserve balance information has been presented since then.

What can be done?

The first option, and the one being recommended by the Finance Committee, is to revert to the Approved Method of calculation, i.e., those used through mid-June 2019.

This first option will redistribute the reserve balances to what the Finance Committee feels are the correct, approved balances as they should have appeared as of December 31, 2020. This option should also include the Board rescinding two prior motions from October 2020, one of which never happened and the other which seems to conflict with existing Bylaws and Rules.

The first option should also include an immediate re-run of the 2021 RCL Reserve Studies changing only the basic management inputs to those calculated using the Approved Method. This will dispel misunderstanding of the relative risk assessment for the Water Reserve and present a historically balanced picture of the long-term financial health of the three reserves. It will also replace any published studies that perhaps mislead conclusions regarding the financial health of the essential Water Reserve. Concomitantly, the General and Marina will return to a higher risk of need for special assessment.

The second option might be to pick and choose which changes to let stand and which actions to modify or correct but only on a go-forward basis. This seems akin to “cherry picking” and bypasses the issue that the Approved Method is in concert with existing Bylaws and Rules while the Alternative Method does not appear consistent with those Bylaws and Rules. This is not an option recommended by the Finance Committee.

The third option is to simply do nothing. This is also not an option recommended by the Finance Committee.

What are the next steps?

Once the Board selects which reserve balance method is to be used and the option of how to proceed – to be formally determined or reaffirmed by the Board -- attention can focus on designing, communicating and approving the fundamental accounting

approach used by Cape George for its reserves and internal accounting statements for fiscal year 2022 reporting and beyond.

Doing so will help prevent future confusion and misunderstandings. The next steps may also involve some minor modifications to the Bylaws, which would need Member approval. There may also be some minor modifications desired to several Financial Rules, which would be changed only after appropriate notice to Members followed by Board approval.

None of the above next steps should be undertaken until the basic determination of reserve method is decided. The longer it takes to determine or reaffirm the reserve approach, the more difficult any future actions will be.

The following two pages provide the Financial Committee's detailed comparison of the Approved vs. Alternative Methods. They are provided as drafts.

Cape George Reserve Methods Comparison -December 2018 thru December 2019

Approved Historical Method	General	Water	Marina	Unallocated Reserves	Total Reserves
Audited Balance 12/31/2018	279,605	672,802	37,998	0	990,405
Remaining 2018 Excess (3/14/2019)	12,000	11,000	12,019		35,019
Remaining 2018 Pro-Rata (3/14/19)	485	862	252		1,599
2019 6 mo interest allocation	344	616	34		994
Less Expenditures	(7,740)	-	(14,020)		-21,760
Calculated 6/30/2019 Balances	284,694	685,280	36,583	65,519	1,072,076
July 2019 - Dec 2019					
Deposits of 2019 Audit Adj. Excess Income	0	45,786	14,189		59,975
Remainder-2019 Reserve Assessment \$127,204	0	0	0	61,685	61,685
Interest - allocated per 2018 EB	921	2,217	125		3,263
Expenditures Jul-Dec	0	0	0		0
Allocated 2019 Rsrv Assmnt (2017 L1)	38,670	58,563	19,971	(127,204)	0
Calculated 12/31/2019 Balance	324,285	791,846	70,868	0	1,196,999

Alternative Method (Source: Financial Statement Detail)	General	Water	Marina	Unallocated Reserves	Total Reserves
Audited Balance 12/31/2018	279,605	672,802	37,998	0	990,405
6/30/2019 (BS & FBS OOB 2-11-22 run)	284,694	685,280	36,583	65,519	1,072,076
7/31/2019	284,697	685,287	36,283	69,398	1,075,665
8/31/2019	284,700	685,295	36,283	71,854	1,078,132
9/30/2019 (Run date 10/08/2019)	284,704	685,305	36,284	72,739	1,079,032
10/31/2019 (No FS-Oct 2020 TreasRept Only)	285,024	686,074	36,325	75,838	1,083,261
11/30/2019 (CG website - no run date)	285,028	686,084	36,325	78,785	1,086,222
12/31/2019 (GL Run date 2/12/2020)	285,033	686,095	36,326	79,931	1,087,385

Difference 12/31/2019 GL to Approved Method 12/31/2019:

12/31/2019 Unaudited GL		1,087,385
12/31/2019 Calculated Balance		<u>(1,196,999)</u>
	Difference	(109,614)
Remaining Reserve allocation (127,204-79,931)		47,273
Adj. Water excess		58,563
Adj. Marina excess		14,189
Interest Income		3,263
CIP Asset Purchase (2020 Prior Pd. Audit)		<u>(10,796)</u>
	Unreconciled Difference	<u>2,878</u>

2019 Reserve Balance per 2019 Audit		1,090,741
<i>Invst=1025000; Cash=62410; AR-237; IntRcv=3094</i>		
12/31/19 GL Reserve Balance		1,087,385
Difference - GL to Audit		<u>3,356</u>

Unexplained difference Approved Method to Audit 478

Cape George Reserve Methods Comparison -December 2020

Approved Historical Method	General	Water	Marina	Unallocated Reserves	Total Reserves
Calculated Balance 12/31/2019	324,285	791,846	70,868	0	1,196,999
January 2020 - December 2020					
Deposits of 2020 Audit Adj. Excess Income	-	48,692	10,174	0	58,866
2020 Reserve Assmnt = \$130,282				130,282	130,282
Allocate Rsrv Assmnt (2017 L1)	39,606	70,222	20,454	(130,282)	-
Interest Allocation (2020 Audit)	1,146	2,757	156		4,059
Expenditures (2020 Audit)	(43,910)	(3,904)	(20,435)		(68,249)
Calculated 12/31/2020 Balance	321,127	909,613	81,217	-	1,321,957

Alternative Method (Source: Financial Statement Detail)	General	Water	Marina	Unallocated Reserves	Total Reserves
12/31/2019 GL Unaudited	285,033	686,095	36,326	79,931	1,087,385
Fiscal Year 2020					
1/31/2020	285,048	686,130	36,328	83,114	1,090,619
2/28/2020	285,052	686,141	36,328	85,484	1,093,006
3/31/2020 (2019 xcvs-W-6248;M-10847))	285,055	692,396	47,176	86,206	1,110,833
4/30/2020 (JE 31715 Incorrect coding)	285,978	665,598	29,697	93,379	1,074,652
4/30/2020 (JE 31715 - CORRECT coding)	271,698	678,824	30,750	93,379	1,074,652
5/31/2020	285,980	665,604	29,698	95,979	1,077,260
6/30/2020	285,982	665,606	29,698	96,913	1,078,199
7/31/2020	285,983	665,611	29,698	99,634	1,080,926
8/31/2020	285,985	665,615	29,698	101,972	1,083,270
9/30/2020	285,987	665,619	29,698	102,607	1,083,911
10/31/2020	497,685	408,737	152,482	33,072	1,095,394
11/30/2020	497,685	408,737	152,482	193,956	1,181,188
12/31/2020 *	48,027	0	2,078	1,142,527	1,192,632
12/31/2020 - Treasurers Rept. Allocation**	560,537	460,356	171,739	0	1,192,632

* 2020 audit entries not posted

Difference 12/31/2020 GL to Approved Method 12/31/2020

12/31/2020 Unaudited GL Balance		1,192,632
12/31/2020 Calculated Balance		1,321,957
	Difference	(129,325)
Reserve allocation Recognized (130,282 - 64,091)		66,091
2020 Adj. Water excess		48,692
2020 Adj. Marina excess		10,174
Interest Income		3,094
Unreconciled Difference		(1,274)

** Method applied 2014 RDA pro-rata percentages to the total balance; from Treasurer's Report.

2020 Reserve Balance per audit		1,146,036
<i>Invst=1025000; Cash=167,553;IntRcv=841; Due to Ops(47,358)</i>		
12/31/2020 GL Balance		1,192,632
Difference GL to Audit		(46,596)
Unexplained difference Approved Method to Audit		-47,870