



*Strata and Community Title in Australia for the 21st
Century 2015 Conference*

**DEFICIENT SINKING FUNDS:
WHEN IS THE TICKING TIME BOMB GOING TO EXPLODE?**

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1. INTRODUCTION

In 1710, King Charles II of Spain died, childless and heirless. The subsequent War of the Spanish Succession drew in all the major powers of Europe, and saw England's debt swell to a then unmanageable £40 million. Sir Robert Walpole, Chancellor of the Exchequer and later Prime Minister of Great Britain, responded in 1716 by creating a quarantined fund to pay down the debt, which became the first sinking fund. Walpole's fund was designed to chip away at the debt by spreading the interest repayments out over a large period of time, and by 1727 had reduced the interest repayments by a fifth.¹ However, from the 1730's, the fund was increasingly used at the whim of the government, and in 1752 new taxes were permanently incorporated into it. By 1784, short term political considerations had usurped the purpose of the fund, and Pitt the Younger consolidated the fund with all other revenue, effectively abolishing the first sinking fund.²

Modern sinking funds are less ambitious in scope, but are developed for the same fundamental purpose, and suffer from the same deficiencies as Walpole's pioneering fund. Sinking funds are a form of financial management most useful in circumstances where there is a joint liability spread out over time. They have been utilised for the purposes of reducing Australia's national debt,³ however are commonly used in strata properties to provide an equitable model for funding anticipated maintenance liabilities. They ensure that an individual buying into a strata scheme knows what they are purchasing, and ensures that the users of a common asset pay a fair share for that use.

1.1. Legislative Schemes

In 1961, the NSW government enacted the world's first strata title legislation.⁴ This legislation did not oblige the creation of a sinking fund. Future obligations remained substantially underfunded, or at least funded on an ad-hoc basis, until passage of the *Strata Titles Act 1973* (NSW). Section 68(1)(m) obliged the creation of a sinking fund to meet maintenance obligations, a reform that was progressively adopted by other jurisdictions. Broadly, each jurisdiction has adopted one of four models to fund future obligations. Australian states and territories have preferred the cash flow model, which allows for the progressive raising of levies to meet maintenance obligations as they arise. Some jurisdictions use a laissez-faire approach, relying on the common liability of owners to incentivise them to raise funds. A third model requires owners to fund a percentage of the replacement cost of the property. Lastly, the US state of Delaware allows owners to fund a percentage of the administrative budget for the scheme. The table below provides an outline of the legislative requirements throughout a sample of jurisdictions.

¹ Edward Ross, *Sinking Funds*. (PhD Thesis, John Hopkins University, 1892), 9.

² Ibid 11.

³ See, eg, *National Debt Sinking Fund Act 1966* (Cth), repealed by *National Debt Sinking Fund Repeal Act 1994* (Cth).

⁴ *Conveyancing (Strata Titles) Act 1961* (NSW)



Jurisdiction	Application	Funding Model	Extending Out	Coverage
Queensland ⁵	All schemes	Cash flow	10 years	Anticipated spending of capital or non-recurrent nature
New South Wales ⁶	All schemes	Cash flow	10 years	Major expenditure
Victoria ⁷	Schemes with annual fees in excess of \$200,000 per year or more than 100 lots	Cash flow	10 years	Major capital items and their components anticipated to require repair
Tasmania ⁸	All schemes	Cash flow, may be combined with administrative expenses	Not specified	That which is necessary to maintain common property in good condition
South Australia ⁹	All schemes	Cash flow	3 or 5 years, dependent upon size of scheme	Non-recurrent expenditure
Western Australia ¹⁰	All schemes, not compulsory	Common liability	Not specified	Non-recurrent expenditure
Northern Territory ¹¹	All schemes, not compulsory	Common liability	No requirement	Recurring expenditure
Australian Capital Territory ¹²	All schemes with four or more units	Cash flow	10 years	That which is necessary to maintain common property in good condition
New Zealand ¹³	All schemes, may be opted out of	Cash flow	10 years	Future maintenance requirements
South Africa ¹⁴	All schemes	Cash flow	Not specified	Future maintenance and repair requirements
Dubai (Emirate of) ¹⁵	All schemes	Cash flow	10 years	Expenditure of a capital or non-recurrent nature
Hawaii ¹⁶	All schemes	Replacement percentage	No requirement	Replacement of the property
California ¹⁷	All schemes	Cash flow	At least every three years	Major components with a usable life of less than 30 years that the schemes is obliged to repair, if the value is equal to or greater than one half of the gross budget of the scheme.
Texas ¹⁸	No requirement	Common liability	Not specified	Not specified
Delaware ¹⁹	All schemes	Percentage of budget	At least annually	Certain components

⁵ *Body Corporate and Community Management (Standard Module) Regulation 2008* (Qld) ss 139(3), 146, 148.

⁶ *Strata Schemes Management Act 1996* (NSW) s 75A.

⁷ *Owners Corporation Act 2006* (Vic) ss 36, 37; *Owners Corporation Regulations 2007* (Vic) r 5.

⁸ *Strata Titles Act 1998* (Tas) ss 81, 82.

⁹ *Community Titles Act 1996* (SA) ss 113(1)(aa), 116; *Community Titles Regulations 2011* (SA) r 18A.

¹⁰ *Strata Titles Act 1985* (WA) s 36(2).

¹¹ *Unit Titles Schemes (Management Modules) Regulations 2009* (NT) s 49.

¹² *Unit Titles (Management) Act 2011* (ACT) ss 82, 83.

¹³ *Unit Titles Act 2010* (NZ) ss 116, 117.

¹⁴ *Sectional Titles Schemes Management Act 2011* (South Africa) s 3.

¹⁵ *Law No (27) of 2007 Concerning Ownership of Jointly Owned Properties in the Emirate of Dubai* ss52-62.

¹⁶ HI Rev Stat § 514A-83.6 (2011); HI Rev Stat § 514-B-148 (2011).

¹⁷ Cal.Civ.Code §5550-5580.

¹⁸ TEX. Property Code §82.112 (1993).

¹⁹ Del. Title 25 §81-315.



There are advantages and disadvantages to each legislative scheme. A perfect legislative scheme would ensure that the future joint obligations are sufficiently funded without needlessly impacting owners. Finding this balance is not easy. The dominant cash flow model spreads out the burden successfully, however can become deficient quickly. Assuming predictions are correct, maintenance obligations are typically well funded. However, as opposed to the replacement percentage model, cash flow sinking funds can be more susceptible to unforeseen catastrophes such as natural disasters. The percentage of administrative budget suffers from similar concerns. Determining the non-recurrent expenditure as a percentage of recurrent expenditure appears oxymoronic, and is less sensitive to large or sudden liabilities. A common liability obligation is arguably most deficient, as many occupants are often insensitive to their maintenance needs and require more active prompting, despite permitting individual autonomy.

However, whichever legislative scheme a sinking fund operates under, there are some inherent deficiencies that can turn them from a convenient financial technique to a ticking time bomb. Obviously, there is a natural difficulty in predicting future costs. Every property will age differently depending upon its use and environment, while the costs of managing obsolescence will differ from building to building. More specifically, there are other influencing factors making prediction devilishly difficult, including concrete cancer, government policy, size and technological complexity. Finally, even if a perfectly accurate prediction was theoretically possible, the reality of strata schemes make adoption and planning around those predictions difficult.

2. COSTS

The cost of maintenance, broadly speaking, costs significantly more than the cost of each individual building. Improvements in building practices have delivered buildings that last longer and are inhabitable for a larger portion of their life-cycle. The natural consequence of longer lasting buildings is that they require maintenance for longer. Moreover, as buildings are increasingly made up of more complex machinery and plant, maintenance of these components becomes more complex and thus expensive. Coupled with the natural increases in materials and labour, it is inevitable that the cost of maintenance is greater than construction cost. In 1969, 28% of the British construction output was in maintenance, repair and improvement. With increasing awareness and sensitivity to the dangers of tumbledown premises, however, in 1998 it was reported that £28 billion was spent on maintenance, repair and improvement, while only £10 billion was spent on new constructions.²⁰ In general, two factors contribute to cost increases, however other factors also influence them. In particular, the common ownership of property and obsolescence leads to blowouts in maintenance costs.

²⁰ Brian Wood, 'Towards Innovative Building Maintenance.' 23(4) *Structural Survey* 291.



2.1. Common Ownership of Property

First, there are cost multipliers stemming from the nature of the property itself. Common ownership of property has long been acknowledged to be an economically inefficient manner of ownership.²¹ This is not to say that strata living is more expensive; in fact the opposite is true. While lot owners pay less *individually*, as a group they pay more. The common property of strata titled property is over-utilised by the individual owners of that property, in a phenomenon known as the ‘tragedy of the commons.’²² Common ownership also increases the likelihood of individual lot owners causing negative externalities through the use of their own property. For instance, a new resident’s heavy smoking can lead to smoke damage in the adjacent common property, despite that resident being perfectly entitled to smoke within their lot under the by-laws of the scheme.

However, it is important to recognise that while an individual will find that strata living is far cheaper than living in a detached house, this is obscuring the inefficiencies that collective action generates. For example, an occupant of a non-strata property may find that their annual maintenance bill is approximately \$20,000. The same property (all else remaining the same) transformed into a strata property with five lots will ensure that each occupant pays only a fifth of the maintenance obligations. However, cost multipliers stemming from the problems of collective ownership will ensure that that maintenance bill swells to (for example) \$25,000. In other words, while each owner has a smaller slice of the maintenance pie to pay, the pie is larger for strata properties.

2.2. Obsolescence

Second, one of the largest costs for buildings over time is the replacement of obsolete elements and complete renewal when the building is at the end of its life cycle. There comes a point in a building’s life-cycle where it is simply more economic to demolish the building and rebuild. According to Thomsen and van der Flier, however, this ‘general understanding’ is over-simplified, and the resort to renewal can be postponed through effective management through an appropriate sinking fund. The continued upkeep of buildings which are considered more valuable to upkeep, such as heritage listed buildings, demonstrates this.²³ According to Thomsen and van der Flier, the level of maintenance of a building greatly affects whether or not it may become obsolete. Further, they propose a conceptual model of obsolescence to help give context.²⁴ Their

²¹ See generally, Paula Franzese and Steven Siegel, ‘Distress and Dysfunction: Homeowners Associations as Mirror and Metaphor’ (2007) 72 *Missouri Law Review*

²² See, eg, Garret Hardin, ‘The Tragedy of the Commons.’ (1968) 162 (3859) *Science* 1243; Megan Walters and Paul Kent, ‘Institutional Economics and Property Strata Title- a survey and case study.’ (2011) 17(3) *Journal of Property Research* 221, 227.

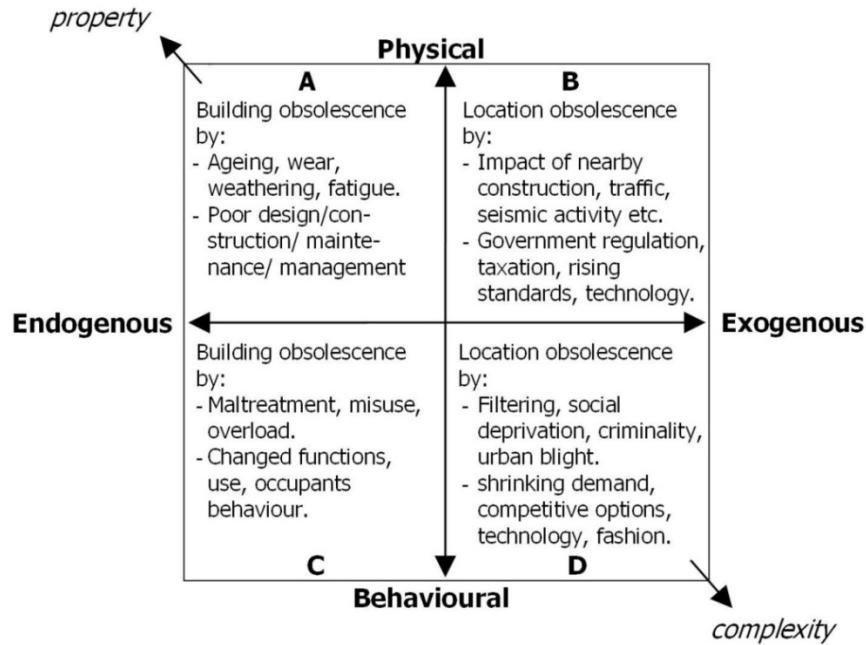
²³ André Thomsen and Kees van der Flier, ‘Obsolescence, conceptual model and proposal for care studies’ (Paper presented at 23rd European Network for Housing Research Conference, Toulouse, France, 5 July 2011) 2.

²⁴ André Thomsen and Kees van der Flier, ‘Obsolescence, conceptual model and proposal for care studies’ (Paper presented at 23rd European Network for Housing Research Conference, Toulouse, France, 5 July 2011) 5.



conceptualisation figure, which is admittedly simplified, is reproduced below.²⁵ Management of maintenance through appropriate sinking funds can reduce the possibility of a building becoming obsolete before its time.

Figure 1 Conceptual model of obsolescence.



There are a multitude of factors which may contribute to obsolescence, most of which can be managed.²⁶ The investment in the property over a long period of time makes minimising obsolescence crucial lest these investments be made negligible. In the reproduced figure 1, the Behavioural/Physical axis shows the correlation between, on one side, the human use or abuse of physical elements (including poor or neglected maintenance) and on the other, physical degradation inevitable over time regardless of the treatment of building elements. The horizontal axis, Endogenous/Exogenous, shows the varying influence of internal (endogenous) factors (that is, factors not remote from the administration or nature of the building itself) such as maintenance or age and the influence of external (exogenous) factors not controllable from within that affect the building’s progression towards obsolescence, such as changes in legislation or technologies.

All the factors represented on the figure are interrelated. If a line were drawn from the top left of the figure to the bottom right, it would represent, on the one end of the scale, that as the complexity of influencing factors increases, they are less controllable by the subject building or its occupants. On the other end of the scale, the property is almost completely in control of less

²⁵ Thomsen and Kees admit that while the figure to an extent simplifies the interrelated concepts involved in obsolescence, but assists in a clearer conceptualisation for a better understanding.

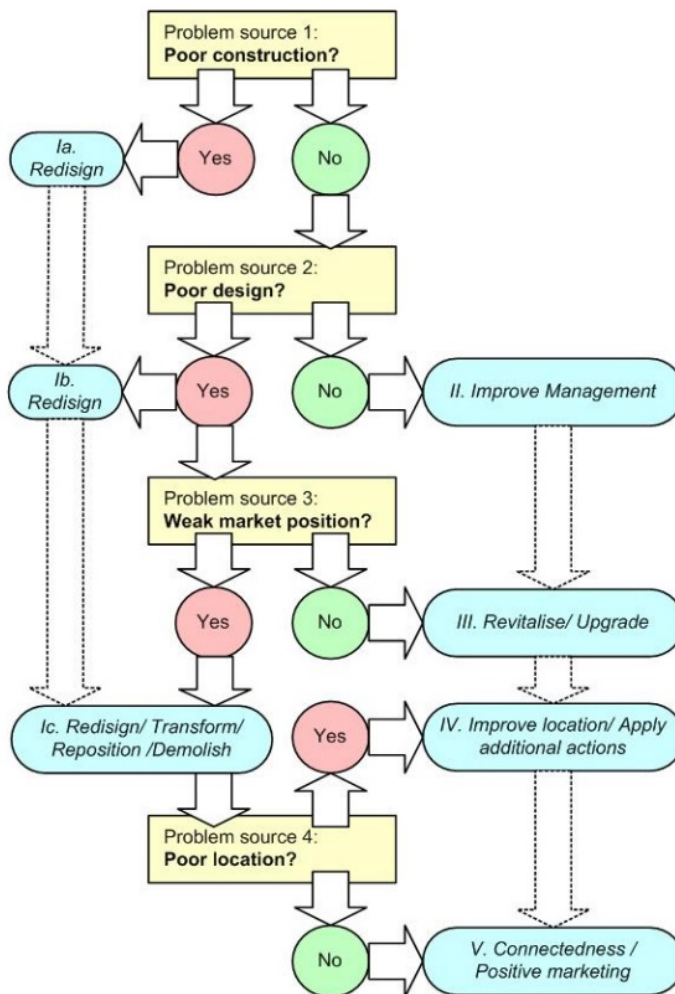
²⁶ André Thomsen and Kees van der Flier, ‘Obsolescence, conceptual model and proposal for care studies’ (Paper presented at 23rd European Network for Housing Research Conference, Toulouse, France, 5 July 2011) 3.



complex influencing factors.²⁷ It is at this less complex end of the scale that an appropriate and well forecasted sinking fund may be able to slow or mitigate the onset of structural obsolescence. Appropriate investment in maintenance and replacement can reduce the influence of the ‘controllable’ factors in quadrant A.

The management plan for building obsolescence suggested by van Kempen, as referenced by Thomsen and van der Flier may be helpful, although it is unlikely that one can stave off obsolescence entirely. Every building reaches a point where it is more economical to rebuild. Many rationalisations behind preserving the existing structure are non-financial considerations like sentimental or cultural value. The diagram below [*sic.*] is a reproduction of van Kempen’s suggested model to manage obsolescence.

Figure 3 Managing housing obsolescence, analytical model (source: van Kempen 2006)



²⁷ André Thomsen and Kees van der Flier, ‘Obsolescence, conceptual model and proposal for care studies’ (Paper presented at 23rd European Network for Housing Research Conference, Toulouse, France, 5 July 2011) 5.



While it is clear that management can decrease the risk of a building falling into obsolescence prematurely, it can only be achieved with an accurate sinking fund. Ultimately, obsolescence is a huge cost, whether dealt with via maintenance or replacement. The complexities of the issues impacting obsolescence make it very difficult to predict the rate at which a building or its elements may become obsolete. This is a major challenge to sinking fund forecasters.

Moreover, when a building does reach the end of its life cycle (the point at which it becomes completely obsolete) the most economical option is often to disestablish the strata scheme, and renew (demolish and rebuild). Sinking funds often do not account for this eventuality, often because in many jurisdictions the consent of 100% of parties with ownership or possessive interest in lots is required. In this way, a lot of buildings which have been long obsolete are prevented by a minority of owners from, sensibly, being renewed. Instead increasingly expensive and inefficient sinking funds are maintained to 'prop up' the buildings. For sinking fund models to be efficient, the ability of single owners to prevent the majority from dissolving the property must be removed in all jurisdictions.

This view is already beginning to prevail in some jurisdictions where the unfairness of current arrangements has become apparent. The draft New South Wales *Strata Schemes Development Bill 2015*, released concurrently with the *Strata Schemes Management Bill 2015*, for public exposure and consultation in July 2015, states in its Overview section that the Bill 'provides for a process to facilitate the renewal of particular freehold strata schemes by way of a collective sale or a redevelopment of the schemes.' The Bill provides for a required level of support of 75% of owners rather than 100%.²⁸ For properties which are no longer economically viable to maintain, the strata scheme would be better able to manage the renewal of the site.

3. INFLUENCING FACTORS

Of the factors that influence the forecasting of sinking funds the problems posed by concrete cancer are a pertinent example of the cost pressures strata properties face. Modern reinforced concrete systems are frequently used in the construction of strata properties. In such a system, reinforcing steel is situated inside the concrete, giving it greater stress-resistance properties. Concrete cancer, more properly known as concrete spalling, arises where the reinforcing steel swells, displacing its concrete casing and leading to cracking and degradation of the concrete. This notoriously occurs as a result of the steel rusting, as is commonly seen on the Gold Coast, yet often occurs through expansion as a result of heating, either in fire or uncontrolled radioactive exposure.²⁹ Part of the problem is a lack of knowledge about the causes and cures for concrete cancer. Balafas and Burgoyne emphasise that 'the properties of rust are not well known,' and that current methods for modelling the degradation of concrete affected by concrete cancer are far

²⁸ Cl 176.

²⁹ Venkatesh Kodur and Monther Dwaikat, 'Fire-induced spalling in reinforced concrete beams.' (2012) 165 *Structures and Buildings* 347; Topias Siren et al, 'Fracture Mechanics Modelling of an In Situ concrete Spalling Experiment.' (2015) 48(4) *Rock Mechanics and Rock Engineering* 1423.



from accurate.³⁰ The manner of degradation is influenced by a range of factors, including the concrete mixture, tensile strength of the steel, exposure to weathering, proximity to salt, heating and countless more factors. With an inability to accurately predict the depreciation of a fundamental structural element, it is impossible to develop an accurate plan for meeting the future expenditures associated with maintaining the concrete.

Yet the factors influencing depreciation go beyond the structural components and extend to the relative complexity of the property. It is clear that a property with more assets to maintain will have a larger maintenance bill than its comparable low-tech counterpart. The typical suburban six-pack of units may only require periodic maintenance of small cost items. By contrast, larger mixed-use properties will have more, and more complex, assets. With the increasing prevalence of these buildings in developments, maintenance costs will swell alongside their complexity. Moreover, technological advances also suffer to a greater extent from obsolescence flaws, as detailed above.

The United States' history with infrastructure provides the best example of how these factors drive up maintenance and construction costs. During the 1950s and 60s, the United States experienced an unprecedented infrastructure boom. They aimed to meet their future maintenance obligations through the inception of the Federal Highway Trust Fund in 1957. Strictly speaking, this was not a sinking fund, however its funding shortfall is equally applicable to sinking funds for strata properties. Notwithstanding the good intentions of the government, maintenance obligations have been consistently neglected, and rectification costs have disproportionately increased. Deloitte Research estimates that on top of the shortened usable lifespan, with its attendant economic costs, the United States requires expenditures of 6 to 20 times the maintenance costs to get infrastructure back up to acceptable standards.³¹ According The Society of Civil Engineers, this amounts to US\$1.7 trillion.

The reasons for this shortfall substantially mirror the deficiencies seen in many sinking funds throughout Australia and indeed the world, despite occurring in different circumstances. An analysis of every bridge in the United States determined that while concrete performs well in comparison to other bridge materials, concrete cancer is responsible for notable decreases in durability.³² However, increasing demand for maintenance of these structures was not linked to a commensurate increase in funding available. David Walker, a former head of the Government Accountability Office stated that 'the problem with the trust fund,' set up to ensure continual maintenance, 'is that it's not funded and you can't trust it.'³³ Moreover, as a comparative analysis of infrastructure cost demonstrates, the complexity of government policy has also pushed prices

³⁰ Ioannis Balafas and Chris Burgoyne, 'Modeling the Structural Effects of Rust in Concrete Cover.' (2011) 173(3) *Journal of Engineering Mechanics* 175, 177.

³¹ Deloitte Research, *Closing America's Infrastructure Gap: the Role of Public-Private Partnerships* (2006), 5.

³² Daniel Farhey, 'Operational Structural Performance of Bridge Materials by Deterioration Trends.' (2014) 28(1) *Journal of Performance of Constructed Facilities* 168, 175. See also Jeffrey Luckai et al, 'A methodology for evaluating the effects of spalling on the structural capacity of reinforced concrete bridge girders.' (2014) *Canadian Journal of Civil Engineering* 41, 197; and,

³³ David Walker, cited in 'America's Crumbling Infrastructure: Bridging the Gap', *The Economist* (London) 28 June 2014.



disproportionally high. The combination of policies favouring the construction industry, an inefficient bureaucracy, protectionist procurement policies and a focus on the individual rights of landholders above the collective need of the community has led to infrastructure costs that are the most expensive in the world on a per capita basis, yet continually fail to deliver positive outcomes.³⁴

The well-documented experience of the United States demonstrates how these influencing factors combine to drastically increase maintenance costs. Despite not being fully understood, concrete cancer is having substantial impacts on the durability and liveability of all structures, with massive rectification costs. Legislative and policy changes over time have increased construction and maintenance costs. These deficiencies are by no means unique to sinking funds. Rather, they impact the entire construction industry. The failure of the United States to consider them led directly to the infrastructure gap currently seen, and is leading to deficient sinking funds in Australia. Confronted with these factors, the United States chose to pass the buck to future generations, with the antecedent consequences placed upon those future generations, an experience directly analogous to strata.

Fortunately, Australia possesses government policy that directly incentivises continued maintenance for some properties. Negative gearing is designed to ensure that the costs of maintaining a property asset, including capital expenditure, are greater than the income of that property.³⁵ This then leads to beneficial tax outcomes. Wood and Kemp, in a comparison of Australian and British taxation of landlords, emphasise that negative gearing in Australia provides a powerful incentive for continuing maintenance, whereas British landlords are more likely to 'kick the can down the road.'³⁶ Abolition of negative gearing, as has been proposed recently, is likely to be accompanied by a commensurate forestalling of maintenance responsibilities, and more deficient sinking funds.³⁷

4. REALITY

The unfortunate reality is that juggling the cost pressures and influencing factors are often beyond the capacities of Bodies Corporate and Body Corporate Managers. Accurately predicting future costs is difficult enough; translating that assessment into action even more so. Broadly,

³⁴ Paul Gregory, 'Infrastructure Gap? Look at the Facts. We Spend More Than Europe.' *Forbes* (online) 4 January 2013 <<http://www.forbes.com/sites/paulroderickgregory/2013/04/01/infrastructure-gap-look-at-the-facts-we-spend-more-than-europe/>>; Noah Smith, 'Road, Bridges and Tunnels Matter, America.' *Bloomberg View* (online) 15 December 2014 <<http://www.bloombergvew.com/articles/2014-12-15/road-bridges-and-tunnels-matter-america>>

³⁵ Australian Tax Office, *Negative Gearing* (2 April 2015) <<https://www.ato.gov.au/Individuals/Tax-return/2014/In-detail/Publications/Rental-properties-2013-14/?page=16>>

³⁶ Gavin Wood and Michael Kemp, 'The Taxation of Australian Landlords: Would the British Tax Treatment of Rental Investments Increase Tax Burdens if Introduced in Australia?' (2003) 40(4) *Urban Studies* 747, 750.

³⁷ ACIL Allen Consulting, *Australian Housing Investment: Analysis of Negative Gearing and CGT Discount for Residential Property* (Report to Property Council of Australia and Real Estate Institute of Australia, 12 June 2015), 38; see also Reserve Bank of Australia, Submission to House of Representatives Standing Committee on Economics, *Inquiry into Home Ownership*, 25 June 2015, 23.



there are three realistic scenarios. First, the committee may be sufficiently educated to agree to an equitable distribution of levies into the future. Second, the committee may be sufficiently educated, but selfishly decide to pursue a deficient sinking fund to place the burden on future occupants. Third, the committee may be ignorant of the most desirable funding model. Obviously, the first is the optimal outcome; the only uncertainty is the unavoidable uncertainty in cost assessment. It is necessary to dissect the second and third approaches to determine the specific problems that arise.

4.1. Selfishness

Selfish committee members provide the biggest threat to sinking funds. Ignorant committee members may by chance adopt a sinking fund which deals fairly with future problems; selfish committees will deliberately adopt a sinking fund that places the burden upon future occupants. This commonly arises in properties with a high turnover of occupants. The current owners, foreseeing that they will only be in occupation in the short term, recognise that they will not take the benefit of an item to be repaired five or ten years into the future. They will attempt to minimise the amount they contribute to that item, assuming (often correctly), that deferred maintenance will not negatively impact the sale of their own lot, and will in fact maximise their return on investment.³⁸ For example, residents who experience concrete cancer in their unit may hide the problem. The damage may be noticeable to an expert, but to the untrained eye the property will not be shackled to major, necessary, rectification works. As delaying maintenance works leads to consequential damage with further costs, an inflated maintenance cost is passed on to a subsequent owner. This defeats the purpose of a sinking fund as an equitable method of distributing costs.

The desire to eschew an equitable sinking fund in favour of self-interest is also seen in the sale of strata lots. Under strata title legislation in Queensland, the seller of a lot is required to provide a disclosure statement to the buyer, stating the amount of levies to be paid by the owner of the lot.³⁹ Sellers have a commercial interest in minimising the recurring levies disclosed to the buyer: a buyer is more likely to purchase, or purchase at a higher price, a lot with minimal recurring costs. Yet while sellers cannot opt out of disclosure, they can shift costs away from recurring annual levies and towards special levies, which do not require disclosure. Maintenance will then shift from an equitable, preventative model, and towards an inequitable ad-hoc approach. This disadvantages the purchaser and other lot owners, who may not be in a financial position to unexpectedly meet the levy.⁴⁰

4.2. Ignorance

³⁸ Murray Campbell, 'Sunk Funds.' (2004) 74(5) *Australian CPA* 80.

³⁹ *Body Corporate and Community Management Act 1997* (Qld) s 206(2)(b).

⁴⁰ Hera Antoniadou, 'Strata Living and the 10 year sinking fund plan.' (Paper presented at Pacific Rim Real Estate Society Conference 2008), 6.



A large factor is a fundamental misunderstanding from Bodies Corporate about the necessity of ongoing maintenance and a sinking fund to pay for it. At its simplest, a Body Corporate is merely a collection of individuals. These individuals have lives outside of the Body Corporate, and while they may have some accounting or engineering background, the vast majority will have limited knowledge of the rationale behind a sinking fund, or the benefits a thorough sinking fund delivers. Provided with the prospect of making a decision despite an inherent factual uncertainty and their own lack of knowledge, inexperienced Bodies Corporate will often adopt a 'wait and see' approach, passing the buck to future occupants. For instance, when repainting is required, many occupiers believe that pressure cleaning will preserve its lifespan. This is based on a fundamental misunderstanding of the purpose of paint as a protector of the underlying base material, and leads to greater damage that is even more cost-prohibitive to rectify. Notwithstanding their own lack of knowledge about maintenance or sinking funds, many members of Bodies Corporate remain ignorant about the complex legal obligations in strata schemes.⁴¹ The overwhelming attitude is one of laissez-faire property management, with a limited awareness of the consequences of their decisions.

Compounding this is oversensitivity to external influencers, including perceived macro-economic circumstances and government policy. Declines in consumer confidence will be positively correlated with committee reluctance to adopt a thorough funding model.⁴² In small groups of individuals, as on a Body Corporate committee, it is far more likely that the individuals will have a similarly biased perception of economic conditions. This magnifies incentives against acting. Fortunately, Australia possesses a taxation policy which, in the case of landlords, encourages continued maintenance. However, these are localised factors. Committees commonly come under the sway of powerful individuals, or ignore the necessity of continued maintenance. Typically, a sinking fund is either manifestly inadequate or excessive. Sinking funds rarely eliminate these deficiencies.

In the 31 years that my company, Solutions in Engineering, has been in the industry, some trends have become apparent. The accuracy of professional predictions over time is impressive. In particular, the cash flow model generally sees no change in forecasted contributions over the short to medium term. By analysing a representative sample of sinking funds which have been updated on average every 6.5 years, these trends become visible. These results bode well for the current model of sinking funds. However, that is not to say that the aforementioned problems should not be addressed; improvement and accuracy should always be sought.

Where significant changes are seen in the cash flow model used by Solutions in Engineering, they are generally attributable to factors other than those predictable in the report. Of particular note is that these changes are not due to procedure, negligence, or inappropriate forecasting but rather occur where the sinking fund has not been adopted, adopted in part, or not followed by

⁴¹ Judy Atkinson, *Building Community in Strata Corporations*. (MA Thesis, Royal Roads University, 2003), 5.

⁴² There is limited scholarly research into this, yet it is a logical extension of the general trend observed.



the committee of the Body Corporate. Other changes are attributable to other environmental challenges, such as concrete cancer. Solutions in Engineering Inspectors follow a well developed procedure noting typical and peculiar elements and items for maintenance. The more regular items often fall into, among other things, categories including building exterior; roof; access for work at heights; main foyer; lobbies and hallways; stairwells; common rooms; trade toilet/bathrooms; laundry; gymnasium; sauna; steam room; vehicle accessways; external walkways; barbecue area; swimming pool; pergolas/patios; fixtures/fittings; landscaping; plant; maintenance equipment.

By noting items in these categories, and assessing their lifespan and maintenance cycle, as well as the cost of replacement, maintenance and/or labour from reliable industry data texts a dependable and consistent forecast can be made. The examination of a number of Solutions in Engineering reports shows that over time, this method bears up against scrutiny, and changes to the predicted contributions for a given year between reports is not attributable to report deficiencies.

5. SOLUTIONS

Determining a rule for why Bodies Corporate act in a certain way would be almost impossible. Sinking funds are a complex area, and a myriad of incentives act on each member of the committee. Individuals often act irrationally, and may over-estimate the importance of their own plans, perceived economic weakness or government policy. In many cases, the committee may come under the influence of one or more powerful members, or occasionally a dominant Strata Manager. Translating individual desires into an acceptable group decision often means that rational questions, such as the consequences of water ingress through peeling paint to the underlying building envelope, are ignored. Expert sinking fund developers can, to an extent, minimise the deficiencies, but no matter how accurate their predictions, they still have to be adopted by the Body Corporate Committee. Due to the many influencing factors many Bodies Corporate adopt sinking fund budgets that are either inappropriate or inefficient.

To an extent, the problems can be avoided by educating those in a strata scheme about the necessity of a comprehensive sinking fund. By recognising their obligations to the common asset, owners may voluntarily adopt a thorough sinking fund. Yet even if each individual was equally knowledgeable, the incentives to avoid hard decisions would remain and many sinking funds would remain deficient or become deficient when funds for improvements or unforeseen maintenance issues are taken from the sinking fund instead of being paid by way of special levy.

Governments have used policy to alleviate some of the issues from deficient sinking funds, yet these invariably suffer from their own problems. In many cases, they represent an unwarranted intrusion into the power of the strata scheme to manage their own affairs. By contrast, they may leave too much up to the strata scheme, with the end result being an underfunded sinking fund.



Getting this balance correct is challenging from a policy perspective. Our experience has shown that the cash flow model generally delivers a sinking fund with minimal deficiencies, however even then an underfunded or ignored sinking fund may be a ticking time bomb.

The cash flow model's weakness is in those who make decisions about adoption of the recommended levies and spending. If all major non-recurrent maintenance costs are budgeted in the sinking fund, all non-recurrent costs in the administration budgets, and the recommended levies are adopted, most buildings will be properly funded with respect to maintenance. Further, the Bodies Corporate must adjust levies for the following financial year when the recommended balance in the sinking fund at the end of the current financial year is deficient. The fund will most likely not be deficient if the discipline of raising special levies for unforeseen maintenance expenses is maintained.

6. SUPPORT LEGISLATION

Legislation could force Bodies Corporate to adopt the levies in the sinking fund analysis, unless the Body Corporate can show reasons why they should not adopt those proposed. This refusal would be kept in written form and held on the Body Corporate records. If this was introduced in conjunction with a mandatory (perhaps online) education course for members of the executive committee then members of the committee would be better placed to make sound financial decisions.

Concrete cancer is a massive issue that will continue to grow in size as buildings built under older, less stringent, building codes and built close to bodies of salt water experience the vagaries of aging. Biannual inspections by suitably qualified inspectors would allow these issues to be identified early. Rectification works could then be undertaken to stop the problem spreading. It is gratifying to see the Queensland Government recognise the possibility of further legislation to help protect owners from the catastrophic consequences of concrete cancer; more jurisdictions should respond to the dangers that concrete cancer poses.⁴³

Finally there is a need to legislate to provide that when a building gets past its useful life and becomes uneconomic to maintain, that a scheme can be dissolved without requiring a resolution without dissent. Ideally, a majority vote would be sufficient, although perhaps 75% would be required. In this it is gratifying to see the proposed *Strata Schemes Development Bill 2015* (NSW), which will allow for the sensible renewal of properties. Currently the hip pocket rules, and, in too many cases, short term penny pinching overrules the long term needs of the building asset. We are fighting human nature, and this is one of those rare occasions where well thought out legislation is warranted.

⁴³ Tony Moore, 'Concrete Cancer a problem in Brisbane, Sunshine Coast, Gold Coast', *Brisbane Times* (online), 17 June 2015 <<http://www.brisbanetimes.com.au/queensland/concrete-cancer-a-problem-in-brisbane-sunshine-coast-gold-coast-20150616-ghpfqi.html>>