

A Comparative Analysis of Australia's Sinking Fund Governance Within a Strata Scheme

Hera Antoniades¹

Abstract: In recent years a number of issues have arisen within Australia's built environment regarding strata title sinking funds and their relationship to the standard of housing stock. In particular, focus has centralised on the emerging problems associated with inadequately maintained amenities in strata title buildings.

The purpose of this paper was to undertake a national comparative analysis of current and proposed legislation applying only to sinking funds, in order to evaluate the potential effectiveness of the regime. The research methodology applied in this instance was action research. Action research is regarded cyclic, where there is intention or planning before the action, and then a review or critique after the action. This methodology has cycles of defining the problem, identifying the action or possible solutions followed by reflection and testing and in the case of governance, implementation and changes towards existing policy and legislation.

The research concluded that the development and implementation of a 10 year sinking fund plan would relieve the burden for a strata owner being charged an unexpected special levy. Long term planning and forecasting would mitigate the cost of upkeep and maintenance of the building for the "future-generation owners" of the already existing strata schemes.

Key words: Governance, sinking fund, strata schemes, strata title, action research

1. INTRODUCTION

In recent years a number of issues have arisen within Australia's built environment regarding strata title sinking funds and their relationship to the standard of housing stock. In particular, focus has centralised on the emerging problems associated with inadequately maintained amenities in strata title buildings.

The concept of "strata" is where a person or a company has the right to the ownership of cubic air space within an allocated boundary. This portion of air space is known as a "lot" and each lot is within a strata scheme. The strata scheme comprises of a building, or a collection of buildings and the scheme can vary in size from only 2 lots to over 750 lots.¹

The strata scheme can be either residential, non residential, or a mixture of both. Some examples of strata schemes are apartments, townhouses, home units in multi level buildings, villas, shops, warehouses, office space and retirement villages. The common property for the strata scheme includes external walls, windows, stairwells, roof, driveways, foyers, fences, lawns, gardens. The ownership of the common property is shared amongst the owners of the lots, and the lot owners are referred to as the owners' corporation. The owners' corporation is responsible for the maintenance and repair of the common property and the overall management of the scheme.

The first strata title laws were introduced in NSW during the early 1960's, with the commencement of the Strata Titles Act 1961, however, management and dispute provisions did not commence until the introduction of the Strata Titles Act 1973 on

the 1 July 1974.² There have been many changes over the decades, and in New South Wales, in recent years, the Strata Schemes Management Act 1996 has been updated to "keep up with the increasing complexity and sophistication of strata developments."³

Other Australian states and territories have passed strata titles legislation, although with differing names to the act and the terms of governance arrangements.

2. BACKGROUND – SINKING FUNDS

The role of the owners corporation is to manage the business of the strata scheme including the maintenance of the common property. Therefore, in New South Wales, strata levies which incorporate an administration fund and a sinking fund are charged to each lot owner. A budgeted forecast for these funds is prepared, and the strata levies are calculated for each lot.

The purpose of the sinking fund is to provide sufficient funds for the owners corporation to adequately meet the long term capital improvements and maintenance relating to the common property of strata schemes. Sinking funds can be used for items such as the painting of the common areas of the building e.g. hallways and stairs; replacement of common property items e.g. carpets and roof; overhaul and replacement of the lift and hot water systems; landscaping upgrades, driveway upgrades etc

In New South Wales, if the owners corporation sinking fund has insufficient funds for capital expenditure, then a special levy

¹ Lecturer, University of Technology, Sydney. Faculty of Design Architecture & Building, School of the Built Environment, email to hera.antoniades@uts.edu.au

Antoniades, H (2008), Strata Living and the 10 year sinking fund plan, Pacific Rim Real Estate Society Conference.

² Department of Fair Trading National Competition Policy Review Report 2001.

³ NSW Office of Fair Trading, 2009. Strata Living, FT045

can be raised to cover the cost of the expenditure⁴. However, this can disadvantage lot owners, who perhaps are not in a financial position to unexpectedly meet this financial contribution. This dissatisfaction is further supported by a survey undertaken during 2008 and 2009 by the University of New South Wales,⁵ where one-third of survey respondents commented that special levies were raised because the owners corporation had not budgeted adequately for major capital works.

In a discussion paper, written by the Property Council of Australia, in 2005,⁶ it was stated that a “level playing field for strata title schemes” was desirable. In other words all strata schemes should have adequate funds so “that sufficient reserves are able to meet future capital expenditure requirements”. The Property Council of Australia argued that it was “critical” to adequately provide for the buildings, because “cities, urban and regional areas could suffer from an ugly blight of under-maintained strata buildings into the future”.

In July 2005 at the Strata and Community Title Australia conference⁷, Gary F Bugden discussed many of the concerns challenging strata title owners, and highlighted issues such as the large number of poorly maintained older buildings and if there was no “prospect of addressing the degradation of the building” then perhaps it was necessary to commence a complete redevelopment of the area and the buildings.

In New South Wales, the Strata Schemes Management Act 1996 underwent two major reviews, in consultation with the public.⁸ Effectively from 7th February 2005 and onwards, all new strata schemes coming into existence are required to prepare a 10 year sinking fund plan; and from 1st July 2006, there was a four phase implementation of the 10 year sinking fund plan for existing schemes.

Therefore, the introduction of the 10 year sinking fund plan in New South Wales is designed to overcome the need to charge huge “one-off” amounts to lot owners. The aim of the 10 year sinking fund is to build up reserves for these future capital costs. Additionally, the long-term planning and forecasting would mitigate the cost of upkeep and maintenance of the building for the “future-generation owners” of the strata schemes.

A survey of strata owners in New South Wales, was undertaken and analysed during 2007.⁹ The survey focused on issues relating to the financial aspects of the current strata levies and the total lot numbers within the lot owners’ strata scheme. The respondents generally considered the implementation of the 10 year sinking fund plan to be a very good idea, however concerns were raised that the 10 year sinking fund projection was an additional financial commitment when in some cases the respondents had only owned the unit a relatively short time, in comparison to the age of the strata scheme.

A larger study undertaken during 2008 and 2009¹⁰ concluded that just over one in ten respondents considered the overall condition of their building to be poor and identified non-rectified defects and structural issues, as the most common problems. This included water ingress, water leaks in internal areas, defective services (e.g. broken lifts or air conditioners, electrical faults, cracking to internal and external structures, poor fire and safety compliance. Almost two-thirds of the respondents who owned a property that was built since 1997, commented on the ongoing defects in their building.

The survey concluded by stating that “Poor management of major repairs and maintenance in strata properties has implications for the quality of life of tens of thousands of people in NSW and billions of dollars worth of assets.” Indeed recent published literature echoes similar concerns. For instance Randolph (2007)¹¹, comments “no process has been devised to deal with blocks that are at the end of their physical or economic life” and Sherry (2006)¹² discusses the need to redevelop older strata schemes in New South Wales as the buildings reach the end of their “life cycle”.

3. RESEARCH OBJECTIVE and METHODOLOGY

Currently, the regulatory regime applying to sinking funds is established at the state and territory level. The purpose of this paper is to undertake a national comparative analysis of current and proposed legislation applying to sinking funds in a strata scheme, in order to evaluate the potential effectiveness of the regime. The research methodology applied in this instance was action research. Action research is regarded cyclic, where there is intention or planning before the action, and then a review or critique after the action.¹³ Action research has also been defined as “bringing together action and reflection, theory and practice”.¹⁴ This methodology has cycles of defining the problem, identifying the action or possible solutions followed by reflection, testing and in the case of governance, implementation and changes towards existing policy and legislation.

4. SINKING FUNDS

In comparing the legislative regimes for sinking fund requirements, within Australia, it is important to note that across each jurisdiction there are differing terms to describe strata schemes and owners’ corporation. For example as shown below in Figure 1, in Queensland, Victoria, and Tasmania, the “Owners Corporation” is identified as the “Body Corporate”.

⁴ Strata Schemes Management Act 1996, Division 2

⁵ Easthope, H. Randolph, B. Judd, S. (2009) Managing Major Repairs in Residential Strata Developments in NSW, a study by the City Futures Research Centre at UNSW, Built Environment July 2009. Survey was undertaken between 2008 and April 2009, with 244 valid responses.

⁶ Property Council of Australia, 2005, Discussion paper, submission of sinking funds.

⁷ Strata and Community Title in Australia for the 21st Century Conference: Strata and community Titles in Australia – Issues 1 Current Challenges, presented by Gary F Bugden, Griffith University.

⁸ NSW Government, (2004) Strata Schemes in 2004-the further issues Discussion Paper and Government Issues Paper (2003) Living in Strata Development in 2003.

⁹ Antoniadis, H 2008, Strata Living and the 10 year sinking fund plan, Pacific Rim Real Estate Society Conference.

¹⁰ Easthope, H. Randolph, B. Judd, S. (2009) Managing Major Repairs in Residential Strata Developments in NSW, a study by the City Futures Research Centre at UNSW, Built Environment July 2009

¹¹ Randolph, B. Easthope, H. (2007) Governing the Compact City: The Governance of Strata Title Developments in Sydney.

¹² Sherry, C. (2006) Termination of Strata Schemes in New South Wales – Proposals for reform, Australian Property Law Journal.

¹³ Dick, B <http://scu.edu.au/schools/gcm/ar/art/arthesis.html> accessed 26/07/2010 University of Queensland

¹⁴ Reason, P., & Bradbury, H (2006) Handbook of Action Research

COMPARISON OF VARYING TERMS USED IN EACH JURISDICTION ACCROSS AUSTRALIA

State/Territory	Strata Schemes	Owners Corporation
NSW	Strata Schemes	Owners Corporation
QLD	Community Title Scheme	Body Corporate
ACT	Unit Title/ Community	Body Corporate or Owners Corp
VICTORIA	Subdivision Strata	Owners Corporation
TASMANIA	Strata Scheme	Body Corporate
NORTHERN TERRITORY	Unit Title	Management Corporation
SOUTH AUSTRALIA	Strata Scheme	Strata Corporation
WESTERN AUSTRALIA	Strata Scheme	Strata Company

Figure 1

Source: Extract from *The Law of strata title in Australia: A jurisdictional stocktake*

4.1 SINKING FUNDS in New South Wales

With major reviews to the Strata Schemes Management Act 1996, New South Wales underwent substantial changes to the management of the sinking fund within a strata scheme.

Currently, Part 3, of the Act, s 66 and s 69 requires the owners corporation to establish an administrative fund and a sinking fund respectively. The administration fund is used for the recurrent expenses relating to the common property. This would include expenses for the day-to-day activities of the strata scheme such as minor repairs, payment of the insurance premiums, maintenance of the gardens and lawns; and the sinking fund meets expenses of a capital nature such as major repairs or improvements to the common property, painting the buildings or replacing fixtures or fittings, roof, gutters and fences. However, there are some minor exceptions for the sinking fund requirement where strata schemes comprise of 2 lots.

There is provision under s 75 and s 76 of the Act, to levy the necessary contribution for the administration and sinking funds, and furthermore, s 75A requires the owners corporation to prepare a 10 year sinking fund plan. However, the owners corporation can either engage expert assistance or if they are of the opinion that there is sufficient expertise amongst the owners, then the owners corporation may prepare the 10 year sinking fund plan.

Currently, there are no penalties in the legislation if the owners corporation does not develop and adopt a 10 year sinking fund plan. This is considered to be a major weakness with the existing legislation, because the sinking fund will not accumulate sufficient reserves to adequately cover the capital expenses of the common property within the strata scheme. Buildings need to be maintained regularly to retain their value. Long term planning and forecasting would mitigate the cost of upkeep and maintenance of the building.

4.2 SINKING FUNDS IN QUEENSLAND

In Queensland, Strata Title is regulated under the principle Act, called the Body Corporate and Community Management Act 1997 (the BCCM), and complimented with a variety of regulation modules specific to the type of Strata Schemes ranging from large and small lots, residential complexes, serviced apartments, business purposes, hotels and resorts.

The sinking fund requirements are detailed in the Standard Module Regulation 2008 under s 79 1 (i)¹⁵ and under the Accommodation Module Regulation 2008 under s 78 1 (i)¹⁶. The regulations seek a “detailed and comprehensive estimate” for the schemes first 10 financial years and specify that an estimate for the repainting of common property and buildings must be included. The maximum penalty for non compliance is set at 150 penalty units. This penalty is vastly different from New South Wales which has no penalty provided in the legislation.

Furthermore, in Queensland, section 139, parts 1 and 3 under the Standard Module Regulation, and section 137, parts 1 and 3 under the Accommodation Module Regulation, stipulates the requirement for the sinking fund budget to be adopted. Again, in New South Wales, there is no such requirement to enforce the 10 year sinking fund plan. Additionally in Queensland, the sinking fund must maintain the necessary funds required for the current financial year and to have an appropriate “proportional share” of funds accumulated over the next 9 years. The regulations also provide detailed examples on the method used for the “proportional share” calculation.

Therefore, in comparison with New South Wales, the Queensland regime appears to be more rigorous with regards to the accumulated funds in the sinking fund, and the enforcement of the 10 year sinking fund plan.

4.3 SINKING FUNDS IN VICTORIA

The Owners Corporation Act 2006 and the Owners Corporations Regulations 2007 oversee the Strata title regime in Victoria.

Under s 23, part 1, of the Act¹⁷ the owners corporation has the authority to set annual fees to cover expenses such as the general administration, maintenance, repairs, insurance, and other recurrent obligations of the strata scheme; and part 2 provides that if a maintenance plan has been approved by the owners corporation, then the annual fees must also include any fees “designated” for the purpose of the maintenance plan.

However, there is no provision for a mandatory sinking fund or a 10 years sinking fund plan, as there is in comparison with New South Wales, and also Queensland. There is provision however, under section 24¹⁸ for the levy of “extraordinary fees”. This would appear to be the equivalent of a “special purpose levy” which is used in New South Wales, however, the Victorian legislation imposes conditions. Generally if there are insufficient funds in the sinking fund of the strata scheme then a special purpose levy can be raised.

¹⁵ Body Corporate and Community Management (Standard Module) Regulation 2008 (Qld).

¹⁶ Body Corporate and Community Management (Accommodation Module) Regulation 2008

¹⁷ Owners Corporation Act 2006

¹⁸ Owners Corporation Act 2006

Therefore, Victoria does not enforce a mandatory accumulated sinking fund account and only makes reference to an optional maintenance plan, if adopted by the owners corporation. If the sinking fund is inadequately costed and budgeted, the consequential impact on depleted amenities in strata schemes will invariably lead to poor quality maintenance and deterioration of the common property, a lower standard of living for the occupiers and potential loss of appreciated value on the real property.

4.4 SINKING FUNDS IN THE AUSTRALIAN CAPITAL TERRITORY

Sinking fund legislation in the Australian Capital Territory is regulated by the Unit Titles Act 2001 (ACT). Under s 59 there is provision for the establishment of a general fund account for the purpose of the general administration of the corporation, and if required, the establishment of a fund for particular purposes. The levies for the day-to-day expenses of the corporation are held in the administrative fund, whilst funds for a specific purpose and relating to capital items are held in the “special purpose fund”. This appears to be similar to the sinking fund legislation requirements in New South Wales, and also Queensland.

Additionally, in the Unit Titles Act 2001 (ACT), s 61 provides for the establishment of a sinking fund if there are 4 or more units in the strata plan. It is also permissible, with conditions, to transfer funds from the special purpose fund, to the sinking fund. The sinking fund cover items such as the painting or repainting of any building that forms part of the common property, repair or replacement of fixtures and fittings, and anything else on the common property.

Section 62 stipulates that the owners corporation must prepare an initial 10 year plan and s 63 requires a review of the initial sinking fund plan, and if necessary, to amend the plan not later than 4 years after the plan is approved. Under s 63A if the owners corporation had an initial sinking fund plan, then the owners corporation must prepare a plan every 10 years, and s 63B requires a review of the sinking fund plan, and if necessary to amend the plan not later than 5 years after the plan was approved.

The Unit Titles Act 2001 (ACT) has very stringent requirements for budget review of the 10 year sinking fund plan, in comparison to New South Wales, but is similar in terms of the accumulation of funds required for sinking funds in Queensland.

4.5 SINKING FUNDS IN TASMANIA

There have been significant changes to the regulation of Strata title in Tasmania, particularly with the introduction of the Strata Titles Act 1998 (Tas).

Under s 82 a body corporate must maintain a fund for the purpose of covering recurrent expenditure and capital expenditure. The fund may also be subdivided into these two funds or the fund may be combined. This is different from sinking fund legislation in New South Wales and Queensland, where the funds must be kept separately, and if a transfer of money between the two accounts is required, then certain conditions are imposed to ensure the money is reimbursed to the appropriate fund.

Section 83 provides for the provision of a levy for the purposes of raising an amount necessary to meet other anticipated expenditure. This concept is similar to the special

purpose levy in the New South Wales legislation for sinking funds. However, there is no requirement for the preparation of a 10 year sinking fund plan in Tasmania.

4.6 SINKING FUNDS IN SOUTH AUSTRALIA

In South Australia, sinking fund strata law is covered under the Strata Titles Act 1988 (SA) and also the Community Titles Act 1996 (SA).

Under the Strata Titles Act 1988, s 27, the owners corporation can raise funds for the general day-to-day expenses and the future expenditure of a capital nature for the strata scheme, with no specific mention of a mandatory sinking fund plan.

However, in contrast, the Community Titles Act 1996 (SA), under s 116 states that the community corporation must establish an administrative fund and a sinking fund. Furthermore the non-recurrent expenditure is to be allocated against the sinking fund, whilst the day-to-day expenses are taken from the administrative fund.

Similar to Tasmania and Victoria, there is no legislative requirement for a 10 year sinking fund in South Australia. Consideration should be given to perhaps provide “seed funding” for needy buildings to kick start a long term sinking fund plan.

4.7 SINKING FUNDS IN WESTERN AUSTRALIA

The Strata Titles Act 1985 (WA) was introduced after a legislative review and a report by the Law Reform Commission of Western Australia.¹⁹

Under s 36, the strata company must establish a fund for the administrative expenses for the common property, and may establish a reserve fund for the purpose of “accumulating funds to meet contingent expenses other than those of a routine nature, and other major expenses of the strata company likely to arise in the future”.

Therefore, the option of a sinking fund for the purpose of capital expenses is similar to the sinking fund legislation in Victoria. As with Tasmania, Victoria and South Australia there is no legislative requirement for a 10 year sinking fund in Western Australia.

4.8 SINKING FUNDS IN THE NORTHERN TERRITORY

The Unit Titles Act 2001 (NT) regulates sinking funds in the Northern Territory. Specifically, s 61 requires the owners corporation to establish a sinking fund plan if there are 4 or more units in the unit plan. The sinking fund can be used for the painting or repainting of any building that is part of the common property, renewal, replacement or repair of fixtures and fittings that are part of the common property and other capital expenses for which the corporation is responsible.

Under s 62 an initial 10 year sinking fund plan must be prepared by the owners corporation and under s 63 the owners corporation must review the initial sinking fund and if necessary

¹⁹ Law reform commission of Western Australia, Discussion paper for a Review of the Strata Titles Act

amend the plan not later than 4 years after the plan was approved. Subsequent 10 year plans every ten years (s 63A) are required, and a review of the subsequent sinking fund plan and if necessary an amendment to the plan not later than 5 years after the plan was approved is required under section 63B.

This requirement for the review and amendment of the sinking fund plan is very similar to the Australian Capital Territory sinking fund legislation.

Where there is an uncompleted stage of the development, s 64A provides that no contributions to a general fund is payable.

5 CONCLUSION

The purpose of the paper was to undertake a national comparative analysis of the current and proposed legislation applying to sinking funds, in order to evaluate the potential effectiveness of the regime.

The research focused on the strata schemes sinking fund requirements within each jurisdiction, and uncovered varying significant inadequacies and inconsistencies with each jurisdictions' governance.

For instance, the implementation of a 10 year sinking fund plan would build up reserves for future capital costs. The 10 year sinking fund plan is required in NSW, Queensland, the Australian Capital Territory and the Northern Territory. A weakness with the NSW legislation is that there are no penalties for non compliance with the 10 year sinking fund plan. However, in the Australian Capital Territory, and the Northern Territory the regime appears to be more rigorous where it is mandatory to establish, review and amend the 10 year sinking fund plan and penalties are applicable for non compliance with the relevant legislation. Whilst Queensland regime does not require the review of the 10 year sinking fund plan, there is a mandatory requirement to accumulate sufficient funds in the sinking fund to meet the future needs of the capital expenditure. Therefore, this could be interpreted as a requirement to regularly review and amend the 10 year sinking fund plan on an ongoing basis. Similar to Queensland, the Australian Capital Territory and also the Northern Territory have legislative requirements for the accumulation of funds in the sinking fund accounts.

The special purpose levy has a similar concept in NSW and also Tasmania. Furthermore, in Western Australia and Victoria the option of the sinking fund for the purpose of capital expenses is similar. With both of these states, the sinking fund requirement is not mandatory. However, in Tasmania and South Australia it is mandatory to have a sinking fund, but, there is no requirement in the legislation for a 10 year sinking fund.

The development and implementation of a 10 year sinking fund plan would relieve the burden for a strata owner being charged an unexpected special levy.

In conclusion, if a sinking fund is inadequately costed and budgeted, the consequential impact on depleted amenities in strata schemes will invariably lead to: poor quality maintenance; deterioration of common property; lower standard of living for the occupiers; potential loss of appreciated value on the real property; and also a lower rate of return for the property investor. Therefore, buildings need to be maintained regularly to retain their value. Long term planning and forecasting would mitigate the cost of upkeep and maintenance of the building for the "future-generation owners" of the already existing strata schemes.

Additionally, consideration should be given to perhaps provide "seed funding" for needy buildings to kick start the 10

year sinking fund plan. Therefore a wider application for the 10 year sinking fund requirements would benefit the community.

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