Condominium Fees

How Low Can They Go? How High is Up?

John Warren, CA

During discussion of the financial statements at annual general meetings I am often asked how to reduce condominium fees or asked how high can condominium fees go, always in the context that owners are paying too much. Not quite so often, but more dangerously, owners stand for election to the Board of Directors and the main plank in their election platform is a promise to reduce fees - though how that is to be accomplished is always unclear. The desire to reduce current fees and eliminate future fees increases, though understandable, reflects, at best a misunderstanding of condominium costs and if put into effect are almost always damaging to the quality of life of those who live there.

COMMUNITY LIVING

Before we discuss costs, it is important to understand the meaning of community living. That is when you live in a house you can do things that are not possible in a community living environment. In your own house, if you don't have the money, you can decide not to fix the fence, not to repair the roof, not to clean the windows, to ignore the flowers and bushes and so on until you can't put up with your neighbours complaints or the municipality issues work orders to compel you to fix up your house. In a condominium that is not possible because, in addition to owners with limited incomes, some owners will be selling and want the most curb appeal and others will want the fence and roof fixed and the windows cleaned because that is the environment in which they want to live.

Owners have to recognize that their particular circumstances do not determine their condominium's costs; it is the collective circumstances of all in the condominium which determines them. Owners also have to understand that not all costs benefit owners equally. An owner once told me that owners who live on the ground floor should not have to pay for the elevators as they did not use them and was not, I think, entirely convinced when I replied that, whether owners use them or not, they have to pay because that is the nature of community living – all owners contribute to all common element costs.

IT'S NOT ABOUT FEES - IT'S ABOUT COSTS

It truly is not about fees, but only about costs. There is no landlord making a profit and no profit margin – the owners are the landlord. So to calculate condominium fees all you do is add up all the costs to operate the community of homes and collect each owner's proportionate share, as outlined in Schedule D to the Declaration.

If you want fees to go down, costs must go down, which sounds simple but isn't; because it's anything but easy to arrive at the "right" costs. Condomin-

ium costs are determined by the price, quality and quantity of utilities, goods and services purchased and so before the "right" costs can be determined, the community has to decide on the quality they want.

Quality considerations include such things as the quality of concierge, management, cleaning and other service providers, how often the building is to be cleaned, how many times the windows are to be washed each year, how extensive the plantings and landscaping are to be, how often carpets and hallways are to be refurbished and on and on.

For example, owners have to decide the concierge coverage necessary for their security and how skilled the concierge personnel have to be to meet their standards. Is it necessary to have two concierge personnel 24/7; one concierge 24/7 or something less than full time coverage? What quality of concierge personnel is necessary, those paid minimum wage or those with better skills who are paid more. This is not an easy task as owners will have different opinions; different abilities to pay and their expectations change over time.

Once the quality determinations are made, the job of the Directors is to obtain the best price, quality and service that meet those expectations

CONDOMINIUM COSTS

Condominiums spend money only in five broad areas.

1. *Funding the reserve for major repairs and replacements*
   The *Condominium Act* mandates reserve fund studies and these studies include a recommended funding plan. Directors that choose not to follow the recommended funding plan do so at their peril as that course of action may expose them to liability and, in my opinion, Directors should never expose themselves to the possibility of liability no matter how remote. There is just no realistic opportunity to reduce this cost.

2. *Utilities*
   Heat, lights, air conditioning and water are largely a function of the weather and usage. Residents set their thermostats, turn lights on and off and use water in the manner that suits them. If it is hotter than average the air conditioning costs go up; if colder, then heating costs go up (and vice versa). Water costs what the municipality charges for amounts used.

   All the board can do is exhort residents to reduce consumption; look for ways to reduce heating and air conditioning costs in the common areas and institute energy saving measures such as boiler retrofits if the community is prepared to pay for them. However there are limits to reductions of heat and air conditioning in the common areas both by regulation and by the comfort that residents expect.

   Cable television can always be purchased at a better price in bulk by the condominium than individually. Communications costs are largely legislated, that is the number of telephones required is mostly determined by regulation, one in each elevator, one in the pool, one in the hot tub, one in the mechanical room, etc. and the price is set by the authority that regulates telephone companies. There are limited savings possible in utilities after energy savings measures are instituted.

3. *People costs*
   People costs include concierge, landscaping and snow plowing, cleaning, management, superintendent, elevator and mechanical service, window washing and garage cleaning. These costs can be reduced but only if owners are prepared to accept reductions in service levels or the quality of services provided. For instance, the Board could reduce people costs by either hiring cheaper concierge personnel, by reducing the hours the concierge is on site from say 24 hours a day to 12 hours a day or some other number. Cheaper personnel are cheaper for a reason; they are generally not as well trained nor as motivated, while reducing coverage leaves the building exposed when the concierge is not on duty.

   Directors have little room to reduce services in any significant way because if the cuts are large enough to substantially reduce costs, the change in service level probably requires approval by a vote of the owners and approval is very difficult to obtain.

4. *Repair and maintenance costs*
   Repairs and maintenance include such things as annual plantings, fire, elevator and mechanical equipment inspections and repairs, cleaning and maintenance supplies such as cleaning materials, bulbs and parts, ice melter, waste disposal, cleaning and routine repair and maintenance to the exterior, interior and mechanical, electrical and plumbing systems. These costs can be reduced but only at the expense of the long term condition of the building.

   Deferred maintenance, as it is called, sacrifices the long term condition of the building to short term cost cutting. If the common areas are not well maintained then over time they become run down, negatively affecting the quality of life in the building, market values and ultimately increasing future costs to fix the building. If the property is to be properly maintained, there is not a lot of room to reduce these costs

5. *Administrative costs*
   Administrative costs include insurance, professional fees, office and meetings and other costs incidental to operations. Insurance is mandated by the *Condominium Act*.

Professional fees are either mandated, as with the audit, or necessary to protect the condominium and its Directors. Office, meetings and other costs are generally small and significant reductions are not possible.

Overall, once the quality decisions are made the Board of Directors has limited ability to significantly reduce costs without reducing quality and many costs are not easily reduced at all.

HOW HIGH IS UP?

So, if cost reduction is problematic, how high can condominium fees go? Forecasting the future is more than a bit of a guess, but I think there is general recognition that the costs in our lives go up each and every year; that is we spend more for a cup of coffee, a coat, a car, a house and a car mechanic, plumber or electrician than we did last year and we recognize that this trend will, in all probability, continue. It is not a large leap to recognize that price increases in the general economy, over time, will result in increases in condominium costs. The most often used measure of cost inflation is the Consumer Price Index, the CPI; however, the consumer price index is not all that applicable to condominiums as the basket of goods and services in the CPI calculation is different from the costs incurred by condominiums. Condominiums consume more utilities and do not purchase food, clothing, cars or vacations, for instance. A better measure of the cost inflation prospects for condominiums would be one of the construction cost indexes but that information is not generally available and so we are stuck with the CPI. My best prediction is that, barring extraordinary increases caused by such things as oil at $200 a barrel or regulatory changes such as the new garbage disposal costs in Toronto, is that owners should expect costs to rise at rates perhaps slightly in excess of CPI increases.

In summary, it is difficult to reduce condominium fees in any significant way without reducing the quality of life in the condominium and if lifestyle quality is to be maintained in the future, condominium fees will rise over time at least by inflation.

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The Myth
of Cents Per Square Foot

(A CAUTIONARY TALE OF TWO COMPARABLE BUILDINGS)

By John Warren, CA
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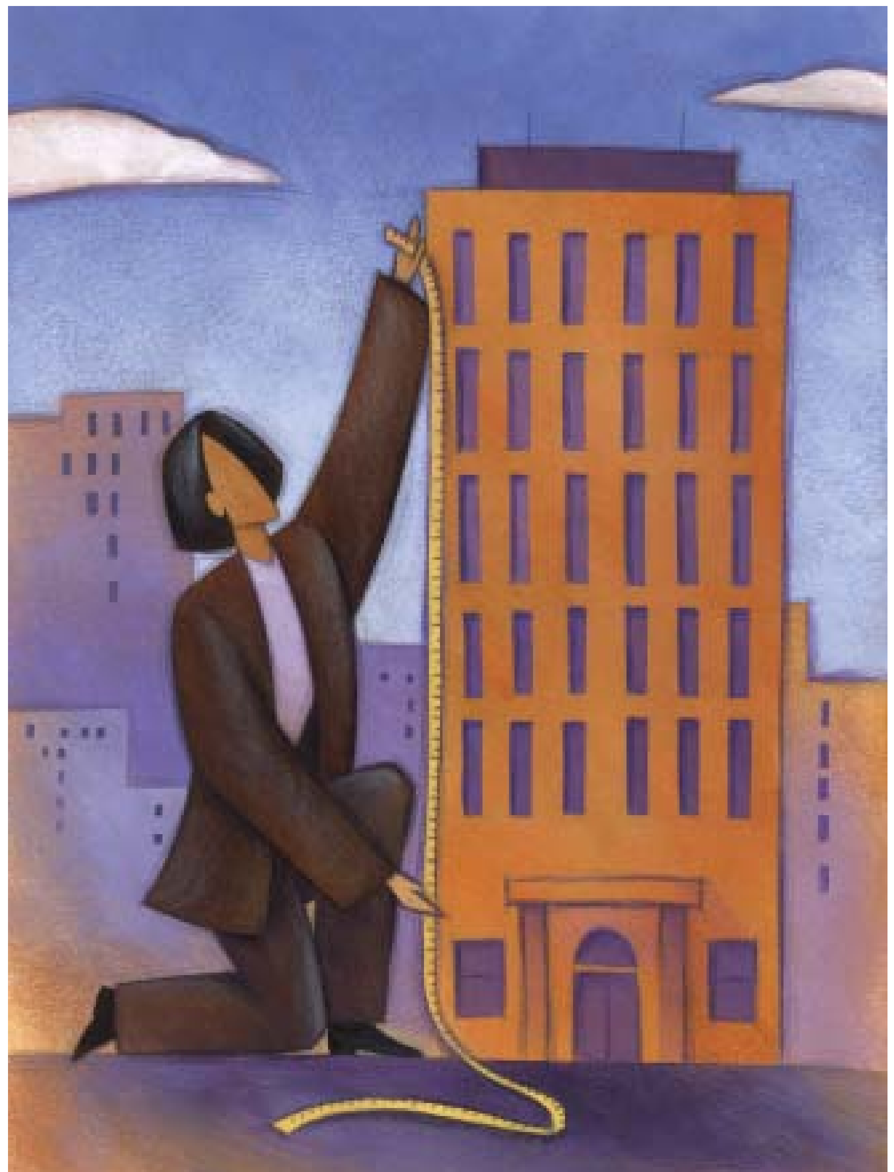

At Annual General Meetings (AGMs) that I attend "cents per square foot" comes up periodically, always in the context that whatever condominium community I am at is paying too much in common element assessments compared to surrounding condominiums as expressed by this magic calculation. It is also clear that the Board should correct this problem by reducing fees without reducing services, a process somewhat akin to waving a magic wand and expecting the problem to disappear – it only happens in the movies. Occasionally these cents per square foot calculations can give rise to substantial discontent and, in the extreme, requisition meetings to remove directors. This is unfortunate because comparisons based on cents per square foot never, never express the financial realities of the condominiums so compared. Using this calculation to compare condominiums is like using a chain saw to sculpt a copy of a famous statue; people may recognize the result but nobody should pay a lot of attention. Now, never is a strong word and I am prepared to agree that somewhere, at some point in time there may be two or more condominiums that can be realistically compared based on this measure, but that rare circumstance, if it exists, only proves that comparing condominiums based on cents per square foot and expecting useful results is a myth.

Now, as it happens, I have two condominiums in my portfolio that, by looking at them, you would think are comparable; they are located within sight of one another about the same distance from the same subway stop; they were built by the same developer, are about the same age, offer identical services and amenities, are managed by the same management company, have about the same size grounds to look after; look to be more or less the same size and even look alike architecturally. If any two buildings look to be comparable it would seem to be these two and therein lies a cautionary tale. Before we proceed to the comparison of these buildings, we should discuss the factors that impact cents per square foot to be able to understand why the calculation is so problematic. In order of importance they are: suite size, number of units, services offered and age of building.

Suite size is the most significant factor because, other than heating and air conditioning, most costs do not increase or decrease with increases or decreases in suite size. To illustrate, lets use two mythical buildings of 200 units: building A with an average suite size of 1,500 sq. ft. and building B at 1,000 sq. ft. Concierge services 24 hours a day, seven days a week and 365 days a year in each building will generally employ one person around the clock and will cost each building the same amount, roughly $140,000. For A that calculates to 3.8 cents per square foot, while for building B it is 5.8 cents per square foot; same service, different cost per square foot. This will also be generally true for services like elevator, electrical, mechanical, heating and air-conditioning, cleaning, management and landscaping. So the first rule is that buildings are only comparable if their suite sizes are pretty much the same.

> Suite size is the most significant factor because, other than heating and air conditioning, most costs do not increase or decrease with increases or decreases in suite size.

The second most important factor is number of units and for much the same reasons as suite size; costs do not increase with each additional unit, they increase in steps. To use another example, the cost of elevator maintenance is much the same as long as there are three elevators even if there are 10, 12 or 16 units per floor. Cost increases substantially only when it is necessary to have four elevators to service the building. To illustrate the issue however lets go back to our two mythical buildings with concierge service but now they have the same suite size of 1000 sq ft and building A is 15 stories with 150 units while building B is 15 stories with 210 units. Both will contract for the same level of concierge service as the increased number of units in building B typically does not warrant more the one person around the clock and so we can again use a cost of $140,000. For A that calculates to 7.7 cents per square foot, while for B it is 5.6 cents per square foot. Again, same service, different cost per square foot and this will also generally hold true for the other services mentioned under suite size. So the second rule is that buildings are only comparable when the number of suites is similar.

Services offered is next and covers such things as whether or not both condominiums have a concierge and for the same amount of time each day; whether they both have services such as pools, whirlpools and saunas which cost a lot to heat and maintain, fitness centers; whether or not cable TV is included in common element assessments and whether suites are individually metered for utilities. Obviously two buildings with different services will have different cents per square foot even if all other factors are comparable. So the third rule is that you have to have virtually identical services to compare buildings.

Last is age of the building. You can never compare a brand new building to an older building because new buildings operate under a budget that the developer set and marketing considerations generally make the first year budget low. It can then take the condominium two or three years to increase fees to a level sufficient to pay for the actual costs necessary to operate the building and to properly fund the reserve for major repairs and replacements. It is common that new buildings have to raise their fees 40 to 60

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percent over the next three years, so if cost per square foot was 36 cents in 2005 it is likely to be somewhere between 50 and 60 cents per square foot by 2008. Further, a building now 15 years old has probably had reserve fund studies prepared over the years; has followed them and so has money on hand to pay for major repairs and replacements as they come up. A building that is 35 years old, on the other hand, probably did not fund its reserve adequately in its early years as the impact of an aging building was not so clearly understood in those days and may now be forced to raise fees substantially and even assess owners to cover the required costs of major repairs and replacements.

Even though the two buildings mentioned at the beginning of this article seem to be quite comparable there are problems if current cents per square foot is the only measure used.

Now the cautionary part, even though the two buildings mentioned at the beginning of this article seem to be quite comparable there are problems if current cents per square foot is the only measure used. Table 1 is a summary of these buildings for their 2005 fiscal period.

So, what's the conclusion? Well I can hear it now, Condo 2 is definitely the better bargain, same amenities and services, bigger suites and all for $5 more a month, mind you another $100,000 is needed to buy there. Unfortunately for those who bought in 2005, this is no longer true and though the indications were there, they would most probably not be fully considered in their purchase decision; Condo 1 has a surplus while Condo 2 has a deficit; Condo 1's reserve contributions are $475,000 and forecast to increase only by inflation while Condo 2's contributions are $300,000 and are forecast to increase by 40% in 2006 and 12% in both 2007 and 2008. The 2006 financial statements disclosed the following:

- Condo 1 raised CEA 1.6% to $638 per month or 47 cents per sq ft.
- Condo 1 assessed $350,000 for building envelope and lobby refurbishment
- Condo 2 raised CEA 9.9% to $696 per month or 41 cents per sq ft, most of the increase due to increased reserve contributions.
- Condo 2 special assessed $80,000 to recover prior and current deficits

If Condo 2 had put all its reserve increases in excess of inflation into 2006, its 2006 fees would be approximately $805 per month or 47 cents per sq ft, the same as Condo 1. So what

TABLE 1

	Condo 1	Condo 2
• Age	22	20
• 2005 Surplus (deficit)	$50,000	$-30.000
• Reserve fund contribution	$475,000	$300,000
• Reserve fund contribution increases forecast in %	inflation	40/12/12
• Recent sales price	$375,000	$475,000
• Recent sales per sq ft	$234	$253
• Number of suites (10% more in condo 2)	222	245
• Average suite in livable square feet (25% more in condo 2)	1,360	1,700
• Total assessments (CEA) (11% more in condo 2)	$1,670,000	$1,850,000
• Average CEA per suite per month	$625	$630
• Average cents per sq ft per month	46	37

are we to conclude from all this. First, even buildings that look comparable like these two may not be a good match. Second, even if we can properly adjust cents per square foot calculations for the four key factors today, there is no guarantee for the future. We would expect that the Condo 2 with larger suites and more units would have lower cents per square foot and this was the case in 2005 but it did not hold true after that year. Third, special assessments distort cents per square foot calculations as happened when Condo 2 raised its reserve contributions sharply while Condo 1 special assessed to fund reserve expenditures.

The inescapable conclusion is that the chances that you can find even two condominiums with similar numbers of suites and suite sizes, which offer identical amenities, are about the same age and which have the same current financial condition and future prospects are, as they say, slim to none. Consequent-ly, as I opined at the start, it is a myth that effective comparisons of condominium communities can be made based solely on cents per square foot calculations.

John Warren, CA is a partner with Adams, Masin & Tilley LLP, Chartered Accountants who provide audit and financial services to all sizes and types of condominiums. John would like to express his thanks to Brookfield Residential Services Ltd. who conduct extensive research in this area and who made their data available to him. Without their assistance this article would not have been possible. ■

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Financial Health:
What Does it Look Like?

By John M. Warren, C.A.
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This question is asked quite often at Annual General Meetings – How do I know whether my condominium is in good financial shape? What does financial health "look" like? Most owners are not accountants and are seldom comfortable that they really understand the financial condition of their condominium. It's not that the financial statements don't contain enough numbers; rather its that there are too many numbers and it is difficult for owners to determine which ones are the important indicators of financial health.

The way the question is put is a good start to this discussion. "Looking" at and evaluating the present building condition is a good first step because financial health is inextricably linked to the current physical condition of the condominium. So "look" at your condominium and rate it from 1 to 10 – perhaps as follows: Terrible - 0 to 3; Needs a lot of work – 3 to 4; Tired, run down – 4 to 6; Good – 6 to 8; Excellent 8 to 10. To arrive at your ranking "look" at the following:

- Cleanliness of the common areas, garage and grounds; how clean are they; is there graffiti or litter?
- Condition of lobby, hallways, stairwells, the garage and other common areas. Are there obvious signs of damage and wear?
- Condition of lawns, shrubs, trees, fences, sidewalks, roads, windows and building exterior. Are there bare patches in the grass, are shrubs and trees overgrown or dead, are fences old, rickety and falling down, do roads have potholes and patches, do sidewalks and curbs have cracks and are they uneven, are windows dirty or clean and are there water and other weather stains or indicators of wear on the building exterior?

The reason to "look" at the building before looking at financial information is that financial health has three components,

1) current physical condition and main-

tenance standards
2) future major repair and replacement costs and
3) current operating status.

If the building is not currently in good physical shape with good maintenance standards, then owners will have to pay sometime in the future to remedy those deficiencies and the costs to remediate can be very, very large – or the building will stay run down.

Conversely, if the building is clean and in good physical shape, future costs will not be needed to remediate but only to maintain the current good condition. Fortunately Toronto and, I suspect, all of Ontario does not have buildings in the 0 to 3 category, being those in such terrible shape as to be beyond redemption and candidates only for demolition. The rule, if that is the right term, is that a rating between 3 and 6; being those buildings that need a lot of work or are run down, indicates financial problems at some level and the more work needed and the more run down the building is the bigger the financial problems are likely to be. This is so because if money had been available over the years the building would not be run down, the Directors would have spent the money to clean and maintain the building, to improve curb appeal and provide a better standard of living for residents.

Even if the building rates above 6 and looks to be in good or excellent shape, problems may nonetheless exist, as many significant repair and replacement issues are not readily evident to the naked eye. The condition of windows and roofs, boilers, plumbing, heating and air conditioning equipment, garage waterproofing membranes and other major structural components are not easily assessed visually.
The Condominium Act recognizes this problem and requires that an expert prepare a reserve fund study every three years to determine expected major repair and replacement costs and their timing over at least the next 30 years. The *Act* also requires that the Directors implement a plan to collect the funds necessary to ensure that the reserve fund will be adequate to pay for the major repair and replacement costs anticipated in the study. The most important part of the reserve fund study for our purposes is the Notice of Future Funding of The Reserve Fund that has been approved by the Board. In that document the important numbers are the annual contributions to the reserve fund over the next 30 years, Other Contributions if any, and whether the fund balance is negative at any year end.

If percentage increases in annual allocations to the reserve fund are greater than the inflation rate used in the reserve fund study, those increases can only come through increases in owners' assessments, indicating that future owners' assessments will rise faster than inflation. If there are "Other Contributions" that indicates that a special assessment will have to be levied or funds will have to be borrowed to be able to pay for anticipated repairs or replacements.

If special assessments are not levied or funds not borrowed, then the repairs or replacements forecast for that year will have to be deferred and the building allowed to deteriorate. If any year-end balance is negative (i.e. in brackets) it means that the fund is expected to be overdrawn at that date – the expert is forecasting that there will not be enough money to pay the costs forecast for that year meaning, as above, that those costs will have to be funded either by special assessments or debt or deferred, allowing the building to deteriorate.

The next step is to assess the day-to-day financial health of operations. Operating financial health is more than just having enough money to be able to pay invoices on a timely basis. If that is all that the condominium can do then they are, in effect, running on empty. By that I mean that the money collected each month is all spent by month end and there is no money available to deal with unexpected expenditures.

- Roofing
- Parking Garage
- Balconies & Railings
- Windows
- Mould
- Water Penetration
- Energy Retrofit
- Reserve Fund Plans/ Tech Audits
- Thermography/ Elect/Mech/Walls/Roofs
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Now some of us may operate our personal bank accounts on this basis but that may not be so bad because most of us have credit cards to pay for unexpected costs or we can borrow should circumstances require it. Condominiums cannot do this; the *Condominium Act* does not allow condominiums to borrow without the owners agreement and wisely so. Boards should not be able to incur debt without the knowledge and consent of the owners and owners should never allow borrowing to fund current operating costs. Governments have done this over the years; it is called deficit financing and as we are now too painfully aware it just shifts the financial burden into the future; it does not make the burden go away.

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Look on the balance sheet (or statement of financial position, they are the same) of the most recent audited financial statements. At the bottom of this page will be a line called something like "Operating Fund" and this is the amount of the condominium's "rainy day" fund. A condominium corporation whose day to day operations are in good financial health will have a rainy day fund equal to 1 or 2 months of owners' assessments. This is the amount that the Directors have on hand to pay for unexpected expenditures such as utility rate increases or unexpected costs that can't be charged to the reserve fund and enables them to deal with these matters, when they arise, without financial stress.

If the operating fund is negative (i.e. in brackets) the condominium is using deficit financing to fund operations. Not only is there no "rainy day" fund, the corporation is, effectively, overdrawn at the bank. Owners contributions in the current month are being used to pay for goods and services purchased in previous months, not a good state of affairs at all.

To summarize, financial health in condominiums is comprised of three components, the current physical condition, the health of the reserve fund and the health of the operating fund. The current physical condition indicates whether or not owners' assessments over the years have been sufficient to keep the building in good shape. The health of the reserve fund is dependent on three factors, whether there are sufficient reserve funds on hand to fix current problems; whether future reserve allocations contain large increases or other contributions and whether those future reserve allocations are enough to keep the fund positive. The health of the operating fund is dependent on how good current maintenance standards are and whether there are sufficient funds put aside for a rainy day. ■