CAO Guide on Condo Finances

Director Training

Condominium Authority of Ontario

www.condoauthorityontario.ca

Table of Contents

Have a Question?

If you have a question about any of the information in this Guide, please contact us. We have a team available to answer any questions you may have.

This guide may be updated from time to time. You can access the most up-to-date version on the CAO website.

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CAO Contact Information

Please submit any inquiries via the **Contact Us** portal on our website.

Monday to Friday:
9:00 a.m. - 5:00 p.m.

CAO Local number – 416-901-9356
CAO Toll Free number – 844-880-5341

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Document Purpose

This Director Training Guide supplements CAO's Director Training Modules and serves to deepen participants' knowledge of issues affecting condominium living. This guide will cover a range of topics including financial statements, bank accounts, budgets, reserve funds and reserve fund studies, audits and auditors, and taxes. These areas will be presented in the context of the relevant legal obligations under the Condominium Act, 1998 ("the Condo Act).

This guide will be updated from time to time. To obtain the most up-to-date version, please visit CAO's website at condoauthorityontario.ca.

Part 1: Financial Statements

Financial statements provide a picture of the financial position of your condominium corporation. at a fixed point in time or over a longer period of time, such as a month, a year, or a year to date.

Directors must know how to interpret the various financial statements that they will receive throughout a given year as this information is essential when making decisions for a condominium. For example, a director should understand the difference between audited and unaudited financial statements in order to determine the appropriate level of scrutiny that should be applied.

This section will help directors learn about the process of compiling different types of financial statements as well as understanding the components of a financial statement.

1.1 Definitions

1.1.1 What are Financial Statements?

Financial statements are reports that summarize the financial activities of a condominium corporation. Typically, condominium corporation financial statements include:

- Statement of financial position
- Statement of operations
- Statement of operating fund
- Statement of reserve fund
- Statement of cash flows

There are two different types of financial statements a director will see:

- Internal unaudited financial statements (prepared by management if not self-managed); and
- Audited financial statements (which will be discussed in section 1.7 of this Guide).

1.2 Users of the Financial Statements

There are four main users of the financial statements:

1. Directors
2. Owners
3. Auditors
4. Lenders

Directors:

- Will review and use monthly unaudited financial statements to monitor the financial position of the condominium corporation throughout the year; and
- Will review audited financial statements annually and approve them to be presented to the owners at the annual general meeting.

Owners

- Will receive a copy of annual audited financial statements once approved by the directors in the annual general meeting package or can request them during the year; and
- Potential purchasers of a condominium unit will also receive a copy of the annual audited financial statements as part of the status certificate package.

Auditors

- Will audit the annual internal financial statements and attach their auditor's report to be distributed to the owners.

Lenders

- Would require audited statements if the condominium corporation requires a loan.

1.3 Accrual Accounting

There are two major types of accounting methods: cash accounting and accrual accounting. According to generally accepted accounting principles in Canada, financial statements for condominium corporations must use the accrual method.

The basic definition of the accrual method of accounting is where revenues and expenses are recorded when the transaction occurs rather than when payment is received or made. An example of this would be where the condominium hires a company to make a repair and it is completed in the month of May. The expense for this repair has to be recorded in May even though they did not receive the invoice or pay the invoice until June.

The most common accounting errors to look for when reviewing the financial statements will be in the liabilities section. If an invoice is dated after the condominium corporation's year-end, but the work was completed before year-end, according to accrual accounting it needs to be included in the year-end financial statements. Often these amounts are not recorded, and the effect is to understate the expenses for the year.

It is important for directors to review invoices that either have been received late or expected to come after the condominium corporation's year-end to determine if the work was done prior to the year-end and in that case include the expenses in the same fiscal year.

The accrual method is to ensure the condominium corporation's financial position is accurate.

> Accrual accounting ensures that the recording of an expense incurred in a particular year cannot be avoided by arranging to delay payment until after the year. The reverse is also true where an expense cannot simply be recorded in a year because it was budgeted for it if the condominium did not actually incur the expense. This is the basis for accrual accounting which also eliminated the possibility of manipulation of the financial results.

1.4 Monthly Unaudited Financial Statements

1.4.1 Timing

Monthly unaudited financial statements are usually prepared by the condominium corporation's manager. Typically, these should be submitted for review to the board by the 20th of every month and before the monthly board of directors meeting. All directors should receive a copy. For self-managed condominium corporations, the financial statements would be prepared by the directors or by a bookkeeper monthly.

1.4.2 Involvement of Directors

The unaudited financial statements are prepared by managers or directors / bookkeepers (if self-managed), however they should always be reviewed in depth by the directors. It is important that records are kept monthly by the condominium corporation's managers or directors (if self-managed) and are accurate as they will be the basis for financial decisions made by directors. Therefore, it is important to review statements monthly and identify any errors or omissions, and ensure they are corrected so they do not carry forward to future months. Diligent directors should review the statements in detail and ask questions of the preparer when they become aware of unexplainable variances or other potential errors.

> As a best practice, directors should ensure that inaccuracies or errors within the unaudited financial statements are remedied as soon as possible. If the condominium is managed, the queries should be sent to the accounting department and the directors should expect a response in a timely manner, certainly within the next month.

> If the condominium is self-managed, the queries should be sent to the bookkeeper. If these questions are not addressed, the errors will remain in the financial statements going forward and the directors will be making decisions based on inaccurate internal financial statements. In the extreme, and if the errors do not get corrected before next year's budget has to be prepared, the financial position of the condominium corporation will be worse than it appears.

1.5 Components of the Unaudited Financial Statements

1.5.1 Balance Sheet

Think of the balance sheet as a snapshot of the condominium corporation's financial position at a specific point in time (usually at the end of every month). There are three main sections on a balance sheet.

1. Assets

Assets are items that the condominium corporation owns. Typical examples of assets are:

- Operating and reserve cash in bank accounts
- Investments
- Common expenses fees receivable

- Prepaid expenses
- Capital assets (superintendant suite or guest suite)

2. Liabilities

Liabilities are what the condominium corporation currently owes to its creditors. Typical examples of liabilities are:

- Accounts payables
- Accrued liabilities
- Mortgage payable

3. Fund or net asset accounts

Theoretically, this represents the amount of money that would be returned to the owners of the condominium corporation if it liquidated all its assets and repaid all of its debt.

The basic accounting formula is: Assets – Liabilities = Equity (Net Assets).

There are typically four types of funds or net asset accounts in a condominium corporation's financial statements:

- Operating fund
- Reserve fund
- Contingency fund
- Capital asset fund

1.5.2 Statement of Operations

A statement of operations summarizes the condominium corporation's revenues and expenses for a period of time and typically compares them with the budgeted numbers. If revenues exceed expenses, the result is a surplus. If the expenses exceed the revenues, the result is a deficit.

Here are some procedures that the directors should perform monthly on the statement of operations to ensure the financial statements are accurate and to address potential issues before they become significant:

1. Directors should check if the common expenses fees for the month agree to the budget. A condominium's budget is based on the ownership percentages in Schedule D of the declaration and that always totals to 100%. Therefore, the total

common expenses fees recorded each month should agree to the budget, and if they do not agree, the differences should be investigated. If there is a difference, this could suggest that the amounts being charged monthly to the unit owners for their common expenses fees are incorrect.

2. Directors should also look for any large discrepancies in expense accounts from the prior month, the prior year or in comparison to the budget. If there are large discrepancies, inquiries should be made, as there may be understated, or overstated expenses and adjustment may be needed to correct the financial statements.
3. Look to ensure that there is no credit (negative) balance in the expense accounts. An expense account would normally have a positive balance which indicates the total of that expense incurred for the year to date. Occasionally there are some expense categories such as utilities that the condominium will pay the bulk bill for the common areas and amounts used by the owners in their own units. The condominium will then recover amounts from the unit owners for their personal consumption. If these recoveries exceed the bulk expenses for the period, the entire account becomes negative. In the case of utility recoveries, this negative balance is an early warning sign that there may be problems with the meters and will require the testing of the functioning of the meters. Essentially, they are recovering more from the unit owners than the entire condominium is using including the common areas and this cannot be correct.

1.5.3 Statement of Reserve Fund

A separate reserve fund schedule should be included in the financial statement package. This statement will detail the contributions to the reserve fund and the expenses (major repairs and replacements) that have been charged against the fund.

> Directors should review reserve expenses monthly to ensure the expenses qualify as eligible reserve fund expenditures. If directors are unsure that an expense will qualify, inquiries should be made with the condominium corporation's manager or auditor. Refer to section 4 of this Guide for details as to what expenditures will qualify for this fund.

1.5.4 Statement of Contingency Fund

Directors may want to separate some operating funds. One common example is by creating a contingency fund that is kept aside for emergencies. This can be done by including a separate schedule in the financial statement package. This statement should detail any contributions or withdrawals from the contingency fund.

1.5.5 Statement of Capital Asset Fund

If the condominium corporation has purchased capital assets such as a superintendent's suite, guest suite, vehicle, or other assets, they should be recorded on the statement of financial position. If there is a mortgage or loan against the asset it will be recorded as a liability on the statement of financial position as well. The net amount of the cost of the asset less the corresponding liability will be recorded in the capital asset fund. A separate schedule for this fund should be included in the financial statement package. This statement should detail any purchases of capital assets during the year, amounts transferred into the fund to pay the mortgage and or loan and the corresponding interest paid in that year. If the asset is amortized, the statement will also include the amortization for the year. It is important to note the capital assets are segregated in this fund so that they are separated from operating funds. The net capital asset fund balance is not a cash fund and combining it with the operating funds would mislead owners to believe there is more cash in their surplus than in reality.

1.6 Accounts and Schedules within the Unaudited Financial Statements

1.6.1 Bank Accounts and Bank Reconciliations

A bank reconciliation should be included for each bank account in the monthly financial package. A bank reconciliation is a document that compares the balance in a condominium corporation's bank account with the bank balance in its accounting records at the end of each month. The reconciliation details any differences between the two balances and is an important process to ensure that all bank transactions are recorded and can be an early warning for potential fraudulent activity.

Directors should review monthly bank reconciliations, specifically the outstanding cheque section. Directors should look at the subsequent bank statement and look to see if the outstanding cheques are actually clearing.

If a director has not seen an outstanding cheque clear on a subsequent bank statement, an inquiry should be made as to why it has not been deposited by the vendor yet. This helps address stale dated cheques as well as following up with vendors to ensure they have received payment, and this eliminates the chance that the condominium corporation becomes delinquent with a vendor.

1.6.2 Investment Accounts and Schedules

Investment schedules detail the investments currently owned by the condominium corporation and should be prepared monthly. Included in the schedule will be each of the condominium corporation's investments as well as the interest rate and maturity date.

Directors should compare their condominium corporation's investment schedule to an investment provided by the investment broker or the institution that holds the investments. Bank accounts, along with investments, are typically the largest assets on the statement of financial position and can grow to very significant amounts. If there are investments on the monthly internal statement that are not on the broker statement, it is important that the directors immediately inquire and determine why there is a discrepancy. See Section 2.2 of this Guide for more information regarding investments.

1.6.3 Accounts Receivables (Arrears)

Every month, directors should receive a copy of a common expenses fees receivable listing which will show outstanding owner amounts currently over a 30, 60 and 90-day period.

Directors should monitor the monthly aging report for common expenses fees receivable and ensure that they apply liens within three months to preserve the condominium corporation's lien rights. Often the board of directors choose not to lien the unit for outstanding fees and instead try to be "light-handed" with their collection policy. This policy can lead to losses for the condominium corporation so directors should understand the financial implications of missing the deadline and losing their lien rights.

1.6.4 Accounts Payable and Accrual Listings

Monthly financial packages should include an accounts payable listing and an accrual schedule. As discussed in the accrual accounting section, the expense must be recorded in the period that the expense was incurred. Often, the invoice does not arrive for some time after the work is done or the purchase is received. A payable and accrual listing is where directors can monitor the expenses that have been incurred in the current period but not yet paid.

Not only should directors be reviewing the monthly accounts payables and accrual listings, but they should be reviewing all invoices received after the end of the period. If there are any invoices received for work that was done in the period, they should ensure that they are recorded in the payable or accrual listing. If these are not recorded, they should inquire as to why they are missing and ask to have them added to the listing. This is the most important at year-end to ensure that the expense is recorded in the appropriate fiscal year and included in the audited financial statements.

1.6.5 Budget Variance Report

Included in the financial package may be a budget variance report. This report will detail variances between actual expenses and the budgeted expenses. If there are large discrepancies, this report will include detailed explanations.

The directors should also be reviewing the actual expenses and comparing them to the budgeted amounts. They should obtain explanations for all significant variances so that they can assess if the condominium corporation is staying within its financial plan. This also helps the directors in determining future spending for the remainder of the year and to begin the preparation of the next year's budget.

Directors should note that items like utilities are going to vary significantly from month to month. Hydro amounts will be significantly higher in the summer due to more air conditioning being used but lower in the winter. Gas will be higher in the winter as more heating will be used as opposed to the summer. Many budgets do not account for these seasonal fluctuations and therefore the directors should be aware of this when evaluating year-to-date results.

1.7 Audited Financial Statements

1.7.1 Timing

In addition to monthly financial statements, directors will receive draft audited financial statements to review and approve. This occurs annually after the condominium corporation's fiscal year-end.

1.7.2 Involvement of Directors

It is important to note that the preparation of the annual financial statements is the responsibility of the board of directors, and not the auditors. The auditors will use the financial statements as a basis to perform their duties and then attach their auditor's report.
The directors are presented with and approve the draft audited financial statements. Once approved, the audited statements are sent to the owners in the notice of the annual general meeting (AGM). The audited financial statements are then presented (usually by the auditor or treasurer) to the owners at the AGM.

The auditor's report communicates to the owners if the financial statements are materially correct in accordance with Canadian accounting standards for not-for-profit organizations. See the audit section for more description of the audit.

Directors should review the final unaudited year-end statements in detail before the are sent to the auditors. If there are errors or changes that the directors require, management or the bookkeeper should be asked to make them. These changes should be made before audit begins. Often the directors do not review the financial unaudited statements and consequently, after the auditors complete their work, the directors as for changes. This can result in delays in issuing the final audited financial statements and in some cases can require the AGM to be postponed.

The sections of the audited financial statements will often be similar to those in the monthly unaudited financial statements. It is important to note that the final audited figures may be significantly different due to adjusting entries made during the audit. Usually, audited statements are more condensed than the monthly financial statements, often having various accounts grouped together for presentation purposes.

The following sections are typical in the audited statements:

- Auditor's report
- Statement of financial position
- Statement of revenue and expenses
- Statement of operating fund
- Statement of reserve fund
- Statement of cash flows
- Notes to the financial statements

1.7.3 Auditor's Report

Every audited financial statement will have an auditor's report. The auditor's report is where the auditor will express an opinion on the financial statements and include a statement if the financial statements are not in accordance with the requirements of the Condo Act and the regulations (see audit section for more details).

1.7.4 Statement of Financial Position

The statement of financial position is the same as the balance sheet on the monthly unaudited financial statements. The statement of financial position contains the condominium corporation's assets, liabilities and fund balances as of the fiscal year-end date. See section 1.5.1 of this Guide for more information.

1.7.5 Statement of Revenue and Expenses

As with the statement of operations section in the monthly unaudited financial statements, the statement of revenue and expenses is where you will see the condominium corporation's revenues and operating expenses for the fiscal year. See section 1.5.2 of this Guide for more information.

1.7.6 Statement of Operating Fund

The statement of operating fund is one of the most important sections in the audited financial statements. The statement of operating fund is where we find the condominium corporation's cumulative surplus or deficit position as at the fiscal year-end. If the condominium corporation is in a surplus position, the directors have collected more revenues than operating expenses since the registration of the condominium corporation. If, however, they are in a deficit position, the operating expenses have exceeded the revenues since the registration of the condominium corporation.

An operating surplus can be applied against future common expenses or transferred into the reserve fund at the discretion of the board of directors. It is important to note that the surplus can never be directly distributed back to the owners except on termination of the condominium corporation.

> If the board of directors choose to transfer some of the operational surplus to the reserve fund, it is important that they understand that it cannot be transferred back to the operating surplus. Once in the reserve fund, these monies can only be used for the purpose of the reserve fund (major repairs and replacements of the common elements and assets). Therefore, it is more flexible to leave monies in the operating fund (with no restrictions) and make transfers only when immediately needed in the reserve fund.

If the condominium corporation is in a deficit position, then there are two options to eliminate it. The board of directors can either increase monthly common expenses fees or they can levy a special assessment. Directors should be immediately aware if the condominium corporation falls into a deficit and consider these options above to ensure they can maintain sufficient cash flows.

1.7.7 Statement of Reserve Fund

The statement of reserve fund contains the reserve fund transactions for the fiscal year. The owners' contributions and the interest earned for the year are shown as revenues or additions to the fund and any expenses are deducted before arriving at the final year-end balance.

When reviewing the statement of reserve fund, the directors should compare the actual ending balance with the projected ending balance in their reserve fund plan. Directors should attempt to maintain an actual reserve fund balance close to their projected balance in the notice of future funding. If the balance falls below the projections, the directors should inquire as to why there are differences and consider if they will need additional contributions in the future to support the balance in the reserve fund. For more information regarding the notice of future funding, please see section 4.4.6 of this Guide.

1.7.8 Statement of Cash Flows

The statement of cash flows is standard on all audited financial statements. Directors often find this statement confusing, yet it simply shows the inflows and outflows of cash during the year. The statement can be useful to see the condominium corporation's sources and uses of cash. Examples of this statement would be cash inflows from maturing investments while examples of outflows could be the purchase of assets such as a superintendent's suite.

1.7.9 Notes to the Financial Statement

The notes to the financial statements are where the directors will find items such as a description of the operations of the condominium corporation, and information about the reserve fund study and notice of future funding. The notes also contain information including:

- Related party transactions (amounts paid to directors and officers);
- The condominium corporation's financial commitments;
- The condominium corporation's contingent liabilities (lawsuits);
- Mortgage information;
- Special assessments; and
- Other information required by the regulations.

Directors should review the notes for accuracy and inform the auditor if any information is inaccurate or omitted.

1.8 Differences between Draft and Final Audited Statements

Draft financial statements are for the directors' review only. They should never be sent to the owners or given to any third parties, such as lenders, as they are not complete. They are for the directors to review and approve prior to the AGM. The auditor provides draft statements for the directors to review. Directors should examine the draft audited statements in conjunction with the adjusting entries. The entries will provide a link between the unaudited financial statements and the draft audited statements. Any questions or changes should be addressed with the auditors during this review stage before the final audited financial statements are released.

1.9 Approval Procedures for Draft Audited Statements

Once directors are satisfied with the numbers and details presented in the draft audited financial statements, they can approve the drafts. The directors must approve the draft financial statements, and this is typically completed at a monthly board meeting. As per section 66(4) of the Condo Act, two directors will sign the statement of financial position page which signifies the board's approval. The directors will also be asked to sign a representation letter to the auditors representing that they have provided all required information to the auditors during the audit.

The board should remember that the audited financial statements must be attached to the AGM package that is sent to the owners in accordance with Section 69(1) of the Condo Act. As this AGM package has a mailing deadline, it is essential that the audit is completed and the draft audited financial statements are approved by the directors in time for the auditors to release the final audited statements. Timing can often be very tight and planning for these deadlines is essential.

Owners will expect to have the audited financial statements attached to the AGM package. This is a requirement under section 69(2) of the Condo Act.

The directors should consult their legal representatives if the AGM package was sent out without the audited financial statements attached, as an owner or other interested party could challenge the validity of the meeting. A challenge could cost the condominium corporation significant amounts in legal fees and other costs to reconvene the AGM.

Part 2: Bank Accounts and Investments

The largest asset for most condominium corporations is the money in the condominium's reserve fund, which is typically held either in a bank account or invested in eligible securities. The Condo Act has specific requirements for managing a condominium corporation's bank account, including provisions regarding an account's location and registration. The Condo Act also outlines requirements for investing a condominium corporation's reserve fund money, such as developing an investment plan and detailing which type of investments are permissible.

This section will provide condominium directors with information on how to ensure that all activity related to the condominium corporation's money is in compliance with the provisions of the Condo Act.

2.1 Bank Accounts

2.1.1 Locations

The location of the condominium corporation's bank accounts must be **in Ontario** and at a bank listed under schedule I or II of the *Bank Act,* S.C. 1991, c. 46, a trust corporation, a loan corporation, or a credit union authorized by law to receive money on deposit. Bank accounts cannot be located in an institution outside of Ontario.

2.1.2 Name of Accounts

The bank accounts cannot be in a manager's or board member's personal name. Rather, they must be in the name of the condominium corporation only. There should be at least one bank account for the operating fund and one for the reserve fund. Section 115 (2) of the Condo Act prohibits combining both funds into one account.

2.1.3 Deposit of Monthly Fees

While common expenses fees are initially deposited into the operating fund bank account monthly, the reserve fund portion of the fees should be immediately transferred to the reserve fund bank account. This requirement is often ignored or overlooked, and failure to keep these monies separate is a contravention of section 115(4) of the Condo Act. Ignoring this rule will require the auditors to note the contravention in the auditor’s report.

When a condominium corporation is in an operating deficit and having financial difficulties, directors may be tempted to borrow money from the reserve funds and transfer them to the operating bank account to help with cash flows and payments of the operating expenses. This misuse of the reserve funds is expressly prohibited by section 93(2) of the Condo Act, as one cannot use the reserve fund as a loan even if it is to the operating fund.

If the condominium corporation is having issues with operating deficits, the directors should consider other sources of funding such as increases in common expenses fees, loans, or a potential special assessment.

> The board should ensure that the full reserve monies are transferred to the reserve bank account monthly, and a calculation should be included in the monthly financial package as proof. By doing this calculation, the directors will know immediately if they need to start to investigate sources of additional operating funds.

2.1.4 Condominium Corporation’s Bank Accounts

In some situations, the directors control one or more bank accounts and management will not have access to the monthly statements. In these cases, the bank statements should be given to management so they can update the accounting records monthly.

The directors should forward these monthly bank statements to management to ensure that the accounting records are updated and accurate.

2.1.5 Automatic Payments

Automatic payments are often used to pay for expenses, such as utilities, in order to avoid late payment penalties. As they are automatic, the directors should ensure that the actual monthly payment amounts are the same amount as was billed on the invoices. Directors should also monitor the year-to-date utility expenses to watch for unexpected variances. This will ensure that billing errors or meter malfunctions are discovered at an early stage and allow the utility company to investigate and fix the problem.

> When automatic payments are made and the amounts are widely different to the budget, variances will occur. These types of variances are often overlooked or ignored until the audit is performed. Auditors may request an explanation which will delay the audit. Therefore, as soon as the directors are aware of growing variances there should be inquiries made to determine if the expenses are correct or if there are possible meter malfunctions.

2.2 Investments

Directors are allowed to invest money from both the operating and reserve fund in order to earn additional revenue. However, directors must be cautious when investing money from the operating fund, as this money may be needed at short notice to cover any unexpected operating expenses.

2.2.1 Types of Investments

Section 115(5) of the Condo Act is very restrictive and specific with regards to what types of investments the condominium corporation may have. The objective is to minimize the risk to the owners and protect their savings.

The board may invest in "eligible securities," defined as:

Bond, debenture, guaranteed investment certificate, deposit receipt, deposit note, certificate of deposit, term deposit or another similar instrument that:

- is issued or guaranteed by the Government of Canada or any province or territory of Canada;
- is issued by an institution located in Ontario insured by Canada Deposit Insurance Corporation or the Financial Services Regulatory Authority of Ontario; or
- is a security of a prescribed class.

2.2.2 Government Guaranteed

The first option indicates that if the security is not issued by one of these government entities, it must be fully guaranteed by one of them. There are many investments in Canada that have guarantees but are not government guaranteed and, therefore, are not eligible. The individual who is responsible for choosing the investments must ensure that they understand who is offering the guarantee, and if not directly offered by a government entity listed above, it is not eligible.

There are certain credit unions in provinces other than Ontario that offer 100% guarantees; however, the guarantee is backed by a fund that was created by the province but not contractually guaranteed to support the fund should it fail. In that situation, these credit union guarantees would not qualify as an eligible investment and must be avoided.

2.2.3 Located in Ontario and Insured

The second option is that the security is issued by an institution in Ontario and insured by various insurance plans. There has been much discussion in the condominium sector as to whether or not the purchased security has to remain under the insurance limits. Currently, the Canada Deposit Insurance Corporation insurance limit is $100,000, and the Financial Services Regulatory Authority of Ontario insurance limit is $250,000.

The most conservative approach is to ensure all investments are fully insured within the above limits, considering that the limits include principal and interest. If the directors purchase investments above the insurance limit, they have exposed the condominium corporation and its owners to risk if that institution fails. Directors must ultimately decide how they wish to divide the investments considering the risks discussed above. It is also important to note that some condominium corporations have reserve funds that have grown to many millions of dollars. These condominium corporations may have difficulties finding enough institutions if they choose to try and keep all investments fully insured.

2.2.4 Prescribed Class

The third option is for the security to be of a prescribed class, however, at this time there are no regulations that offer additional types of investments, so the directors are restricted to the two types above.

2.2.5 Name of Investment Account

The investments must be either registered directly in the name of the condominium corporation or held in a segregated account under the name of the condominium corporation by a member of the Investment Dealers Association of Ontario and insured by the Canadian Investor Protection Fund.

2.2.6 Liquidity of the Investments

The operating fund investments have to be convertible to cash within 90 days following the request of the directors while there is no similar conversion requirement for the reserve fund investments. Therefore any, or all, of the reserve funds can be invested in eligible securities and there is no maximum maturity. However, the directors have to still develop an investment plan and consider the need for the funds. For more information regarding investment plans, see section 2.3 of this Guide

> The directors should ensure that they choose an investment advisor that is fully versed in the Condo Act with respect to the allowable investments. There are many investment advisors in the province, however, they do not all have a detailed knowledge of condominium law and choosing the right advisor will avoid the unfortunate situation of purchasing an investment that is not eligible and having a negative comment on the auditor's report.

2.3 Investment Plan

Directors must develop an investment plan before investing any of the money in the condominium corporation's reserve fund account. This plan must be based on the anticipated cash requirements of the reserve fund as set out in the most recent reserve fund study.

There is no guidance as to the format of this report, and therefore, there is no requirement for the directors to pay for a formal elaborate report. At this time, section 115(8) of the Condo Act clearly mandates that the directors look to the reserve fund study which projects the timing of upcoming major repairs and replacements. Before they invest the condominium corporation's money in eligible securities, they would have to ensure that the money is available when the projected repairs are to be made.

> The choice of the maturity date of the investments should be carefully determined in conjunction with the upcoming reserve fund expenditures. Often the directors choose longer-term securities to maximize interest rates. However, directors should be cautious as this can create a cash flow shortage if the money is needed to pay for a repair and the investment has not matured.

Part 3: Annual Budgets

Every owner of a condominium pays common expenses fees. The amount paid by each owner is based on the total amount of funds required for managing the condominium that year, including operating expenses and reserve fund contributions.

Determining the total to assess the owners for the common expenses is one of the most important financial decisions made each year by the board of directors. The condominium directors are required to create a budget, which can be a complex exercise that involves significant planning and research.

This section will describe the process for preparing a condominium corporation's budget. It will also discuss the implications of a budget where the condominium has an operational surplus or deficit.

3.1 Definition

The annual budget is an estimation of revenue and expenses over a one-year period. The annual budget is a formal, detailed, and written plan for how the condominium corporation's funds are going to be generated and spent in the upcoming fiscal year. The annual budget will identify the sources of income and how the board estimates spending this income on the operations and maintenance of the common elements.

> When setting budgets, the board should not be trying to set the budget on a predetermined percentage increase. The budget should be based on realistic expenditures plus the required contribution to the reserve fund. If the amount creates a large percentage increase in the common expenses fees, the board should look to other sources of funds such as operational surpluses that remain from previous years to minimize the percentage increase.

The budget is primarily made up of two sections, an operating and a reserve section. The operating section of the budget deals with all the services and costs related to the operations of the condominium corporation on a day-to-day basis. The reserve section relates to the reserve contribution which is found in the reserve fund study.

When setting the budget, a director should carefully examine the notice of future funding to ensure that the correct reserve fund contributions are used in the document. If the budget contains an amount that is lower than the notice of future funding that was sent to the owners, the auditor will have to report this as a contravention of section 94 of the Condo Act.

3.2 Contributions

The Section 84(1) of the Condo Act requires each owner to contribute to the common expenses in the proportions specified in the declaration. The common expenses fees for each unit are calculated by multiplying the total annual budget by the percentage allocated to that unit for common expenses as per schedule D of the declaration.

EXAMPLE

The fee is calculated as follows: if the total common expense fees is \$100,000 and the percentage for a specific unit is 6%, then the annual fees for that unit will be \$100,000 × 6% = \$6,000 per year. The \$6,000 can then be divided by 12 to calculate the monthly common expenses fees. \$6,000 ÷ 12 = \$500 per month.

3.3 Purpose of Budgets

3.3.1 Meet Financial Obligations

The main purpose of a budget is to ensure that the condominium corporation can meet all of its financial needs (operating expenses and reserve contribution) for the year that the budget has been prepared.

If a condominium corporation is in a deficit, the board should consider the use of budgeting to help eliminate the deficit by budgeting for a surplus. This would entail charging more in common expenses fees than what is required to pay for the total operational expenses and the reserve fund contribution for the year. The remaining amount would be a surplus and would be directly applied to reduce the deficit. If this is not acceptable to the board because the increase in common expenses fees will be too high, they can always consider a special assessment.

Commonly the board will budget for a deficit while in this situation and this is not advisable as the condominium corporation will go into a larger deficit. Eventually they will not be able to pay their operating expenses and will be forced to find other sources of funds to eliminate or reduce the deficit.

3.3.2 Communication to the Owners

The budget is also an important tool for communicating with the owners and to project the financial needs of the condominium corporation for the upcoming year. The budget package is the document that provides the owners with the calculation of their common expenses fees for the coming year and details of any increases.

> As the common expenses fees are of significance to the owners, it is vital that the board provides clear and detailed information regarding the budget and potential increases well in advance of the year-end. If the increase is substantial, it is recommended that the board schedule an owners' meeting to explain the budget and allow the owners to ask questions. Sending out a budget with large increases at the last moment will shock the owners and will cause feelings of resentment towards the board.

3.4 Types of Budgets

- **First year budget** – an initial budget prepared by the declarant for the first year of operation.
- **Annual budget** – prepared for the second year and each subsequent year. This is usually prepared by management for the board's approval or by the board themselves if they are self-managed.
- **Amended budget** – a budget that is prepared at any time throughout the year due to a change in financial circumstances such as unexpected expenditures. If amended, the budget must be sent to the owners.
- **Reserve fund budget** – often this budget is prepared to show the contribution to the reserve fund and the anticipated reserve fund expenditures for the next year.

3.5 First Year Budget Guarantee

The first-year budget is prepared by the declarant. Section 75 of the Condo Act provides protection to the owners by requiring the declarant to repay the shortfall to the condominium corporation if the declarant's budget is insufficient to pay for the actual expenses for the first year.

After the board receives the audited financial statement for the first year they should consider if there is a deficit in the statement of operations. If there is a deficit, they must send a copy of the audited financial statements along with a notice to the declarant, within 30 days, to repay the deficit to the condominium corporation. The declarant must pay the amount to the condominium corporation within 30 days of receiving the notice.

> Section 75 of the Condo Act guarantees protection for the owners for the cost of expenses anticipated in the first-year budget. It does not however provide a guarantee for discretionary expenses that the board may choose to incur that were not anticipated in the first-year budget. The board should consider this when making spending decisions in the first year and when submitting the notice to the declarant if they should have a deficit at the end of the first year. Often the directors will have to negotiate if the declarant believes that there are discretionary expenses included in the deficit.

3.6 Planning and Calculations

This budget process normally begins in the last quarter of the condominium corporation's fiscal year. The directors receive a preliminary budget prepared by management (if managed) or prepare one themselves (if self-managed) prior to the budget meeting.

Once the budget is distributed, a budget meeting is held to review the document line by line. The budget is either approved or is sent for changes and may go through multiple reviews before being finalized.

It is important that, when calculating the budget, realistic estimates of all income and expenses are used. Often boards will set an unrealistically low budget for expenditures to minimize the common expenses fees. This practice will usually result in a deficit when the actual results are calculated at the end of the year. This is also not consistent with adhering to the board's "duty of care" requirements.

3.6.1 Timing

Timing of the budget is very important as this sets the common expenses fees for the following year and needs to be communicated to the owners to ensure that the new fees can be collected on time.

If the budget is delayed and released too late, the condominium corporation will continue to collect the previous year's fees, and this will immediately impact the financial results of the new year. Often, they will have to ask the owners for an adjustment to make up for the under collected fees and this causes many logistical problems.

3.7 Deficit and Surplus Budgets

3.7.1 Deficit Budget

A deficit budget is a budget where the expenses will be higher than the revenues for the year. These are created when the condominium corporation has carry-forward surpluses and the board decides to use some of the surplus against the current year's budget. This can be a useful technique to minimize an increase in common expenses fees.

Section 84(2) states that the surplus in a condominium corporation can only be applied against future common expenses fees or transferred to the reserve fund. If a board chooses to maintain a surplus, they must always consider how much is needed for working capital and then consider the requirement above. If they maintain a very large surplus, they must have an explanation for this to disclose to the owners if asked.

3.7.2 Surplus Budget

A surplus budget is a budget where the revenues are higher than the expenses for the year. Surplus budgets are created if the condominium corporation wants to recover past years' deficits by collecting more common expenses fees from the owners than the anticipated expenses.

3.7.3 Special Assessments

In a situation where the deficit has grown to an uncontrollable level or the condominium corporation has incurred unexpected operating expenditures, the board of directors can levy a special assessment. A special assessment can also be levied if the reserve fund is lower than required and needs to be increased to reach an adequate level of funding. A special assessment may be collected from the owners in one payment or a series of payments over a period of time.

Communication with the owners is vital if the board is intending on levying a special assessment. This amount due from the owners will be in addition to their monthly common expenses fees and the board should provide full details of the special assessment. Once again, the board should consider calling a meeting of the owners to explain the reason for the special assessment and, at minimum, provide the owners a forum to ask questions in advance of the payment due date.

3.8 Identifying Elements of the Budget

It is important to identify all the elements of income and expenses when preparing the budget. Typically, a condominium corporation budget can be broken down as follows and may vary slightly depending on the composition of each condominium corporation.

3.8.1 Revenue

The main source of revenue in any condominium corporation is the common expenses fees collected from the owners. Other sources can vary but some of the more typical revenues are interest income, guest suite rental income, party room rental income and roof rental income for telecommunications antennas.

3.8.2 Expenses

- **Reserve contribution** – this is the amount for the current year’s contribution to the reserve fund that is obtained from the notice of future funding. Since it is obtained from the notice of future funding it is a fixed component of the budget.

- **Service and maintenance contracts** - these contracts are typically signed for multiple years so the amount for each contract is readily available and thus these expenses can be categorized as fixed in nature.

> Contracts are normally signed for multiple years and therefore the cost is available when budgeting. If a contract is coming up for renewal during the budget process, the changes in contract should be addressed to avoid under or over-budgeting. Some of the examples for these contracts are air conditioning and heating, elevator, management and cleaning.

- **Repairs and maintenance** – these are expenses not covered by the service and maintenance contracts. Examples of these expenses would be air conditioning and heating repairs, supplies, fire and safety repairs, garage, landscaping, snow removal, repairs, and waste removal. These expenses are typically variable in nature.

- **Utilities** – these are variable as they are based on consumption as well as market pricing unless a fixed contract is signed.

Utilities are typically a very significant portion of the budget and in some cases are more than 40% of the total budgeted expenditures. As this is a variable cost, it is important that particular attention be given to the determination of the budget for these costs. A variance at the end of the fiscal year in the utility expenditures can cause a large, unexpected deficit if the budget was set too low.

- **On-site personnel** – these are usually the concierge or cleaning staff and can be direct employees or they can be contracted out to separate companies. These are usually a fixed cost. If they are direct employees, the budget should include all of the payroll taxes and benefits such as Canada Pension Plan, Employment Insurance and health plan premiums.

- **Administration** – these are typically audit fees, telephone and insurance premiums which are fixed in nature. Consulting, legal fees, office expenses and meeting costs tend to be variable in nature.

- **Recreational facilities** – these are swimming pool repairs, guest suite repairs, fitness equipment repairs, party room repairs and are normally variable in nature.

- **Shared facilities** – if the condominium corporation is a party to a shared facilities agreement, a shared facilities' budget would normally be prepared. This budget should be obtained to ensure that the correct amount is entered into the condominium corporation's budget and the monthly contribution to the shared facilities is typically a fixed cost.

Part 4: Reserve Funds and Reserve Fund Studies

The Condo Act requires that the board of directors maintain a reserve fund at all times. A reserve fund is a contingency plan for ensuring that the necessary funds are available if required for financing the major repair or replacement of the common elements or assets of the condominium corporation. The Condo Act requires that a reserve fund study be conducted periodically by a specialist to ensure that there are sufficient funds set aside for future repairs and replacements.

This section will provide directors with information on how to create and sufficiently fund a condominium's reserve fund in accordance with the Condo Act.

4.1 Reserve Fund Definition

The reserve fund for major repairs and replacements is a distinct fund that a condominium corporation must maintain as per section 93(1) of the Condo Act.

4.2 Purpose of the Reserve Fund

The reserve fund shall be used solely for major repair and replacement of the common elements and assets of the condominium corporation.

A reserve fund in a condominium corporation can be likened to a savings account for a homeowner. A part of the overall budget must be contributed to the reserve fund so that the condominium corporation has the resources to pay for any major repairs and replacements of the common elements and assets. However, unlike a homeowner, it is not an optional contribution, it is mandatory. See the section on contributions to the reserve fund below.

Unlike the general operating fund in a condominium corporation (which is unrestricted), only major repair and replacement of common elements can be charged to the reserve fund (for more information please see section 4.6 of this Guide).

4.3 Contributions to the Reserve Fund

The condominium corporation shall collect contributions to the reserve fund from the owners as part of the contributions to the common expenses. These contributions must be deposited to the reserve fund bank account in accordance with section 115(4) of the Condo Act.

> The common expenses fees are collected each month from the unit owners and deposited into the operating bank account. At this time, a transfer from the operating bank account to the reserve bank account should be made for the reserve fund portion to comply with the law noted above.

4.3.1 Contributions for First Year

For the first year of operations of the condominium corporation, the declarant is responsible for preparing the budget and establishing the contribution to the reserve fund. The contributions should provide sufficient funds for the major repair and replacement of the common elements and assets of the condominium corporation. However, for the first year, the contribution should not be less than 10% of the budgeted amount required for the contributions to the common expenses exclusive of the reserve fund, as required by sections 93(5) and (6) of the Condo Act.

> It is common practice for a declarant to set the contribution to the reserve fund for the first year at 10% of the budgeted expenditures with the assumption that this is the minimum, but this is often not enough. The Condo Act mandates that the contribution be sufficient for the major repair and replacements and many declarants are now using a higher percentage such as 15% or higher, for the first-year budget.

4.3.2 Contributions for Subsequent Years

Starting in the second year of a condominium corporation, the board is responsible for preparing the budget and determining what portion of the common expenses fees collected from the owners will be transferred to the reserve fund. Again, it is the obligation of the board to budget for contributions to the reserve fund that will be sufficient for the major repair and replacement of the common elements and assets of the condominium corporation.

4.4. Reserve Fund Study

4.4.1 Definition

The reserve fund study is a report compiled by a qualified reserve fund study provider and the Condo Act prescribes who can qualify as a reserve fund study provider. The study considers the common elements and assets of the condominium corporation and provides an estimate of the future cost to repair and replace those items. The study is a projection that usually takes place over a period of 30 years.

As well as providing an estimate of the costs of the future repair and replacements, the study contains a table which will recommend the annual contribution to the reserve fund that will ensure sufficient funds are always available to cover those costs.

The study will also contain assumptions regarding inflation rates and interest rates which will affect the annual balance and the contributions required.

4.4.2 Types of Reserve Fund Studies

The first type of study each condominium corporation is required to have completed is referred to as a comprehensive, or **class 1** study. This requires the providers to physically visit the property to examine the common elements and assets as well as verification of records and conduct interviews with the directors, employees and agents of the condominium corporation. This study establishes a 30-year timeline to be used for the projections.

There are two types of updated studies referred to as **class 2** and **class 3** studies.

A **class 2** reserve fund study update includes a site visit and includes many of the requirements of the comprehensive study.

A **class 3** reserve fund study does **not** include a site visit but does involve verification of records and interviews with the directors, employees and agents of the condominium corporation.

The condominium corporation would be required to conduct a class 3 study if the preceding study was a class 1 or class 2 study. The condominium corporation would be required to conduct a class 2 study if the preceding study was a class 3 study. Essentially after the first class 1 study is done, the class 3 and 2 studies are done alternatively at least every three years.

> The board should ensure that the correct class of reserve fund study is commissioned when the updates are required. If the wrong class is prepared, the auditors will have to report the contravention in the auditor’s report.

4.4.3 Timing of the Reserve Fund Study

The first reserve fund study must be completed within the first year after registration. After the first study is completed, the future studies must be done at least every three years.

> The board should ensure that they plan and arrange to complete the reserve fund updates within the deadlines. If the update is not completed in time to meet the deadline, the auditors will have to report the contravention in the auditor’s report.

4.4.4 Reserve Fund Study Review

Once the reserve fund study provider has completed their report, they will present it to the board to review and approve the plan. There will be various cash flow scenarios that are offered for the board to decide upon. Directors should meet with the provider and management (if applicable) to discuss the funding plan and the projected expenditures. This is the time that the directors must ensure they have a clear understanding of the plan, especially the annual contributions to the reserve fund which will need to be included in the annual budget.

When directors are reviewing the reserve fund study report with the provider, it is important to make sure that opening balances of the reserve fund that are used in the study correspond to the most recent balance as per the audited financial statements.

It is also important to ensure that the provider considers all projects that the board is anticipating in the next few years. If the reserve fund study is missing upcoming expenditures, the actual expenditures will exceed the projected expenditures and the funding plan will be insufficient.

4.4.5 Plan for Future Funding

Within 120 days of receiving the reserve fund study from the reserve fund study provider, directors must review it and propose a plan for the future funding of the reserve fund that the board determines will ensure that the fund will be adequate for the purposes for which it was established. A very important part of this requirement is for the plan to ensure that the fund will be adequate.

For more information regarding adequacy of funding, see section 4.4.8 of this Guide.

> It is very important for directors to understand that they have the power to choose a funding plan that is different from the funding plan as recommended by the provider. It is equally important for directors to understand that if they choose to disregard the provider's plan, they must ensure the fund will achieve the requirement of adequacy. It is rare for a board to create their own plan as boards will usually rely on the recommendations of the provider.

4.4.6 Notice of Future Funding

Within 15 days of proposing a plan, the board must send the owners the notice of future funding of the reserve fund. If the board chooses a funding plan that differs from the reserve fund study provider's funding plan, the notice must include a statement that indicates the areas, if any, in which the proposed plan differs. This statement must be clear regarding the fact that directors decided to stray from the advice of the professional reserve fund study provider. It is also a requirement that the notice of future funding be sent to the auditors of the condominium corporation.

4.4.7 Contents of the Notice of Future Funding

This form contains the opening balance of the reserve fund for each year, the required contribution for the year, an estimate of the interest earned on reserve fund assets, an estimate of the anticipated expenditures for the year and an estimated final balance. The reserve fund study provider has to include assumptions about interest that will be earned on the reserve fund investments and also assumptions about the inflation rates over the period of the study.

4.4.8 Adequacy of Funding

It is a requirement that the reserve fund be adequate by the end of the second year after registration of the condominium corporation. Currently, there is no definition of adequate in the Condo Act. There are various definitions of adequate that are currently being used in the industry. The directors will have to consult their reserve fund study provider, legal representatives, and auditors to discuss and ensure that they have chosen a funding plan that is acceptable and will be in accordance with this requirement.

4.4.9 Additional Contributions

In the three-year period between reserve fund study updates, the board may feel that the reserve fund balance has declined to a lower than desirable balance due to additional or unexpected expenditures. The board can choose to transfer any amounts from the operating surplus to the reserve fund.

If the board decides to make an additional contribution to the reserve fund from the operating surplus it should ensure that the money is transferred from the operating fund bank account to the reserve fund bank account. Often a decision is made to make a motion at a board meeting, but the actual cash is not physically transferred to the reserve fund bank account. This causes the reserve fund assets to be understated and in turn the condominium corporation is in contravention of section 115(4) of the Condo Act.

4.4.10 Reducing Contributions

In the three-year period between reserve fund study updates, the board may determine that the reserve fund balance is higher than the balance projected in the reserve fund plan due to expenditures that cost less than expected or projects that were budgeted in the present year but were postponed because they were not required.

A situation may arise whereby the current reserve fund study and the notice of future funding has been issued to the owners detailing what the future contributions into the reserve fund will be. The board realizes that the actual balance of the reserve fund is much greater than the amount that the reserve fund study is calling for and would like to reduce the contribution to the reserve fund for that year.

The concern is that all owners have received a copy of the notice of future funding, which is showing what the board has committed to contribute each year. If the board chooses to reduce the contribution without informing the owners, it will result in a qualification in the auditor’s report.

The only way to avoid this is to go back to the reserve fund study provider and request a reduction in the reserve fund contribution for the year. A new reserve fund study would have to be prepared with a revised contribution. They would then have to issue a new notice of future funding to the owners.

4.4.11 Cash Flow

The reserve fund study is also a good tool for determining how to invest the reserve funds of the condominium corporation. The study will be a timeline for directors to plan when major projects will be conducted and to ensure they have the cash to pay for them. Based on the reserve fund study, the board can determine the length of time they would like to invest the reserve funds and whether more funds should be held in cash, or if they should be invested for a longer term at a higher interest rate.

EXAMPLE

In this scenario, a condominium corporation has a total of $1,000,000 in investments and very little cash. The investments are all in GIC’s and are coming due this month. Interest rates are not good for one and two-year terms, so the board decides to invest the entire $1,000,000 in five-year term GIC’s to earn the best interest rate.

The problem with this plan is that the condominium corporation has a major project coming up next year which will cost the condominium corporation $500,000, and now that most of the funds have been locked in for a five-year term, the condominium corporation will not have the funds available to complete the project. It is important to remember that it is the board’s responsibility to know the cash flow requirements of the reserve fund and invest accordingly.

4.5 Income

4.5.1 Interest

As previously mentioned, each condominium corporation is required to maintain a separate bank account for the reserve fund cash, or a separate broker account for reserve fund investments. If the bank account earns interest, this interest must be kept in the reserve fund. All interest earned on any reserve fund investments must also be paid into the reserve fund.

4.5.2 Rebates

On occasion, there may be rebates earned when certain common elements or assets are replaced or upgraded. These may be energy rebates, or incentive rebates. If the cost of a project that initiated this rebate was charged to the reserve fund, the corresponding rebate earned must also be recorded in the reserve fund.

EXAMPLE

In this scenario, a condominium corporation has conducted a lighting retrofit in the building and has charged the project to the reserve fund. A rebate from the hydro provider was given to the condominium corporation for installing this energy-efficient equipment.

The condominium corporation is currently in a deficit position in the operating fund, so when this rebate is received, the board decides to deposit the rebate into the operating fund to help offset the deficit.

As the lighting retrofit was a reserve fund project and the rebate was a direct result of the project, the rebate must be recorded in the reserve fund and be deposited into the reserve fund bank account. If the rebate remains in the operating fund, the auditor will be required to include a contravention in the auditor’s report, as required by section 67(4) of the Condo Act.

4.5.3 Special Assessments

If the board feels that the reserve fund is underfunded and the condominium corporation does not have a surplus in the operating fund, it is in their power to levy a special assessment to the owners. Each unit owner would be assessed based on their ownership percentage, just as they are for their monthly common expenses fees.

4.5.4 Loans

If the board feels that the reserve fund is underfunded, and the condominium corporation does not have a surplus in the operating fund and the board does not wish to levy a special assessment to the owners, it is possible to secure a loan for an additional contribution into the reserve fund. To secure a loan, the condominium corporation must have a borrowing by-law in place which must be voted on by the owners.

4.6 Expenditures

Section 93 (2) of the Condo Act confirms that the reserve fund shall be used solely for major repair and replacements of the common elements and assets of the condominium corporation. While there is no specific definition of a major repair or replacement, there are generally accepted industry standards.

Operating expenditures such as monthly maintenance contracts, general repairs, utilities, or administration costs must be charged to the operating fund and never to the reserve fund.

There is no threshold for what constitutes a major repair currently. However, the intended purpose of the reserve fund is to fund the larger repair or replacement of the common elements and assets. The board should consider the size of their condominium corporation and develop a plan for what they consider a major repair.

> If the board has a project and they are not sure if it qualifies as an eligible reserve fund expenditure, they should contact their auditor to confirm the treatment. The board does not require the consent of the owners to make an expenditure out of the reserve fund as per section 95(2) of the Condo Act.

Part 5: Audits and Auditors

Condominium corporations are required to have an auditor appointed by the owners at each annual general meeting. A condominium auditor conducts an audit on an annual basis, through which the auditor determines whether the condominium corporation’s financial statements are materially accurate. An auditor will also ensure that the financial statements comply with the requirements in the Condo Act for audited financial statements.

This section will explain the purpose of an auditor and details regarding their obligations in conducting an annual audit.

5.1 Definitions

General and useful terms and concepts for board members:

- Audited Financial Statements
    - The audited financial statements are financial statements which have been examined by an independent auditor who is licensed to practice public accounting in the province of Ontario, who has issued an opinion on the financial statements.
- Independence
    - Independence is a fundamental requirement for an auditor. An auditor must be independent in fact and in appearance. Independent in fact implies that the auditor has no interests in the condominium corporation other than the audit. Independence in appearance implies that the auditor avoids situations to be perceived as having a relationship with the condominium corporation in any other capacity, such as an advisory capacity or providing other services.
    - The Condo Act clearly states that no director, condominium management company, or anyone who has a financial interest in the condominium corporation shall be appointed as an auditor of the condominium corporation.
- Materiality
    - Materiality is the amount in the financial statements that a reasonable intended user would consider to be significant to the condominium corporation. A material error would be so significant that it would affect a user’s financial decisions regarding the condominium corporation. Auditors use materiality to help guide their work to the most important and critical audit matters.
    - The ultimate goal of the auditors is to ensure that the audited financial statements are materially correct. These include the owners, board of directors, the condominium management company, Canada Revenue Agency and potential lenders of large enough amounts that they have the power to demand the audited financial statements.
- Expectation gap

- An expectation gap arises when the intended user’s perception of what are the auditor’s duties differs from what are the auditor’s professional responsibilities.
- In practice, the expectation gap results from the intended users not reading the entire audit report. The audit report clearly defines what are the auditor’s duties and obligations.
- Importantly, audits and auditors should not be viewed or perceived as an insurance policy against fraud. The purpose of the audit is to ensure that the condominium corporation is following the applicable financial reporting framework, the amounts in the financial statements in all material aspects are fairly reported, and that the financial requirements under the Condo Act are being followed.
- To avoid expectation gaps users should read the entire audit report.

5.2 Requirements

As required by the Condo Act all condominium corporations must appoint an auditor at the first meeting of owners and the appointed auditors will continue to be the auditors until the next AGM.

The only exception to this rule occurs when:

- The condominium corporation has less than 25 units;
- The condominium corporation has held a turn-over meeting; and
- All owners provide written consent to forgo the audit requirement.

> If the owners of a condominium corporation with less than 25 units intend to waive the audit requirement, it is important to ensure that written consent is obtained from each owner. If even one unit owner refuses to sign the waiver, the audit must proceed.

5.3 Purpose and Benefits of an Audit

The purpose of an audit of the condominium corporation’s financial statements is to provide assurance to the intended users that the audited financial statements are materially correct.

In accordance with section 67(4) of the Condo Act, an audit of the financial statements will also determine whether or not the condominium corporation is complying with or has contravened any of the Condo Act’s financial requirements.

The audit will provide many inherent benefits to directors, including adjusting entries to comply with the financial reporting framework and the Condo Act's financial requirements. Directors should carefully review and make inquiries to the auditor and, if applicable, their condominium management to understand these entries and their impact to the condominium corporation.

The audit will also identify areas where the directors, if they desire, could implement internal control systems to further elevate their level of active involvement over the day-to-day management of the condominium corporation.

Adjustments and contraventions are also important for evaluating the condominium management company's ability to follow the Condo Act requirements.

5.4 Selection, Appointment and Replacement of Auditors

Auditors or audit firms are required to have a licence to practice public accounting in the Province of Ontario. Auditors are required to maintain their independence from the condominium corporation throughout the period under audit.

Condominium corporation audits should not be viewed as a commodity such as a simple purchase of office supplies. The audit is a very important requirement and is included in the Condo Act to protect the owners. Not all auditors or audit firms are familiar with the specific requirements under the Condo Act meaning that auditor experience and expertise is critical as condominium corporations become more complex.

Owners and directors should carefully consider the audit nominees' experience, qualifications, and expertise with condominium corporation audits prior to voting for the auditor at the AGM. This is critical to ensuring that the most suitable auditor for the condominium corporation is appointed.

Once an auditor has been appointed, they will remain as the auditor of the condominium corporation until such a time when the auditor resigns or is replaced by a vote of the owners at an AGM or at a special meeting of owners.

The owners appoint their auditor for the next year at the AGM. Usually, the incumbent auditor is proposed to be reappointed unless the board recommends a change in auditor to the owners. Additionally, any owner can nominate a replacement auditor if the nomination occurs in response to the preliminary notice of meeting sent to all owners. The proposed auditor and the incumbent auditor will then stand for appointment at the AGM to be voted on by the owners.

Owners cannot pass a motion at the AGM to allow the board of directors to choose the auditor at a future date. If an auditor is not appointed by the owners at the AGM, the existing auditor remains in that position until the next AGM or until they appoint a successor (at another duly called owners' meeting).

During the year, the auditor can be replaced by the owners at a meeting called specifically for that purpose. The auditor must be given 30 days written notice prior to the mailing of the formal notice which is sent to the owners at least 15 days before the owners' meeting. The notice to the auditor must include the reason for their removal and a copy of all material that is proposed to be sent to the owners in connection with the meeting. The auditor has the right to make written representations to the owners which must be included in the notice of meeting.

Auditors are entitled to attend any meeting of owners and are entitled to speak on any matter of business relating to and impacting the audit and their position as the auditor.

Auditors have the right at all times to access all records, documents and accounts of the condominium corporation. The auditor is also entitled to all information and explanations from the directors, officers, or employees of the condominium corporation as well as any condominium managers or condominium management companies under contract with the condominium corporation that the auditor deems necessary to facilitate the audit.

It is important that accurate records are kept for the purpose of facilitating the annual audit and provide them when asked by the auditor. If proper recordkeeping is not done, it may delay the completion of the audit, which could then delay the AGM. It could also result in obtaining an undesirable audit opinion.

5.5 Audit Involvement

An audit is a process requiring involvement from many different parties, including but not limited to, the following:

- Board of directors
- Bank
- Legal counsel
- Condominium management company representatives including accountant and property manager (if applicable)
- Investment advisor (if applicable)

The board is responsible for signing documents required for the completion of the audit, including, but not limited to, the following:

- Audit engagement letter
- General representation letter
- Various tax return documents
- Audited financial statements
- Confirmations such as:
    - Bank confirmation
    - Investment confirmation
    - Loan confirmation
    - Legal confirmation

Directors are required to provide information requested by the auditor, as they are responsible for governing the condominium corporation. If the condominium corporation uses a condominium management company, the management company will be required to provide the auditor with all information requested in a timely manner to facilitate completion of the audit in time for the AGM deadline.

The condominium corporation's bank will provide a balance confirmation to the auditor, thereby confirming the condominium corporation's bank account balances, any loan balances, and any investments, as at the specified year-end date.

The condominium corporation's legal counsel may provide a confirmation disclosing any known legal claims the condominium corporation is party to.

5.6 Timing of the Audit

The majority of the audit work occurs after the condominium corporation's year-end. Certain audit items, such as confirmations, take time for banks, investment advisors, and legal counsel to compile and send to the auditors. It also takes time for the condominium corporation to record year-end items such as liability accruals (items completed during the fiscal year, but not invoiced until after year-end).

It is imperative that when scheduling the audit, consideration is given to the following:

- Time for the condominium management company or the condominium corporation's bookkeeper to close the condominium corporation's books and prepare the books and records for the auditor;

- Time for the auditor to complete the audit, including time for completion and return of various audit confirmations from external parties;
- Time for the directors to review, meet and provide approval of the draft financial statements and the adjusting audit entries;
- Time for directors and the auditors to finalize any other adjustments to the final statements; and
- Time for scheduling the AGM;
    - The Condo Act Section 47 (1) requires the board to provide a preliminary notice of meeting to the owners at least 20 days before the final notice is sent; and
    - The Condo Act requires the audited financial statements to be attached to the final AGM package which is required to be sent to the owners at least 15 days prior to the meeting.

If the board is requesting the auditor to attend the AGM, it is imperative that the auditor is given as much advanced warning as possible so they can reserve the date and time. Often, the condominium management or the board may overlook giving advanced notice to the auditor, resulting in the auditor being busy on the day of the AGM. It is best practice to contact the auditor as soon as the board has chosen the AGM date.

5.7 Audit Procedures

The auditor will perform audit work on the statement of financial position, statement of operations, statement of reserve fund, statement of cash flows, and the notes to the financial statements.

The auditor will perform the majority of their audit work on the statements of financial position and operations.

Procedures the auditor performs may include the following, but are not limited to:

- Confirming bank balances, debt balances, investment balances;
- Examining the collection of receivable balances;
- Examining capital assets balances;
- Examining and confirming liabilities;
- Examining fund balances;
- Inspecting capital projects;
- Examining revenue streams and sources; and
- Examining operating expenses and nature and eligibility of reserve fund expenses.

5.8 Audit Outcomes and Implications

Once the auditor has completed the audit, draft audited financial statements will be provided to the directors for their review and approval.

It is critical that all directors read the audit report, notes to the financial statements, and perform a detailed review of the items provided by the auditor. The audit report and notes will also contain any financial contraventions to the Condo Act.

When an auditor is able to determine that the financial statements are free from material misstatement and there are no additional matters to discuss, the audit opinion will be unmodified. An unmodified opinion confirms that the financial statements are accurate with no material differences.

An unmodified opinion is desirable as it ensures that the condominium corporation complies with the financial reporting framework and complies with the financial requirements in the Condo Act.

In situations when the auditor is unable to determine the financial statements are free from material misstatement the opinion will be modified in the following forms:

- **Qualified Opinion** – A qualified opinion occurs when the auditor has obtained sufficient and appropriate audit evidence to conclude that there is a misstatement individually or in the aggregate that is material, but not pervasive to the financial statements. This means that the misstatement is limited in scope and not throughout the entire statements.

- **Adverse Opinion** – An adverse opinion occurs when the auditor has obtained sufficient and appropriate audit evidence to conclude that there is a material misstatement individually or in the aggregate that is material and pervasive to the financial statements. This means that the misstatements are throughout the entire statements.

- **Disclaimer of Opinion** – A disclaimer of opinion occurs when the auditor is unable to obtain sufficient and appropriate audit evidence on which to base an opinion and that the effect could be material throughout the statements. This means that the auditor was unable to get the information required to issue an opinion.

The implications of modified opinions can be severe for condominium corporations.

> If a condominium corporation has a modified opinion, in any form, it can significantly impact the owners' ability to sell their units, potentially impacting the owners' personal equity in the property.

5.9 Contraventions

Section 67(4) of the Condo Act requires that the auditor include statements in their report that they consider necessary if the condominium corporation's financial statements are not in accordance with the requirements of the Condo Act and the regulations. Therefore, a secondary objective of the audit would be that any financial contraventions of the Condo Act be identified and disclosed in the audit report and in the notes to the financial statements.

In order for the condominium corporation to be in compliance with the Condo Act, the conditions below must be met. If any one of the conditions is not met, the condominium corporation is in contravention to the Condo Act, and the related contravention will be disclosed in the audit report.

- The condominium corporation must have at least two bank accounts, one designated as an operating account and one designated as a reserve account. For more information regarding investments, see section 2.2 of this Guide;
- The bank accounts must be in the name of the condominium corporation;
- Bank accounts must be held at eligible institutions located in Ontario;
- Owners' assessments must not be commingled prior to being deposited into a bank account in the name of the condominium corporation. This means that the common expenses fees for a condominium corporation cannot be combined with common expenses fees of another condominium corporation;
- Investments must be eligible;
- Operating investments must be convertible to cash within 90 days of the request;
- Total reserve cash, reserve investments, reserve interest receivable, minus any reserve liabilities must be equal to or greater than the reserve fund balance;
- The actual reserve fund allocation for the year must be at least the amount that was stated in the notice of future funding that was issued to the owners;
- The condominium corporation must have an investment plan for reserve fund money;
- Reserve fund studies must be updated at least every three years. For more information regarding reserve fund studies, please see section 4.4. of this Guide.

- Future reserve fund allocations in the notice of future funding of the reserve fund must be sufficient so that the balance at any year-end is adequate;
- Reserve fund expenses must qualify as major repairs or replacements;
- The condominium corporation must pass a by-law prior to paying remuneration to directors and officers and the by-law may not exceed three years; and
- The condominium corporation must pass a borrowing by-law prior to incurring any debts.

It is imperative for directors of the condominium corporation to understand the potential outcomes and implications of these contraventions for themselves and the owners of the condominium corporation.

Part 6: Taxes

Although a condominium corporation is a non-profit organization, there are still requirements for collecting taxes and filing various tax returns. There are often penalties and interest incurred if these tasks are not properly completed.

This section will provide directors with guidance on collecting taxes and filing tax returns for their respective condominium corporations.

6.1 Income Tax Status

Condominium corporations are non-profit organizations in accordance with the *Income Tax Act* (R.S.C, 1985, c.1) and therefore do not pay income taxes on their common expenses fees collected from the owners. There are, however, various types of income that are not tax exempt and cause a potential issue with the Canada Revenue Agency. Income such as guest suite rentals, party room rentals and rooftop rentals for telecommunication equipment are not tax exempt. Condominium corporations earning these types of income should consult with their auditor to determine implications.

The Canada Revenue Agency has conducted a project where they made inquiries into all non-profit organizations to see if they were earning these taxable types of revenues. Condominium corporations were included in the project, and many issued warning letters that specifically addressed the fact that these types of revenues were not tax exempt and should not have been earned by the organization. Consult with your auditor to discuss the tax implications of any revenue sources.

6.2 Filing Requirements

While the condominium corporations are non-profit organizations, they are also corporations and as such, must file annual corporation tax returns. The filing deadline is six months after the year-end, and this is usually done by the auditors. The penalty for late filing this return is 5% of the unpaid taxes. Given that condominium corporations do not usually pay any tax, the penalty will rarely apply, however the filing requirement still exists for every year that the condominium corporation is in existence.

There is another required tax form known as the T-1044 non-profit organization (NPO) information return that must be filed by condominium corporations under certain circumstance as follows:

- It received or is entitled to receive taxable dividends, interest rentals, or royalties totalling more than $10,000 in the fiscal period;
- It owned assets valued at more than $200,000 at the end of the preceding fiscal period; or
- It had to file an NPO information return for a previous fiscal period.

The penalty for late filing this return is $25 per day up to a maximum of $2,500 for each year it missed filing.

Many directors have discovered that this form was required due to the size tests above and were not filed. In these cases, it is imperative that directors seek the advice of a tax professional as there are some strategies available to minimize the penalties.

6.3 Harmonized Sales Tax (HST)

Residential common expenses fees are exempt with respect to the HST and therefore the owners do not have to add HST to their monthly fees. The condominium corporations do have to pay the HST on the applicable expenses which they incur, such as contracts and various repairs. Unfortunately, condominium corporations do not get to claim the HST back as input tax credits and therefore must include those amounts in their annual budget.

Common expenses fees for commercial units are not exempt and nor are other types of revenues known as taxable supplies. Examples of taxable supplies are guest suite rentals, party room rentals and rooftop rentals for telecommunication equipment. The basic exemption for a non-profit organization such as a condominium is $50,000 per year of taxable supplies. Therefore, once a condominium corporation reaches above $50,000 annually of these types of revenues, the directors have to register for and collect HST on those revenues. This is another important requirement that is often overlooked, and it is important to note that the condominium corporation will eventually be required to pay all of the HST from the time that it is required to register.

> Directors should be aware of the tax requirements above and monitor the taxable supplies each year and direct management to register as soon as the condominium corporation exceeds the annual exemption of $50,000. In some cases, this has turned into many thousands of dollars of uncollected taxes and these amounts will incur penalties and interest.

Part 7: Glossary of Key Terms

Accrual Accounting: An accounting method where revenues or expenses are recorded when a transaction occurs rather than when payment is received or made.

Assets: A resource with economic value that a condominium corporation owns or controls with the expectation that it will provide a future benefit.

Cash Accounting: An accounting method where revenues or expenses are recorded in the period when the cash is received or payment is made rather than when the transaction has occurred.

Financial Package: A package of financial reports that is presented to the board of directors, usually monthly, which includes the balance sheet, statement of revenues and expenses and other reports to report on the transactions of the corporation.

Financial Position: The current balances of the recorded assets, liabilities and equity of a condominium corporation.

Liabilities: A financial obligation of a condominium corporation that results in the condominium’s future sacrifice of economic benefits to other entities.

Operating Fund: The fund that is used for the day-to-day operations of the condominium.

Operational Surplus: This is the amount of operating assets that are remaining after all operating liabilities have been accounted for in the condominium corporation.

Operational Deficit: This is the amount by which the operating liabilities exceed the operating assets at a point in time in a condominium corporation.

Reserve fund: A fund that condominium corporations save and use to handle the larger financial burdens, for major repair or replacement of common elements and assets as needed.

Reserve Fund Study: Determines how much money needs to be in the reserve fund to ensure major repairs/replacements can be paid for in the future.

Special Assessment: An extra one -time charge added on top of an owner’s common expenses fees.