tips for protecting community association finances

Community Association Benefits

One of the most important responsibilities for community association board members is protecting community finances.

Volunteer boards of condominiums and homeowners' associations often perform a number of functions vital to governing the association successfully, fostering community harmony, maintaining common areas and establishing and enforcing rules.

The ability of the association to perform these functions depends on its success as a business. And one of the board's most important business functions is to ensure the association's financial well-being. Here are 20 tips to help volunteers protect their community association finances. Before implementing them, however, consult with the association accountant and check your governing documents and state statutes, which may specify other requirements.

1. CONDUCT AN ANNUAL FINANCIAL AUDIT, REVIEW OR COMPILATION

A certified public accountant (CPA), selected by the association board, should conduct an annual analysis of the association's finances. The CPA should have access to original or electronic books and records. Everyone involved with the association should cooperate fully during the analysis.

The association board may request one of three levels of service from the CPA—compilation, review or audit.

In a compilation, the CPA presents the association's financial statements in a manner consistent with generally accepted accounting principles. A compilation provides little analysis and no balance confirmations.

In a review, the CPA investigates record-keeping practices and accounting policies using analytical procedures and inquiries. The CPA provides "negative assurance" that the financial statements are materially correct.

In an audit, the accountant performs a more thorough analysis that may include confirming bank balances, physically inspecting and tracing transactions to invoices and evidence of payments. Although an audit is a more comprehensive examination of an association's financial statements, it isn't an analysis of the board's policy decisions or its use of resources. After the analysis is completed, the CPA renders an opinion based on the audit tests and examinations. Neither the association nor the manager contributes to the auditor's independent opinion.

Before deciding which report to obtain, discuss it with your CPA or check association documents and state statutes. An audit may be required. And always consider conducting a review or audit when the association experiences a major change like assuming control from the developer, receiving large settlement monies or hiring a new management company.

While it may be too costly to conduct an audit every year, the board should commit to having one performed at least every few years. In the interim, the association should have an annual review performed, with the stipulation that the bank balances be independently verified.

2. IMPLEMENT RECOMMENDATIONS FROM YOUR CPA'S MANAGEMENT LETTER OR REPORT OF INTERNAL CONTROL

A report is required in the audit process when significant deficiencies or material weaknesses are noted in the association's internal control of financial reporting.

A management letter may be issued in a review or an audit. In a management letter, the CPA may report weakness in the association's financial systems, as well as issues concerning internal control, income tax, reserves and document compliance.

The association should use these recommendations to make appropriate changes to its processes and procedures.

3. RECONCILE BANK STATEMENTS MONTHLY AND ENSURE THAT THE BOARD REVIEWS THEM AT LEAST QUARTERLY

The board should review bank statements or passbooks for all cash accounts at least every three months and ensure that bank statements are reconciled in a timely fashion, which generally should be monthly since some banks require associations to report fraud within 30 to 60 days of the statement date.

If the treasurer reconciles the bank statements, then the board should designate another person to review the reconciliation. If a manager, management agent or bookkeeper does the reconciliations, the board should carefully evaluate the system, its internal controls, reconciliations and calculations.

4. MONITOR FINANCIAL ACTIVITY AND REPORTS

Check invoices against checks paid and the original receipts for credit card accounts. If the association has a professional manager or a bookkeeper, the board treasurer should conduct this review. In self-managed associations, a board member without access to the bank accounts or credit card privileges should check for unauthorized use.

The association accountant (whether a CPA, management company, onsite personnel or volunteer) should submit a financial report to the board at least every three months. The report should include a balance sheet, profit and loss statement and a comparison of actual expenditures to the budget. The financial statements should show activity for both the operating and reserve funds.

The financial report should include an explanation of significant variances, such as cash surpluses, shortages, excessive accounts payable or receivable or major budget overruns. The board should investigate excessive variances and ask questions if the financial statements are not produced 15 to 30 days after the close of the accounting period. The board should review the income statement closely, compare it to the budget and question any major differences. The board should also monitor a list of aged accounts receivable (delinquencies) and accounts payable (unpaid bills).

5. FIND THE RIGHT BANKS

Safeguarding association funds requires cooperation from the bank to be effective. Some banks do not enforce dual-signature requirements, or they prohibit electronic transfers among accounts, despite their being under different FTI numbers. Find banks that have safeguards in place to minimize theft, especially through electronic transfers.

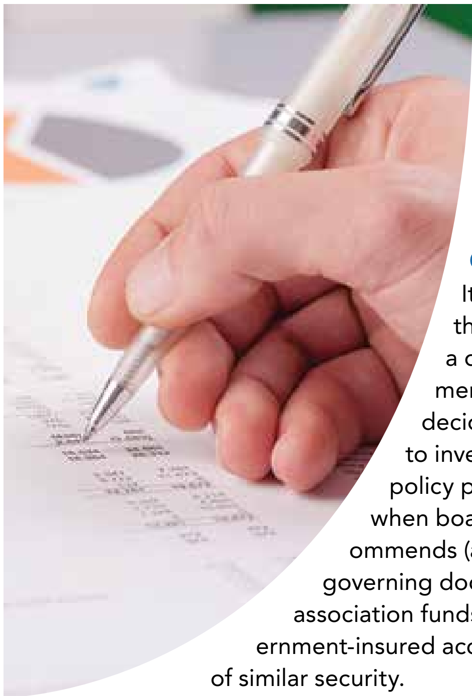
Select banks that are insured by the Federal Deposit Insurance Corporation, and do not deposit more than $250,000 (the FDIC limit) in one bank. The FDIC limit applies to the total amount per association per bank, making it necessary for some associations to deposit funds in more than one bank.

6. ENSURE THAT THE BOARD CONTROLS RESERVE TRANSACTIONS

The board must have full and separate control over the association's reserve accounts, including signature control of bank accounts. If a professional manager, office manager or bookkeeper handles the finances, make sure that reserve transfers and withdrawals require the name and signature of a board member. Do not give one person—even a board member—total control over reserve accounts. All transactions made by board designees should be recorded and verified in writing. The board should approve these transactions, and document the approval in the board's meeting minutes.

7. CONDUCT A RESERVE STUDY

A reserve study should be prepared every three to five years, and it should be reviewed annually. Insist that a Reserve Specialist™ conduct the study. Use the reserve study to determine whether reserves are adequate, how the funds are being spent, the rate of funding and how much the annual assessment must be to meet funding goals. Always keep reserve funds separate from operating accounts.



8. ESTABLISH AN INVESTMENT POLICY THAT ENSURES SAFETY OF PRINCIPAL

It's very important for the association to have a documented investment policy. The board decides where and when to invest, and an investment policy provides continuity when boards change. CAI recommends (and some association governing documents require) that association funds be invested in government-insured accounts or instruments of similar security.

Make sure the balances do not exceed the banks' or fiduciaries' insurance limits. Preserving the principal is the utmost investment objective for associations, not earning high yields. The higher the yield, the greater the risk. Deal only with licensed, insured and bonded brokers and agents. For more on the topic of investing reserve funds, refer to *Reserve Funds: How & Why Community Associations Invest Assets*, 2nd Ed., a Guide for Association Practitioners.

9. KNOW THE ASSOCIATION'S FEDERAL TAX IDENTIFICATION NUMBER

All associations have a federal tax identification (FTI) number, and all board members should have a record of it. This number should not be provided to association members. Set up all bank accounts with this number—never a board member's social security number or other means of identification. Review all bank accounts periodically, and make sure they are all under the association's name and FTI number.

10. DO NOT COMMINGLE ASSOCIATION FUNDS

The association's funds should not be commingled with the funds of any other organization. If the association does commingle funds, however, it should put the monies in a trust account with clearly defined safeguards.

11. ESTABLISH AND DISTRIBUTE COLLECTION POLICIES

The association should have a written collection policy explaining how delinquent assessments will be handled. Distribute the policy to all members and enforce it uniformly. Only the board should be authorized to approve bad debt write-offs or account adjustments over a certain dollar amount.

12. USE A LOCK BOX SYSTEM OR EFT FOR ASSESSMENT PAYMENTS

Obtain a bank lockbox so assessment payments go directly into its account or work with the association's bank to set up electronic funds transfers and other means by which owners can make payments online. This enhances collections and speeds up deposits. It also ensures that assessment payments are sent directly into the association's account without being handled by volunteers, employees or agents.

13. ESTABLISH A SIGNATURE CONTROL POLICY

Associations should require two board members' signatures—one should be an officer— on all reserve checks, redemptions or fund transfer. For operating accounts, associations should require two signatures on all checks above a certain limit. Monitor check activity by asking the bank to return canceled checks or provide electronic images of the canceled checks along with the monthly statements. Though obtaining a second signature can be an inconvenience, associations should weigh the extra protection this procedure provides against any delays it may cause.

14. INSIST ON DIRECTORS AND OFFICERS' LIABILITY INSURANCE AND A FIDELITY BOND FOR MANAGERS AND EMPLOYEES

The association should provide board members with adequate Directors and Officers' liability insurance to protect them against lawsuits alleging errors or omissions in the performance of their duties. Part of the Directors and Officers' liability insurance provides fidelity insurance bonding on the board members, but it may not be sufficient.

Associations must also see that their manager and other association employees are sufficiently bonded to cover all association funds reasonably at risk. The association's fidelity bond should also cover volunteers who have access to or handle funds.

Associations that contract for professional management should insist that the management company have its own fidelity coverage, which would provide the first line of recovery in the event of a theft by an employee. Fidelity coverage for the management company is not included in the association's base policy, but can be added with a managing-agent rider.

The amount of an association's total fidelity coverage should be equal to or greater than the association's reserves and several months operating funds.

15. PROHIBIT KICKBACKS

Employment agreements and management contracts should specify that kickbacks from contractors, employees or others are strictly prohibited. Also, association financial policies should state that benefits, credits, discounts or free services provided by a financial institution or contractor must benefit the association, not the management agent, employee or individual contractor.

16. REQUIRE DISCLOSURE OF CONFLICTS OF INTEREST

The association's financial policy should include a requirement that board members, officers, committee members and manager disclose relationships they may have with prospective consultants, contractors, attorneys, accountants or other service providers before the board retains their services.

17. KNOW THE ASSOCIATION'S INSURANCE COMPANY AND CONSULT WITH THE AGENT

Every board member should keep copies of the association's insurance policies or, at least, the declaration(s) page. Ask the agent to attend a board meeting once a year to discuss the association's policies and whether additional or increased coverage is needed.

18. ALWAYS MAINTAIN CONTROL OF ASSOCIATION DOCUMENTS

Documents, including association books and records, generated by the manager, paid staff, the board or a volunteer are association property. These documents must be turned over to the association when a management contract expires or when a volunteer's term is completed.

19. ESTABLISH GOOD FINANCIAL PROCEDURES

The board must ensure that its financial systems are safe by implementing effective internal controls. Here are examples of good checks and balances.

- More than one person should handle cash, whether from assessments, vending machines, guest fees or other sources of revenue.
- Require two signatures on all checks over a certain amount and on all reserve or investment transactions.
- Do not allow the person who approves invoices to write checks.
- Do not allow the person recording receipts to make deposits.
- Minimize cash transactions.
- Write all checks to the payee—not to "cash."
- Pay all employees and vendors with a check or electronic transfer.
- Insist that all payments to the association are made payable to the association—not the manager, managing agent or board member.
- Deposit checks directly to the association's account on a daily basis or store overnight in a fireproof safe. Consider ACH, lockbox and other direct deposit options. Reconcile bank statements monthly.
- Arrange for an annual financial audit, review or compilation by a CPA, which may include a management letter or report of internal control. Obtain an engagement letter from the association's CPA that defines the work and fees.
- Review all insurance policies annually, especially those relating to financial matters.
- Review the association's tax status and tax planning for the coming year with a CPA.
- Conduct a reserve study every three to five years, review it annually and incorporate it into the budgeting process.
- If the association books are maintained on a cash basis, maintain the accounts receivable on the accrual basis. A report of payables should accompany the financial statements.

20. REQUIRE FINANCIAL SAFEGUARDS IN THE MANAGEMENT CONTRACT

Associations with management contracts should require the managing agent to observe procedures that safeguard association funds. The association should always have its attorney review the original management agreement and renewals before signing.

While no single suggestion is fail proof, these safeguards used in combination should help to create a system of checks and balances to keep your association and homeowners from being victimized.

Additional CAI resources on this topic available from www.caionline.org/shop

Insurance: How Community Associations Protect Themselves, by Clifford J. Treese, CPCU, ARM, and Katharine Rosenberry, ESQ.

Risk Management: How Community Associations Protect Themselves, by Clifford J. Treese, CPCU, ARM

Conflicts of Interest: How Community Association Leaders Honor Their Duties, by Tonia C. Sellers, ESQ., and Jay S. Lazega, ESQ.

The Board Treasurer: Roles & Responsibilities in Community Associations, by Howard A. Goldklang, CPA

Reserve Funds: How & Why Community Associations Invest Assets, 2nd Ed., by Mitchell H. Frumkin, PE, PP, RS, and Nico F. March, CFM

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