

Thinking on the Unthinkable: Good Association Financial Practices

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In 1994, many homeowner associations were devastated by earthquake. However, each year a small number of associations suffer an event in many ways just as jarring--the discovery that a director or agent trusted with the finances abused that trust. Unlike earthquakes, this type of disaster can largely be prevented. Boards and property managers should calmly address the unthinkable--that some future employee or board member may, if given the opportunity, betray the association's trust.

Of course, the vast majority of volunteer directors are trust-worthy, and true breaches of that trust are quite rare. In times of conflict within an association, accusations of financial mismanagement or even dishonesty are often too quickly and unfairly thrown. Healthy financial practices can quickly prove the integrity of a board or manager, to the ultimate benefit of all. This is not written for homeowners who distrust their managers or boards. If there is distrust, the relationship may need changing--hire a new manager, or elect a new board. Rather, this is intended to provide some important guidelines to be considered in preserving the healthy relationship. As with any guidelines, these should be considered in the context of each particular association's circumstances.

The law already places specific auditing responsibilities on association directors. Under Civil Code §1365.5(a) and (b), directors must at least quarterly:

1. Review current reconciliations and income/expense statements for all accounts;
2. Compare the current reserve revenues and expenses with the budget; and

3. Review the latest bank statements for all accounts.

Reserve accounts must require at least two signatures for any withdrawal.

The fact of having a professional manager in place, keeping good records of the association's finances, is itself a good first step. A good manager is trained in record keeping and financial reporting. The Civil Code also places specific responsibilities on managers. Managers must bank association funds in a federally insured account in the name of the association or as trustee for the association.

The law prohibits commingling of association funds with other associations' except in very limited and specifically authorized circumstances, and requires disclosure to the board of all service charges and other pertinent details regarding the operation of association bank accounts (Civ. Code §1363.2). In addition to these statutory minimum standards, other practical measures can reduce the risk of disaster. Association operating accounts can be amended so that two signatures are required on checks or withdrawals. Reserve accounts can be amended so that three signatures are required for any withdrawal. Although it is more convenient for associations to authorize their managers to sign checks, the best practice is to separate check writing from check signing. Have the manager cut the checks and not the board, and have directors sign the checks and not the manager. [This means, boards, you will have to work with your manager and make yourself available to sign checks that cannot wait for the next board meeting.]

Inadvertent or intentional accounting errors can often be revealed by comparing the

banking information with the summary information maintained by the association and manager. The association can request its bank to send monthly statements to both the manager and the board.

Income and outflow totals can be compared against any summaries or monthly compilation statements to ensure accuracy. Prior to signing any check, the board should insist on being provided invoices or statements to document the expense. The board may also request a monthly check register report from the manager, showing all activity in each association account. A classic technique of wrong-doing is the use of phantom vendors or phony invoices. Know your vendors and know what they do. Information is the best source of security and confidence.

Ask questions. Make sure that all board members have a solid understanding of how the association's funds are handled. There should be no information which a treasurer, president or manager cannot readily provide. A pattern of secrecy, exclusive control or other method of keeping all information with one person is an unhealthy sign, and builds mistrust and avoidable conflict. Many embezzlement victims find in hindsight that they allowed financial information--and therefore, fiscal accountability--to be concentrated too narrowly.

The last line of defense, but certainly one of the most important, is insurance. Associations should have not only directors and officers ("D&O") insurance, but also fidelity coverage. Fidelity insurance is different than general liability insurance coverage, as it specifically protects against dishonesty -- ask your insurance broker about it. One insurance broker in the area recommends fidelity insurance coverage in the amount equal to the reserve account balance plus three months operating income. The association also can and should inquire as to whether its management firm has fidelity bond coverage for its employees. Reasonable financial accountability standards and practices will greatly benefit the association. In addition to reducing risk of mismanagement, financial accountability will reveal ordinary budgetary problems more

quickly. Another benefit is a greater level of comfort and trust on behalf of the homeowner membership, and strengthening of the relationship among the association's board, membership and manager.

Greater confidence and trust benefits everyone, and is the rational response to proper handling of association business.

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