Community Association Management Insider®

Helping You Run Your Condo or Homeowners Association Legally and Efficiently

SPECIAL ISSUE

FEATURE

Here's how you can allocate budgetary surpluses to benefit members.

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Determine How to Use Association's Unexpected Income

Associations, whether large or small, depend heavily on money to operate. Every aspect of keeping a community safe and running smoothly has a cost associated with it. Too often, associations make the news for negative financial reasons—fraud, bankruptcy, or other shortfalls that disrupt the community. However, an association that's being run effectively combined with a strong local economy could have more money than expected. That's great news for the association, but it creates the question of how that budgetary surplus should be used.

Allocate Funds Appropriately

The financial health of a community association is one of the most important things that an association manager must constantly monitor. Without enough funds, the association's board of directors may struggle to cover costs and may eventually have to increase assessments. When you get a pleasant surprise that you have a budgetary surplus, rather than a shortfall, make sure to allocate it appropriately to benefit the community association and owners.

So what steps should you take? After a board initially determines that there's a surplus, its decision about allocation should depend on the association's needs and the tax consequences of that decision. Boards will normally look at their needs and wants to determine what project, if anything, they might use the funds for, such as adding the funds to a contingency or replacement reserve.

There isn't a "one size fits all" rule for where surplus money should be allocated. Having a rule can create trouble. The board should have the flexibility to apply the funds where needed, which will vary from association to association and from time to time depending on the association's financial and physical needs.

Consider Main Issue

Normally, the biggest issue is whether the funds should be returned to the owners and if so, how you would do it. But the answer to this is probably going to vary from state to state and depend on the

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governing documents. Often, the funds may need to be returned to the current owners even if the surplus is due to a settlement to reimburse the association for repair expenses. Some might want the prior owners to get a share of the reimbursement. In that case, the board should get legal advice on what it can do with the funds. It's difficult to rebate surpluses because owners move—so the recipient of the rebate may not have paid the money that generated the surplus. A board could also choose to prepay future expenses to eliminate the surplus.

Give Board Freedom to Make Decisions

Generally, policies help guide the board as it tries to comply with the law and make things run smoothly within the community. But in the case of a surplus, you shouldn't draft a policy for how these funds will be allocated—or not allocated—or ask the board to implement such a policy. That's because a policy governing the allocation of a surplus could restrict the flexibility the board needs when making allocation decisions.

The items that could use an extra boost from more funding vary from year to year. And a policy that locks the board into allocating some or all of a surplus to a certain item that doesn't need more money every year could mean that other items that need attention are ignored—even though the association has extra funds.

For example, a surplus allocation policy that requires all or a certain percentage of any surplus to be put into the reserve fund for capital improvements is impractical because each year there could be various items in the community

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that desperately need attention, while a capital improvement isn't even on the horizon. And it's especially impractical if owners are forced to pay increased assessments to fix an item that needs immediate attention because money has been allocated to a project that won't take place anytime soon.

It's constraining to have a policy, but there should be a procedure by which the board analyzes the budget to determine the reason for the surplus and appropriate options to consider for the use of the funds.

Instead of a policy, a board should use its discretion and rely on advice from the association's accountant and manager. Because you field complaints and suggestions from owners, and you are the most familiar with the community's needs, strengths, and weaknesses, you have good judgment as to which items need a financial boost now and which can wait. You can advise the board about which items are a financial priority.

Investigate Unexpected Windfall

If the surplus wasn't expected, the board should look into how it happened, but not with suspicion. Rather, an investigation should be done to find out where the savings were achieved or whether something that was budgeted had not yet

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➤ Get Control Over Association's Troubled Finances

While budgetary surpluses can be a pleasant surprise for managers and boards to handle, boards should be prepared to address budgetary shortfalls as well.

If your association is facing a budget shortfall, you can suggest options for the board to consider. Although each association's specific circumstances are unique, using one or more of the following four options may close the gap:

- Utilize the prior year's accumulated surplus. If such a surplus exists, then depending on the nature, magnitude, and timing of the expense, it may be appropriate to spend some or the entire surplus to resolve an outstanding obligation.
- You may also be able to use the prior year's accumulated working capital contributions. At the time of closing on a home, many associations collect working capital contributions that are used for the association's working capital needs. You should maintain approximately three months of operating expenses in this fund. If there's an excess of three months of expenses in the fund, the board should consider using it to address an unexpected need.
- Think about reducing other expenses, which is always a good idea. However, it's rare that an expense reduction by itself is enough to provide the needed funds for unforeseen circumstances. You may want to defer an expense, additionally. If the payment arrangement with a vendor can be renegotiated and deferred, it might assist with current cash flow needs.
- Amend your current year's budget. Certain expenditures, such as a sizeable increase in insurance premiums, affect both current and future members. In this situation, it may be advisable to amend the maintenance budget immediately and increase maintenance fees accordingly.

In certain circumstances it's appropriate to obtain financing to address the association's needs. But associations usually resort to obtaining a loan for only capital replacement projects, such as repairing or replacing roofs or sidewalks.

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been done. Although a surplus could indicate that assessments are too high, that's rarely the case. More often, a surplus results from a time difference—for example, you budgeted for a new copier in December, but you didn't buy it until January. It can also be caused by an unpredictable variance—for example, you save on plowing during a year when it doesn't snow as much as usual.

Generally, associations budget too thinly, so surpluses rarely occur. But when they do, the best approach is to maintain assessment levels and apply the surplus to reserves or additional resident services or enhancements to the community. Only if a surplus continues for more than one or two years and reserves are adequate and fully funded should an association consider reducing assessments.

Surpluses are normal accounting and financial events that should be dealt with using common sense. Managers should try not to overreact. If there are large surpluses, look to see if necessary expenditures for maintenance and services are being made and paid for. If so, then surpluses should be viewed as a pleasant surprise—and obviously preferable to deficits. ♦

CUTTING COSTS

Catch Common Overbilling Errors When Using Contractors in Community

With so many things in an association-run community depending on cash flow, one of a manager's most important duties is to carefully watch costs. But there are so many other aspects of managing a community—such as hiring and training staff, keeping on top of maintenance, and fielding member requests and complaints—that you might be tempted to spend less time on keeping track of contractor costs. You may be tempted to pay invoices without really examining them, assuming that if you're working with reputable vendors or contractors that you've worked with before, the charges are correct. But if you need to save time, do it elsewhere. Whether they're accidental or intentional, mistakes are too often made on them. To avoid being overbilled, look closely at contractor invoices. Here are the most common overbilling errors that managers find in contractor invoices and how you can spot—and correct—them.

Vague or Incomplete Details

When a contractor sends you an invoice that's vague, it should be a red flag. Since the association is paying for the work, it should know exactly where that money went. And it's not an unreasonable expectation. This usually happens in two ways.

Description of work. A contractor may send you an invoice with only a vague description of the work done. If you don't know exactly what work was done, you won't know if you're being billed for the service you requested. You could be

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billed for work that you didn't order, isn't your responsibility, or wasn't done at all. If you get a vague invoice, ask the contractor for another one that describes in detail the work that was done. The word "miscellaneous" in an invoice also is a red flag, and you should find out exactly what services and costs this category includes.

Hours and number of workers. Sometimes a contractor will bill you for labor costs at an hourly rate, and either charge you for more hours than it actually worked or for more employees per hour than actually worked on the job. If the number of hours you're being charged for isn't specified in the invoice, ask the contractor for this information. Then ask the contractor how many people worked on the project. If either number seems too high, ask the contractor to explain. If you still have questions about the number of people who actually worked on the project, ask your employees if they can recall how many of the contractor's workers were on the job and when.

Unauthorized, Unnecessary, or Nonexistent Work

Sometimes a contractor will bill you for work you didn't authorize. The contractor may have gotten the go-ahead from one of your employees, even though the employee wasn't authorized to give it. Or a member may have asked the contractor to do work and bill it to you.

If you're being billed for unauthorized work, ask the contractor for the name of the person who authorized it. If one of your employees authorized it, instruct the employee not to authorize work again without your permission. If a member authorized the work, tell the contractor that the member had no right to authorize the work or to bill it to the association. The best solution is to negotiate a provision in your contract that says you'll pay the contractor only for work that "authorized individuals" have approved in writing.

Some contracts give your contractor the right to perform tasks and charge them to you when certain conditions are found or when work is "necessary." But you shouldn't always trust a contractor's judgment of when a condition is found or when work is necessary. This has happened commonly with snow accumulation. For example, if your contract authorizes a contractor to remove snow and bill the association when at least an inch of snow has accumulated on the ground, make sure that you're not being billed for removal of snow after significantly less than the specified amount of snow has fallen.

Check your contract to see how "necessary" work is defined and whether you think the work billed on your invoice meets that definition. If it doesn't, tell the contractor that you refuse to pay for it. It's smart to include a clause in your contracts saying that contractors must get your written permission to perform necessary work or work that hinges on certain conditions.

And watch out for being billed for work or items the contractor didn't actually provide. If you get an invoice for work you don't remember being done, check to see if it was actually done. If you're unable to check on it yourself, ask the con-

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tractor about the work in question. This way, you put the contractor on notice that you're inspecting invoices closely and that you won't accept any padding.

Calculation Methods for Costs

Rates—and they way they are "rounded up"—are one of the most important things that you should check for accuracy. There are two areas where discrepancies occur:

Labor rate. Sometimes a contractor will bill you for labor at a rate that's higher than the contract rate. If a billing rate seems incorrect, check to see whether it matches the rate set in your contract. If the contractor gets paid by the hour, your contract should always set out the exact billing rate.

Hours improperly rounded up. Sometimes contractors who are paid by the hour round up to the nearest hour, even if your contract with them requires them to bill you to the nearest 10- or 15-minute increment. If this happens once or twice, it won't cost you too much, but the costs will add up if you get a lot of bills that are rounded up to the nearest hour.

If you're being routinely billed for full hours of work and your contract doesn't permit rounding up, ask the contractor to explain. If the contractor admits to rounding up, negotiate a reduction in your bill and tell the contractor you will no longer accept rounding up. If the contractor denies rounding up, put the contractor on notice that you'll be examining the invoices closely and monitoring some of the work time yourself.

Personnel Not Essential or Not Used

Sometimes a contractor will bill you for the time of nonessential personnel or trainees. As a rule, you should not pay to train new employees, and you certainly shouldn't pay for the time of employees who don't work. If you get a bill and the labor portion seems too high, ask the contractor exactly who was working on the project and in what capacity. If the contractor says that a trainee was used, tell the contractor you don't want the trainee's time to be billed at the full rate. Try to find out whether everyone on the job was actually working. Check with your employees to see if they noticed how many of the contractor's workers were actually working at the job site.

Sometimes a contractor will charge you for the use of a subcontractor when no subcontractor was actually used. If you suspect that no subcontractor was used on the job, ask the contractor for the name and phone number of the subcontractor and call to find out whether it did any work.

Trumped-Up Charges

Unfortunately, there are some unscrupulous contractors who inflate costs or charge for items or services that never come to fruition. Watch out for these pitfalls.

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Double-billing. Sometimes a contractor will bill you twice for a back-ordered item—once when it orders the item and again when it receives the item. A contractor may also try to bill you either for work in progress or work that it hasn't yet begun and then bill you again after the work is done. What's the solution? If you get a bill for work or items that seem familiar from a previous invoice, check to see whether you have already paid for them. If so, show the contractor the original invoice and the canceled check if necessary. To avoid this double-billing problem, you should pay for items only after they are actually received or used and for work only after it's actually done.

Improper taxes. Sometimes a contractor will charge you for nonexistent sales taxes and simply pocket the extra money. For example, a contractor could try to bill you for materials and labor and then compute and add on sales tax for both the materials and the labor—even if there is no sales tax on labor. Having your accountant double-check that all sales tax computations are legitimate can help you avoid this.

Travel time. Sometimes contractors overbill you for travel time. The amount of travel time may be excessive or rounded up to the nearest hour. If a contractor charges you an excessive amount for travel, ask what its travel schedule was. Say that you won't pay for excessive travel time and that even if the contract doesn't say so, you want travel time rounded up to the nearest 10-minute increment, not to the nearest hour.

Past-due amounts. A contractor may bill you for amounts past due that you have either paid or have never been billed for. If you get a bill for an amount past due, check your records to see if you were ever billed for that amount and whether you paid it. If it turns out that you have already paid the amount and the check has cleared your account, show the canceled check to the contractor. If you haven't been billed for that amount, ask the contractor for a copy of the original invoice, which should state what you were billed for.

Late fees not in contract. Sometimes a contractor will bill you a late payment fee even if the contract doesn't authorize late payment fees. It may also try to charge you interest on the overdue amount or an administrative fee for the cost of billing you twice. If you're charged a late fee or interest charge, check your contract to see if it allows such fees. If it does, check to see whether you paid within the deadline. If it doesn't, get the fee or charge removed.

Brand-name parts. A contractor may bill you for more expensive brand-name parts but actually use generic or used parts. Make sure your contract specifies what kinds of parts the contractor will use. Ask the contractor for a copy of the invoice for the product that identifies the product's brand name, unless the product's brand name is clearly visible on the product itself. ♦

RISK MANAGEMENT

Take 10 Steps to Head Off Financial Fraud

Keeping track of finances is an integral part of running a community association. There's typically a regular flow of money being collected and paid out on a day-to-day basis in order to ensure continuous operations. But, although dealing with cash can be overwhelming, it's crucial not to take shortcuts with the association's cash management procedures. One common mistake that associations make is having the same person who prepares the checks also doing the books. That arrangement makes it difficult to tell if someone is embezzling from the association. So what can you do to safeguard income and disbursements? Here's how you can set up proper internal controls.

Understand What Can Go Wrong

Effective controls and standard procedures for income and disbursements—that is, payments to vendors, employees, and others—are essential to the sound management of any business, including community associations. The failure to have effective internal controls can seriously hurt communities when employees are dishonest. Proper internal controls can prevent theft altogether or at least make it apparent much sooner, so losses can be minimized.

Set Proper Controls

To help you avoid situations like the one above, here are 10 key steps you should consider taking to handle income and disbursements properly.

Step #1: Have members send assessment checks to bank lockbox. The fewer people involved in the process of receiving monthly assessment checks, the tighter your internal controls will be. One way to reduce the number of people involved is to arrange with your bank to have members send all monthly assessment checks straight to a lockbox under the bank's exclusive control. Check with your bank to determine what the cost will be to set this up.

Step #2: Keep employees' duties separate. You may have one person you trust handle all aspects of cash management. But giving all those responsibilities to one person violates good internal control procedures. To prevent theft in case your trust is misplaced, follow these rules for separating cash management duties of employees:

- The person who prepares the checks shouldn't also be the one who approves and prepares the invoices and purchase orders;
- The person who signs the checks shouldn't also be the one who approves invoices, prepares purchase orders, checks, or payroll, or makes purchases; and
- The person who signs checks shouldn't also be the one who makes bookkeeping entries for accounts payable or the general ledger.

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Risk Management

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Some very small communities may find themselves too shorthanded in personnel to separate all of these functions. If it isn't cost effective for your community to hire enough staff to keep these duties separate, consider taking other precautions. For example, rotate cash management duties periodically among staff members, require all employees who handle cash to take vacations, and perform internal audits during those vacations to catch discrepancies early.

Step #3: Use prenumbered checks for all disbursements. Always make disbursements by prenumbered check—don't use currency to pay for expenses, including payroll. In addition to inviting theft and dishonesty by employees and others, using currency makes for sloppy documentation of expenses. Also, make sure checks are payable to a specified payee, never to "cash" or to "payee."

Blank checks should be locked up where only those people authorized to prepare checks can get them. And make sure all checks are issued in sequential order, to ensure that they are accounted for properly.

Step #4: Make sure check requests have supporting documentation. Your association should have a clearly defined policy for approving check requests. All check requests should be accompanied by supporting documentation, such as detailed invoices from vendors. So require supporting documentation before any check requests are approved. Doing this helps ensure that the payment is legitimate and establishes a clear paper trail to help you maintain sound internal controls.

The person who prepares the checks should confirm that the invoice is consistent with the purchase order and other documentation. And all supporting documentation should stay with the checks when they're presented for signature.

Remember to make payments only when you have an original invoice, never from any kind of duplicate. Often, community associations mistakenly pay a bill twice because someone paid a bill from a duplicate, instead of an original invoice. Also, stamp all duplicates accordingly.

Step #5: Record checks into disbursements record immediately. Enter daily disbursements into a spreadsheet or other recordkeeping tool that shows the date, the vendor or other payee, the check number, the invoice number, and the amount paid. Indicate the reason for the payment, such as janitorial supplies, so the bookkeeping staff can account for it properly.

Step #6: Immediately mark supporting invoices and purchase orders as "Paid." Stamp all invoices and purchase orders "Paid," once the check is issued. And put the date and check number on the supporting documentation. You can also use an "audit block stamp." These stamps have blanks for people with various responsibilities to fill in to indicate they've reviewed the paperwork and confirmed payment. This is another way to prevent bills from being paid twice.

Step #7: Control check signing to protect against embezzlement and forgery. Never sign blank checks or permit anyone else to sign them. This is an open invitation to theft.

Step #8: Be very careful about who can sign checks and transfer funds. To control any temptation by your employees to embezzle money, be very careful

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about whom you authorize to sign checks on, or transfer funds from, your accounts:

- **For the association's operating account.** Associations should require their managers to have a co-signor for all checks above a certain amount. Each association must decide for itself what that threshold amount will be. It's also smart to require two signatures to transfer funds over a predetermined amount from the operating account.
- **For the association's reserve account.** The manager shouldn't have any authority at all to sign checks from this account or to transfer funds out of it. Only officers of the association should have the authority to sign checks or transfer funds from the reserve account, and associations should require the signature of two officers.

Checks should be mailed by someone who doesn't have the authority to sign checks. Keep in mind that exerting control over who can write checks on, and transfer funds from, accounts can also help you save money on your employee dishonesty insurance premium, also known as a fidelity bond. One of the most important factors insurers take into account in calculating how much to charge in premiums for each policy is how much money is vulnerable to theft by an employee. By reducing the amount of money susceptible to theft by a dishonest employee, you can lower the cost of your association's insurance premiums.

Step #9: Record disbursements into accounts promptly and reconcile bank statements monthly. It's important to record all disbursements into the appropriate accounts and adjust accounts payable accordingly to ensure accurate accounting for association expenses. Disbursements should be recorded daily or, if this isn't possible, at least weekly. And remember that employees with accounting responsibilities shouldn't also handle the checks and make the disbursements.

When your bank sends you statements for each account, reconcile the accounts immediately to determine if there are any discrepancies. But be sure that the person who does this has no other accounting duties.

Step #10: Encourage board and/or committees to take active role in preventing theft. Especially for smaller associations that might not have the staff to have true separation of duties, it's essential that your board, treasurer, and/or finance committee take an active role in preventing theft. This type of involvement, coupled with the diversified skills of the association's leaders, is one of the great strengths of the community association model.

An inactive board, treasurer, and/or finance committee is an obvious weakness from an internal control perspective because the association is leaving everything to the management company to handle.

Boards should look over bank statements every month and reconcile all income and disbursements. Have your bank statements sent directly from the bank to the treasurer or other committee given that responsibility. The association accounts must be in the name of the association, not the manager, to make sure the statement is delivered directly. ♦