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South Coast Homeowners Association

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IN THIS ISSUE

FALL MEETING – FINANCIAL CONTROLS AND RESPONSIBILITY

Our fall meeting will cover two areas of association finances as follows

Beth Grimm – Attorney (and frequent South Coast HOA contributor from Northern California) will present a real case study of a small association with major deferred maintenance, too low assessments, attempting to convert a condo project to a planned development to shift maintenance responsibility to the owners, no professional guidance and what happens when someone tries to sell their unit in this association in the midst of all this chaos.

Michael Gartzke, CPA will present some financial information regarding -

a) Ongoing board member financial statement/bank statement review
b) Keeping bank signature cards updated
c) Fraud losses by associations
d) Update assessment and expense trends and changes from area associations

Date – Monday – December 7, 2015
Time – 7-9 PM – (refreshments at 6:45)
Place – Encina Royale Clubhouse – 250 Moreton Bay Lane, Goleta (101 Fairview Exit – north)

2016 Dues Notices were mailed out the first week of November. Annual dues are discounted by $30 if paid by December 15, 2015. Please forward your invoice to your Treasurer, bookkeeper or manager for prompt payment when you receive it.

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HOA FINANCIAL DATA COMPARISONS AND TRENDS RESEARCH PROJECT (Part 2)

2015

By: Michael J. Gartzke, CPA

Author's Note: This is an update to an article I wrote which appeared in the January 2012 newsletter. You can access that article on our website www.southcoasthoa.org and click the newsletters tab and then 2012. Part 1 of this revised article ran in May 2015.

ASSESSMENT INCOME

Operating Assessment:					
Per Unit Per month	**2005**	**2008**	**2011**	**2014**	**Percent Change**
Median	$229	$273	$284	$290	26.6%
Average	247	325	328	334	35.2%
75 Percentile	275	330	350	353	28.4%
25 Percentile	176	217	212	215	22.1%
Percent of Total Assessment	75.1%	75.4%	72.7%	70.8%	

To keep pace with rising costs and to increase fund balances, operating assessments increased between 26% (median) and 35% average during the nine year period. Increases leveled off over the past 3 years. Operating assessments make up approximately 71% of the total assessment but this allocation can fluctuate between 50 and 90%. The allocation has changed to a higher proportion to reserves over the past six years. See below.

Reserve Assessment:					
Per Unit Per Month	**2005**	**2008**	**2011**	**2014**	**Percent Change**
Median	$78	$86	$113	$122	56.4%
Average	79	96	118	130	64.5%
75 Percentile	104	132	145	158	51.9%
25 Percentile	53	60	74	83	56.6%
Percent of Total Assessment	24.9%	24.6%	27.3%	29.2%	

Allocations for the reserve portion of the regular assessment increased by greater amounts to that of operating assessments, resulting in a higher portion of the total assessment funding reserves. The median amount increased $44 per unit per month while the average increased $51. Reserve funding recommendations have increased and these associations have aged an additional nine years, resulting in increased major maintenance requirements.

Total Assessment:					
Per Unit Per Month	**2005**	**2008**	**2011**	**2014**	**Percent Change**
Median	$301	$364	$391	$403	**33.9%**
Average	327	420	446	464	41.9%
75 Percentile	390	480	490	510	30.8%
25 Percentile	245	290	320	339	38.4%

This is probably the most popular metric reported to the associations each year – how their regular assessment compares to the median. Since 2005, the median has increased by $102 per month, a one-third increase. The CPI for the same period went up 20% so the median assessment increased by an amount greater than the inflation rate. The mix of expenses paid by associations is not the same as the mix of expenses included in the CPI.

Special Assessments - Associations	**2005**	**2008**	**2011**	**2014**
	5	11	6	3

Special assessments arise for a number of reasons. After Hurricane Katrina, insurance premiums for some associations increased substantially that were not budgeted for at the beginning of the year. One local water district increased rates for condominiums by $30/unit per month mid-year. This resulted in several special assessments. Major maintenance projects are also subject to special assessments.

Investment Income:	**2005**	**2008**	**2011**	**2014**
Median	1.29%	2.86%	0.65%	0.27%
Average	1.50%	3.68%	0.77%	0.55%

Back in 2004-05, we saw interest rates drop to what we thought were historical lows. Associations earned less than 1.5% on their cash that year. Rates increased until the upheaval in the financial markets in the fall of 2008. Since then, interest rates on cash investments have continued their freefall. Reserve studies have taken these lower investment returns into consideration which is a contributing factor in increased reserve funding from assessments.

Operating Expenses:

When I prepare financial statements, I categorize operating expenses into one of four main categories – utilities, common area maintenance, insurance and general and administration. I format the income statement to subtotal expenses by these main categories which facilitates developing the data shown below. Expenses such as income taxes and bad debt expense become part of administration while security services are usually included under common area costs.

Utilities:					
Per Unit Per Month	**2005**	**2008**	**2011**	**2014**	**Percent Change**
Median	$63	$72	$63	$81	28.6%
Average	62	75	67	79	27.4%
75 Percentile	83	104	101	106	27.7%
25 Percentile	38	48	38	54	42.1%

The increase in utility costs added $18 to the median operating assessment from 2005 to 2014. Municipal utilities such as water and trash have increased steadily in recent years. With the recent drought, water districts have increased fixed charges (not related to usage), a process which is continuing. Wet winters help reduce common area water costs but we haven't had many wet winters lately. Natural gas costs spiked after Katrina but have stabilized and even decreased in recent years. Electric costs have also remained stable.

Common Area Maintenance					
Per Unit Per Month	**2005**	**2008**	**2011**	**2014**	**Percent Change**
Median	$93	$99	$101	$104	11.8%
Average	112	146	151	148	32.1%
75 Percentile	127	160	154	146	15.0%
25 Percentile	70	67	78	76	8.6%

Although the median amount hasn't changed much, the average cost has gone up 32%. Associations with higher monthly assessments tend to have them because of the larger common area services and responsibilities they have, such as landscaping, building maintenance and amenities.

Insurance					
Per Unit Per Month	2005	2008	2011	2014	Percent Change
Median	$49	$63	$62	$60	22.4%
Average	58	77	69	68	17.2%
75 Percentile	74	101	84	83	12.2%
25 Percentile	36	49	43	45	25.0%

Insurance premiums jumped dramatically after Hurricane Katrina in the summer of 2005. Premiums have stabilized or decreased for many associations over the past 3-4 years which has contributed to a lower rate of assessment increases. Some associations made changes in their coverages which also affects premiums.

General & Administrative					
Per Unit Per Month	2005	2008	2011	2014	Percent Change
Median	$24	$32	$37	$36	50.0%
Average	31	47	46	44	41.9%
75 Percentile	33	46	56	52	57.6%
25 Percentile	20	23	28	25	25.0%

Included in this category are professional and management services, office, printing and postage costs, bad debt expense (uncollectible assessments), taxes and permit costs.

At the conclusion of each review engagement, I provide the association with comparative data and graphs to help explain where they rank compared to other area associations. Association clients have told me that having this information from their accountant provides the Board with a credible defense of their budgetary policy in the eyes of their membership.

WHEN DOES HIRING A HANDYMAN BECOME A LIABILITY FOR YOUR ASSOCIATION?

By Timothy Cline, CIRMS

Editor's Note – Tim is an HOA insurance specialist and is a long-time member and contributor to South Coast HOA through articles and presentations. See his contact information in the sponsor section at the end of the newsletter.

By definition, a handyman is like a human Swiss Army knife - a convenient way to efficiently accomplish a variety of tasks. Always cheaper than hiring a contractor, a handyman represents a budget-saving alternative; helping to keep maintenance costs for the community association lower and, at least at first blush, being a task-accomplishing hero to cost-conscious board members and the owners they represent. As enticing as it is to go to Craigslist or AngiesList to hire a handyman, is it a fiscally responsible business decision for a board of directors? Or does hiring a contractor simply create a heightened exposure for their community?

There are many eye-opening considerations:

Handymen are typically unlicensed.

In California there is no "handyman" classification available through the State's Contractors State Licensing Board (CSLB). The absence of a license is problematic for both the individual and the association. If the total value of the construction work being performed meets or exceeds $500 (for both labor and materials), a license is required. Penalties for an individual contracting without a license can range from a warning letter to jail time, depending on the severity of the offense. For the condominium association, inadvertently hiring an unlicensed contractor (an individual performing a task for which a license is required) means that there are fewer remedies if things go wrong. The State CSLB will not step in and resolve any dispute should the association be dissatisfied. Furthermore, should litigation ensue, a contractor's license helps to establish an "independent contractor" relationship which may help insulate a board of directors for the individual's actions.

Many handymen have no liability coverage.

If there is any property damage or bodily injury that results from a handyman's activities it's unlikely the handyman would have liability coverage to address the resulting claim/lawsuit. By comparison, commercial general liability coverage, which is typically maintained by licensed contractors, provides two distinct benefits: (1) an association can request to be named as an "Additional Insured" on the contractor's liability policy and, thus, potentially be provided with defense and indemnity should the HOA be named in a lawsuit; and (2) if there is a claim that is tendered to the association's property or liability insurance coverage, the fact the contractor has liability coverage may provide a recovery opportunity (an option to subrogate against the contractor's policy) softening or eliminating the impact on the association's own loss history.

Handymen typically do not maintain any workers' compensation coverage.

There have been a number of cases in California where a person who claims to be an independent contractor gets injured, then turns around and claims to be an employee of the association in order to collect workers' compensation benefits.

In some circumstances the erosion of the independent contractor relationship is codified in case law. For example, if the association hires an individual to perform a task for which a license is required, that individual will immediately be deemed to be the employee of the association for workers' compensation benefits (State Compensation Ins. Fund v. Workers' Comp. Appeals Board (1985) 40 Cal.3d 5, 12-16). This provision of the Labor Code makes an unlicensed contractor who is performing work for which a license is required an employee of the hirer, for the purpose of workers' compensation. How easily could such an issue arise? In a former newsletter we discussed that the California Business and Professional Code requires a contractor's license to trim a tree measuring 15 feet or more. (Bus. & Prof. Code, § 7026.1, subd.(c)). If your handyman is on a ladder trimming even the lowest branch on a fifteen foot tree and is injured, he could be deemed the association's employee and entitled to full workers' compensation benefits.

California's State Compensation Insurance Fund (State Fund) does offer an alternative for the sole proprietor: the opportunity for the handyman to purchase their own coverage.

Unfortunately few handymen avail themselves of this opportunity holding firm to the belief that because they have no employees they are not required to maintain protection. No one would judge them for trying to keep their expenses down, but failing to maintain their own coverage and their lack of a valid contractor's license likely means that the exposure for any injury sustained by a handyman on the premises will commute to the association.

There are 43 different construction trade licenses recognized by the CSLB. That's potentially 43 different ways your handyman, and by extension your association, could get in hot water. Risk transfer is a way to protect the association and the association's claims history from the calamities caused by inexperienced and under qualified workers. The cost/benefit analysis for using a handyman may be favorable, but only in the short term...until there's a claim. Using licensed and insured contractors is an important first step for the board to properly manage risk.

This letter contains only a general description of coverage and is not a statement of contract. For a more detailed description of the policy conditions and exclusions, please consult the policy itself.

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FRAUD HAPPENS – A TRUE STORY

WSCAI Journal - February, 2014
By: Catherine Kuhn, CPA; Cagianut & Company, CPA

Editor's Note – This article first appeared in the CAI Journal for the Washington State Chapter in 2014. Cathy manages the Cagianut & Company CPA practice in Washington. Long-time members will remember Gayle Cagianut had a large HOA practice in Ventura County and Southern California before moving north. This article is reprinted with their generous permission. Further resources available at www.hoacpa.com

Have you ever heard a Board member or Manager say:? "Fraud can't happen in our Association. We have good controls and people we can trust."

In the Community Association industry, fraud can happen anywhere, anytime – from the management company, to the on-site employee, to the volunteer treasurer or other board member. The typical embezzler is someone that is personable and well-liked by everyone around them. In our experience, in this industry, the following are other common attributes:

- Active in CAI
- Well educated in the industry
- Highly regarded by their board members or others
- Considered to be friends or "like family" to those around them
- No extreme outward increase in financial status

The intent of this article is not to cast a negative light on everyone around you; but rather to increase your awareness and skepticism of circumstances that can give rise to fraudulent activity, and controls you can put in place to help prevent it.

First: A "real-life" story from Southern California that will hopefully cause you to keep reading this article:

Kristin Davis, the owner and CEO of Paradigm Management Group, (Thousand Oaks) and her Chief Financial Officer, Melissa Hoff, were arrested in September, 2013 for allegedly embezzling approximately $900,000 from the Big Sky HOA in Simi Valley. Big Sky is a master–planned community of about 800 homes. The Ventura County District Attorney's office filed 12 felony counts against Davis, including grand theft, forgery, and insurance fraud. Hoff was charged with grand theft and criminal conspiracy. They are out on bail and proceedings are on-going.

While Paradigm was in operation, it managed about 50 communities, both in Ventura County and Orange County. Other HOAs have reported losses that occurred during this time. Detectives are investigating these additional allegations which may result in additional charges being sought. In late fall, 2013, Kristin was charged with <u>another</u> $700,000 embezzlement from the Oak Park Calabasas HOA.

These embezzlements took some time to uncover, investigate, and charge. The Big Sky HOA contracted with Paradigm in February, 2008. The Board discovered the thefts in October, 2009. After this, Davis closed down Paradigm and opened a new company called MK Management. The Sheriff's office conducted the investigation which resulted in the September 2013 arrests. One California law firm in the area, writing about the Big Sky HOA case, stated that prosecutors are reluctant to prosecute these types of cases due to the enormous amount of paperwork to organize and sift through, and because jurors may become "bored" by all the financial documents presented as evidence.

Following are some of the "schemes" used by Davis:

- **She inflated the amount of fixed management fees and falsified the management contract.** She charged (fixed fees) more than the amount in the official management contract. As new board members came on the board, she altered certain pages in the contract, and had the new member sign the falsified alterations. The management company was in control of the operating cash account and she had various board members approve disbursements, based on the altered contracts. Related to this, she added in numerous ancillary services that were never provided, such as escrow fees, legal fees.

- **She created invoices made payable to her management company**, printed checks, and signed them, for items such as "20 hours billable time" that didn't occur.

- **Her management company had access/ control of ALL cash accounts; including reserve cash accounts and CDs**. She was able to access accounts on the internet and direct transferred funds into her Management Company account. Bank statements (including scans of checks) were NOT provided to the board.

- **She gave them excessive delinquency information to focus on, instead of the financial statements and bank reconciliations**. The Board was more focused on the income and less focused on the expenses. Due to high delinquencies, they didn't question the lack of cash as quickly.

- **How was this activity uncovered?** In the Big Sky case, after several months, a new board member reviewed the monthly financial packet and started asking questions because several things were not making sense. The other board members focused on the information and agreed, and this led to the discovery and investigation that resulted in the charges.

One final note on the Kristin Davis case: At one point in her career, Kristin served as the Executive Director for CAI- Channel Islands, CA.

Now that (hopefully) I have your attention, the rest of this article will discuss three areas:

- **WHY** does fraud occur?
- **HOW** is it perpetrated (most often) in the Community Association industry?
- **WHAT** are some prevention techniques?

WHY does fraud occur?

- **Opportunity:** A lack of strong financial controls will provide the opening needed.
- **Motivation:** The fraudster may be incurring significant family financial challenges, including health care issues.
- **Attitude:** An honest person who feels they are underpaid and underappreciated may rationalize the need for fraud.

HOW is fraud perpetrated (most often) in this industry?

- **Kickbacks:** Vendors pay off the manager or board members "under the table" by including the kick-back amount in over-inflated contracts and "kicking back" the difference in cash or equivalent, such as a car.
- **Corporate Credit Cards**: The on-site manager or other employee uses the card for non-association purchases.
- **Bank Signature cards**: Obtaining signature cards from the board and then adding in the manager signature
- **Work not performed**: Paying for either work not performed, or for the same work, multiple times
- **Non-existent employees**: Paying a person not on the payroll

- **Expenses:** False expense reports and vouchers

WHAT are some prevention techniques? Following are some industry standards. They are the responsibility of the entire board, not just the Treasurer:

- **Read the monthly financial statements**! Compare the budgeted to actual expenses and ask questions regarding the variances.

- **Review the monthly or quarterly bank statements and bank reconciliations**. The reconciliations should be performed in a timely manner, and reviewed consistently by the board. The bank statements should have the scans of the checks. This includes ALL cash accounts, including CDs. Ask your bank to generate at least quarterly CD statements or reports; and if they can't provide that; consider changing banks. The bookkeeping department for the management company is not the internal control.

- **Understand who has signing authority for all bank accounts**. The board should ensure they have control over the reserve cash accounts, including two board member authorizations for all disbursements/transfers. If the management company signs on the operating account; ensure the invoices are being reviewed and compared to the disbursements, by someone other than the check signer.

- **Document all material and unusual transactions in the board minutes**; including the descriptions (and operating or reserve) and dollar amounts of reserve expenses.

- **Review contracts carefully**, and when hourly and ancillary charges exist, be very specific about the nature of the expenses and appropriate limits. Have contract signatures notarized; ensure all board members understand and have the appropriate notarized contracts.

- **Consider an annual CPA Review**, While a reviewed financial statement by a CPA is not a guarantee to uncover fraud, it can act as a deterrent. (California law requires a review for all associations with revenues greater than $75,000 per year.

Fraud Happens! Following these basic controls can help prevent it.

***Special Thanks** to Detective Russell King of the Ventura County, CA Sheriff's office (Major Crimes Unit) and the law firm of Swedelson Gottlieb (Los Angeles), for providing certain content in this article.*

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