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Association of Professional Reserve Analysts (APRA) is a nonprofit corporation established in 1995 by principals of America's leading reserve study companies. The purpose of APRA is to provide a forum to establish a common base of knowledge, standards of care and professionalism within the reserve study industry.

The **APRA Advisor** is a bimonthly publication designed to expand the understanding of reserve planning and increase awareness of **Professional Reserve Analysts**.

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The Board Lost Millions

A true story. The details have been slightly altered to avoid revealing the identity of the association, board members or managing agent. Much of my expert witness work involves boards acting irresponsibly. I have never seen a board intentionally act irresponsibly. The boards always think they are doing right – even if it is absolutely wrong. This case is no different.

This particular board included a registered securities broker and a licensed insurance broker. The securities broker recommended to the board that he invest the HOA reserves in the stock market. He offered to do it for half of the commission the association was paying a third party investment advisor who was not using the stock market. The board accepted the offer because it could maximize earnings on reserves which were near \$1,000,000.

The manager gave strong advice that this was not appropriate and asked the association's attorney who wrote an opinion letter stating the same thing. Both advised that the board's fiduciary duty was to protect the principal and investments in the stock market would not protect principal. The board proceeded with the new strategy anyway and the securities broker invested reserves in a variety of funds, both domestic and international. The stock market was doing well – very well – and everyone was happy.

The board also resolved to allow the insurance broker board member to place the insurance to save the commission paid to their previous broker.

While things were going along well in the stock market, the association received a settlement from construction defect litigation. The settlement was several million dollars – but also several million dollars short of what they would need to do the repair. Striving to avoid a special assessment,

the board resolved to let the same securities broker invest those millions in the stock market as well. He did – and the association continued to do very well.

Then the market turned. In a few months, losses exceeded \$300,000 and over time, nearly \$3,000,000 was lost before the bleeding stopped. The homeowners were not happy and the board was more than shaken. Now they decided to get some new legal advice! They discovered that investing in the stock market could be considered a breach of fiduciary duty (Isn't that what the first lawyer opined?). Since the securities broker was licensed and normally should carry about \$5 million in Professional Liability Insurance, legal action was begun against him. Guess what? He did not have insurance! He was licensed but he was trading online and carried no insurance. He subsequently fled the state.

The next step – submit a claim on the association's Directors & Officers Insurance. Unfortunately, the board member/insurance broker failed to report the action against the stock broker, so no coverage! However, because the board ignored the advice of the manager and their attorney, they probably lost their protections against being sued individually. In any case, the five well-meaning board members were sued for losing \$3,000,000. It was now pretty evident to them that playing the stock market with reserve funds was not appropriate.

The case settled after many years. While the details are not known, we can safely assume that legal expenses were substantial for these board members. And the fear of possibly losing everything they had caused many sleepless nights. Hopefully, they were not ruined completely in the settlement. The association was probably partially made whole but likely still out millions.

I picked this case because boards all too

frequently circumvent the law when transacting HOA business. They think: “Meeting without notice is okay.” “Discussing business by email is okay.” “Hiring unlicensed vendors is okay.” “We don’t need a reserve funding plan. We’ll just deal with things when they happen.” After all, it is just an HOA – let’s just use common sense and do what we think is right!

It is not okay. It will eventually lead to emotional pain and economic suffering for both the board members and the HOA. When boards act carelessly, they can be sued individually. Board members, do your members a favor. If you can’t follow the law - resign. Kidding yourself is not worth it.

By Roy Helsing - The Helsing Group
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Case for Maintenance

One of a homeowner association’s primary charges is maintaining the common elements. When done properly, the members are happier and homes sell for more (also a happy event). Proper maintenance requires consistency, planning and funding and is necessary to:

1. Protect and maintain member property values.
2. Protect the board from personal liability, and
3. Preserve legal options when a

contractor fails to perform renovation properly.

Maintaining Property Values. The board has direct control over member home values, particularly in condominiums or planned communities with extensive common elements. How well those common elements are maintained directly affects how quickly homes sell as well as for how much. When maintenance slides, buyers *do* take notice. Curb appeal is the number one key to home sales.

Protect from Personal Liability. One of the board’s basic duties includes maintaining, repairing and replacing common elements. What if the board ignores that charge? HOA boards are protected by the “Business Judgment Rule”, a legal theory designed to protect directors from personal liability for decisions made while on the board. However, the Business Judgment Rule does not protect against failure to “*exercise ordinary and reasonable care.*”

Failure to act is no defense. The board must act and act prudently. This issue directly affects the effectiveness of Directors & Officers (D&O) Liability insurance which provides legal defense for the board if sued. As a wise insurance agent once said, “D&O doesn’t defend against stupidity.”

Preserving Legal Options with Contractors. Many developers lean toward low cost designs and materials that are quick to assemble. Speed of construction can run roughshod over quality of construction due to lack of proper detailing. Since one phase of construction often conceals another (framing is covered by sheeting which is covered by rain barrier which is covered by siding which is covered by paint, etc.), haste generally means sloppy installation that has dire consequences. Most construction defects, however, don’t reveal themselves immediately. It may take years.

In the meantime, the HOA is charged with proper, adequate and consistent maintenance. That means that the roof is kept clean and in good repair, the gutters are kept clear so they don’t overflow, siding is recaulked and

re-nailed periodically, etc. Failure to do these things can be used by a contractor as a defense for poor construction. If the HOA is faithful in doing its part, the case for construction defect is easier to prove.

Does your HOA have an adequate maintenance plan in place? If not, ratchet up and get moving. There is simply too much riding on failing the charge.

By Richard Thompson - Regenesis, Inc.
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Ask the Professional Reserve Analyst

Q What level of reserve funding should we consider a minimum level?

A Some state statutes require minimum thresholds for reserve funds. But those minimums don’t address what is adequate. One of the main objectives of performing a reserve study is to determine the current Percent Funded. If a reserve study indicates the HOA is, say, 35% funded, the Funding Plan can chart a course toward 100% or a lesser level that the board chooses like, say, 75% either by special assessment or over a period of years if special assessments can be avoided during the build up period.

The reason that some HOAs cruise along for years with inadequate reserves is the board has no plan to achieve it. All members should pay a fair share for the assets they benefit from. To achieve this, for example, for a 30 year roof that costs \$60,000, \$2,000 should be set aside each year to meet the funding objective. If less than \$2,000 is

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set aside, future owners will be required to make up the difference. To remain accurate, the reserve study should be updated for inflation, yield on invested reserves and known cost and useful life changes.

Q I am Chairman of the Finance Committee. In preparing this year's budget, I noticed several transactions charged to reserves that look like they should have been paid from the operating account: a spa filter and tree pruning. Your thoughts?

A Reserve plans deal with any repair or replacement item that has a useful life of 2 to 30 years. Under this definition, both items qualify as reserve expenses. However, if the expense is small and the operating budget can support it, paying for it out of the operating account would be okay. If not, it's appropriate to reimburse the operating account from the reserve account.

Q Is there a rule of thumb about how much the average HOA should have in reserves? We want to start saving for future renovation projects and some have suggested 10% of our monthly fee be

set aside.

A If it were only that simple. Reserve funding is driven by the number and kind of components it includes. Sometimes the components are few. Sometimes the components are many. To further complicate the issue, certain components may be repaired or replaced in phases. For example, a 100 unit condominium may have two to five painting phases. Each phase is considered a component for purposes of the study.

Then, the issue of funding level comes up. If the HOA has less money than it should (too often the case), then current members are obligated to make up the difference in addition to what normally would be required. HOAs that currently have 100% of necessary funds, will charge their members much less. That is the way the system was intended to work.

As a rule of thumb, adequately funded common wall HOAs maintaining both the structures and grounds pay around 33% of the monthly fees into reserves.
By Richard Thompson - Regensis, Inc.
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Board in Denial

The board of Nottacare Condominium has just convened to discuss a painful but avoidable issue, a special assessment. The roof is five years overdue for replacement and many of the temporary patches have failed, drenching four different units repeatedly. Mary in 1A has made many desperate appeals that something be done and Bob in 4B peppers his demands with four letter expletives. The other two owners are talking to their lawyers. There is a smell of tar in the air. And as bad as it is for these residents, the cure will be painful for one and all.

Nottacare's situation is not unlike that at many HOAs across the country. Nottacare's failed roof is what accountants call "an unfunded liability". A liability is a debt or obligation, in this case, the obligation is to replace a roof. Unfunded means there is no money to fulfill that obligation. Do the math: UL + \$0 = MSA. (Unfunded Liabilities + No Dough = More Special Assessments) Caramba!

Many HOA boards trip merrily along seemingly oblivious that all things wear out, ignoring the high costs of repairs, failing to prepare for those events and clueless how to overcome being clueless. Denial is not a river in Africa. It's a deadly mindset that not only leads to erosion of HOA assets and home values but also creates a pervasive mistrust, hostility and resentment from the members. So at Nottacare Condos, some are wailing "Raindrops Are Falling on My Head" and all are steamed because here comes another unwelcome special assessment!

Okay, you get the picture and it ain't pretty. But the good news is that Nottacare is a mythical place and your HOA is real and the board is fully prepared to meet these challenges. What's that you say? You just had a special assessment or the board is talking one up as we speak? Holy guacamole! Don't they know that special assessments are the product of poor planning? Don't they know they penalize innocent victims (the current members) that are forced to pay for former members who bailed out before the ax fell? Don't they know a properly funded reserve study could have

avoided all of this and made them heroes instead of zeros?

A reserve study analyzes future repair and replacement needs and devises a renovation schedule and funding plan that the board, the manager and members can follow with ease. It answers the bottom line question "How much is enough?" A proper funding plan shares costs fairly among all members, not just the poor suckers who get stuck at special assessment time. And with money in the bank, the board will never have the excuse of not doing things when they need doing. No more Raindrop Water Torture. The place will look so good, you'll never want to move!

Denial is a dangerous place to be. There is lots of turbulent water and crocodiles waiting to munch the board in denial. Before you round the bend and meet face to face with avoidable catastrophe, investigate the benefits of a reserve study. *By Richard Thompson - Regensis, Inc.* [APRA](#)

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Fraud Squad

Fraud can devastate the finances of a homeowners association. The association treasurer or property manager can often have access to 10s or 100s of thousands of dollars with little oversight. Embezzlement can be both

planned or spontaneous and the perpetrator young or old.

Associations are at risk because they are vulnerable. Board members may not be financial gurus who know what to look out for. Property managers do not require any kind of special licensing or education. Many boards simply don't want to be bothered and delegate too much responsibility to one individual.

In accounting terms, fraud is the misappropriation (theft) of assets. "Assets" often means cash, but can include other assets such as furniture, equipment and supplies. Misappropriation of assets can be accomplished in several ways. Examples include:

1. Theft of cash receipts. Associations should insist that all payments be by check made payable to the association, not the management company or the Treasurer.

2. Stealing assets. If someone walks off with your expensive pool furniture, you have been defrauded. That's why pool keys are controlled and locks are changed from time to time.

3. Paying for goods and services not received. This is probably the hardest fraud to detect. Examples include:

- The President has his home remodeled and charges it to repair and maintenance.
- The resident manager adds a brother to the payroll even though he does no work for the homeowner association.
- The manager has bogus companies bill the association for nonexistent repairs and maintenance. The auditors don't detect the fraud because the billings are supported by official looking invoices and the canceled checks have been endorsed in the names of the phony companies, giving the appearance of valid transactions.

Fraud may be concealed through:

1. **Falsified documents.** Fictitious invoices, forged check requests or purchase orders, and forged signatures on checks. Altered checks are those where either the payee was changed, the

amount altered or the endorsement forged. A cash shortage can be concealed in a bank reconciliation by using a false total for the outstanding checks. For example, the outstanding checks may add up to \$5,252.11, but the bookkeeper shows the total as \$5,752.11 to hide a \$500 theft.

2. **Collusion.** Collusion means two or more people working together to perpetrate the fraud, making detection more difficult: A crooked board member who authorizes a bogus payment to a crooked manager who shares the booty. An auditor sees that the transaction was approved and believes it to be valid.

Fraud can often be detected by merely paying attention to your financial statements, bank statements and budget variances. Missing documents, a general ledger that is out of balance, strange budget variances should alert the Board that something may be wrong. These signs should cause the board to ask questions. If evidence of fraud is compelling, never accuse anyone directly. Let your attorney do the talking.

Fraud occurs when too much authority rests in a single individual. Whenever one person has all three of these powers, fraud is possible:

1. **Initiates transactions:** Can have checks prepared, people added to the payroll, money transferred, bank accounts opened, accounts receivable written off.

2. **Approves transactions:** Can approve own requests: a treasurer or manager who not only prepares the checks, but signs and mails them too.

3. **Records transactions:** Allows bogus transactions with phony accounting entries. Examples: Receives cash from a delinquent owner, then writes it off as a bad debt; Records an alimony check as "Repairs-General"; Makes a cash withdrawal and posts it as "Administrative Expense." All thefts, of course, are charged to expense categories that are under budget so there won't be any unusual variances.

An effective system of internal financial control requires "division of duties".

First, do not allow any one individual to complete a transaction from beginning to end.

1. Checks should have two signatures.
2. Have supporting invoices, contracts, time cards, etc. when signing checks.
3. Do not allow the manager to keep association money in a company "trust" account. The association's money should be kept in an association bank account.
4. When using an outside payroll service, monitor the payroll each period.
5. Don't pay any large expense that wasn't preauthorized.
6. Be alert to a deteriorating accounting system. Financial statements, records and files should be up to date and furnished to the Board on a timely basis. Beware of financial reports that are consistently 2 or 3 months late, bank reconciliations that don't agree with the books, accounting entries that are unexplained or don't make sense -- all of these things are cause for alarm.
7. Check manager references before you hire or contract. Do not rely on professional affiliations. These organizations cannot assure the competence or honesty of their members.

In the final analysis, you can't prevent a determined crook, but you can increase the odds in your favor. Be alert. Put Fraud Squad precautions into place, chances are the issue will never surface. *By Gary Waltrip, CPA [APRA](#)*

Excuses Excuses

Homeowner association members who pay their assessments late or not at all sometimes come up with some interesting excuses. Here are five common ones:

Excuse #1 "I didn't get what I paid for so am withholding payment." Members have a right to require the board to perform its duties but withholding assessments is not the way to do it. The obligation to pay HOA fees has nothing to do with the HOA's obligations to provide maintenance and service. A

member that withholds payment becomes delinquent and should incur all penalties provided for in the HOA's collection policy.

Excuse #2 "You didn't bill me." The requirement to provide invoices is rarely found in the governing documents, however, HOAs are generally required to send the approved budget to each member annually which should also contains notice of the HOA fees owed.

Excuse #3 "The HOA has no right to make me pay for common area upkeep." Actually, the board not only has the right, it has a duty to collect assessments. This authority is established in the governing documents and state statutes. When people buy into a homeowner association, they agree to abide by those documents and that includes paying assessments.

Excuse #4 "I never use the recreational facilities and shouldn't have to pay for them." Admittedly, recreational facilities are expensive to operate and for some HOAs represent a large part of the budget. Nevertheless, the obligation to pay for a common amenity has nothing to do with the level of usage. Many move into an HOA specifically for the recreational amenities. They're willing to pay for them because they take full advantage of the opportunities they provide. Even if you're not using some of the amenities, they make the community more desirable and the homes more valuable. Those that don't use the facilities should consider whether an HOA without amenities might work better. If so, it might be time to move.

Excuse #5 "The HOA fees are too high." HOA fees reflect the cost of maintaining the common elements. All have to pay their fair share. If the HOA fees are too high, where can money be saved? The board should be open to ideas on reasonable ways to cut costs. But simply lowering fees because someone wants to pay less is not reasonable.

Excuse excuses. Many try to cash them at the Bank of HOA. Like a bum check, the HOA should refuse to accept them. *By Richard Thompson - Regensis, Inc. [APRA](#)*

Dear Mr. IRS

I am responding to your letter denying the deduction for two of the three dependents I claimed on my Federal Income Tax return. Thank you. I have questioned whether these are my children or not for years. It's only fair that since they are minors and not my responsibility that the government knows something about them. You may apply next year to reassign them to me and reinstate the deduction. This year they are yours!

The oldest, Kristen, is now 17. She is brilliant. Ask her! I suggest you put her to work in your office where she can answer people's questions about their returns. While she has had no formal training, it has not seemed to hamper her knowledge of any other subject you can name. Taxes should be a breeze.

Patrick is 14. I've had my suspicions about this one. His eyes are a little too close together for normal people. He may be a tax examiner himself someday if you don't incarcerate him first. He and his friends have raging hormones. DO NOT leave any of them unsupervised with girls, explosives, inflammables, vehicles or telephones. I'm sure you'll find the telephones a source of unimaginable amusement. Be sure to lock out the 900 numbers!

Heather, my youngest, slid through a time warp or came from a bad trip in the 60s. She wears tie-dyed clothes, beads and sandals. Most people under twenty understand the curious speech she fashioned out of valley girl-boys-in-the-hood-reggae-yuppie lingo. She wears hats backwards, pants baggy and wants one of her ears pierced four more times.

You denied two of the three deductions so I guess it's only fair you get to pick which two you will take. I prefer you take the two youngest, I still go bankrupt with Kristen's college expense but then I'm free! If you take the two oldest at least I have time for counseling before Heather becomes a teenager. If you take the two girls I won't feel so bad about putting Patrick in a military academy. Please let me know of your decision as soon as possible as I have already increased the withholding on my W4 to cover the \$395 in additional tax and made a down payment on an airplane.

Yours Truly,
John Q. Smith [APRA](#)