SOUTH COAST HOMEOWNERS ASSOCIATION

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2000 LAW UPDATE

Editor's Note: This summary includes information provided at our January and February law update sessions from materials distributed by Karen A. Mehl and David A. Loewenthal, member attorneys of the South Coast Homeowners Association. These bills were signed into law in late 1999 and were effective January 1, 2000. Next month's issue will profile pending legislation for 2000.

SB 1148 – HOUSING DISCRIMINATION RESTRICTIVE COVENANTS (Civil Code 1352.5) This law requires boards of directors to amend governing documents (CC&Rs, Bylaws, etc.) which permit discrimination based upon race, color, religion, sex, marital status, national origin, ancestry, familial status or disability and to restate the documents without member approval. The difficulty in the law as it is currently written is that language that may be considered discriminatory to some (e.g. occupancy restrictions) may not be considered discriminatory to others. Discriminatory language relating to race, for example, is easily identified. A new disclosure is required to be affixed to the face of all association documents (see January 2000 newsletter) which states that any discriminatory language contained in the documents is void.

AB 1048 – CONSTRUCTION DEFECT RECEIPTS DISCLOSURE – The association is now formally required under Civil Code Section 1365 to disclose the amount received as a result of any construction defect settlement and the amounts expended from these funds. Most associations so affected by defect settlements have been reporting these disclosures in their reviewed or audited financial statements. Distinctions are to be made between direct costs (contractors, builidng materials) and indirect costs (legal, consultants, etc.). These disclosures can also be made in the association's budget.

SB 382 – OLDER PERSONS' HOUSING – Revises Civil Code Sections 51.2 and 51.3 (The Unruh Civil Rights Act). The "qualified permanent resident" does not have to be an owner. This new law adds "disabled adult children" of seniors to the list of qualified permanent residents who are allowed to live with their parents in a senior development. Subject to legal challenge, an association can exclude some disabled adults if it can be established that the disabled adult is a danger to himself or others in the development. Seek competent legal counsel if this is an issue at your association.

AB 1687 – VOTING DISCLOSURES - Assocations are now required to provide members with information regarding votes taken at membership meetings, including the number of votes cast for, against and abstaining for each matter voted on by the members. In the case of election of directors, information must be provided on the number of votes cast for each nominee. If the election was conducted by class of membership, then the votes must be classified by class of membership.

AB 1055 – PLAYGROUND SAFETY – Before October 1, 2000 all associations operating playgrounds accessible to the public shall have a playground safety inspector, certified by the National Playground Safety Institute, conduct an initial inspection to determine what upgrades are necessary to comply with regulations issued by the Department of Health Services (Title 22. Division 4. Chapter 22) with upgrades completed by January 2003. An attempt to access these regulations at www.dhs.ca.gov/epic met with failure along with www.calregs.ca.gov. Perhaps our county parks department will have information on how to comply with these regulations. If we learn more, we will pass it along to you.

AB 860 – THE "PET BILL" – or "LIFE #10" – This bill was thought by some experts to be dead but like the proverbial cat, the bill's author is attempting to breathe new life into the bill by requesting a second hearing before the Senate Judiciary Committee. A hearing date has not yet been granted. We have a tape of the first hearing, lasting 30 minutes that showed how ridiculous this bill is. Briefly, this bill would override any CC&R prohibitions with respect to pet ownership. Pets are defined as "any domesticated bird, cat, dog or aquatic animal".

INDEPENDENT CONTRACTOR REPORTING UPDATE

In the January 2000 newsletter, I reported on a new law, AB 196, that would render an incredible paperwork burden on California associations as well as all businesses. Starting in January 2001, you would be required to report to the California Employment Development Department, within 20 days of engaging a contractor, information such as name, address, phone number, social security number, contract amount, when payment is to be made, etc. for each contractor that you hire. These contractors would include tradesmen (painters, plumbers, carpenters, etc. licensed by the California State Contractors License Board) along with landscapers, computer consultants, property managers, cleaning people, accountants, attorneys, etc. who are not incorporated and for who you expect to pay $600. Many associations utilize several of these people at different times throughout the year and would have continuous reporting obligations as a result.

In mid-December, I attempted to set up a meeting with one of the law's co-authors, Hannah-Beth Jackson, Santa Barbara's Assemblywoman, to discuss my concerns about the enormous paperwork requirements required. I had no luck until my editorial ran in the *Santa Barbara News-Press* on January 19. The commentary was essentially the same article that appeared in the January newsletter issued earlier that month. The next day, I received a call from Ms. Jackson's chief of staff offering a meeting on February 4, 9 AM, take it or leave it.

My meeting with Ms. Jackson was cordial and friendly. She is a family law attorney and spoke to the dismal record of child support collections in California and we must do everything within the law to improve these payments. This reporting is designed not for tax compliance but to increase collection of child support payments by identifying those parents who are receiving nonwage payments and then tracking them down or by levying the contract before it is paid to the contractor. She indicated that it is no big deal for California businesses to comply with this requirement since we are all computerized now.

I disagreed. Many associations, especially small ones, are run by volunteers whose limited time to attend to association matters is best spent on the furtherance of association business such as maintaining the property, not on child support compliance. While many small businesses contract out for payroll services, where compliance can be handled by computer, most write their own checks on their own computers (or manually). Even businesses with a bookkeeper or accounting staff will be pressed to add an additional compliance chore to their duties. While state and local government agencies will be compensated by the state for compliance costs, no funds will be provided to homeowner associations for their additional expense. I was disappointed that as a co-author of the bill, Ms. Jackson seemed to know little about this reporting provision.

Ms. Jackson indicated that the director for the new state agency that will be implementing all of the child support collection activities had just been appointed in late January and that nothing was yet known about the specifics of compliance. She indicated that perhaps some organizations could be exempted from this reporting requirement. In my opinion, that would require a change in the law and at this writing, I am not aware of any pending legislation that would exempt associations or other tax-exempt organizations from the reporting requirement.

In summary, I had my meeting with Ms. Jackson but did not get anywhere. The legislature needs to hear from the "big boys" such as the California Chamber of Commerce, Contractor Associations, California Association of Realtors, etc. I suspect that nothing will happen until all California taxpayers receive the "educational materials" that the Employment Development Department will mail out this fall detailing the reporting requirements for independent contractors. Remember, you read it here first!

PROTECTING YOUR ASSOCIATION'S ASSETS

by Gary Waltrip, CPA

Editor's Note: Mr. Waltrip is a CPA in San Jose with many year's experience in providing accounting services to homeowner associations. He is a Past-President of ECHO and has served as Past Chairman of the Accountant's Common Interest Realty Association Conference. His article emphasizes why internal controls are so important. Our thanks to Gary for his generous permission to reprint his article.

Recent frauds have devastated the finances of some homeowners associations: The treasurer of a HOA in Los Gatos disappeared with the reserve fund. The CAMS fraud of the 1980s resulted in a property manager disappearing with the cash from several associations. And right now in the Bay Area, a manager is said to be regularly embezzling funds from his association clients and no one seems to know what to do to stop it.

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 board members are also apathetic and simply don't want to be bothered. They then delegate too much responsibility to one individual with little or no oversight.

WHAT IS FRAUD?

In very simple terms, the accounting definition of fraud is the misappropriation (theft) of assets. (The legal definition is much broader). This theft is often called "defalcation." "Assets" often means cash, but can include other assets such as furniture, equipment and supplies.

HOW IS FRAUD ACCOMPLISHED?

Misappropriation of assets can be accomplished in several ways. Examples include:

1. Embezzlement, or the stealing of cash receipts.

This is why member checks should always be made out in the name of the association, not the management company or the name of the Treasurer. However, if the manager or Treasurer has sole signature authority on the operating bank account, they can deposit the funds and then write a bogus check.

One recent fraud I saw happened when the manager received an insurance check for storm damage made out to him, not the Association. He cashed the check and told the member that his claim was not covered.

Receipt of actual cash should be heavily discouraged, since it is the easiest asset to steal.

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. Causing the association to pay for goods and services not actually 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 onsite manager adds his brother, girlfriend and bookie to the payroll and they are paid a salary each month even though they do no work for the association.

- The offsite manager has various companies bill the association for miscellaneous repairs, maintenance, supplies, inspections, etc. The various companies are all shells operated by the manager and no work was actually performed. 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.

- The manager (this is an actual case) performs a "reserve study" for the association, charges them $5,000, and buries the expense in the reserve fund where it won't show up in the monthly operating statement. The "reserve study" is a one-page sham whose actual value is less than the paper it is typed on. (I saw one fraud where $3,000 was charged for a superficial "reserve study" and the check was co-endorsed by the reserve study preparer and the manager!)

HOW FRAUD IS CONCEALED
Fraud may be concealed through:

1. Falsified documents.
Fictitious invoices (bills) as described above. Forged authorizations such as check requests or purchase orders, and of course, forged signatures on checks. Altered checks are those where either the payee was changed or the amount altered or the endorsement forged.

A shortage in cash can be concealed in a bank reconciliation by simply using a false total for the list of outstanding checks. The list of checks may add up to $5,252.11, but the bookkeeper shows the total as $5,752.11 to hide the $500 she stole from the laundry receipts. Columns of numbers that don't add up can be used to hide cash discrepancies in the check register, the cash receipts journal or the bank reconciliations.

2. Collusion.
Remember this word, it is a major factor in fraud! Collusion means that two or more people were working together to perpetrate the fraud, and this makes detection more difficult. A crooked board member who authorizes a bogus payment could be in collusion with a crooked manager who shares the booty. An auditor sees that the transaction was approved and believes it to be valid.

HOW FRAUD MAY BE DETECTED
The existence of fraud can sometimes be detected by merely paying attention to your financial statements, bank statements and budget variances. (This is why California Civil Code 1365.5 exists.) Missing documents, a general ledger that is out of balance, strange budget variances may alert the board that something is wrong. However, do not jump to

conclusions! These signs may not be proof of fraud at all, but they should make the board ask questions. Never, never accuse anyone of fraud or you can be sued. Let your attorney do your talking for you.

OPPORTUNITIES FOR FRAUD -- ARE YOU AT RISK?
Fraud occurs when too much authority rests in a single individual. Whenever one person has all three of these powers, he can defraud you:

1. Initiates transactions.
He can request to have checks prepared, people added to the payroll, money transferred, bank accounts opened, accounts receivable written off.

2. Approves transactions.
Not only can he request the above, he can approve his own requests! An example would be a treasurer or manager who not only prepares the checks, but signs and mails them too.

3. Records transactions.
Wow! Not only does he initiate and approve transactions, he gets to record them in the accounting records too. This allows him to hide bogus transactions with phony accounting entries. He accepts cash from a delinquent owner, then writes off the receivable as a bad debt. He records that check for his back alimony as "outside contractors." He withdraws the cash in that old bank account and writes it off as "miscellaneous administrative expense." Of course, he takes care to charge his thefts to expense categories that are under budget so there won't be any unusual variances.

A GOOD EXAMPLE that is common in large associations with payrolls --
One individual can add people to the payroll, change their pay rates, then receives and distributes the presigned checks.

DIVISION OF DUTIES --
All effective systems of internal control require "division of duties" -- not allowing any one individual to complete a transaction from beginning to end. Use the "HOA Internal Control Questionnaire" to determine whether you have potential problem. Discuss any concerns with your CPA.

CONCLUSIONS - THINGS TO LOOK OUT FOR
There is no guarantee that you can prevent a determined crook from ripping you off, but you can slow him down. Do the following:

1. Checks should be dual signed.
If you give your manager or your treasurer the power to sign checks with their signature alone, you are asking for trouble. If they also keep the books and prepare the operating statement, you are even more exposed. Make sure you see the supporting invoices, contracts, time cards, etc. when you sign the checks. Ask questions and be downright nosey.

2. Don't allow your cash accounts to be commingled with the manager's.
Some management companies use so-called "trust" accounts where they have complete control of the association's cash. I have seen one example where the manager borrowed the funds of several associations for his own use.

3. If you use an outside payroll service, carefully monitor the payroll each payroll period.

4. Don't pay for anything large and expensive that wasn't authorized in advance.
Even emergency repairs can be authorized over the phone. If your manager presents you with a bill for dubious repairs, "reserve studies," etc., that were not discussed and approved by the board in advance, investigate.

5. Be alert to a deteriorating accounting system.
Operating statements, general ledgers, accounts receivable records, vendor invoice files, contract files, board minutes -- all of these should be in good shape, timely, and furnished on a regular basis for the board's inspection. Out of balance conditions, financial statements that are always 2 or 3 months late, bank reconciliations that don't agree to the books, accounting entries that are unexplained or don't make sense -- all of these things are cause for alarm. This is the milieu in which fraud and waste thrive. Be aware and pay attention!
This is not a comprehensive list, as there is no end to the frauds inventive minds can create!

6. Check references before you hire a manager. Many frauds could have been prevented if someone had carefully checked the references of the manager or bookkeeper (or other employee/contractor) before they were hired. It is a big mistake to think that all managers are competent and honest simply because they are members of an industry trade group like CAI or ECHO. These organizations generally cannot assure the competence or honesty of any service provider who joins them. You must check references yourself.

A FINAL WORD -- Be alert, but don't be paranoid. If you treat honest employees like crooks, they will resent it and may quit or even sue you for impugning their reputation. If in doubt, consult with your CPA and your attorney.

UPCOMING MEETINGS

May 4 – 6 – Community Association Institute's semiannual National Convention will be held at the Anaheim Hilton. Details available from South Coast and also thorough CAI's website – www.caionline.org.

June 2-3 – Executive Council of Homeowners (ECHO) conducts its annual two-day educational seminar at the Santa Clara Convention Center in San Jose. Call Mike Gartzke for additional information – 964-7806.

PLEASE FEEL FREE TO MAKE COPIES FOR YOUR BOARD MEMBERS SHARE THIS NEWSLETTER WITH YOUR ENTIRE BOARD OF DIRECTORS

PUBLICATIONS AVAILABLE FROM SOUTH COAST HOA

2000 *Condominium Bluebook* – A compilation of laws and other useful information to assist in association administration. $14.00 postpaid

Operating Cost Manual for Homeowners Associations – a useful guide when developing your association budget, published by the California Department of Real Estate - $ 5.00 postpaid.

Extra Copies of the South Coast Newsletter – Can be added to an existing membership for only $10 per year. This would allow an extra copy to be sent to another address within the association. Copies of the Bluebook or other publications distributed by South Coast are not included in this subscription.