

Condo Insights

#69 – Protecting and investing reserve funds – Part 3

The first two articles in this series focused on reserve fund management, investments and controls to protect reserve funds. This article will review practices to prevent misappropriation of association funds.

Misappropriation refers to the theft or unauthorized use of association funds by someone in a position of trust or responsibility over those funds. Misappropriation can take a wide range of forms, among them appropriating association funds (cash or credit cards) for personal use and expenses, falsifying receipts, and collusion with vendors for kickbacks. Misappropriation of association funds can occur due to lack of proper financial controls, poor record-keeping, or a failure to follow the association's governing documents.

Misappropriation of funds has serious consequences for the association and its members. It can lead to significant financial losses, potentially requiring higher fees, assessments, special assessments, or even bankruptcy in severe cases. Such incidents can erode trust within the community, making it difficult for the association to function effectively. This can lead to low participation and involvement, which can further damage the association's finances and stability. Individuals found to have misappropriated funds may face personal legal liability, including fines, imprisonment, or both, while the association itself may also be held liable. The lack of sufficient reserve funds can lead to delayed or inadequate repairs and maintenance, impacting the quality of life for residents.

Strong, consistent fiscal controls can prevent misappropriation of funds and can be a deterrent to would-be embezzlers. While not all theft can be prevented, sound financial practices, consistent implementation of internal controls and a few basic policies can minimize the potential and opportunities for mismanagement and can lead to quick discovery of any misappropriation of funds or manipulation of records.

A basic step that an association board can take to prevent financial misappropriation includes maintaining accurate and comprehensive financial records. This includes keeping detailed records of all financial transactions including income, expenses, and bank statements, reports comparing actual performance to budget, check registers, as well as receivables and payables reports. The financial reporting package should include proof that bank statements are reconciled monthly. The Board should review interim financial reports on a regular basis, usually monthly or quarterly.

Regular financial reports provide the Board with information about the association's cash position, income and expenses and the best reporting provides reasons why the expenses were incurred. Issuance of periodic reports to the Board provides the Board with timely information to ensure the Association is on a stable financial path and to allow the Board to make adjustments. When a board understands how much the association is spending and on what, it can make informed decisions, including where spending could be better controlled and when (and how much) fees may need to be increased.

A single board member should never have complete control over the association's entire financial process. If there are no qualified volunteers among the members, hiring professional management provides a level of oversight for association financial activity. Even with outside management, segregation of duties, eliminating credit cards, and board approval of contracts, bills and invoices are part of fiscal control plan. At least one board member should review and approve operating expenses, and two board members should approve reserve expenses. Associations should have their financial activity audited on an annual basis by an independent accountant.

What should an association or board member do if they suspect that a director, employee, or manager has misappropriated association funds? There are several steps to deal with the situation, including the following:

Gathering as much evidence as possible, including the association's financial records, bank statements, invoices, and other relevant documentation. In New Jersey, association members are entitled to review such documents by law. Report findings (in writing) to the board and demand an open investigation. Notify other association members to help address the issue, and if necessary, hire an attorney to force an investigation if the board is reluctant to act.

Those who believe they have discovered fraud, theft or other criminal conduct by a board and believe they have concrete evidence should bring the matter to the attention of the county prosecutor or other appropriate law enforcement agency. (If it relates to an association employee, depending on the nature of the conduct, an owner may wish to initially bring it to the board's attention). The New Jersey Department of Community Affairs and prosecutors typically do not act on owner complaints regarding allegations of board misconduct such as acting irresponsibly or contrary to the bylaws since associations are private communities for which there is a remedy through a civil court proceeding.

If evidence exists proving that someone misappropriated association funds and restitution is not a likely or viable resolution, association members can insist that the board members submit the claim to the association's insurance company rather than bear the burden of the loss or impose an assessment, assuming there is theft coverage.

New Jersey law mandates that condo associations maintain fidelity bond insurance to cover losses resulting from dishonest or fraudulent acts by those handling or managing association funds. This insurance typically covers losses due to theft, embezzlement, or other forms of dishonesty by association directors, officers, employees, managers, or volunteers. The purpose of fidelity bond insurance is to protect the association and its members from financial loss caused by the misconduct of individuals entrusted with handling funds. The Federal Housing Administration also requires associations to maintain fidelity bond insurance.

Theft or embezzlement of condo association reserve funds is a serious issue with significant consequences for the association and its members. By taking steps to prevent misappropriation and addressing it promptly if it occurs, associations can protect their finances, maintain the trust of their members, and preserve financial stability.

Board members are volunteers managing significant assets for Association members. Implementation of fiscal controls, preparation of periodic interim financial reports and preparation of annual audited financial statements by an independent accountant are part of best practices for condominium, community and homeowner's associations. Incurring the expense to ensure fiscal controls are in place is a reasonable and responsible action for condominium, community and homeowners associations.

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