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Tips for Preventing Theft and Fraud of Association Funds

MULCAHY

Community Association Cheat Sheet©

BRINGING ANSWERS TO COMMUNITY ASSOCIATIONS

This publication discusses significant points of law as they apply to community associations and is not intended to offer specific legal advice or responses to individual circumstances or problems.

MULCAHY LAW FIRM, P.C.

3001 East Camelback Road
Suite 130
Phoenix, Arizona 85016
Phone: 602.241.1093
Toll Free: 877.206.7164
Facsimile: 602.264.4663
E-mail:
bmulcahy@mulcahylawfirm.com
www.mulcahylawfirm.com

THEFT OF ASSOCIATION FUNDS

Theft of association funds is unfortunately becoming common in community associations. Arizona newspapers have reported in the past few years misappropriation of funds by a management company, the unexpected closure of a small management company after individuals absconded with funds from several associations and a manager taking a million dollars from an association.

<u>If you have not heard about someone stealing money from community associations, do an internet search. Fraud in community associations is rampant.</u>

What can the association do? Understand and identify the risks the association faces and implement steps and actions that board members can do to help prevent the association from falling victim.

PERCEIVED OPPORTUNITIES

A well-known criminologist and expert on the sociology of crime, Donald R. Cressey (1919 - 1987), created the theory of the fraud triangle to help explain the components that need to be present to allow a white collar criminal to commit occupational fraud. In the model, the three sides of the triangle are rationalization, social pressure and perceived opportunities. Two legs of the triangle, rationalization and social pressure are difficult for an association to manage. However, perceived opportunities can be managed quite effectively by the association. Practicing good risk management and being aware can mean the difference between operating without any theft or fraud and being another victim.

MISAPPROPRIATION OF FUNDS

Misappropriation may look like: 1.outright taking of cash; 2. faked expenses; 3. non-existent employees or former employees included on the payroll; 4. transferring association funds to another community, the management company, or the manager; 5. use of association funds as collateral on personal loans; 6. showing investments on the financial statements as certificates of deposit when they are actually non-existent. 7. a manager paying personal bills with association funds.

Warning signs **of potential fraud** include the following: missing bank statements and reconciliations, general ledgers that do not balance, missing and altered documents, photocopies rather than originals, unexplained cash shortages, unauthorized credits to receivable accounts, increased past due accounts, duplicate payments to vendors, unexplained overdraft and other bank charges, unauthorized purchase transactions and payments for unspecified services.

Accounting checks and balances are vital steps toward protecting the association's assets, but, vigilance and awareness are also needed. The board of directors should periodically set aside time for a full discussion of all financial matters, and, above all, they must maintain a level of skepticism. Ultimately, the buck stops with the treasurer and the treasurer must be especially vigilant with oversight of association funds.

SELECT AND USE THE ADVICE OF PROFESSIONAL ADVISORS

The board of directors must select a team of advisors and/or a management company to best serve the association. Depending on the size of the association, advisors may include some or all of the following: 1. Attorney; 2. Insurance agent; 3. CPA; 4. Investment consultant; and/or 5. Reserve specialist.

The board should do its due diligence and research any and all advisors that they may want to employ. Select advisors who are knowledgeable, experienced and dedicated to community associations. Additionally, there must be excellent communication between the association's treasurer, the advisors and also among the advisors themselves.

THE MANAGEMENT COMPANY

A major decision of the board of directors is the selection of a management company to perform financial services. Working together, the board and advisors can make a good selection by considering: 1. the company's reputation for integrity; 2. experience of the managers and the company; and 3. the qualifications of, and processes followed by the financial department.

The Management Company (continued)

Ask questions and consider:
1. Ask questions of other community associations who have a successful working relationship with their management company.
2. It is perfectly acceptable and indeed *necessary* to research the association's management company.
3. One or more key board members, including the treasurer, should take the time to visit the management company, tour their offices and meet with key personnel.
4. Ask if the management company has conducted criminal background checks regarding employees in their company who handle association funds and ask to see the report.
5. Inform the management company of the association's concern and diligence to protect the association funds from theft and embezzlement and ask what prevention measures they have in place and what insurance they carry.
6. Inquire about the company's policy/methods regarding the working relationship with the board of directors. The management company/manager should *know* board members and have a working relationship with them.
7. A report, of the visiting board member's findings, should be presented to the board of directors and possibly the advisors at the board meeting following the members' visit to the management company.
8. See our Mulcahy Cheat Sheet© on "How to Select a Management Company" for further in-depth information.

Review the Association's Insurance Coverage

A board of director's primary responsibility is to preserve and maintain the association's assets. Associations should carry employee dishonesty/crime (Fidelity Bond) insurance coverage in addition to any coverage the managing agent might carry. This policy should cover anyone who has access to the association's funds.

Review the coverage offered by the insurance company and meet with your insurance agent to be assured that it meets the needs of the association for the following:
1. Employee dishonesty; 2. forgery or alteration of records; 3. protection while on association premises; 4. protection while in transit regarding association business; 5. money orders and counterfeit currency; and 6. computer fraud.

Be Aware and Vigilant - *TAKE CONTROL*

Our law firm suggests that boards have the following accounting and financial controls in place to prevent embezzlement and fraud in their association:
1. Keep association records up to date (don't fall behind on financial statements, budgets);
2. Assign control of all reserve funds to the entire board (not one person);
3. Monthly financial reports should be prepared and made available for board review (include in the monthly report: a balance sheet, a statement of revenues and expenses and a comparison of actual revenues and expenditures to budgeted amounts);
4. Require two signatures (including at least one board member) on all checks or transfers greater than a pre-designated amount;
5. Prior to signing checks, authorized check signers must review invoices and supporting documentation;
6. Review bank statements and reconciliations on a monthly basis;
7. Keep only a small amount of petty cash on hand and in a secure place and have a procedure for keeping track of petty cash;
8. Regularly review delinquent receivable balances;
9. Purchase adequate fidelity insurance to cover the volunteers and employees who handle funds. In addition, arrange for directors and officers coverage (D&O insurance) in the event the board is accused of financial mismanagement;
10. Hire a CPA to conduct an independent annual review or audit; and
11. If your board discovers that funds are missing from your association, remove the suspected fraud perpetrator from a position of control, put a stop on all bank account activity, notify your insurance carrier and check with your association attorney for advice on how to proceed.