How to Guide for

Protecting Your HOA from Fraud and Financial Crimes

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Protecting Your HOA from Fraud and Financial Crimes

As Board Members you have more than likely heard the term *fiduciary duty* more than you care to remember. However, fiduciary duty is of the utmost importance, especially as a Board Member. As a *fiduciary,* your obligation to the association is to act in the best interest of the association, show good faith and act diligently. Association management companies and Community Association Managers also have a fiduciary duty to the association and Board of Directors.

Most Board Members take their roles as community leaders seriously with integrity and understand their responsibility to the association. The same can be said for association management companies and Community Managers.

Unfortunately, there are and have been individuals that represent these groups with little or no semblance of integrity. Theft of association funds is on the rise. We've all seen news reports that detail misappropriation of funds, a management company closing after funds from several associations disappeared and Board Members who make off with the Associations reserve funds.

We all say that it won't happen to us, yet fraud, embezzlement and other methods of theft happen daily to both individuals and companies alike. And homeowner's associations are no exception.

How Fraud Can Impact Your HOA

But why should homeowner's associations worry about fraud? A common belief is that if a management company steals from the HOA, the problem can be easily resolved by suing the company, recovering the funds, and letting insurance cover everything else. This may be true but, depending on the circumstances, it can take *years to recover your funds*. In the meantime, the HOA must determine how to continue paying the bills and completing projects that relied on the now missing operating or reserve funds.

Homeowners will most likely be upset about special assessments to bridge the gap of funds, and banks may be hesitant to lend your HOA the necessary money.

On top of all this, some funds may never be recovered. Your fidelity insurance may have been insufficient; the management company may have folded and is nowhere to be

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found. With all these factors to consider, boards of directors must realize that with fraud, full recovery is rarely a certainty.

Here are a few common fraud tactics used against HOAs:

- Falsified bank statements
- Falsified balance sheets
- Payments made to vendors that don't exist
- Exorbitant "consulting" fees paid to people who either did not exist or had no credentials to consult (except for on a fraudulent plan)
- Payments for highly excessive or unnecessary repairs, amenities, etc. (like buying more patio furniture than would ever fit at the pool)

When fraud occurs in an HOA, boards are left scrambling to try and recover the losses. Once it happens, everyone probably has the same thoughts running through their minds: "I can't believe it. *He/she was such a good person*." But it doesn't have to be this way. By implementing fraud prevention procedures, monitoring association financial accounts, acquiring sufficient insurance, and just generally having an active role in board member duties and responsibilities, your HOA can work to prevent fraud.

The Board of Directors' Role in Fraud Prevention

One important rule for board members to keep in mind is that picking an HOA management company solely based upon the lowest price is always a bad idea. Sometimes you get what you pay for. Most often the savings comes in the form of reduced financial controls and oversight which can result in a bigger chance for one person to visit a tropical island with your associations' money!

Fraud takes both motivation and opportunity. If either is not present, fraud cannot occur. While the board of directors cannot control the motivation, they can control the opportunity.

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Many cases of fraud where funds were taken from association accounts may have been prevented if the board of directors had carefully reviewed their financial statements. While serving on the board is a volunteer position (and many board members have families and full-time jobs), the commitment to serve as a board member comes with certain fiduciary responsibilities. Board members *must* take measures to safeguard association funds and property – even when you aren't using a management company.

Here are some easy steps your board can take to help protect the association and its assets:

Select a Reputable HOA Management Company

Some boards choose to self-manage, but often there are not enough volunteers who can commit the time or have the experience to handle the financial and administrative tasks of the Association. When the decision is made to hire or change management companies, the board should take time and do its due diligence in selecting a new company. As I stated before, there is a lot more to consider than just selecting the lowest bidder.

In addition to the suggestions mentioned in this White Paper, there are other important things your board should review before hiring a management company or bookkeeper.

1. *Ask to see certificates of Insurance* – Any reputable Management company should have some, if not all of the following insurance policies in place: General Liability Insurance, Workers Compensation Insurance, Errors and Omissions (E&O) insurance, Employment Practices Insurance, Cyber Crime insurance, Automobile Insurance and most importantly a Fidelity Bond. The insurance policies should have appropriate coverage limits (minimum of 1 million dollars per occurrence per policy)
2. *Ask about accreditations and certifications* – Look for management companies who are members of industry groups such as HOA-USA and Community

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Associations Institute (CAI). Often these industry groups have licensure, certifications, continuing education and have a strict code of conduct and ethics rules. Ask what credentials your potential property/portfolio manager has, and verify those credentials.

3. *Do a site visit* – visit their offices and meet their staff. The property manager isn't the only one who will be providing service to your association, so ask questions. See how professional the office staff are, and how organized the office seems to be. Ask yourself if the office and staff projects the image of a professional management company. Find out how long they have been in business, and how many clients they manage.
4. *Ask about hiring practices* – The employees are going to be the ones who handle your association on a day to day basis. Good hiring practices are key to protecting your assets. Do they have a good recruiting and interviewing process to ensure the most qualified candidates are hired? Are criminal and credit background checks performed during the hiring process? Do they provide education and training for their staff? How do they handle claims of sexual harassment, employee performance issues or customer complaints against staff members?
5. *Ask about financial controls* – Financial controls are key to ensuring that the opportunity for fraud is minimized. You should notice if there are enough staff members in the accounting department to have appropriate segregation of duties to prevent fraud. Ask about their financial controls, who signs checks, who approves invoices, who can add vendors, etc. Ask if the association will have its own bank accounts under its name and tax-id number, or is it in the name of the management company, or are the funds co-mingled with other clients.
6. *Ask if they use a Bank Lockbox* – A lock box system allows owners' payments to be mailed or transferred directly to the association's bank accounts. This reduces the chance that the association's money will be deposited into the wrong account.

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7. *Ask about computer and data security –* Protecting the associations electronic data is just as important as protecting its finances, and often go hand in hand. Loss of data, hacking or otherwise lax data security measures can lead to financial fraud as well. Ask what controls the company has in place to prevent viruses like the "Cryptolocker" virus. How do they handle employee passwords – are they required to be changed at least every 90 days? How often is the data backed up? Where are the computer backups stored (on-site or off-site)? Do they have a disaster recovery plan in place that will mitigate service interruptions should their office and computers be lost through fire or burglary?
8. *Review the proposed contract –* Contracts detail who is responsible for what, and what you should expect from the relationship, as well as remedies for non-performance. If the management company does not require a contract, or if it's a one page "letter of understanding" **buyer beware**. Why would you turn over all of the associations funds and assets to a third party to manage without a contract? The contract should detail all fees that may or may not be charged to the association (some fees may be usage based and not recurring). Sometimes the monthly fee may be low in the proposal, but there may be additional fees that can double your monthly costs. Make sure you understand the true cost of utilizing that company. The contract should also detail controls and restrictions on the management company as it pertains to the association funds, such as limits on expenditures without approval, etc.
9. *Check References –* Ask for at least 3 references of similar types of communities, then call them. Ask about the service, responsiveness, professionalism and their satisfaction with that company.

After you have selected a reputable management company, the board's role in preventing fraud doesn't end there. As I mentioned before, the board still must be vigilant to control the opportunity for fraud. A few other ways your board can reduce the opportunity for fraud are:

Require Timely Reports

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The board should receive the association's month-end financial statements and bank reconciliations within the following month – usually within the first 10 days. If this is not happening on a regular basis, the board may find itself unable to perform its fiduciary duties.

“Within the following month” is not a hard and fast rule, but the cause for the delay should be reasonable—like a change in management. Sometimes at the end of the year, these reports take longer, but preliminary statements should be ready on the regular monthly schedule. Timely reports promote proper vigilance, which in turn can help the board can catch fraud before too much damaged has occurred.

At a minimum, the board should require the following types of accounting reports be delivered to them on a monthly basis:

- Balance Sheet
- Income statement (or profit and loss statement)
- Outstanding Accounts Payable
- Outstanding Accounts Receivable
- Check Register
- Bank Statements
- Bank Reconciliation(s)

Review Financial Reports

If there is any difference in the month-ending balance between the balance sheet and the actual bank statement, there should be a reconciliation form to explain the differences, generally due to deposits or withdrawals in transit. Any unexplained differences should be promptly investigated.

The budget-to-actual comparison should also show a budget discrepancy as the

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embezzlement unfolds. The defrauder has to make the cash balance; therefore, the money has to be expensed somewhere, and since HOA budgets are usually tight, small differences can be noted and addressed. This comparison needs to be done quarterly so that any problems are promptly addressed and corrected.

When there are questions, request copies of invoices to validate the charges.

When associations use these procedures frequently and thoroughly, they discourage potential defrauders by increasing the odds of detection.

Proper Management of Accounts

Board members should ensure that bank statements are sent at least Monthly (quarterly for certificates of deposit), and are accompanied by reconciliation reports. The accounts should **always be in the name of the association**, not the manager or an owner or anyone else. If the account is not in the association's name, then the association does not own it and someone else has control of it and can take it.

If possible, you should request that the bank email a copy of the statement(s) directly to the board of directors so you can verify bank statements have not been altered.

Conduct Audits

While it may be too costly to conduct an audit every year, the board should commit to having an independent Certified Public Accountant (CPA) to perform one at least every few years. In the interim, the association should have an annual review performed, with the stipulation that the bank balances be independently verified.

Review Your HOA's Insurance Policy

While having insurance will not protect you from embezzlement, it will certainly help

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you if it does happen.

The association board and/or manager should discuss their policy an Insurance Agent that specializes in working with HOA's. The review of the Associations Policies should also include the Declaration of Covenants (DCCRs). The Covenants usually outline the **minimum** Insurance required, and is the Fiduciary Duty of the Board to follow these requirements. The Board should make informed decisions on the types and amount of Insurance that is best for the Community.

The Insurance review will show what type of coverage is in place to cover the actual Dollars and Cents in the Operating and Reserve Accounts. The Community will either not have coverage, Employee Dishonesty or a Crime and Fidelity Policy. The worst scenario is not having any coverage at all.

Many associations may have employee dishonesty coverage included with their general lability or business owners' policy, since it is an endorsement on many policies. Employee Dishonesty will have a listed dollar amount of coverage, which is usually not enough to cover a financial loss unless you've increased coverage. Another issue with Employee Dishonesty is the limited definition of who is covered under the policy. Normally it will only cover named Board members, and sometimes Committee members.

A stand-alone Crime and Fidelity policy or bond has the broadest definition of **who is covered**, **what types of Crime** is covered and it can be purchased in any amount. This is usually the best type of financial theft insurance available.

Who should be included?

- ***Association Employees*** - Especially those with access to any type of funds. This also includes those who have authority to purchase equipment and/or supplies for the association.

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- **Managers/Management** - Your management company should be endorsed onto the association's bond. The management company's bond generally covers funds owned by the management company and sometimes funds they are holding for others. Their bond amounts are usually much smaller than the totals in the association's reserve accounts, especially if they have a large number of clients.
- ***Accountants/Bookkeepers*** - If you use a bookkeeper, whether a volunteer living in the association or contracted, that person should be endorsed onto the policy.
- ***Board Members AND spouses*** - Board members are volunteers, they may not qualify under the strict definitions of the policy as "employees." Be sure your policy includes an endorsement for volunteer directors and their spouses.
- ***Committee members*** - Important for any committees that may have access to equipment or supplies.
- ***3rd parties* –** provides coverage should a third party obtain account information and forge checks.

What scenarios should be covered?

- ***Theft by employees*** – The major purpose of the bond which would include the people listed above for theft or embezzlement.
- ***Computer theft*** – Theft of files from the computer or other uses of the computer to gain access to the bank accounts should be covered.
- ***Theft by outside parties*** – This includes physical burglary or robbery. How much money is kept in the association office? Who takes the money to the bank, and what happens if that person is robbed on the way?
- ***Forgery or alteration*** – Physical changes to checks or bank statements . While the bank may reimburse for an obvious forgery, remember the earlier statement that most fraud takes place over a long period of time. Banks may only be "on the hook" for a limited amount of time – think of

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those notes on your bank statements indicating that you must bring up any problems or concerns within 30 to 60 days of the statement.

While it may seem obvious, be sure that your fidelity bond is sufficient. The amount should cover your total reserve funds, plus operating funds. One recommended formula is total reserve funds plus three times your monthly operating income. FHA and other Lending institutions are now requiring these amounts of Crime and Fidelity and higher for condominiums anyway. Be sure that you have taken into account the additions to the reserves that will take place after the bond has been placed for the year. If you settle a large lawsuit, have a special assessment or otherwise have a major change in total cash assets, remember to increase your fidelity coverage.

Consider inviting your insurance agent to a board meeting to review these issues. Let the agent know your questions in advance so that he or she has time to put together information about your policies and explain any recommendations.

Summary

Even with these steps, there is no guarantee that the association will be protected. However, following these basic steps will significantly reduce the risk of theft, and minimizes the association's reliance on luck and the trustworthiness of its directors, officers and managers.

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Consider Choosing Community Association Management to Partner with your Community

Community Association Management has established a long history of creating caring communities in North and South Carolina. Our Community Association Management Company is one of the largest of its kind in the Carolinas and is devoted to the professional management of association communities. For many years, we have placed priority on providing the highest standards of excellence and service to enhance the individuals and communities we serve. As a full-service community management company, our highly skilled, professional staff of community mangers, bookkeepers, administrators and maintenance staff are ready to anticipate and meet client's needs. With our staff of dedicated professionals, we are large enough to meet all your needs, but small enough to give your association the personal, individual attention you deserve.

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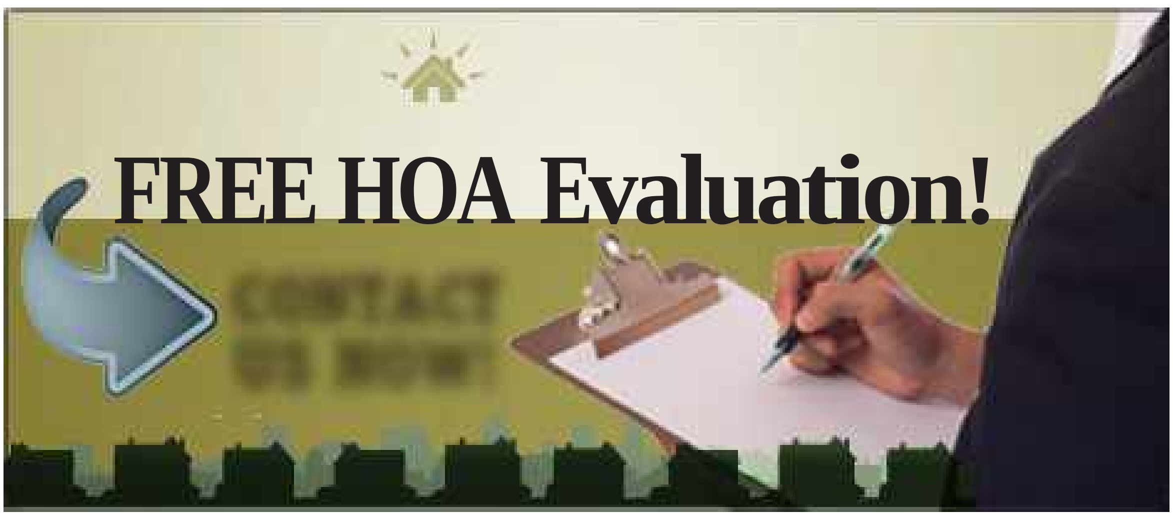
We recognize that each HOA has unique and specialized needs, so we have a dedicated community manager assigned to oversee your association. To make sure every detail is taken care of, a team of support staff supports each portfolio manager. From our finance department to our Customer Service department and our Compliance Inspection Department, we are all dedicated to providing a variety of services designed to assure the ongoing care and maintenance of your member's properties and the satisfaction of your community.

Call us today to find out how choosing Community Association Management to manage your association can make it more efficient and less time consuming for your board!



About the Author: Derek Greene is the founder and CEO of Community Association Management, Limited., one of the state's leading HOA Management Companies with offices throughout North and South Carolina. Before starting Community Association Management, He served as Senior Vice President at Bank of America over Change Management in the ATM division. Derek has a number of licenses and certifications in the HOA industry and is currently serving his third term on the Community Association Institute North Carolina Legislative Action Committee (NC-LAC).

Portions of the insurance section were contributed by Andrew Bateman with Trisure, a insurance agency dedicated to serving the HOA Industry nationwide.

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