



A Funny Thing Happened on the Way to the Bank

Fraud in the Community Association

by Joel W. Meskin, Esq., CIRMS ♦ Featured in Katzman & Korr: Legal News Tailored for Community Associations
Vol. 1 / 2008

If you ask any person who lives in a condominium if fraud or embezzlement would ever happen in his or her association, it is more than likely that you will be assured that it would never happen – wouldn't even be possible – in the resident's community. But no association is immune from the risk of fraud. Why are community associations inherently vulnerable to fraud and embezzlement?

Community associations, whether they are a condominium, cooperative, homeowner's association, or property owner's association, are legal entities, like any other business entity. The people governing that entity are responsible for maintaining the association's interests pursuant to its governing documents. The difference, however, between community associations and business enterprises is that the associations are often run by volunteers, some with no experience in running a business or management, and others with too little time to devote to the task. Associations and their boards are often ready – even willing – to let others handle the responsibilities. They may also be too quick to trust. This level of trust and acceptance would never be allowed in the same individuals' business enterprises.

The Red Flags of Fraud

Most often, if someone is engaging in fraud or embezzlement, there are clear indicators that something is amiss. Fraud is most often perpetuated by employees who pay personal bills out of petty cash, waive the dues or assessments of various community members, or give association repair and maintenance contracts to friends, relatives, or certain vendors in return for kickbacks. As with any organization, if the opportunity is there and there are no controls, temptation can get the best of some people.

The following examples of association practices or in-

dicators of fraud should prompt an association to pay closer attention to business practices:

Sloppy Hiring Practices

Every association should conduct background checks on prospective employees. Background checks are inexpensive procedures, and it is prudent to check not only employees, but board members as well. Associations should also check references and contact the former employers of prospective managers.

Changes in Lifestyle

Stay alert to significant changes in employees' spending habits or financial circumstances. Invading employees' privacy is illegal, but if an association puts checks and balances in place, the temptation for employees to stray would be avoided in the first place.

Poor Check-Signing Practices

Associations should avoid requiring only one signature on each check. Very often this practice is the result of trying to reduce or avoid the inconvenience of having to collect more than one signature on a check. But associations should view this simple control as part of the cost of living in an association. Be equally wary of using a rubber stamp. Make sure signature cards are properly updated when officers or management companies change.

Poor Check-Handling Practices

Check-handling practices must be monitored closely. Be wary if checks are deposited haphazardly or at random intervals. Do not allow blank checks to be stored in the open in the association office or in the treasurer's house. Are checks being written out of sequence? This is another cue that something is amiss.

Control of Bank Records

Who receives bank statements? Is it the same person who handles all bank transactions and business? This



is very often the case in a small association. It is prudent to separate these tasks, so one person is charged with writing checks and conducting association business and another person receives bank statements and balances accounts.

No Vacations

Always be wary of employees who never take time off. An employee who earns \$22,000 a year and never takes time away from the office should prompt a hard look. If an employee is refusing to take time off, it may be because he or she doesn't want irregularities to be revealed during his or her absence. Banks require their employees to take time off, and any other entity that handles funds should make the same requirement.

Preventing Fraud and Embezzlement

Most association fraud and embezzlement happens because someone discovers that the crime is easy to commit. But there are three steps that an association can take to minimize the likelihood of these crimes happening. The most effective step is to retain the appropriate professionals to set up procedures, checks and balances, and a division of tasks to prevent these crimes. The following checklist outlines the steps associations can take to minimize the risk of this crime happening in their community:

Hire Professionals

Wherever possible, professionals should set up the association's procedures. If at all possible, the fee for doing so should be included in the annual budget. If the association can afford to retain an accountant to handle the books and bank reconciliation, the association is taking a major step toward avoiding problems. The accountant should carry errors and omissions insurance and a fidelity bond. Associations should retain an attorney who is versed in community governance. Professionals who specialize in services for community associations, including CPAs and attorneys, under-

stand that their clients are budget-driven entities and usually offer free arrangements that are appropriate to these clients. When asked, most association members who claim that a professional's fee was too expensive never asked for a fee quote.

Background Checks

Anyone who handles association funds should undergo a background check. All employees should be evaluated with the same care that would be applied to the review of a prospective employee of any other business enterprise.

Whenever Possible, Divide Tasks

At least one person – or two in a more secure arrangement – should sign checks. A different person should reconcile the bank statements. The person who writes checks should not be the same person who deposits checks. A lockbox should be used to store checks collected from association members. Associations should require original invoices to be presented with checks for signature. The check signatory should stamp or otherwise indicate that the invoice has been paid.

Manage the Paper Trail

Duplicate bank statements should be delivered to separate individuals. Financial reports and bank statements should be renewed monthly. Blank and unused checks should be kept in a secure location. Checks should be issued in numerical order. Personal identification numbers and access codes should be kept in a secure location and changed regularly, especially when an employee leaves or signatories are replaced.



Collect Dues and Assessments with Care

Dues and assessments should not be paid in cash.

Dues and assessments should be deposited as frequently as possible.

Direct deposit of dues or assessments should be allowed.

Copies of all checks should be retained.

Insurance Safety Nets

As a last step to protect their interests, associations should carry sufficient fidelity (employee dishonesty) and crime (non-employee dishonesty) coverage. No matter how well an association protects itself, no matter how carefully it screens its employees, and no matter how proactive it is, there will always be those creative souls who will try to take advantage. Why, then, should an association bother to put in place the procedures to protect its interests? The answer is that any fidelity carrier will look to those controls during underwriting, and the controls will impact premiums.

Fidelity coverage is also known as employee dishonesty coverage. Fidelity coverage for associations should include directors and officers, association employees, and association property managers as insured persons. Fidelity insurance is also sold with crime coverage to protect from non-employee theft.

What is the purpose of fidelity coverage? It indemnifies the community for loss of money, securities, or any property because of acts of fraud, dishonesty, forgery, theft, larceny, embezzlement, misappropriation, or any criminal acts on the part of the directors, officers, committee members, association employees, board members, and volunteers. Coverage can also protect the association against criminal acts by an independent managing agent.

As a general rule, the fidelity bond should cover the greater of either (1) the maximum funds that will be in

the custody of the association or its management agent at any time the bond is in force, or (2) any amount required by the association's bylaws of three months assessment plus current reserve funds, as required by the secondary lenders. Unwary community associations often assume that their policy provides coverage for any exposure. But this is often not the case when a package policy is sold with set limits that bear no relation to the formulas set above. This is why associations should turn to professionals who are versed in the needs of the community association industry.

Third-party crime coverage protects associations from the effects of a non-employee committing one of the following crimes: (1) forgery and alteration; (2) theft, destruction, and disappearance (premises and transit); or (3) computer fraud and wire transfer. The coverage can be sold as part of fidelity coverage or as a separate package.

A Final Note

The good news for the community association industry is threefold. First, fidelity claims are still rare, and when they happen, they are usually resolved quickly and quietly between the association and the offender (very often to avoid the embarrassment and stigma of fraud). Second, associations can take simple and inexpensive steps to minimize the risk of such incidents from happening. Finally, fidelity and crime coverage are inexpensive compared to other associations insurance.

Community associations are wonderful places to live because they work to guarantee that the community maintains its physical character and that certain standards are enforced for the lifestyle of families and the value of the property. But the choice to live in a community association comes with duties and obligations. Those duties and obligations are not, and need not be, burdensome, but they do require attention, as does any



other investment or business venture.

To protect their finances and property, associations should hire the right professionals, put in place in the proper controls, and give these items the attention they would give any other financial or business venture. At the same time, as with any other investment, taking out adequate insurance is a prudent step to provide peace of mind.

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