FINANCIAL FRAUD

SAFEGUARDING ASSETS OF YOUR HOMEOWNERS' ASSOCIATION

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HOW COULD THEY HAVE DONE THAT? This is usually the first question that is asked right after a *trusted* person (e.g., manager, treasurer or staff member) has run off with the Association's bank account – committed financial fraud.

The next question we should be asking ourselves is; **WHAT COULD WE HAVE DONE TO PREVENT THIS FRAUD?**

Fraud comes in many forms. Not the least of which is the Board of Directors not exercising oversight of the daily financial management of the Association. The board has a fiduciary duty to protect the assets (*i.e., cash*) of the Association, and the possibility of fraud is inversely proportional to the oversight activity exercised by the Board of Directors in meeting their fiduciary duty.

Today, we are going to concentrate on financial fraud or cash register dishonesty – the misappropriation of your Association's cash by an unauthorized individual or organization. This cash register dishonesty comes in many forms:

1. Unauthorized transfer of cash from the Association's bank account.
   a. Someone ran off to Bimini with your bank account.

2. Diversion of member's dues payments.
   a. The member's checks ended up in a non-member's account, or
   b. The member's checks went into another member's account.

3. Inappropriate payment to vendors.
   a. Invoices for services were exaggerated and paid without review and verification.
   b. Payments were made to non-existent vendors.

4. Failure to collect dues or charge late fees and interest on a timely basis.
   a. The cost to collect these amounts from delinquent members is greatly increased.
   b. The member is using the Association's money for free – no interest or late fees are collected by the Association.

To safeguard the Association's cash we must do more than simply have good internal accounting controls. We must also follow the "**PRUDENT PERSON**" rule, for the board members; or the "**PRUDENT EXPERT**" rule, for managers, accountants and other professionals involved with the Association.

Ask yourself:

WHAT WOULD A PRUDENT PERSON OR EXPERT DO IN THIS SITUATION?

Let's not forget to add intangible items to our list of assets to be safeguarded, because their neglect can cause the Association to waste financial resources. These safeguards include:

1. Safeguarding assets from unexpected loss through adequate insurance.
2. Using only licensed contractors.
3. Seeking competent professional advice and following it.
4. Following Internal Revenue Service (IRS) codes and regulations to prevent unnecessary income tax assessments.
5. Hiring and training competent personnel.

As a Certified Public Accountant (CPA), my initial concern is with the Association's system of internal accounting controls (*including those of the management company*), as well as with the accounting guidelines legislated by the DAVIS-STIRLING ACT[1]; for example, financial statement reporting requirements[2] and the duties of the Board of Directors[3]. However, before we talk about specific internal accounting control procedures, let's first look at legislative accounting guidelines.

BUDGETING PROCESS[4]

It is often said that a journey of a thousand miles begins with the first step. Well, the first step for a Homeowners' Association is the **BUDGETING PROCESS**. Proper **PREPARATION** and **MONITORING** of the budget is a key starting point for safeguarding financial assets.

Davis-Stirling requires that "...the association shall prepare and distribute to all its members a proforma operating budget." It goes on to say that "[a] copy of the operating budget shall be annually distributed not less than 45 days nor more than 60 days prior to the beginning of the association's fiscal year." Finally, the law requires that we estimate the revenues and expenses of the Association for the next fiscal year, and include an amount necessary to defray the cost of reserve components (*or notify members whether a special assessment will be required*).

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1 California Civil Code (CC) § 1350. Short title "...the Davis-Stirling Common Interest Development Act."
2 CC § 1365. Financial Documents.
3 CC § 1365.5. Board of Directors; Duties; Reserve Accounts.
4 CC § 1365.

At one of our Wine Country Resource Panel's (WCRP) meetings, a presentation was made by a panel of experts on this very important budgeting process. In their presentation they pointed out that the budgeting process requires:

1. Knowledge of the past revenues and expenses of the Association (*history often repeats itself*)
2. Full cooperation from vendors (*the doctrine of no surprises*)
3. Participation by the members (*a budget committee is essential*), and
4. An eye into the future (*a crystal ball can't hurt*).

By following their recommendations, a well thought out budget can be prepared. However, simply having a well thought out budget does not prevent potential fraud, you must compare the amounts included in the budget with the actual activity. This is accomplished through a periodic review of the Association's financial statements.

PERIODIC REVIEW OF FINANCIAL ACTIVITY[5]

After this well thought out budget has been prepared and distributed to the members, the next step, as partially required by Davis-Stirling, is to review the periodic financial activity of the Association. This is accomplished on a quarterly basis (*unless required more often by the governing documents*) by:

1. Reviewing the financial statements of the Association (Davis-Stirling only covers the income and expense statements[6])
2. Reconciling all cash balances to the bank statements, and
3. Comparing actual operating and reserve revenues and expenses with budgeted amounts (Davis-Stirling only covers the reserve activity[7]).

When actual activity is significantly (*or unexpectedly*) different than the budgeted amounts the Board of Directors should know why.

1. Is the cash in the bank account different than the amount on the financial statements?
2. Are the members paying their dues?
3. Is money being spent on unbudgeted items?
4. Look outside; are the maintenance and repair items that were paid for being done?

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5 CC § 1365.5.
6 CC § 1365.5(a)(5).
7 CC § 1365.5(a)(3).

These legislated and suggested duties provide for an historical (*after-the-fact*) review of the financial activities of the Association. However, the best defense is often a good offense, and a good offense is embodied in a good system of internal accounting controls.

INTERNAL ACCOUNTING CONTROLS

In addition to the budgeting process and the periodic review of financial activity, a good system of internal accounting controls should be put in place to make it harder for someone to run away with the cash.

In an article published in THE ECHO[8], *Internal Controls - A Mandatory Policy for A CID Association*, by Joelyn K. Carr-Fingerle, CPA, the emphasis of internal controls was placed primarily in the cash area because cash (*including investments*) is often the largest asset listed on the financial statements. She cited the need for two signature checks (*required by Davis-Stirling for withdrawal from the reserve accounts only*[9]), proper check handling and timely bank reconciliations[10], and she also emphasized that the board "must know what is going on financially". Finally, the article included a reprint of ECHO's *HOA Internal Controls Checklist* that was designed so that the Association's internal control system could be documented and evaluated by the Board of Directors (*see Schedule A*).

In addition to the controls cited in this article, there are other significant areas of internal accounting controls that should be established. The following internal accounting controls are designed to provide you with a starting point, they are not intended to be exhaustive. They should be adapted to meet the individual needs of your Association.

CASH RECEIPTS

Members' Assessments – All assessments should be paid either with a check or through an automatic withdrawal directly from the member's bank account (ACH). When paid with cash (*including cashier's checks and money orders*), a pre-numbered cash receipt should be prepared (*record the amount received, date, member's name and unit number, and sign the receipt*) and the original given to the member. A copy (*consider a 2-part NCR receipt book*) should be retained by the treasurer or manager and made available to the Board of Directors.

Other Cash Receipts – All other cash receipts should be paid with a check. When paid with cash, a pre-numbered cash receipt should be prepared (*see member assessments above*) and a copy should be retained. We want to discourage the collection of cash whenever possible.

Deposit Slips – All checks, which should be restrictively endorsed "For Deposit Only", and cash should be recorded on a bank deposit slip and taken to the bank on a daily basis.

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8 August 1996, Vol. 25, No. 8, page 1.
9 CC § 1365.5(b).
10 CC § 1365.5(a).

Lock-Box Deposits – A bank lock-box system (*where available*) should be used. Under this system, all (*or most*) members make their payments directly to the Association's bank. These payments are directly deposited into the Association's account and a report is provided by the bank on a daily basis.

Reconciliations – The daily deposit slips (*remember to account for all pre-numbered cash receipts*) along with the lock-box deposit reports should be reconciled to the bank statement on a monthly basis, and to the financial statements on at least a quarterly basis (*more often, if financial statements are prepared monthly*).

Whenever possible, the individual reconciling the bank statements should not be the individual making the deposits.

Bank reconciliations and bank statements should be provided to the Board of Directors on a monthly basis – and the board needs to review and understand how to read these bank reconciliations and bank statements.

When bank statements are going to an accounting department, consider having the bank send a second copy of the bank statement directly to the Treasurer to be compared with the bank statement attached to the bank reconciliation.

CASH DISBURSEMENTS

Operating and Reserve Expenditures – All expenditures should be made with checks or electronic funds transfers, not cash. Checks should not be made payable to cash.

Signatures – Operating checks need only one signature, however, reserve checks and reserve withdrawals require two signatures. For operating accounts, signers can be members of a management company; however, for reserve accounts, the signers must be either two members of the board or an officer and a board member.

Canceled Checks and Bank Transfers – All canceled checks should be examined for alterations to amounts and/or payees, and verified that endorsements are not to unauthorized recipients (*e.g., one of the check signers*). Also, verify that all bank transfers go from one Association bank account to another Association bank account.

Reconciliations – The canceled checks (*remember to account for all checks*) and bank transfers should be reconciled to bank statements on a monthly basis, and to financial statements on at least a quarterly basis (*more often, if financial statements are prepared monthly*).

Whenever possible, the individual reconciling the bank statements should not be the check signer.

Signature Cards – The president of the Board of Directors should send the signature cards directly to the bank. The Board of Directors should periodically verify directly with the bank that the authorized signers are still correct and confirm how many signatures are required. With this after the fact verification, you can help prevent an incorrect signature card from getting to the bank or having old board members still listed as check signers.

INVESTMENTS

All investments (*including cash*) should be held in a bank or savings institution that provides $100,000 in FDIC insurance coverage (*you should not put more than $100,000 in any one institution*), or in an investment that is backed by the full faith and credit of the federal government (*e.g., treasury bills*). However, there are several banks and financial institutions that provide their own insurance coverage, which can be as high as $500,000. This insurance may meet the needs of the Association for security purposes – ask your banker.

Also, investments at brokerage firms are secured by insurance offered by the Securities Insurance Protection Corporation (SIPC). SIPC protects customers of member broker-dealers against failure of the broker-dealer. However, this coverage is limited to $500,000, including $100,000 in cash. This does not protect against the risk of loss of your principal.

Your fiduciary duty suggests that you should not use the Association funds to speculate in the market. These funds have a specific short-term or long-term purpose, and they should not be put at risk – you may lose it all.

COLLECTION OF DELINQUENT ASSESSMENTS

Davis-Stirling requires that "[a] statement describing the association's policies and practices in enforcing lien rights or other legal remedies for default in payment of its assessments… shall be annually delivered to the members…."[11]

The Association's collection policy should be based on guidelines established by Davis-Stirling[12] and it should be followed without exception for all members on a timely basis. Notices of delinquency should be sent, late charges and interest should be added, liens should be filed and other legal action should be taken as soon as possible. This will prevent the delinquency from getting out of hand for most members.

In addition, if the member has been paying his/her dues timely, but the funds have been diverted, this member may provide you will a built in early warning system.

[11] CC § 1365(d).
[12] CC § 1367. Lien for Delinquent Assessments.

INSURANCE

Make sure your Association has insurance in effect that covers a cause of action in tort (*liability insurance*) and that meets the minimum coverage standards set by Davis-Stirling[13]. The Association must maintain general liability insurance coverage of at least $2,000,000 if there are 100 or fewer separate interests; or at least $3,000,000 if there are more than 100 separate interests.

Don't forget liability insurance for your volunteer board of directors[14]. The minimum coverage is $500,000 if there are 100 or fewer separate interests, or $1,000,000 if there are more than 100 separate interests.

LICENSED CONTRACTORS

Always use licensed contractors to provide services for the Association. These contractors should have their own liability and workers' compensation insurance policies naming the Association as an additional insured before any work can begin. Make sure that their insurance company is required to notify you immediately of any changes or a lapse in coverage. As an additional precaution, you can obtain workers' compensation insurance for independent contractors. You should contact your insurance provider for details.

Use of licensed contractors does not, in itself, prevent fraud. However, they are more likely to have adequate liability insurance that could cover any losses resulting from fraud.

PROFESSIONAL ADVICE

The law requires that a CPA provide an annual review of the financial statements of all Associations with gross income in excess of $75,000.[15] However, **the review cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist.**

Because every Association has different needs and resources, you should talk to your accounting professional to help you evaluate and/or set up your own system of internal accounting controls.

Whenever you suspect something may be wrong, you should immediately contact your legal and/or accounting professional, depending on the nature of the event. These professionals can assist you in determining whether additional safeguards are necessary (*close the barn door with the horse still in*), or you have to take action to recover lost assets (*close the barn door after the horse got out*). Before or after the horse has gotten out, if you suspect fraud, you may want to have your CPA conduct a Fraud Audit. This is a special purpose

13 CC § 1365.9. Liability for Common Areas; Action Against Association; Insurance Requirements.
14 CC § 1365.7. Liability of Volunteer Officer or Director; Criteria; Limitations.
15 CC § 1365(b).

examination of your Association's books and records, and is designed to identify and/or quantify financial fraud. This type of audit is outside the scope of your regular year-end financial statement review or audit, it is a separate engagement that must be requested from your CPA.

MINUTES OF BOARD MEETINGS

The minutes of the board of directors meetings should reflect all financial decisions made by the board; such as, contract approvals and major expenditures. In addition, changes in relationships should also be recorded, such as, banks, management company, accountant or attorney.

If contracts are approved or major expenditures are agreed to, the amounts should be recorded in the minutes. This will enable the board (*and your accountant*) to compare the approved amounts against the actual expenditures reported in the financial statements.

HOA INTERNAL CONTROLS CHECKLIST

The ECHO Accountants Resource Panel prepared an *HOA Internal Controls Checklist*, which is reproduced at Schedule A.

This checklist includes a series of questions with "YES", "NO" or "N/A" answers. It is designed not only to answer questions about the existence of internal controls, but also to educate the board and/or managers about the types of controls that are available. It should always be used when establishing or evaluating your system of internal controls.

CONCLUSION

As you can see, Financial Fraud – Safeguarding Assets of Your Homeowners' Association is significantly more involved than simply watching the cash. Therefore, in order to preserve the value of your Association's assets you should consider the following:

1. Establish a system of internal accounting controls.
2. Prepare a meaningful budget and monitor financial activity against this budget.
3. Invest conservatively and reconcile bank balances regularly.
4. Collect assessments, late fees and interest timely.
5. Have adequate insurance.
6. Use licensed contractors.
7. Seek professional advice, and
8. Hire and train competent personnel.

SCHEDULE A

HOA INTERNAL CONTROLS CHECKLIST

GENERAL CONTROLS: *(Those that have an indirect impact on the accounting system; their contribution is to provide an environment that is conducive to the protection as assets.)*

A. ORGANIZATIONAL STRUCTURE

1. Is there a coordinated insurance program, reviewed annually? ❑ Y ❑ N ❑ N/A
2. Is there adequate comprehensive liability insurance for the association's assets? ❑ Y ❑ N ❑ N/A
3. Is the liability insurance level in accordance with CC § 1365.7? ❑ Y ❑ N ❑ N/A
4. Is association personal property listed and tagged with an association ID? ❑ Y ❑ N ❑ N/A
5. Is there an accounting capitalization policy? ❑ Y ❑ N ❑ N/A
6. Does the general membership vote on earthquake insurance annually? ❑ Y ❑ N ❑ N/A
7. Is there a Directors & Officers liability policy in force, conforming with governing document requirements? ❑ Y ❑ N ❑ N/A
8. Are there records retention policies and procedures? ❑ Y ❑ N ❑ N/A
9. Do budget and insurance disclosures conform to CC § 1365? ❑ Y ❑ N ❑ N/A
10. Is a reserve study performed every three years per CC § 1365.5 and updated annually? ❑ Y ❑ N ❑ N/A
11. Does the board clearly understand the duties, authority and responsibilities of each member? ❑ Y ❑ N ❑ N/A
12. Are there written job descriptions for each member of the board? ❑ Y ❑ N ❑ N/A
13. Does the board have a written manual of policies and procedures? ❑ Y ❑ N ❑ N/A
14. Does the board keep accurate minutes of board and of committee meetings? ❑ Y ❑ N ❑ N/A

B. ACCOUNTING ADMINISTRATION

1. Is there an accounting manual listing items in each general ledger account? * ❑ Y ❑ N ❑ N/A
2. Is there a general ledger account for each association budget line item? ❑ Y ❑ N ❑ N/A
3. Does the board receive prompt financial reports at least quarterly? ❑ Y ❑ N ❑ N/A
4. Does the board regularly compare financial results to the budget and review variations? ❑ Y ❑ N ❑ N/A
5. Is the comparison done in accordance with CC § 1365.5? ❑ Y ❑ N ❑ N/A
6. Does the board obtain bids for services and document decisions for acceptance of all bids? ❑ Y ❑ N ❑ N/A

* <u>NOTE</u>: *Lack of an accounting manual or defined chart of accounts can lead to inconsistent accounting treatment or misclassification of revenue or expenses from one period to the next. Such misclassification can deter comparability from period to period and make it difficult for the board to understand financial results or make meaningful comparisons to the budget.*

SPECIFIC INTERNAL CONTROLS: *(Those that relate to specific assets such as cash and receivables.)*

C. CASH AND BANK ACCOUNTS

1. Are bank and investment accounts in the name of the association? ❑ Y ❑ N ❑ N/A
2. Are bank signature cards current? ❑ Y ❑ N ❑ N/A
3. Are persons handling association cash bonded? ❑ Y ❑ N ❑ N/A
4. Total cash balances with any one financial institution do not exceed $100,000? ❑ Y ❑ N ❑ N/A
5. Are cash deposits in FDIC insured accounts? ❑ Y ❑ N ❑ N/A
6. Are bank statements reconciled monthly by someone with no other cash receipts or disbursement functions? (*"Other cash functions" include making bank deposits, recording cash receipts, writing checks or approving payments.*) ❑ Y ❑ N ❑ N/A
7. Does the reconciler receive the bank statement unopened (*to prevent loss or alterations*)? ❑ Y ❑ N ❑ N/A
8. Does the reconciler compare check details with journal entries? ❑ Y ❑ N ❑ N/A
9. Does the reconciler examine checks for signature, alterations, or irregular endorsements? ❑ Y ❑ N ❑ N/A
10. Does the reconciler compare bank dates of deposit with the cash receipts journal? ❑ Y ❑ N ❑ N/A
11. Are long outstanding checks (*over 90 days*) reviewed for disposition? ❑ Y ❑ N ❑ N/A
12. Are bank reconciliations reviewed and approved by the board at least quarterly? ❑ Y ❑ N ❑ N/A

SCHEDULE A

HOA INTERNAL CONTROLS CHECKLIST

D. Cash Disbursements

1. Does the association use pre-numbered checks issued in sequence? ❑ Y ❑ N ❑ N/A
2. Are checks prepared from a properly (*initialed*) approved invoice or request? ❑ Y ❑ N ❑ N/A
3. Are invoices and bills checked for accuracy and pricing before payment is authorized? ❑ Y ❑ N ❑ N/A
4. Are invoices checked for proper classification in the general ledger? ❑ Y ❑ N ❑ N/A
5. Do all checks require dual signatures, at least one of which is a board member? ❑ Y ❑ N ❑ N/A
6. Do reserve checks and transfers between accounts require two board members or one board member and one officer's signature authorization? ❑ Y ❑ N ❑ N/A
7. Does the signing board member check and cancel invoices or other documentation when signing? ❑ Y ❑ N ❑ N/A
8. Is there a policy of never making checks payable to cash? ❑ Y ❑ N ❑ N/A
9. Is there a policy of never signing blank checks? And is it adhered to? ❑ Y ❑ N ❑ N/A
10. Signed checks do not "back track" to preparer – to reduce possibility of alteration? ❑ Y ❑ N ❑ N/A
11. Bills are paid timely to avoid charges and to take advantage of available discounts? ❑ Y ❑ N ❑ N/A

E. Accounts Receivable

1. Is the delinquency policy statement issued to all homeowners annually? ❑ Y ❑ N ❑ N/A
2. Are late charges levied against overdue accounts? ❑ Y ❑ N ❑ N/A
3. Late charges do not exceed $10 or 10 percent of the monthly assessments? ❑ Y ❑ N ❑ N/A
4. Is interest charged, not to exceed 12% per annum, on overdue accounts? ❑ Y ❑ N ❑ N/A
5. Are receivables aged to identify delinquent accounts and reviewed monthly? ❑ Y ❑ N ❑ N/A
6. Are delinquent accounts pursued in a timely manner and according to policy statement? ❑ Y ❑ N ❑ N/A
7. Is there a written collection policy and has it been sent to all homeowners? ❑ Y ❑ N ❑ N/A
8. Are liens filed in a timely manner to enhance collectibility of overdue accounts? ❑ Y ❑ N ❑ N/A
9. Are bad debt write-offs reviewed and approved by the board? ❑ Y ❑ N ❑ N/A
10. Are checks received restrictively endorsed immediately after the mail is opened? ❑ Y ❑ N ❑ N/A
11. Are cash receipts deposited intact, daily? ❑ Y ❑ N ❑ N/A
12. If on an accrual basis, are subsidiary accounts reconciled to general ledger periodically? ❑ Y ❑ N ❑ N/A

F. Independent Contractors

1. Do independent contractors have W-9s on file before payments are authorized? ❑ Y ❑ N ❑ N/A
2. Are $ for all independent contractor accumulated? ❑ Y ❑ N ❑ N/A
3. Are 1099s issued by 1/31 for all independent contractors who were paid $600 or more? ❑ Y ❑ N ❑ N/A

G. Payrolls (*Use this section only if the association hires regular employees and maintains its own payrolls.*)

1. Do different people do the following?
   - A. Approve hours worked as recorded on time cards? ❑ Y ❑ N ❑ N/A
   - B. Prepare paychecks? ❑ Y ❑ N ❑ N/A
   - C. Distribute paychecks? ❑ Y ❑ N ❑ N/A
2. Are detailed personnel records kept, including W-4 forms, I-9 forms, employment applications, performance reviews, and approvals for pay increases? ❑ Y ❑ N ❑ N/A
3. Are approvals required before adding or deleting from the payroll? ❑ Y ❑ N ❑ N/A
4. Are records kept of benefits, unused vacation, sick days, etc.? ❑ Y ❑ N ❑ N/A
5. Is payroll preparation rechecked and calculations verified? ❑ Y ❑ N ❑ N/A
6. Are payroll tax returns reconciled to the general ledger? ❑ Y ❑ N ❑ N/A
7. Are payroll reports, including DE43 forms for new employees, filed regularly? ❑ Y ❑ N ❑ N/A

Compiled by members of ECHO's Accountants Resource Panel
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Minimizing Financial Fraud

"On your bank accounts"

Karl T. Lofthouse

Crime surrounds us, or so it seems. It also seems that almost everyone is trying to get at our money. Some of these attempts are "legitimate" (e.g. businesses trying to convince us of the usefulness of their products or services in exchange for a portion of our money). Some attempts are "not so legitimate" (e.g. someone trying to collect the money without providing the benefits). The legitimate attempts just require some due diligence and sound decision-making on our part. The non-legitimate attempts require us to exercise extreme caution in order that we not lose our "hard earned money" unnecessarily. The problem is; discerning the difference between the two. There will be no advance warning, as to which is which. To complicate matters further, some "legitimate" providers are so incompetent that they border on the "non-legitimate". So what are we to do? Theoretically, we should treat every potential business transaction with extreme caution until we have some history of dealings with the persons involved. However, as a practical matter, it is sometimes those "we trust" that have the ability to do us the most harm. We would, therefore, advise exercising caution even on routine business transactions.

We have covered some ideas below, from a banking standpoint, that when followed religiously, might save your association thousands of dollars, by thwarting would-be thieves and criminals. The creativity of the devious mind is endless and we can't hope to cover everything, but at least you should get some ideas here that will be beneficial to your HOA. It is interesting to note, that as simplistic as some of these ideas are, people are still stealing money, utilizing them, even during this 21st century. Of course, everything has become more sophisticated lately, theft especially, and we will also touch on some of the new variants.

> Note: As we move forward in this discussion we are reminded of an old NCR sales slogan.
> "There are only two steps between Honesty and Dishonesty; the <u>Need</u> and the <u>Opportunity</u>".

Signature Cards;

1. Make sure your bank has current signature cards (with the names and signatures of new board members and/or account signers). This should be done immediately when someone is replaced. It serves as protection both for the HOA as well as the persons being replaced.

> While scrutinizing large checks or transfer requests for authenticity, the bank will compare signatures between those documents and the signature card. If a former board member or manager requests a transaction that is not to the liking of the new board, and the signature card has not been updated, you will be hard pressed in trying to explain to the bank that the item should not have been honored. Time is of the essence, especially if the person being replaced might not be happy about it. Numerous checks can be written (against the wishes of the new board), in a very short

time. Think of the signature card as a contract between the Association and the bank. What it says on the card, the bank will honor.

2. Determine the signing guidelines (e.g. 2 signers* on the checks) and stick to them (we often have associations asking us to process large "reserve account" checks with only one signature (when two are required and the other signers are unavailable)). This would defeat the original purpose of the two-signer idea. Obviously, these associations needed to plan ahead. Also it's a good idea to have the signing guidelines printed under the signature line of the checks (e.g. 2 signatures required). This then can become self-monitoring.

3. If there are different signers on the operating and reserve accounts (e.g. the assn. manager might sign on the operating account, but only directors or officers of the association can sign on the reserve account, according to the Davis Stirling Act), then have a different signature card for each account.

4. Don't even consider using facsimile signatures (signature stamps).

> There have been many cases where an unauthorized person has used the stamp to put a valid signature on a check. Many banks will not even accept signature stamps. All other banks will hold the account holder (the association) responsible (you will sign a separate agreement with the bank) for the checks even if the stamp was used fraudulently.

Checks:

1. Make sure all checks are serial numbered and are used sequentially.

2. Make sure all voided checks are accounted for.

3. Store the surplus check and deposit slip supply under lock and key. Only remove from this supply those checks that you will use immediately.

4. Don't sign blank checks.

5. Forget the loyalty to the local printer when it comes to checks. The major check printing companies (Deluxe, Safeguard, Harland, etc.) are a better way to go. The reasons are two-fold. First, these companies will never be confused about how to print the MICR line on the bottom of the check, and in fact will already know the ABA number of your bank. Second, they have research departments that strive to improve the security features of their checks in order to make it more difficult for criminals to steal your money (e.g. Micro Print Signature Line, Chemical Protection, Erasure Protection, Security Screen). Deluxe even offers a secure mail program.

> *Note that most banks will not assume the responsibility of monitoring signing requirements on checks requiring multiple signatures. We all know, however, that the Davis Stirling Act requires any withdrawal (checks or transfers) from an HOA reserve account to be authorized by two people. Most HOA banks will honor this requirement.

Items 1-4 above may seem obvious. What is not obvious are the following:

a. Thieves often will take un-used checks (far down in the sequential numbers) that you might not notice missing for months.

b. Thieves will steal checks from postal boxes, use acid, or chemicals, to erase the amount and payee lines, leaving the signature intact, then remake the check with different amounts or payees, before cashing it themselves. Deluxe's** "Chemical Protection" leaves obvious starburst stains when a chemical is used.

c. When color copiers first were released, they could duplicate checks done in four color perfectly. Deluxe's "Security Screen" now prevents this by displaying a void message when a check is photocopied.

d. Thieves will use a copy of your check to submit another order and have it shipped to themselves. Deluxe's "SecureMail" program will make this more difficult, if not impossible.

e. In addition, Deluxe's manufacturing facility produces negotiable instruments, therefore plant security is very important for them.

6. Print-as-needed checks. Some software programs allow us to <u>print</u> the entire check (on blank check stock paper) on our computer, while the check is being written, thus relieving us of the necessity of keeping a check supply on hand. While this is convenient and less costly (than having pre-printed forms), it also involves opportunities for theft. We need to make certain that these check-writing programs are kept under password control so unauthorized persons will not be able to help themselves to the associations money.

Statements:

1. Review, on a regular basis, the activity on all bank statements of all accounts of the association.

Look at the sequential numbers on the cleared checks. If any of them are way out of sequence, they could have been stolen as is described in no. 1 above. Check all transfers to make sure that the receiving account was also an account belonging to your association. While checking the transfers, make sure the transfer went in the right direction (e.g. from operating to reserve), and not backwards or circular (out of and back into the same account – it happens!). Either one of these situations can cause checks to be returned.

Review the checks that have cleared for similar amounts. It could be that an invoice was incorrectly paid twice. Usually this happens by accident, but a few years back we noticed three similar checks (in the $5,000 range) coming through an account of an HOA in SF. All were written to the same tree service, for removal of the same tree. Upon investigating for potential fraud, a

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CPA firm noticed that the mgt. company was also writing checks for their monthly fees for double and triple the amount agreed upon, and furthermore, couldn't or wouldn't provide financial statements for the prior five or six years. That management company is no longer in business. No one knows how much was taken, and the manager has disappeared from the area.

In another association in the East Bay, an $11,000 contractors invoice was paid twice. The contractor was not intending to defraud, just didn't keep good records, and didn't give credit on the previous statement for the cash receipt. When the error was finally noticed, the job was finished and it was too late because the contractor was too small to be able to write a reimbursement check. This error would have been caught if the association had an established policy of only paying from the original of an invoice (something I imagine every CPA cautions all his clients about).
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2. Make sure that the balances on the bank statements agree with those on your monthly financials.

One management company (no longer in business!) was transferring money from reserve accounts of 30 associations into the personal accounts of the management company owner. The company subsequently gave doctored monthly financial statements to the associations, showing the correct reserve balances (the associations never got copies of the bank statements). This company managed to find associations, to work with, who were way too trusting, didn't know what to look at, or weren't very careful. If an association got wise to what was happening and challenged the situation, the Mgt Co. Owner would threaten lawsuit and many of these associations eventually settled for 50 to 75 cents on the dollar, while agreeing not to speak about the situation. What is amazing is that this company was in business over ten years and managed to steal upwards of one and a half million dollars.

Old Statements and Checks:
Keep these records in a safe place, and shred when no longer needed. Do not discard in the trash or a dumpster.

A management company was relocating its offices and was clearing out their storage locker. In it were old checks (in this case belonging to the Mgt. Co.) that had been used in a previous location. These were promptly disposed of into the dumpster. When they realized the error, they retrieved the checks but could not find one final page (with three checks). A week later one of those checks surfaced at our bank, written, for a very large amount. It immediately caught our attention because it was hand written.

Bookkeeper fraud:
If a bookkeeper has the desire to defraud the association, the most frequent thing that happens is that the board will not receive the complete financial picture of the association. Let's say that the bookkeeper is writing unauthorized checks from which he/she benefits. Then he/she could actually have the bank statements sent directly to himself/herself and then pull those fraudulent checks before any one else sees the statements. This situation could be alleviated by sending bank statements first to the treasurer, for review, then, forwarded to the bookkeeper.

Association Employees:
If you have HOA employees, consider writing the payroll checks from a special payroll bank account.

Just transfer into this account, from the operating account, as much as you need on payday. This procedure should insure that your main money fund is isolated and protected from anyone who may become possessive about the associations money. Payroll checks can be cashed in the strangest places.

Involving your bank:
In summary, we would encourage you to notify your bank immediately if you suspect fraud on your association's accounts. The sooner the bank knows about the potential fraud; the sooner they can assist & advise you. For example, the accounts can be frozen in such a manner, which will allow all credits (deposits) to be posted, while at the same time intercepting all debits (checks). The checks can then be scrutinized for accuracy and appropriateness, and then be either rejected or charged to the account. When it is determined that things are again under control and safe, the accounts can then be un-frozen.

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