

DECEMBER 2007

Protecting Your Assets: What Associations Can Do to Protect Community Assets against Theft and Other Risks

By: Leslie S. Brown
Peter S. Philbin

Many of our community association clients ask us to advise them of ways in which they can better protect their community's assets, especially association money (collected assessments), in light of the threat of theft, embezzlement, loss or other risks. Recent news stories of theft of association funds by insiders for many area communities have caused the local community association industry to put more emphasis on safeguarding association assets from insider misappropriation and has prompted industry professionals to actively assist communities in proactively protecting property before a loss has occurred. This memo highlights a few key precautionary steps associations can take to safeguard their assets and funds from insider misappropriation. Of course, no plan is fool-proof, but associations can reduce the risk of assets being misappropriated or mishandled by insiders with a few key actions highlighted below.

Audits. All community associations should have an annual audit/review ("audit")

prepared by an independent certified public accountant (CPA) at the end of the association's fiscal year. We recommend that our clients consider CPA firms that have experience with community associations. The auditor has unique expertise in matching and reconciling the association's financial transactions to determine if there are any discrepancies in the association's books and financial records. The auditor will be able to identify discrepancies and questionable transactions and alert the association to any entries. Although many communities, especially small communities with smaller budgets, find the expense of an annual audit hard to justify, the annual audit is a critical step in maintaining the integrity and accuracy of the associations' financial records. In addition to being a good idea in practice, an annual audit may be mandated by the association's bylaws, declaration or articles of incorporation.

In addition to the annual audit, associations should also consider a transition audit upon

termination of the association's management agent or when emerging from developer control. Most management contracts contain provisions for how and when such transition audit should and can take place. Associations should take advantage of this process as it will help ensure a smooth transition to new management and also will help keep the integrity of financial accounts and records intact upon the set-up and creation of new bank accounts and assessment collection systems.

When there is a great suspicion of loss or theft of association money, the association can undergo what is called a "forensic" audit whereby a CPA with specific experience in forensic auditing will examine the associations' financial records to detect and interpret evidences of both normal (nonfraudulent) activity and abnormal (fraudulent) activity. The auditor will conduct the examination of fraud or presumptive fraud with a view to gathering evidence that could be presented in a court of law. Although the cost of a forensic audit can be high, if there is a substantial fear of misappropriation, the forensic auditor's finding of such will help the association pinpoint the perpetrator and provide expert evidence that could be used in a legal action to recover missing funds.

Insurance Coverage. When there has been a loss of community assets due to the theft or fraud by insiders, the association may be able to obtain insurance coverage for the loss from its own carrier. This type of coverage is often called in the industry "employee dishonesty coverage" and it usually covers the theft of monies, securities, investments, *etc.* – essentially the

association's monetary assets – by directors, officers, committee members, agents (*including the association's management agent*) and employees of the association.

Management usually maintains a separate policy of fidelity/dishonesty coverage. However, such policies normally only protect management and theft by management. Association insurance will, similarly, usually only protect against theft by association directors, officer, employees and certain volunteers. Management must usually be specifically added by endorsement to an association's policy. It is important for associations to: 1) affirm that their dishonesty coverage provide for employee dishonesty coverage, and 2) ensure that the policy covers both directors, officers and employees of the Association, and, importantly, the associations' managing agent. Merely insuring against theft or fraud by a director or officer is not enough. *The coverage must also cover the management agent, on-site employees, committee members, etc. – essentially anyone who handles the associations' money or is charged with the duty of safeguarding money.*

Associations should also be aware that some insurance companies will not write this coverage if the community does not already have adequate safeguards in place for protecting funds and assets. If the community does not have expenditure limits in place that trigger authorization approvals for the disbursement of funds, counter-signature protocols for certain disbursements, or cash-handling safeguards, the carrier may not write the coverage.

Please check with your insurance agent as to your particular community's requirements.

In the end, this type of coverage is not very expensive in light of the protection it offers.

Management Contracts. In most communities, the entity handling and managing the association's assets is a third-party management firm. Accordingly, the association must make sure that the management agreement contains adequate provisions to guard against loss, such as provisions for how the agent is to handle the association's assets. All management contracts should contain the following provisions to help protect the association:

- No co-mingling of funds with other association funds.
- No signature authority on reserve accounts (or at least joint signature requirements).
- Board approval required for expenditures over a certain dollar amount.
- Clear indemnification clauses regarding the theft of money or assets.
- Opportunity to conduct a transition audit upon termination of the relationship.
- GAAP standards of accounting used (or equivalent methods, whatever governing documents require)
- Agent has fidelity coverage and will add association as a "named insured" under such coverage or be responsible for being added to Association's policy.

- Controls for cash handling and check writing (more than one person's authorization required).

These types of provisions will help the association protect its assets and allow the association to hold the management agent responsible in the event the management agent does not follow these protocols and a loss occurs. As always, any time a community is negotiating a management contract, it should consult with its attorney regarding the contract's provisions.

Financial Reports. Boards should also insist that the bank or other financial institution holding association funds provide a copy of statements directly to the Board or its representative (e.g., Treasurer or other Board liaison). This simple step allows the Board to help reconcile the reports that it receives from management in the Board packets with the activity shown in the financial institution's records. While an extra step, it is a check that is worth the effort.

In short, Board members should remain active and alert as to the financial condition of their association. Understand where funds are going, ask questions and, importantly, make sure such questions are answered in a timely and satisfactory manner.

If you have any questions about the content of this memo, please do not hesitate to contact one of our community association attorneys.