Complete This 7-Step Checkup on Your HOA's Financial Controls to Prevent Embezzlement
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Consider it a reminder to double-check your financial controls. Here we offer seven tips to ensure you're protecting your HOA's funds. Our comment: Conduct a physical inspection of bank accounts and other financial resources: email or call the institution to verify the existence and amounts

Keep Your Eye on the Ball

"The first rule for boards is to really be aware of what's going on with the finances at your association," explains Erin McManis, a senior associate at Mulcahy Law Firm PC in Phoenix, who advises many associations. "Board members have a fiduciary duty, so they must act diligently, in my opinion. You can't just turn a blind eye to what's going on."

How do you stay on top of it? Here are seven ways.

1. Conduct regular reviews.

"There are some relatively simple measures associations might be expected to do that might help deter this kind of thing," says Matthew A. Drewes, a partner at Thomsen & Nybeck PA in Minneapolis, who represents associations throughout Minnesota. "In Minnesota, the statutes that govern many associations provide for at least an annual review of the association's financial records by an outside party. It doesn't require a full-blown audit, but it can be one. Having at least that annual review, even if it's not required, may have been something that would have turned up the kind of embezzling that was going on here.

"Members are permitted to vote to skip this review under our law if they meet a certain percentage in a vote," adds Drewes. "But even where they're inclined to save the money, this might be a situation where they're being a little too conservative with their money. It might be well worth the protection to have this done and not vote it down every year."

2. Between annual reviews, conduct monthly reviews.

"Monthly financial reports should always be made available for board review," says McManis. "Those reports should include revenues, expenditures, and a balance sheet."

Don't assume other board members are keeping track. "A treasurer may have certain duties, but all board members should have control and oversight," adds McManis.

That's right, says Brad van Rooyen, a partner at Home Encounter, a Tampa, Fla., company that manages 15 community associations totaling about 3,000 owners. "As a management company, we make sure financials are documented and sent to all board members, not just the treasurers,."

3. Conduct random reviews.

"I think boards should consider asking for copies of all relevant information for all significant activity—all accounts and all checks—to ensure all things are properly accounted for," says Drewes. "Doing that on a random basis could demonstrate there are enough safeguards in that association that if someone was going to try something improper, they'd be taking unreasonable risks. People aren't likely to do that to an association that randomly asks for copies of underlying financial documents."

4. Know the basics of what to look for.

In your reviews, first look for copies of actual bank statements. "Make sure you get bank statements, and I mean actual bank statements," says Andrew Schlegel, CCAM®, executive vice president of community management for Orange County and Los Angeles at FirstService Residential in Aliso Viejo, Calif. "You'll get bank reconciliations usually. But if I'm a board member, I want to see what the bank says in terms of what's in my account.

"Then board members should monitor operating cash levels," says Schlegel. "If nothing else, boards should be aware of how many months' expenses they have in operating cash. We recommend one to three months. If you see that start to go down, that's an issue to investigate.

"One more thing to look for on a bank reconciliation—that's a potential indication of fraud or misappropriation of funds—is recurring deposits in transit," says Schlegel. "When people are hiding or stealing money, they're often doing perpetual cash transfers to cover their tracks. You'll have the bank balance and the book balance. They've taken the money, and the books still show the money is there, but the bank statement doesn't show that. On the bank statement, it'll show a deposit in transit. If you see one of those things for month after month, that's often a sign someone's stealing."

5. Don't let one person oversee all.

"Be wary of the person who insists they have to control everything because financials are really not that complicated," says Schlegel. "Assessments come in, payments go out, and reserve projects are done. I was a banker for quite a few years, and banks make staffers take a vacation because that's when things get uncovered."

6. Recognize the risks of self management.

"It sounds self serving, but I think HOAs should hire a professional management company that's accredited, has insurance, and has proper internal controls," says Schlegel. "From my experience, most of the fraud happens at the director level in self-managed communities. Or it's happened where the board has taken so much control and convinced people they're heroes, shutting the management company out because only the board can be trusted.

"The whole key is you don't want one person to have the ability to initiate, approve, and review transactions," adds Schlegel. "Those are really three distinct steps. Boards initiate transactions because they approve contracts. The management company would review the invoices, authenticate them, and ensure they should be paid. And the third step is that with a company like ours, there's a regional comptroller looking for unauthorized transactions.

"It all gets back to the segregation of duties, and when you work with professional management, if they have enough size, they'll have that with their system," says Schlegel. "For example, the accounting system will have different rights for different people. Accounts receivable people can do only certain things in the system; accounts payable people can do only certain things; and a comptroller who handles financial statements can only do certain things."

7. Don't be afraid to offend by asking questions and creating processes.

"When a new association comes on board, if they want us to have double signature on checks until they get to a level of comfort with the management at our company, I never argue that," explains van Rooyen. "It's other people's money, and the manager needs to ensure the board has a clear picture of the financials.

"We also give boards access through our online portal so they can see balance sheets and have access to the bank account records through our software," he adds. "They can see what's happening in real time. I'll sometimes cut a check and get a call from a board member asking, 'What was that for?' That's a good thing. If your manager starts pushing back on your requests or questions, I'd immediately throw a big red flag and start looking into why."