

Association Finances - Safeguarding from Errors, Fraud and Chasing Bad Debt

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Uncertain times create risk. Desperate people do desperate things. Yet despite the difficult economic times, there are a myriad of ways to protect your association from losses associated with errors and fraud. Association can also reduce losses from uncollectible debt.

It is estimated that global losses to businesses on an annual basis due to fraud exceed 3.5 trillion dollars, or about 5% of their gross revenue. Fraud losses can happen in a number of ways. Common types of fraud involve accounting frauds such as fraudulent vendor billing schemes, duplicate payments to vendors, banking fraud such as ACH or wire fraud, and frauds caused by weak internal controls, such as a lack of segregation of duties.

It's always better to prevent fraud before it happens. When fraud does occur, it is usually detected from whistleblowers, during the course of internal audit or by accident. The least likely way to detect fraud is during the course of an annual audit or review. Knowing that an audit will be conducted by an accounting firm is an excellent deterrent. However, the primary purpose of external auditors is to issue an opinion on the financial statements of an organization, not to detect fraud.

With the management of so much association money under the control of the board or the management company, it is vital that all steps that can be taken are taken. The most effective way to prevent fraud is to make it difficult for fraud to occur. Safeguards to prevent fraud include separation of accounting functions and duties, strong internal controls, consistent monitoring of the internal controls, requiring sufficient detail on invoices and proper vetting of contractors, and most importantly, an understanding by the management team of how the money moves!

For CEOs and board members, it is vital to know the common indicators of fraud. It is typical for someone is committing financial fraud to be:

- living beyond their means
- unwilling to take vacations or be away from the office
- having personal problems, and/or have problems with addiction or gambling

If a person has the incentive to steal money, it is vital to make sure that they don't have the opportunity.

Beyond internal controls, at the management or board levels, there are numerous ways that you can prevent fraud using simple and inexpensive tools. First, use a bank lockbox to receive payments and deposit homeowner checks. Second, establish an investment policy that ensures preservation of capital, followed by liquidity, and finally, return. Establish a good policy for signature control on signature cards and for check signing, and keep all investments that an association makes detailed on the balance sheet and under the umbrella of the management relationship.

Beyond all of the tools that are available to discourage fraud, the most powerful is awareness. Managers or board members should consult with their trusted advisors on best practices for fraud protection. Then, compare these practices against the management company's policies and procedures to make sure that you have adopted the right tools to safeguard your association's finances from errors and fraud.

After the financial meltdown of 2008, many unit owners fell behind on their assessments. Each year, the board of directors creates a budget where income and expenses are estimated for the upcoming year. So when an association determines that a portion of their assessment income might not be collectable

due to non-payments by unit owners, we recommend and the accounting standards require that the expected income be reduced. If some of that money will never be collected, we refer to that as bad debt. Who helps collect it?

- Board members may want to try and collect the debt owed to the association. This is called first-party collections where the association is trying to collect its own debt. We don't recommend this option as there are significant risks that a "collector" may say something that violates fair debt collection practices
- Management companies also may want to collect this debt. Since the debt is not owed to them, this is third-party debt collections. In this situation, the management company will have to abide by federal collections laws. Do they know them? What happens if they go afoul? Do they make phone calls or just send letters? Are they violating any state laws in doing this work? How are they paid for their work?
- Attorneys are the standard approach. Their fee structures vary. They may get paid for each service they render, or they may be paid hourly, or on a contingency basis.
- Collections agencies are also commonly used by associations today due to the fact that they are predominately paid on a contingency basis.

The second component of chasing bad debt, is understanding whether you should pursue the debtor and if so, deciding who you want to collect the debt. A "good" debtor is one who has a job, is maybe renting out their home, or has equity in their unit. A "bad" debtor is probably someone who has declared bankruptcy, is on a fixed income (social security, etc.), or is at an age where they aren't working anymore. Depending on the debt amount, you may select a different collector or structure the payment options with them differently (i.e. a \$10,000 debt may be on a fee for service plan with an attorney while a \$2,500 debt may be on a contingency plan with a collection agency).

If you decide not to pursue an individual, then you probably should write off the debt. At this point, you should consult with your accountant or management company on how this will be reflected on your financials.

In conclusion, a simple analogy about man's best friend may help you remember your responsibility in relation to protecting the assets in your community. Sleeping dogs are cute, but they are not very effective at keeping burglars out of the house. We encourage you to protect the community that you live in, manage or serve as a member of the board of directors, by being a watchdog over the finances of your community. If you have reason to suspect that fraud has occurred or may be occurring, or you need help with dealing with bad debt, we encourage you to engage the services of a hunting dog (a professional) to help you.