

Fraud Prevention

Protecting Yourself, Protecting Your Investment

BY STEPHEN BEER

With all of the negative headlines involving multi-national corporations over the past few years, fraud has been elevated to the forefront of financial topics. This is the theme of a new accounting pronouncement that becomes effective this year. As a result, you can expect to see some fairly substantial changes in the way your accountant performs your building's audit.

In the interest of helping to simplify compliance by your board and managing agent with the required changes, I would like to offer insight into some of the procedures that you will be encountering this year. There are some important, easy-to-adapt procedures the board should consider to protect against fraud.

Entitled Statement on Auditing Services #99 (SAS#99), this standard goes well beyond any accounting pronouncement that came before. It's commonly said that, "when the pendulum swings, it generally swings too far," and so it is here. Instead of allowing the accountant to determine what needs to be done in order to comply with this standard, the pronouncement spells out specific procedures that must be performed. These procedures include focused questions to the many different people involved in your building. The entire engagement team (which consists of a junior or senior accountant who does the actual investigation and paperwork, a quality control professional not directly involved with the client who oversees the accountant's work, and the engagement partner, who is generally a senior partner with the firm and who acts as point-man between client and team) is required to meet and determine ways you, your building staff and managing agent could possibly commit fraud. Then, they are required to design audit procedures that would uncover the types of fraud they could envision.

As I mentioned before, in my opinion, this seems to have gone too far. Accountants representing cooperatives and condominiums have already adapted to several publicized frauds involving cooperative and condominiums in the last two decades. These frauds came to light as a result of investigations by the New York State Attorney General into collusion with contractors. Illegal activity generally originated in the form of kickbacks to employees or managing agents. Even before SAS#99, accountants developed procedures to help uncover potential fraud.

My opinion notwithstanding, let's look

at what you can expect in the near future and consider what you can do to prepare your building's team.

Questionnaires and representations are an integral part of all audits, therefore the expanded use of these audit tools should not cause any concern. However, specific questions will be asked about fraud, whether it is occurring, or how someone could perpetrate fraud at your building. The questions are required to be posed not only to the management executive or the board, but also to the manager's assistant(s) and lower level accounting personnel. These questions are bound to cause a stir. The idea is to dig deep into the pool of people who help run your building and ask relevant questions. This concept originates from investigations of successful frauds.

We suggest there be an open discussion with the building and managing agent staff alerting them to the possibility of these questions. Resolve their concerns by reassuring them that it is not only in the building's best interest, but also in their best interest to respond. Assure them that the questions are not as a result of a specific investigation, but rather as a result of a new mandatory accounting procedure that requires these questions be asked.

One thing that boards can do is to take the initiative and prepare themselves by evaluating their own internal control and operating procedures designed to guard against fraud. Generally, it is the internal accounting control structure of the managing agent that the board of directors relies upon to guard against fraud losses. We have always advocated that an involved board offers the most protection against fraud. Thus, assuring the role of the board of directors in the internal control process is its most important defense against fraudulent activity.

One of the most basic internal controls is making certain that at least one board member performs a detailed review of the management report provided by your agent on a monthly basis. We do realize that board members are all volunteers and must make the time to participate in board matters. Most boards delegate the detailed review of management reports to one member or to a committee, usually the treasurer or the finance committee. However, as officers may change from year to year, it is the responsibility of the entire board to ensure the procedure is uniformly performed. It is important to remember, that it is generally the uninvolved board that is singled



out by a fraud perpetrator.

Rather than offer a laundry list of internal controls you can simply apply, I'd like to explore several of the general risks faced by buildings and offer ideas for controls designed to reduce these risks.

Amounts due from owners—like maintenance, common charges, and various fees—are secured by their units. It is extremely difficult to steal a piece of New York real estate, so the risk of fraud in these areas is minimal. Because of this, we will concentrate on the cash in bank accounts as the most susceptible asset of your building.

The most important basic control for a building's cash is that managing agents utilize a lock box to account for the cash received by the corporation. This leaves only miscellaneous cash receipts such as transfer and application fees potentially vulnerable to misappropriation. Again, member(s) or a committee of the board of directors are generally involved in the processes that generate these fees, so verification of these receipts can easily be incorporated into the board's procedures. Once cash coming in has controls in place, it leaves the hiring of vendors and expenses as the areas most vulnerable to fraud.

This brings us back to the Attorney General's investigations. You may recall that the frauds discovered involved kickbacks and preferred vendors. These are easy to conceal, but there is a simple board operating procedure that can significantly reduce the risk. Knowledge of how these schemes were perpetuated will help you in designing controls to reduce that risk. These schemes usually involve a rotation system whereby conspiring vendors submit exaggerated proposals above a preset amount based on the assurance they would be in line to be a favored contractor

in the future. This means that all of the bids will be higher than the contractor who is being favored to get the job. It also means that the favored contractor can submit a bid in excess of what it should be and still be assured of getting the job. This allows for additional profit, which allows for payment of the kickback. The building would pay inflated prices for the job or goods and services. In most cases, it was the individual employed by the managing agent who was responsible for the building, or the building superintendent who had authority to choose the vendor that allowed this fraud to occur.

Other adaptations of this type of fraud are: 1) hiring a vendor by obtaining only one or no proposal, 2) using dissimilar vendors which guarantees the favored vendor would be the only one qualified for the work and therefore would be awarded the contract, 3) altering or submitting fictitious proposals to direct the board to the favored vendor.

One of the best internal controls that the board may utilize is to independently obtain one proposal for all significant work outside the managing agent. One source for service providers and vendors would be The Official Directory of Co-op & Condo Services that The Cooperator publishes each year, or a board might simply pick a name of a contractor from the Yellow Pages. It may also help assure the validity of the bidding process if all bids are opened in the presence of at least one board member to assure that the sealed bids are not tampered with.

Controlling the expenditure process can be more time-consuming. Short of endeavoring to have members of the board of directors sign all checks, board involvement in the expenditure process may be difficult. Trusting the managing agent and its controls are necessary. In lieu of the trust placed in the managing agent and its controls, and in the absence of board involvement, a monthly review of bank statements and reconciliation is vital. The bank reconciliation is a common place that cash fraud is uncovered. Assuring a watchful eye over this process will go a long way towards protecting your building. When internal controls are in place and followed without exception, the risk of fraud actually occurring can be significantly reduced. ■

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Co-opCondoBoard

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FINANCES

Taxing Matters

By MINDY EISENBERG STARK and STEPHEN BEER

FOR MANY YEARS, THE LEGAL PROFESSION was the brunt of cocktail party humor. Now, in the aftermath of the scandals involving Enron, WorldCom, and Tyco, the accounting profession has taken its place. A typical jibe: “Why did the auditor cross the road?” Answer: “Because he looked in the work papers and that’s what he did last year.”

In many cases they were not far from the truth. The end result was the Sarbanes-Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002. The act established new enhanced standards for public companies, their management, and the accounting profession.

In an effort to police itself and tighten its standards, the American Institute of Public Accountants issued 11 new standards for auditing effective for accounting periods either beginning on or after December 15, 2006. They apply to both public and private companies.

How are co-ops and condos affected? The most significant area is risk assessment. That process has been expanded from simply identifying risk areas to employing a method relating each risk to what can go wrong and then considering the effect on the financial statement for each risk.

These enhanced procedures require that auditors evaluate your relevant controls and verify that they are in place. Based on that, they will ascertain what risks your building faces, meaning any significant risks will require special consideration. If a firm utilizes the audit approach previously used by many smaller accounting firms, this will lead to much more testing. Further, audit sample sizes can no longer be smaller than those required by statistical sampling, therefore significantly more transactions may be examined.

For the first time, the new standards

require that internal controls actually be tested. (Internal controls are all of the processes used to assure the building is

NEW RULES, NEW BURDEN

Under new auditing guidelines, cooperatives and condominiums will now have stricter – and more complicated – standards to follow when reporting taxes. What this ultimately means is that, like everything else, your CPA’s fees will be going up.

properly run and its assets are protected from theft.) Until now, external auditors were merely required to gain an understanding of a building’s safeguards and not to verify that they were actually being performed. That is no longer the case.

As a result, you should expect your accountant to perform more work up front in planning for such a risk-based audit. You should expect a variety of new questions and requests for information. An important benefit is your accountant’s increased knowledge of the details of how your building is run. This will allow the accountants to offer their insight, comments, and recommendations. However, the standards no longer allow for oral

explanations by a client in and of themselves to be sufficient explanations and therefore these may need to be corroborated by other evidence.

There is also a new requirement that the auditor communicate in writing any significant internal control deficiencies and material weaknesses to management and those charged with governance. A significant deficiency occurs when the controls and/or their lack of application cannot reduce the risk of a misstatement in your financials to what would be considered less than a likely occurrence. A material weakness is when your building doesn’t have strong enough internal controls to detect or prevent any material misstatements.

Also, the standards indicate that the failure to correct issues identified in previous years will be considered a significant deficiency. If corrective action is not undertaken, the issue must continue to be reported and highlighted as unresolved.

What this all boils down to is that there is now a much greater burden on the accounting profession concerning the audit procedures and taxation considerations. However, this does not come without a cost. In August 2007, the Corporate Library issued a study of 3,139 companies and found that audit fees rose 64 percent from 2001 to 2006. The median audit fee rose 345.68 percent. Don’t be surprised if your audit fees go up. Nonetheless, the enhanced audit procedures offer better protection from scrutiny and more reliable financial statements. **H**

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