Guide to HOA Community and Condo Association Financial Red Flags

An ebook from Comsource Management

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We've written extensively about HOA community and condo association best practices for budgeting and financial management.

Your board's ability to manage operational expenses, plan for the future with a properly funded reserve budget, avoid special assessments and communicate transparently with your fellow residents is truly the most significant determining factor to a healthy and vibrant community.

Without financial stability and health, and a board that is fulfilling its fiduciary and legal responsibilities to do what's best for the welfare of the community as a whole, myriad problems will arise across the community, leading to greater risk of financial insolvency and community deterioration, both in resident happiness and in its facilities.

To help you and your fellow board members identify financial warning signs and avert major problems, we've pulled together this guide to HOA community and condo association financial red flags. We hope this will help you and your board remain alert and be proactive in protecting the financial health of your community.

Financial Management Red Flags

Lack of an organized and transparent financial management process can cause a host of preventable problems. If your board seems to be struggling with the budgeting process, funding its reserves or communicating with the community, it's time to step back, reassess and start fixing these issues before it's too late.

If you see any of the following challenges on a regular basis, it is time to reevaluate the board's approach to its financial management:

Complaints About Lack of Time

You and your fellow HOA board staff are volunteers and are likely to have extremely busy work and family lives. There will inevitably be disparate commitment levels among board members in many cases, while some might be genuinely committed but lacking the time to do their job properly. When HOA responsibilities get neglected, all sorts of financial and legal risks have a window of opportunity and can fester.

The greatest risk lack of time or unintended neglect creates is within the financial duties of the board.

The best solution is to hire a community management company to handle the heavy lifting and to best utilize the skills sets and time of your board members. However, if that's not allowed by your budget, you can try these approaches to mitigate risks caused by lack of time and unintended neglect of HOA duties:

- Build processes that create efficiencies for board members overall, but particularly for your treasurer or others focused on finances
- Keep open lines of communication and be very transparent
- Match skills and "comfort levels" as best you can with individual board members; you don't want someone who has never managed a budget and has told you it stresses them out to be your treasurer
- Conduct regular finance reviews through scheduled and unannounced audits

The Rise of A Dictator

Lack of time and unintentional HOA duty neglect can create a vacuum of power, pushing the most enthusiastic and most involved-even if this individual is not the board president and particularly if the acting president is uninvolved-to become the sole decision-maker.

No HOA board wants one board member to make unilateral decisions, particularly of a financial nature, without oversight and accountability.

That’s not to say this board member that’s taken control via these circumstances is a bad person. However, if there is no oversight or involvement, at best this board member will get overwhelmed and make mistakes; at worst, they could commit fraud.

Lack of time and neglect is a major factor when power falls into the hands of one or a few, and this creates significant financial and legal risk for your community. Checks and balances is the name of the game.

Repeated Non-Compliance Risk

An HOA board has many fiduciary responsibilities to uphold like CC&Rs (covenants, conditions and restrictions), by-laws, state corporate law and tax law, to name a few.

The law firm Horak Tally via HOAleader explains fiduciary responsibilities this way: “When you’re acting as a fiduciary, you’re serving in a representative capacity, and you must put the interest of the association’s homeowners collectively first,” says Michael S. Hunter, an attorney and partner at Horack Talley in Charlotte, N.C. “You must also exercise sound business judgment and a healthy dose of common sense.”

When a board is run by one or a few, lacks process and is inefficient, any number of areas could slip into non-compliance, which can have devastating consequences not only for your community but also from a personal liability standpoint. These areas include but are not limited to:

- Failure to maintain adequate insurance
- Failure to pay taxes
- Failure to release the HOA financial statement, or release it in time
- Conflicts of interest

Financial Management Process Ideas

Start Early.
Every community situation is different, but one rule stays the same: don’t wait until the month before to start the budget process or you’re asking for complications.

Understand the Methodology.
If you have limited financial management experience, it’s important to familiarize yourself with basic accounting terms and then educate yourself on how your Community Association does it’s accounting.

Have a Process and a Plan.
It’s critical to have a budgeting process. What’s also important is to have a plan or a strategy.

Get the Board's Buy-In.
If you're the board president, treasurer, or are in charge of accounting and finances, it's critical to get the rest of the board to buy in on the methodology of choice and the process by which data is gathered, entered and disseminated. It only takes a few rogue board members to really muddle up the budget and financial statements with bad data or not engaging the approved process.

Be Transparent.
Once the budget is completed and the HOA fees are determined, communicate with your homeowners. Invite them to be involved and to comment. Be available and responsive to questions and concerns. Without clear communication, all of your hard work could be undermined by confusion and unrest among your homeowners.

Seek Internal Help Quickly.
Address issues thoughtfully but quickly; raise alarm bells with fellow board members and communicate with residents. Keeping things too close to the vest will allow financial issues to fester and will cause ill will among fellow board members and your neighbors.

Get Outside Help If Needed.
Enlist outside help through an auditor or a property management firm with financial experience to put a fresh set of eyes on your budget.

Fraud Red Flags

Once you have your HOA accounting tools and processes standardized it's important to be able to analyze the data and identify warning signs and red flags quickly. Festering financial issues, or those that go undetected for long periods, can do great damage to the financial health of your HOA or condo association.

While there are a host of financial challenges, the most damaging and insidious is fraud and embezzlement because this not only damages the bottom line, it also breaches the trust between the board and the community.

Keep these statistics provided by [All Property Management] in mind if you're thinking "that could never happen on my watch:"

- "The median embezzler manages to steal $145,000, according to the Association of Certified Fraud Examiners. 22 percent of embezzlers steal $1 million or more."
- "Embezzlers can keep up the con for an average of 18 months before being caught. Alternatively, a Marquet International study estimates that this could be as long as 4.8 years."
- "28 percent of all companies with fewer than 100 employees are victims of fraud, with an average loss of $154,000."

Tracking your financials and being able to identify signs of fraud are two different skill sets and both are needed to ensure financial stability. Let's take a look at some traditional HOA accounting red flags for fraud to get them on your HOA or condo association board's radar. Some will be obvious to you, others might not be.

Increases in Vendor Costs or New Vendors

If your community has had the same landscaping vendor for 20 years and suddenly a new company is cutting your grass, ask yourself why and then raise this question at the board meeting. This line of questioning should become more urgent if the new company is charging higher fees and the prior vendor's fees had not changed and their performance was not an issue. It never hurts to ask questions and those in charge of vendor decisions should be able to easily justify the change. If they can't, or they get defensive, something might be amiss.

Control Freaks

The more pairs of eyes you have on your financials the better. If you start to see certain board members dominating control of bank access and check writing, look more closely. Every aspect of your HOA or condo association should have oversight; this is even more important with financials. If you start seeing checks made out in the name of individual board members instead of the association, or fees getting paid to questionable or unfamiliar vendors, your fraud alarm should start going off.

According to Jed L. Frankel, a partner at Eisinger, Brown, Lewis, Frankel & Chaiet PA, who advises community associations, via HOAleader, “We’ve seen board members set up accounts in the name of the association, yet the board member controlled the accounts and had access to them,” says Frankel. “It was like a dummy account. All the proper association information was there, and there was someone with the proper documentation to access the account. The only problem was that the board member was using the dummy account as his own bank account. It was easy for him because checks would come into the association, and he’d deposit them into the dummy account, not the association’s account. If there’s not someone monitoring the intake of all checks and tracking all money coming in, you’ll never know that’s happening.”

An interesting but perhaps lesser known red flag in this category are HOA members or community staff members that never take time off. While they could be very dedicated to their job, this also could be a sign of a need to control and be present constantly in order to keep up appearances and hide fraudulent activities.

Diminishing Reserves

Your HOA reserve fund should be healthy and, barring major community projects, steady if not increasing year over year. If money starts disappearing from the reserve fund and there are no approved major capital improvement projects, beware. What’s more, if the reserve fund stays at the same level year over year when it’s intended to increase, start asking questions of those in control of the reserves. Your reserve funds are the lifeblood of your community; the HOA board needs to protect them.

Deliberate Disorganization

Like many HOAs and condo associations, you and your fellow board members have worked hard to create financial processes and protocols that yield transparency and accuracy. If you suddenly see sloppy document filing, missing statements and other unexplained inaccuracies be vigilant. In most cases, this could simply be a sign that you need to get the team together to remind them of your financial policies. That said, this could also be a sign of fraud, as the perpetrator is deliberately attempting to cover up their nefarious activities.

Beware of the "Triangle"

The "Fraud Triangle" concept was created in the 1970's and is helpful for board members in that it provides a window into the mind of the fraud perpetrator. The "Fraud Triangle" consists of three components:

- Incentive. The individual has a motivation to commit fraud due to outside financial pressures caused by addiction, gambling or a business failure, among other possible factors.

- Opportunity. The individual is in a position of power or has decision making ability that affords them a chance to commit fraud. Opportunity can also be created by a lack of financial checks and balances or poor processes and management.

- Rationalization. The individual has the ability to reason away or justify his or her activities. These justifications can take many forms but all forms seek to make what they are doing right in their own minds.

Fraud Prevention Ideas

- Employees, vendors and board members should be subject to background testing
- Conduct annual financial audits, either internally or via outside resources
- Hire a CPA or Community Management firm to develop financial procedures
- Create a task rotation for your board so no one person does the same thing long term
- Separate deposit and bank statement analysis assignments
- Keep blank checks in a safe or secure area
- Change PINs and passwords/codes regularly
- Ban cash payments
- Use automated deposits for dues & assessments
- Make original invoices mandatory and mark when paid
- Send bank statements to different people
- Require employees to take vacations or time away from work

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