

Who Wants to Be an Accountant? Monthly Financial Statements, Audits, and Reserve Funds



Evening With The Board, Sponsored by: Association Services

October 21, 2008

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Monthly Financial Statements

How much time do you spend on the treasurer's report? Honestly??? In a nationwide poll that we did several years ago for a presentation that Gayle Cagianut gave at a CAI national conference, we found that the overwhelming response to this question was 3-5 minutes. And, there were a lot of 1 minute or less answers and very few 5-10 minute answers!

Let's see...you are running a multi-million dollar corporation (yes, you are a multi-million dollar corporation if the value of the property was recorded on the books), you are fiduciaries for other people's money (custodians of the assessments monies) and your annual budget is \$X (you fill in the blank), and you spend only a couple of minutes on the financial statements???

As volunteers, many of you have not been trained to read and understand financial statements. Some think because they were terrible in math in school that they cannot learn this accounting-ese. Some feel that it is boring. Others are too intimidated to ask questions.

Really, it is not that difficult! Tonight we are going to go slowly through the financial statements. We will use a couple of sets of sample reports. We only have a couple of rules:

- Do not be afraid to ask any question.
- Do not let me proceed if you do not understand what I just said.

Reading a financial statement is like reading a book. I know...some of you would prefer a novel, but I approach reading a financial statement as reading a mystery (Agatha Christie style). It is my job to determine "who done it" and "why". So, I am going to try and get you just a bit more interested in the why's of financial statements so that you can better do your fiduciary duty!

Let's start....



Cash, Modified Cash and Accrual Methods of Accounting

I'm sorry, but before we begin, we have to come to an understanding about a few accounting terms. They aren't as difficult as they seem at first glance!

METHODS OF ACCOUNTING

There are three methods of accounting. They are as follows:

- **Cash**
- **Modified Cash**
- **Accrual**

A method of accounting defines how financial transactions are recorded in the financial statements. It is important that a board of directors understands what method of accounting is being used for their financial statements. Without this knowledge, they cannot accurately use the financial statements as a tool.

CASH

The cash method is the method most easily understood and is simple to maintain. It is simply what it states - cash transactions are recorded when they occur. That is, when cash (or forms of cash such as checks, money orders or charges) are deposited into the bank account the association recognizes *income*. When checks are written or cash is taken out of a bank account, the association recognizes *expenses* on its financial statements.

The cash method can be compared to an individual's checkbook. There are transactions recorded when money is put into or paid out of a bank account. A cash balance is kept as a running total. Generally, cash is the only asset on the balance sheet of the financial statement; that is, cash is the only recorded asset of the association.

The weakness of a cash system is that only those transactions that go into or out of the bank are recorded. If the person in charge of financial matters does not make a bank deposit or does not write a check, the board can be misled as to the financial status of the association. They could assume that there is less or more cash, less or more income and expenses, depending on whether all deposits have been made and all checks have been written.

For some very small associations who have very few transactions and make bank deposits and write checks in a timely manner, the cash method of accounting may be appropriate. For most associations, however, most accountants feel that an association needs to use the accrual method or at least the modified cash method of accounting.

Washington law (for the Condominium Act) requires accrual basis statements be available, for purposes of the resale certificate.

RCW 64.34.425 (1)(i):

“A balance sheet and a revenue and expense statement of the association prepared on an accrual basis, which shall be current to within one hundred twenty days

ACCRUAL

The accrual method of accounting is considered to be in compliance with “generally accepted accounting principles” (GAAP). It is the most accurate means of assessing the financial status of an association. Under the accrual method, income and expenses are recorded when they are *incurred*, regardless of when they are deposited into the bank or when checks are written. Thus, income is recorded when the unit owners are assessed, not when they make a payment. The amount of unpaid dues is shown on the balance sheet as assessments receivable. An accrual basis financial statement will then, usually, have at least two assets on the balance sheet - cash and assessments receivable. Expenses are recorded when the product or service is provided, not when the check is written. For example, landscape contract for January would show in the January financial statements even though the landscaper was not paid until February. The amounts owed to vendors, but not paid at the end of the month would show as accounts payable in the liability section of the balance sheet. (There could be other assets and liabilities such as prepaid insurance or taxes, taxes payable, etc. but they will not be discussed here.)

A financial statement under the accrual method then states the true picture of the association. The board would know exactly what expenses had been incurred during the month and what income is due the association. Granted, the cash flow of the association may not agree with the net income as either cash has not been received yet or checks have not been written.

The draw backs to the accrual method are that 1) it is more difficult for users to understand, 2) it may require that the books be kept open later so that bills can be received and properly accrued, and 3) it requires a higher level of accounting/bookkeeping knowledge to properly prepare accrual basis financial statements. For that reason many associations prefer to use the modified cash basis during the year and only convert to accrual basis for their year end audit.

MODIFIED CASH

The modified cash method of accounting is a hybrid between cash and accrual. There is no standard as to what items are modified. It is common for community associations to record income on the accrual method and expenses on the cash method. Thus, there is assessments receivable on the balance sheet but no accounts payable. This method of accounting can be very viable for many associations due to the fact that most expenses

are standard. The majority of the expenses occur on a monthly basis and are fairly static. Some examples are utilities, management contract, pool and landscaping. If expenses are paid promptly and if there are any outstanding, unusual type expenses remaining at the end of the month and those are brought to the board's attention, the modified cash method may be considered to be appropriate for many associations.

Association Services Financial Statements

AS financial statements are prepared on the accrual basis of accounting. In the financial statements that we will be using tonight, both Assessments Receivable and Accounts Payable are recorded.

Financial Statements-What are They and What do they Mean?

There are two statements that are issued on a monthly basis by your management company, and it is important that you understand that each of them has a totally different purpose. They are just columns of numbers, but, remember what I said at the onset – they are trying to tell you something!

Balance Sheet

This is the Association's financial position as of a date in time. That date is generally the end of a month and/or year. There is a basic "rule" with regards to balance sheets (and, hence, their name):

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Equity} \\ &\text{Or} \\ \text{Assets} - \text{Liabilities} &= \text{Equity} \end{aligned}$$

Let's define each of these three categories and give examples of the most common accounts within the categories.

Assets

This is what the Association OWNS.

The most common assets are:

Cash & Investments

Assessments Receivable (A/R) – Monies owed to the Association from homeowners.

Question...what asset is NOT on the books???? The buildings and common property! If it was, you would be much more impressed with the size of corporation you were directing or managing!

Liabilities

This is what the Association OWES.

The most common liabilities are:

Prepaid assessments – Monies paid by members before they are due.

Payables – Monies owed for various reasons.

Refundable deposits – Monies being held by the Association to be returned.

Equity

This is the NET WORTH of the Association. It is often called Members' Equity, Operating Fund, or Retained Earnings.

There actually are two types of equity/fund balances in an association:

- Operating
- Replacement

Okay...now you know the terminology, it is time to put your knowledge to the test. We will look at some actual financial statements.

Financial Statements...a Mystery

The plot opens with pages of numbers...the detective begins the work of sifting through the evidence. What exactly are these columns of numbers and what do they mean? Who is the culprit? What caused the Association to not have enough cash to pay the water bill? Has there been foul play? Or, just an error? Or, maybe, a miscalculation? What clues are there, and how should they be interpreted? With some effort, and after being sidetracked and confused over some issues, the plot begins to unravel and the detective starts to make sense of the financial statements...

Are your Association's financial statements a mystery to you? Are you seeing the "clues" that are being presented in your monthly treasurer's report? Are you asking the **right questions** in order to understand the financial health of your Association? Below are some questions to think about when looking at your balance sheet and income statement each month. Ask the right questions and the financial statements will start being the management tool they were meant to be.

Operating Cash

- Is there sufficient cash to meet your monthly cash requirements? How many months of operating cash does your board feel comfortable with having on hand?

(Note: CAI Guidelines recommend ½ to 2 months of operating expenses. We recommend 1-3 months).

- Is there excess cash sitting in a checking account earning little or no interest? Should you open an operating savings or money market account with the excess?
- Does the board review the bank statements and reconciliations at least quarterly? Are there old outstanding checks which need to be researched? (Uncashed checks can be TROUBLE if they are for such items as insurance and taxes) Are there unusual transfers?

Replacement Fund (Reserve) Cash

- Are funds properly invested in accordance with your Association's investment policy? (*What? You don't have an investment policy? Make this a priority!*)
- Will funds be available for planned replacement fund expenditures?
- Are replacement fund expenditures and transfers properly approved and documented in the board meeting minutes?
- Are two board members signing all reserve checks?

Assessments Receivable

- Does the aging report agree with the financial statements? Is the board taking the proper collection action on delinquent accounts?
- At the end of the year, has the Association determined either which accounts to write off the books or set up with an allowance for bad debts?

Revenues

- Does the assessment income agree with the budget?
- Are all interest, late charges, and violation fees posted in a timely manner in accordance with the Association's collection policy?
- Is miscellaneous income, especially if large enough (e.g. laundry) monitored? (Note: if there is coin or cash involved pay special attention to internal controls)

Expenses

- For items that are significantly over or under budget, are explanations provided?
- Are bills being paid on a timely basis?
- For unusual, non-recurring type of expenses is there a record in the board meeting minutes of approval by the board? For material dollar amount contracts, does the board use a bid process where appropriate?

These are just a few of the questions that can be asked. The numbers in the financial statements should not be a "mystery". They should assist the board members in running their Association, their corporation, in the business-like manner which is required of them. Take time to understand what the numbers are telling you. Important information is available with a little effort and education.

Audits-What Is An Audit?

An audit is engagement performed by an independent Certified Public Accountant to determine if the financial statements of the Association are materially correct, if they are presented in accordance with generally accepted accounting principles (**GAAP**), and if they have adequate disclosures.

- ❖ Independence – Is a matter of **fact and appearance**. The CPA should not, except in very limited circumstances, have ownership within the Association they audit. The CPA should not be paid based on the outcome of the audit or tax returns. The CPA must maintain objectivity in all circumstances and keep an **attitude of skepticism**. The CPA must not be swayed by personalities or the need to “keep the client happy”. This can get interesting with regards to defining the client – the management company, the board of directors or the membership of the Association? (See article attached – “Who is Our Client”)
- ❖ Materially Correct – The auditor, **using judgment**, determines materiality. The CPA professional guidelines set fairly high materiality standards. We believe for Associations that the materiality should generally be \$1,000 - \$2,000. This means that the CPA does not look at each and every transaction – a common misconception. The CPA may randomly look at smaller transactions, but it is not a requirement.
- ❖ GAAP – Generally accepted accounting principles for Associations requires that the financial statements be presented on the accrual basis of accounting, with full disclosures and supplementary information on the replacement fund. GAAP does not require fund accounting, but recommends it. GAAP suggests that property is not capitalized on the financial statements of Associations, but allows the option (and requires it in some circumstances) to place the common areas on the books of the Association.
- ❖ Disclosures – GAAP requires specific standard disclosures on the type of association, accounting methods, tax choices, and other such items. Other disclosures often missed or not understood include the following:
 - FDIC limitation exceeded
 - Related party transactions
 - Litigation
 - Special assessments, and whether the monies have been used as required
 - Contingent liabilities, e.g. mold remediation

An audit also examines the internal control policies, as well as accounting procedures. **Attached** to this handout is a **checklist** of basic internal control policies that we recommend all associations adopt (as adjusted for their particular issues).

When is an Audit Required? Or Recommended?

Washington State Law – Requirements

Old Act Condominiums – Those created before July 1, 1990

64.32.170 (Horizontal Property Regimes Act) – Required an audit once a year by an auditor – all condominiums – however, the new condominium act superseded this law. **HOWEVER**, if the Old Act Condominium’s documents use the Old Act wording, then the governing documents prevail. No mention of GAAP, but our “company policy” is to use GAAP unless otherwise directed, and we strongly recommend GAAP

New Act Condominiums – Those created after July 1, 1990

64.34.372 (Washington Condominium Act)

Condominiums with 50 or more units must be audited annually.

Condominiums with fewer than 50 units – audit is required; however, can be waived by 60% of the owners (other than the declarant/developer)

GAAP required

Homeowners Associations – excludes condominiums, non-residential developments and residential cooperatives

64.38.045 (Homeowners’ Associations)

Associations with annual assessments (note: it specifically says assessments, not other income – interesting) of \$50,000 or more requires an audit; however, can be waived by 67% of the owners GAAP not required; however, “keep financial and other records sufficiently detailed to enable the association to fully declare to each owner the true statement of its financial status”.

Audit Recommendation

A copy of an article discussing “why would you have an audit” is attached, however, here are the summarized reasons:

- ✓ To assist in your fiduciary duty
- ✓ To ensure the Association is being run as a business
- ✓ To distribute complete and accurate financial statements
- ✓ To be accountable to homeowners with regards to their assessment monies
- ✓ To gain knowledge about improved internal controls
- ✓ To achieve compliance with State, tax, and accounting laws and regulations

What Does a CPA Do in an Audit?

A CPA must follow **generally accepted auditing standards (GAAS)**. There have been over 100 Statements on Auditing Standards (SAS's) issued to-date; however, many of the earlier ones have been superseded. They are quite extensive; however, they allow for a lot of latitude and judgment on the part of the auditor. Thus, different CPA firms have different audit procedures. They must do, and document, enough to issue an opinion on the financial statements. (The opinion is in the report which is discussed in a later section.)

We cannot say what other CPA firms do with regards to Association audits; however, with over 20 years experience and currently working with 250 Association clients, we have standardized most of our procedures. That said, we adjust as needed for each engagement based on the facts and circumstances of that Association. Below, however, is a good representation of many of the audit procedures that we perform on a routine basis:

Cash

- ✓ Verify the accuracy of the bank reconciliation.
- ✓ Ensure that there are statements for ALL bank accounts.
- ✓ Research and/or note old, outstanding checks and deposits in transit.
- ✓ Inquire about investment policies and whether funds are FDIC insured and/or if they are earning market rate interest.
- ✓ Determine if there is segregation of operating and reserve cash.

Assessments Receivable (A/R) & Assessment Income

- ✓ Ensure that the A/R on the aging agrees with the financial statements.
- ✓ Inquire about delinquent accounts and determine if bad debt allowance is needed.
- ✓ Test assessment income against the budget.
- ✓ Test special assessment income. Determine if special assessment monies have all been spent, if not, defer to next year.

Prepaid Expenses & Miscellaneous Assets

- ✓ Test insurance expense and set up prepaid insurance, if necessary.
- ✓ Vouch deposits and other miscellaneous assets.

Account Payable

- ✓ Review subsequent month paid invoices to accrue.
- ✓ Test monthly expenses for items needing accrual for which invoices have not been received.

Taxes

- ✓ If appropriate, make the tax determination between 1120 & 1120-H.
- ✓ Calculate tax expense, booking the prepaid tax and/or tax liabilities.

Replacement Fund/Reserves

- ✓ Compare allocations to replacement fund with the budget and reserve study.
- ✓ Trace cash. Book due between funds, if needed.
- ✓ Read minutes for board approval of all reserve expenses.
- ✓ Compare expenses with reserve study projections.
- ✓ Determine if interest income is correctly stated in the reserve fund (or not) – depending on the budget and reserve study.
- ✓ Examine all reserve expense invoices.
- ✓ Determine operating expenses appear to be coded to reserves, or vice versa.

Other Income

- ✓ Determine if other income items are reasonable as compared with prior year and/or the budget.
- ✓ Document and verify large income items, such as insurance settlement proceeds.

Expenses

- ✓ Test standard expenses against the budget.
- ✓ Ensure for recurring expenses that there are the appropriate number of billings (e.g. 12 for monthly, 4 for quarterly) and that they are reasonable.
- ✓ Examine invoices for unusual amounts, including items that appear to be reserve-type expenses paid with operating funds.
- ✓ Examine all invoices that exceed the set materiality limit.
- ✓ Examine a few random invoices.

General

- ✓ Read all board meeting minutes, including executive session, looking for approval of financial transactions and to determine that all disclosures are made.
- ✓ Scan the governing documents for financial requirements.
- ✓ Gain an understanding of the accounting procedures and internal control policies.

Once we have completed the audit process, it is our firm's procedure to send a draft report out with the tax returns and a draft copy of the management letter. (Management letters are discussed later). At this time, representation letters will accompany the draft report. These must be signed and returned before the final report can be issued. We request that the president, treasurer and manager sign the letter of representations. Other CPA firms may have different rules for signing of the representation letter.

What Does the Report Say?

The audit report is the only part of the year end financial statement packet that is “owned” by the CPA. The financial statements and footnote disclosures are the Association’s. Thus, the Association has to take responsibility for both of those and has control over them.

The audit report has very standardized wording. In the vast majority of the cases the audit report gives what is known as a “clean opinion”. That is, the CPA feels comfortable stating that the financial statements are in compliance with GAAP, are materially correct, are consistent in their application of accounting principles, are properly presented with all required financial statements, have the required unaudited supplementary information included and have complete and accurate footnote disclosures.

We include a paragraph, however, that clarifies that this **audit opinion is NOT expressing an opinion on the adequacy of the replacement fund**. This is not required, but many CPAs include this explanatory paragraph. An explanatory paragraph can be used anytime the CPA really wants to be sure that something is understood and included in the year end package, as, again, this is actually the only page under the full control of the CPA.

There can be other type of opinions. A “disclaimer” will say “except for...” then go on to explain what is being disclaimed. This might be used when it is a first year audit or one account balance cannot be verified.

An “adverse” opinion is rarely used in Associations and is a negative opinion, stating that the financial statements are not adequate.

Understanding Audited Financial Statements

The financial statements tell a story about the Association, and those who read and understand them can learn a lot from taking the time to review each page of the audit packet. However, I understand that for most people these financial statements are a mystery (see article included herein). So, when I have a chance to discuss the audit and financial statements with a board of directors, there are three places that I direct their attention (in this order):

Operating Fund Excess <Deficiency> of Revenues over Expenses on the Statement of Revenues and Expenses

This is a long title for “did we break even last year in the operating fund”? This can be found on the Statement of Revenues and Expenses (more commonly known as the Profit & Loss Statement (P&L) or Income Statement). As a nonprofit corporation, your goal is to have enough income each year to pay your operating expenses and fund reserves. Did this occur?

Note: The Operating Fund is supposed to break even each year. However, the Replacement Fund does not have that same constraint. Some years it will have a large net income as the fund is being built up. Other years it will have a large net loss as the monies are expended. While the Operating Fund operates on a 1 year budget, the Replacement Fund operates on a 20-30 year budget, so it is necessary only to break even over those 20-30 years.

Operating Fund Balance on the Balance Sheet

While the Statement of Revenues and Expenses shows the activity for one year, the Operating Fund Balance is the accumulation of income and loss over the life of the Association. The goal should be to have 1-3 months of operating expenses as a balance in the operating fund for contingencies and as a “cushion” for cash flow requirements.

Due Between Funds on the Balance Sheet

Are there any monies owed to or from the operating and replacement funds? If so, is there a repayment plan? If not, should this amount be approved to be written off or “forgiven”?

If a board understands these three items, they can make informed choices for the future.

There may be questions as to why the audited financial statement amounts differ from the year-end financial statement amounts received by the management company. Here are the most common reasons:

- ❖ The management company books are not kept on the full accrual basis of accounting. Accrual means that the expense is recorded in the financial statements when it is incurred and income is recorded when earned. Thus, if a tree trimmer went out on December 30th and charged the Association \$10,000, but the Association did not pay the tree trim bill until January, the management company

books might not have the expense in the prior year. There are many different types of accrual adjustments that can occur.

- ❖ The management company books are kept on the accrual basis; however, they have to close their books before all invoices are received, or all year end transactions are known. If, in the above example, the tree trimmer's bookkeeper was on vacation and did not invoice until January 20th, and the management company closed their books on the 15th, the invoice would not be included in the prior year.
- ❖ There are errors and/or miscodings found by the CPA, such as a water bill coded to electricity which was corrected in the year end audit.
- ❖ Tax adjustments. Most management companies do not compute the tax expense for the year.
- ❖ Year-end adjustments, such as accruing interest on certificates of deposit, booking allowance for bad debts, writing off old, outstanding checks, are not done until the time of the audit.

Management Letters

Management letters are a means for the CPA to communicate with the board of directors about items found within the audit. They are not a required communication. We choose to issue management letters in 98% of the audits we perform. We include such items as the following:

- Suggestions for investment policies
- Notice that there is money in excess of FDIC in one bank
- Reminder to review old, outstanding checks or deposits in transit
- Explanation of a judgment we made on an accounting issue
- Errors found, and suggestions for correction in the future, if appropriate
- Tax advice
- Reminders about compliance with governing documents or State law
- Accounting policy and procedure recommendations
- Internal control recommendations
- Recommendations for items to include in the board meeting minutes
- Kudos when the board and/or management company exceed expectations



Internal Controls Checklist

(These are the *minimum* standards we recommend for associations)

- Board meeting minutes approval will consist of:
 - ⇒ Opening/closing of bank accounts
 - ⇒ All reserve expenditures
 - ⇒ Major contracts
- Board receives financial statements, at least quarterly, consisting of:
 - ⇒ Balance sheet
 - ⇒ Income statement comparison to budget
- Board reviews **all** bank statements **and** reconciliations at least quarterly (including certificates of deposit):
 - ⇒ Operating accounts
 - ⇒ All reserve accounts
- The Board has a signatory policy on cash accounts in compliance with their governing documents and State law. If the Board does not sign checks, other controls are in place to ensure approval and proper payment of expenses.
- The Board must approve all bad debt write offs or adjustments to A/R balances over \$ _____ (depends on Association.)
- All related party transactions/conflicts of interest are disclosed to the Board and, where appropriate, to the membership.
- The Board has a policy to determine what contracts need to go out to bid.
- The Association accepts no cash, or has very specific controls with regards to cash acceptance.

Approved by Board of Directors

_____ Association

Date _____

By _____

Title _____



Year-End Checklist for Board/Management Company

_____ Association _____ FYE

- Run Year-end Reports** (copies for CPA)
 - Financial statements
 - A/R, including prepaid amounts
 - Annual general ledger
 - YTD adjustments, if available*
- Cash**
 - Verify that there are statements, passbooks or printouts for every cash account as of the end of the year
 - Research any old, outstanding items on bank reconciliation (e.g. outstanding checks, deposits in transit, incorrect charges) and resolve or make note of pending resolution
- A/R**
 - Ensure that A/R aging report agrees with balance sheet
 - If on cash basis, ensure that all monthly activity reports are available and all write-offs are documented
 - Write off any collectible accounts or consider setting up bad debt allowance for specific accounts. Make note for CPA
- Other Accounts**
 - If amortizing prepaid insurance, provide amortization schedule
 - Ensure there is documentation for any other asset or liability that has been set up for the year (e.g. prepaid expenses, architectural deposits, payroll taxes payable)
 - Write off any miscellaneous deposits that cannot be documented or reconciled, and/or that will not be refunded in the next year
- Members Equity/ Operating Fund Balance**
 - Ensure that beginning member's equity agrees with prior year audit/review if adjusting entries were booked (preferable!) or that member's equity has not changed since prior year, if adjusting journal entries not booked
 - Segregate any adjustments to equity into a "Prior Period" account and provide documentation of those adjustments
- Replacement Fund/Reserves**
 - Reconcile fund balance with reserve cash and note reason for any due between funds
 - Reallocate unallocated interest to other reserve categories
 - Adjust balances to agree with most recent reserve study
- Income/Expense Statement**
 - Ensure assessments agree with budget
 - Provide documentation for any special assessments
 - Explain large budget to actual variances

(These are standard guidelines to assist in streamlining the audit process.)

Why Have an Audit of the Association's Financial Statements?

By Gayle Cagianut

"Audits cost a lot of money."

"Who can understand financial statements, anyway?"

"Our manager is totally trustworthy."

"Our homeowners don't look at the audit once it is done."

"It is just a waste of time and effort."

Have you heard any of the above statements when it is time for your Association's audit? Or, possibly, is one of these your argument for voting NOT to have an audit? If so, keep reading and, hopefully, by the end of the article you will be re-thinking your decision.

Washington State requires audits for condominium associations when there are more than 50 units and for homeowner associations when there is more than \$50,000 in annual assessments. However, the law also allows, in some cases, for the membership to vote not to have the audit. So, the question is – Why have an audit of the association's financial statements?

Fiduciary Duty

The board has a fiduciary duty to the Association members. The board is accountable to the membership for the use of the members' assessment monies. Also, the management and care of the assets of the Association, including the buildings, common areas and investments are entrusted to board members. As part of this fiduciary duty, they are charged with making objective decisions. Having impartial advisors, such as CPA, is a good fiduciary practice.

Run as a Business

The Association may be a nonprofit and/or mutual benefit organization; however, courts have upheld that it must be run like a business. Business leaders use professionals to guide them in the various areas of need. There are complex accounting, tax, and finance issues in an Association.

Oversight

A year end audit supplies independent oversight of the financial transactions that occurred during the prior year. The CPA is independent of all parties and will give an unbiased opinion of the actions of the board and management company.

Internal Controls

An auditor should assist the Association in setting up internal controls to ensure less chance of error or fraud. Most misstated financial statements are due to human error;

however, there is always the chance that fraud can occur. While audits do not guarantee that all mistakes or fraud will be found, procedures are in place to assist in this process.

Complete and Accurate Financial Statements

CPAs are trained to present financial statements in accordance with generally accepted accounting principles (GAAP). This allows consistency when read by others, such as bankers, potential buyers, etc.

Disclosure to Owners and Potential Owners

Completion of the year end audit with accompanying financial statements and footnotes allows all current, as well as future, or potential, owners a complete, independent summary of the financial status of the Association. If those individuals choose not to read or understand those statements, that is their choice. The information has been made available to them.

Compliance with State, Tax and Accounting Laws and Regulations

There is a maze of laws and regulations which require compliance by an Association. With regards to financial and tax matters, the auditor can assist and guide the board of directors into compliance.

Here are some other thoughts to replace those at the opening of the article:

“Audits help board members perform their fiduciary duty”.

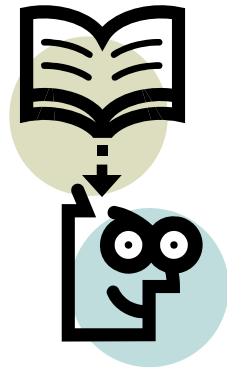
“Dollar for dollar, an audit provides a lot of value to the Association”.

“Audits are a normal cost of doing business...and the Association is a business”.

“The auditor is an independent voice to the Association”.

So, why would you have an audit?

- To assist in your fiduciary duty
- To ensure the Association is being run as a business
- To distribute complete and accurate financial statements
- To be accountable to homeowners with regards to their assessment monies
- To gain knowledge about improved internal controls
- To achieve compliance with State, tax, and accounting laws and regulations



Accounting Truths about Reserves What Do You Really Know???

Play along with the quiz –

Two Truths and One “Fib”

1. AICPA requires that the financial statements record the budgeted reserve allocations as income to the replacement fund – no matter what cash gets transferred.
2. If the Association does not fund reserves in accordance with their budget, but they plan to repay the money at some point, an amount is setup as “Due Between Funds”.
3. The CPA determines whether the Association will repay the monies owed between the funds.

Discussion Notes:

#3 is the fib. That determination really should be made by the Board of Directors and be documented in the Board meeting minutes. Washington law now has a provision requiring repayment – for condominiums – unless there it would impose an “unreasonable burden” on the owners.

For GAAP (generally accepted accounting principles) purposes, CPAs must record the transfer from operating fund to the replacement fund based on what was budgeted to be transferred, not the actual cash transfer.

Two Truths and One “Fib”

1. AICPA is silent with regards to the requirement to include reserve study data in an audit.
2. Reserve study is included in the audit as “Required Unaudited Supplementary Information”
3. Breakdown of the replacement fund balance by component is not required by AICPA.

Discussion Notes:

#1 is false. The reserve study information is “required unaudited supplemental information”. Certain information from the study must be included in the audit or the audit must be amended to state that it is missing, and why it is missing.

The required information to include in the audit is as follows:

- *When the study was performed and whether it was performed by the Board or a professional.*
- *Components (however, how much detail is left to the Board).*
- *Current or future replacement costs*
- *Interest and inflation rates, if any*
- *Remaining useful lives*

In addition, the CPA must disclose if the Association does not fund in accordance with its reserve study.

Two Truths and One “Fib”

1. It is somewhat subjective as to what is an operating expense versus a reserve expense.
2. Board meeting minutes must indicate whether it is an operating or reserve expense.
3. The reserve study and governing documents are the best tools for determining a reserve expense.

Discussion Notes:

#2 is the fib. However, I strongly recommend that approval of all reserve expenses be recorded in the Board meeting minutes. This is an important internal control and it provides an audit trail at the end of the year.

What are operating expenses versus reserves expenses? The reason it is subjective is for a few reasons. 1) What one association chooses to fund in reserves might be taken care of in the operating fund in another association. For example, one association builds up the replacement fund to paint every 7 years. Another association paints 1/7th of its buildings every year as an operating expense. 2) An expense that extends the life of the component may be considered to be a replacement fund expense in some instances. For example, simple roof repairs may be operating expenses; however, fixing a section of roof may allow to put off replacing the whole roof for an addition 3 years, so they will use replacement fund monies. 3) If the issue is a health & safety, water intrusion or other required repair, many attorneys feel that it is appropriate to spend replacement fund monies, even when the component is not in the reserve study.

Sample Balance Sheet with Due Between Funds

	OPERATING FUND	REPLACEMENT FUND	TOTAL
ASSETS			
Cash, including interest bearing deposits	\$ 38,567	\$ 149,524	\$ 188,091
Assessments Receivable	7,723		7,723
Prepaid Insurance	63,138		63,138
Prepaid Income Taxes	386		386
Prepaid Expenses	9,115		9,115
Due Between Funds	(21,066)	21,066	
TOTAL ASSETS	\$ 97,863	\$ 170,590	\$ 268,453
LIABILITIES AND FUND BALANCES			
LIABILITIES			
Accounts Payable	\$ 24,542		\$ 24,542
Assessments Received In Advance	13,497		13,497
Prepaid Special Assessments	1,132		1,132
TOTAL LIABILITIES	39,171		39,171
FUND BALANCES (NOTE 1)			
Operating	58,692		58,692
Replacement (Note 2)		\$ 170,590	170,590
TOTAL FUND BALANCES	58,692	170,590	229,282
TOTAL LIABILITIES AND FUND BALANCES	\$ 97,863	\$ 170,590	\$ 268,453



Here is the amount shown as being due between funds. The amount in the operating fund is a credit as the money is owed from the operating fund and is due to the replacement fund.

Due Between Funds usually occur because:

- The budgeted amount was not transferred as planned by year end
- Expenses of one fund were paid by the other fund.
- There was money actually borrowed from one fund and will be repaid, e.g. sometimes for the insurance premium or when funds are short.

Sample Fund Balance Income Statement

	OPERATING FUND	REPLACEMENT FUND	TOTAL
REVENUES			
Assessments	\$ 450,801	\$ 75,012	\$ 525,813
Late Fees /Violations	1,405		1,405
Move In/Move Out	5,400		5,400
Access Device	1,675		1,675
Guest Suite Usage Fee	14,300		14,300
Roof Lease	14,400		14,400
Interest	775	5,546	6,321
Insurance Settlement Income		24,510	24,510
Miscellaneous	572		572
TOTAL REVENUES	489,328	105,068	594,396
EXPENSES			
Accounting & Tax Preparation	2,000		2,000
Cable	1,306		1,306
Electricity	17,887		17,887
Elevator	16,589		16,589
Gas	6,111		6,111
Guest Suite Maintenance	2,763		2,763
HVAC	4,728		4,728
Insurance	77,368		77,368
Landscape	4,523		4,523
Legal	446		446
Life Safety	13,198		13,198
Management	31,661		31,661
Miscellaneous	22,824		22,824
Office Supplies	10,012		10,012
Other/Misc	2,308		2,308
Payroll	171,306		171,306
Payroll Other	415		415
Payroll Service	1,444		1,444
Payroll Tax	19,462		19,462
Pest Control	980		980
Professional Fees	633		633
Repairs & Maintenance	21,406		21,406
Rubbish	7,435		7,435
Sewer Capacity	16,606		16,606
Social Committee	1,027		1,027
Tax & License	1,538		1,538
Telephone	5,074		5,074
Water & Sewer	36,880		36,880
Federal Taxes	4,138		4,138
Reserve Expenses			
Bird Control		2,902	2,902
Clubroom Blinds		2,737	2,737
TOTAL EXPENSES	502,088	5,639	507,727
EXCESS ->DEFICIENCY-> OF REVENUES OVER EXPENSES	\$ (12,760)	\$ 99,429	\$ 86,669

This is the budgeted reserve allocation. Thus, the total assessments were \$525,813, and of that amount \$75,012 was budgeted to go to the replacement fund.

Sample Required Unaudited Supplemental Information in Audit Report

A full reserve study with an on-site inspection was performed on June 28, 2006 by McCaffery Reserve Consulting as of December 31, 2006 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were based on current estimated replacement costs. Funding requirements consider an annual inflation rate of 3% and interest of 2%, net of taxes, on amounts funded for future major repairs and replacements. The following table is based on the study and presents significant information about the components of common property.

Component	Estimated Remaining Useful Life	Estimated Current Replacement Costs	Fund Balance at Year End
Roofing - Built Up	14 yrs.	\$ 51,425	
Roofing - Standing Seam Metal	24 yrs.	4,550	
Roof Deck	19 yrs.	9,000	
Building Exterior - Painting	11 yrs.	56,100	
Window Sealing	24 yrs.	89,250	
Exterior Repairs	11 yrs.	17,850	
Concrete Repairs	14 yrs.	8,000	
Terrace Membranes	24 yrs.	57,600	
Awnings	7 yrs.	8,000	
Air Conditioning	14 yrs.	20,500	
Roof & Garage Exhaust Fans	9-14 yrs.	31,000	
Emergency Supply Fans	19 yrs.	45,000	
Plumbing Repairs	29 yrs.	100,000	
Fire Pumps & Fire Control Panel	24 yrs.	50,000	
Backup Generator	29 yrs.	75,000	
Security Cameras	7 yrs.	2,500	
Garage Gate	24 yrs.	6,500	
Gate Operator	11 yrs.	2,800	
Elevators - Modernization	24 yrs.	180,000	
Elevators - Cab Remodel	19 yrs.	16,000	
Gym Equipment	7 yrs.	15,000	
Club Room Furnishings	11 yrs.	15,000	
Club Room Audio/Video	11 yrs.	3,000	
Kitchen Remodel	19 yrs.	15,000	
Guest Suite Furnishings & Remodel	9-19 yrs.	22,500	
Lobby Furnishings	19 yrs.	7,500	
Front Desk Remodel	19 yrs.	4,000	
Hall Art/Furnishings	14 yrs.	10,000	
Restroom Refurbish	24 yrs.	2,500	
Computer Equipment	4 yrs.	2,500	
Exterior Furniture	9 yrs.	4,000	
Grills	7 yrs.	1,400	
Planters	29 yrs.	25,000	
Hallways Carpet	7 yrs.	34,650	
Hallways Paint, Including Doors & Stairway	7-11 yrs.	52,600	
Balcony Railings Paint	2 yrs.	13,200	
Balcony Railing Repairs	24 yrs.	24,750	
Balcony Deck Resurface	14 yrs.	45,000	
Lighting - Hall & Garage	24 yrs.	55,500	
Mailboxes	29 yrs.	7,200	
Trash Compactor	9 yrs.	10,000	
Entry Intercom	11 yrs.	3,000	
Card Access System	7 yrs.	5,000	
TOTAL			\$ 170,590

Percent Funded as of December 31, 2006 - 99%

Note: Percent Funded – Optional Disclosure

Sample Wording in Audit Report

The supplementary information on major repairs and replacements is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

If there was no reserve study the last two lines would be omitted and it would state "That information has not been presented."

Approval of Reserve Expenses Q&A

By, Gayle Cagianut, CPA

Q-

During our annual audit, our accountant requested that all reserve expenses be approved in the board meeting minutes. Why? Is this required? This seems like a lot of work and we have a reserve study which has our reserve components listed. Can you explain this recommendation?

A-

An accountant is charged with the duty of ensuring that the financial statements are properly stated. The auditor also has a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. This requires the auditor to use judgment in determining the procedures they will use.

Each auditor will have different ideas as to what procedures are necessary to fulfill these requirements. There is little guidance in the CPA industry with regards to homeowner association audits. The American Institute of CPAs does publish periodic "Audit Risk Alerts" and this question was addressed in the 2000/01 edition as follows:

"What might you (the CPA) consider when reviewing the minutes of your CIRA client?"
Replacement fund transactions. Minutes highlight replacement fund transactions, including replacement expenditures and other additions or subtractions to or from the fund. In addition, minutes reveal the approval of any replacement fund expenditures, accompanied by specific details related to the expenditure.

On a related subject of internal control, the 1999/2000 edition stated the following:

"...more than one board member should review and indicate approvals of requests for all major work to be performed by contractors to help eliminate the opportunity for noncompetitive bidding."

So is it REQUIRED to be in the minutes, from an auditor's standpoint? No. It depends on what the individual accountant feels enhances their ability to determine the correctness of the financial statements and reduces the chance of fraud.

I have four additional reasons why I strongly advise that all reserve expenditures be approved in the board meeting minutes.

1. Washington law makes the point in various sections that reserve monies are "sacred". Such items as requiring two board signers, defining reserve accounts, requiring disclosure of reserve components and requiring payback of reserve monies in a timely manner emphasize the point that reserve monies are to be used as intended and not for operating type of expenditures. Because Washington law specifically places the responsibility for reserve accounts on the board of directors, I feel that the board needs to document their approval of use of monies out of the reserve (replacement) fund.
2. Reserve expenses are still not clearly defined. There is much judgment involved to determine when it is a reserve expense rather than an operating expense. What one

board feels is a roof repair extending the life of the roof (thus, being a reserve expense) may be an operating expense in another Association. Of course, the board should go to the reserve study to determine the definition of the component to assist in their decision. Also, we have found that a board may choose to pay for a reserve expense out of operating when there are excess operating monies.

3. Reserve studies are still an art and a science (as noted by Robert Nordlund, R.S. of Association Reserves). As such, estimates are set up as to replacement cost and remaining useful lives. Thus, even if the board agrees that the expense should come from reserves, and the component is in the reserve study, it is seldom at that exact amount nor on the exact date/year of projected replacement. If the expense is dramatically more than projected or significantly sooner than planned, this could impact the viability of the reserve fund in the future. Thus, the auditor cannot look to the reserve study to determine if the expense is correct as the amount and the replacement date will differ. Only the board can make that determination.
4. Approval in the minutes provides an audit trail as to the amount to be expended. There have been cases of error (and even fraud) where the board approved one amount and a larger amount was paid by the Association. Because this is a “non-standard” type of expense, it cannot be compared with past history or other analytical means. And, as noted in #3 above, the reserve study will not show the exact replacement amount either.

So to answer your questions~

- Is it a requirement of an audit to record approval of reserve expenses in the minutes? No.
- Do I feel that it is a good thing to include board approval of reserve expenses in the meeting minutes? Yes.
- Does it take more time? Yes. Remember that the board of directors is responsible for running the Association in a fiscally prudent manner and their decisions may be questioned at a later date. Minutes are an important corporate record. Talk with the Association’s attorney if there are additional questions regarding minutes as a corporate record.