

# Who Wants to be an Accountant???

(Or, just another “hat” worn by the  
manager!)

Explaining the audit process



## 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). If there are significant deficiencies in internal control policies, a separate letter may need to be sent with the audit. There is a new standard out for audits ending December 31, 2006 that may require more of these letters to be issued when the CPA performs large amounts of accounting work, converts the financial statements from cash to accrual and when the accounting department is not able to assist in writing the disclosures (footnotes).

#### **The Ten Commandments of Internal Control for Your Association**

1. Thou shalt not sign blank checks, nor leave blank check stock unsecured.
2. Thou shalt deposit all checks in a timely manner (preferably daily). If a deposit is not made daily, then the undeposited funds should be adequately secured.
3. Thou shalt not accept cash. If absolutely necessary to accept cash, then do so only with 2 witnesses, then generate a receipt for the files.
4. Thou shalt not make checks payable to "Cash".
5. Thou shalt require invoices, or other type of verification of the expense, on all paid bills. That invoice should be "canceled" in some manner after payment to avoid duplicate payment.
6. Thou shalt have two board signers on reserve withdrawals. Thou shalt not allow telephone withdrawals of reserve funds.
7. Thou shalt update signature cards in a timely manner whenever there is a change in board members or change in management personnel. The board may want to consider having a board member deliver/mail the signature cards to the bank.
8. Thou shalt require approval of write-offs of A/R balances by a person other than the person making the deposits and reconciling the bank accounts. The board shall approve all write-offs over a certain amount.
9. Thou shalt review all bank statements and reconciliations at least quarterly for ALL bank accounts - including certificates of deposit.
10. Thou shalt receive financial statements at least quarterly (monthly, is even better).

An auditor is always on the lookout for fraud; however, fraud detection is not the purpose of an audit. Attached is a copy of the fraud letter that we require each management company to sign before we begin an audit. We are looking for *incentives, opportunities* and *attitudes* with regards to either *fraudulent financial reporting* or *misappropriation of assets*. Some brief examples:

- Incentives/Fraudulent Financial Reporting – Board promises the manager a bonus at the holidays if security costs are 10 percent less than last year.
- Attitudes/Misappropriation of Assets – The manager feels underpaid and unappreciated, so justifies taking the clubhouse rental monies that come in cash.
- Opportunities/Misappropriation of Assets – There are no controls in place when collecting laundry coins.

In an audit, we will find errors. As I tell all boards of directors, managers and anyone else who will listen, as auditors we are not disturbed by occasional errors. These occur as we are human. We will have to point out those errors (generally in a management letter) and we will give suggestions as to how to correct this type of error from occurring in the future, if appropriate. These are to be taken in a constructive manner. If there is anything of significance, then we would need to change the audit report (see future section). However, a *benefit* of an audit is to get professional advice how to improve your policies and procedures and the correction of unintentional error.

# 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) – Requires an audit once a year by an auditor – all condominiums.

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”. Same comment above about our preference to do GAAP

## Audit Recommendation

A copy of an article discussing “why would you have an audit” is in the folio provided; 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 more than 350 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 Can the Manager Do to Assist in the Audit Process?**

Attached to this handout is a detailed checklist for accounting departments to use in getting ready for the auditor. Below are a few items specifically for managers to consider:

1. Ensure that audit is scheduled in a timely manner after the end of the year. If there are any particular deadlines (e.g. the board wants the audit at the February 15<sup>th</sup> board meeting), let the auditor know immediately.
2. Review the year end outstanding assessments receivable for potential bad debts. Determine if there are accounts which need to be written off the books. Determine if there are other accounts for which an allowance for bad debts needs to be setup.
3. Make any necessary income tax elections, such as Revenue Ruling 70-604, if you are filing form 1120 and if your accountant feels that it is necessary. Many CPAs feel that this election should be made annually no matter what tax form is filed. This is generally done at the time of the annual meeting. (Note: tax returns for a 12/31 Association are due March 15<sup>th</sup>). (Attached is a sample resolution and an article about RR 70-604).
4. Repay any monies due to or due from the replacement fund (reserves), if at all possible. If not possible, document how the repayment will occur.
5. Analyze the year end financial statements and have the accounting department make any corrections before finalizing for the year. For example, if you find that an expense has been coded incorrectly (e.g. a landscape invoice was coded to pools), ensure that that has been corrected before the year-end is completed.
6. Analyze the year end financial statements and make note of unusual items and provide this to the year end accountant and include analysis in your year end treasurer's report. For example, if snow removal expense was unusually high due to weather conditions, explain that, or if insurance costs rose an unexpected 30%, make note of that.
7. Review the draft report as soon as it arrives. Specifically review any unusual footnotes to ensure that they are complete and accurate. Read the management letter. Discuss any concerns with the CPA.
8. Ensure that the representation letters are signed and returned in a timely manner. The final report cannot be issued without the signed 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.

## **Explaining an Audit & Financial Statements to the Board**

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 30<sup>th</sup> 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 20<sup>th</sup>, and the management company closed their books on the 15<sup>th</sup>, 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 & Letters of Internal Controls**

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

A Letter of Internal Controls is a required document when certain internal control deficiencies are found. There is a new standard effective for audits ending December 31, 2006 whereby a deficiency letter may be needed when the books are prepared on the cash basis of accounting and other situations where the financial statements are not complete and in compliance with GAAP at the time of the audit. This is a new requirement and we are still researching and deciding what our company policy will be with regards to this standard. In the past, we have never issued a Letter of Internal Control; however, that may now change. Each CPA firm will have to deal with this issue for the upcoming audits.

**You are now  
officially an expert  
with regards to  
audits!! Good luck~**

*Who is our Client?*

*Who exactly is the client in an audit, review or tax engagement?* The engagement letter is usually written to the **board of directors** of an association. Often, it is signed by the **management company**, as an agent of the board. However, it is the actual **membership** of the association to whom the board is accountable.

### ***Primary client - the membership***

It is our firm's strong belief that even though we are generally "recruited" for bids by the management company, and may report to the board of directors, we serve the members of an association. It is these members who pay their dues each month and rely on the honesty and reliability of the board to oversee the proper utilization of those funds. It is to these members that a copy of the year end report is distributed. It is these members who live in and use the common areas of the association and who will elect the next board of directors based upon their performance.

However, the CPA must also interact with the board of directors and the management company. This is another very important aspect of the engagement. In some facets of the review or audit, we feel that the board and the management company are "sub-clients." Let me explain it further.

Our main objective is to ensure that the financial statements are complete, accurate and properly reported. In this instance, our client is the association membership. This is the primary focus of the audit or review engagement. We want to ensure that the members are properly informed of the financial status of their association.

### ***Obligation to the board***

However, another objective in our firm is to educate the board of directors and assist them through the complexities of association management. This is a secondary focus of our engagement, and these issues we direct to the board. There are items which are not of such significance whereby they must be disclosed in the actual audit or review report. Instead, they are matters relating directly to the board's role in an association. We use a "management letter" to communicate these points to the board. These may be suggestions concerning internal control, civil code compliance, documentation, or other items which come to our attention. Since the association is run by a volunteer board of directors, some of whom have little experience or expertise in the area of community associations, we feel that these recommendations are useful to them as they learn better how to manage their association.

### ***The importance of the management company***

Lastly, we are concerned about the management company itself. As we are engaged to audit or review an association's financial statements, we work closely with the manager, who generally has all the records and has had a history with the association. As we are working with the management company, we also provide suggestions to allow them to be better managers. Such suggestions may be the area of internal controls, accounting procedures, civil code compliance or other items as they come to our attention. The manager has the responsibility to be a bit of everything - accountant, attorney, landscaper, construction manager, etc. Thus, it is impossible for them to know everything about everything. Laws and procedures change quickly and we feel that it is our responsibility to inform the managers of these changes. So, in this instance the manager is also our

client. Additionally, we as CPAs have the opportunity to work with many management companies and by doing so we can see what works and what doesn't, and may be able to share some of these ideas.

### ***Put priorities in order***

The scenario I've just presented can cause some problems. It is difficult to have three distinct groups of individuals with whom you work, and to whom you are accountable. Then, what is known as a "conflict of interest" can arise. It is important that the CPA firm have a policy as to whom their client really is, and set priorities as to what influence each of these factors will have on an engagement. When a board of directors or management company have too much control over an accountant, it is possible that the CPA loses objectivity and independence. It is then that the CPA starts to worry more about getting the job, rather than getting the job done correctly. It is unfair to put undue pressure on the CPA to not disclose any information. Luckily, most CPAs will not allow their integrity to be jeopardized in such a manner.

As the financial watchdogs of society, it is our responsibility to properly report and disclose an association's financial position. This is a very important function which should not be taken lightly. The individual members of the association should be assured that the CPA is working on behalf of them. The direction and assistance of the board and management company is invaluable, but must be put in perspective with the goals of the engagement.

## 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 \_\_\_\_\_

October 24, 2006

Dear Management Company CEO or CFO, On-Site Manager, or Self-Managed Association,

This is our annual fraud responsibility notification letter. As you are aware, it is your responsibility to ensure that controls are in place to detect and deter fraud. As your accounting firm, it is our responsibility to assist you in this process. Additionally, we must plan our audit accordingly. As such, we request that you inform us immediately if any of the following occur:

- Suspected fraud or embezzlement.

- Illegal acts by your employees or Association board members.
- Changes in your internal control system.
- Undue pressure from board members to misstate the financial statements, the budget or reserve study.

We have identified some areas which may increase the potential for fraud risk. If any of these occur in any of the audits we perform, please let us know at the onset of the engagement. They are as follows:

- Accepting cash payments.
- Lack of an adequate bid process.
- Not giving timely financial statements to board members.
- Signing of blank checks.

Remember also, it is your responsibility to do the following:

- Communicate the importance of ethical behavior and appropriate business practices to your staff and boards of directors.
- Implement programs and controls to detect and deter fraud.
- Comply with State statutes, local ordinances and contracts.

**We need this letter signed and returned (via fax or mail) before we can begin the 2006 audits on your associations.** We appreciate your cooperation in this matter.

Sincerely,  
Cagianut & Company

Management Company/Association \_\_\_\_\_

Attn: \_\_\_\_\_

Received and read by \_\_\_\_\_ Date \_\_\_\_\_

*Year End Checklist*  
(Accounting Dept/Mgmt. 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 members 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.)

*Association Resolution for Revenue Ruling 70-604 Election-*  
Excess Income Applied to the Following Year's Assessments

WHEREAS, the \_\_\_\_\_  
Association is a corporation duly organized and existing under the laws of the  
State of California;

and

WHEREAS, the members desire that the corporation shall act in full accordance with the rulings and regulations of the Internal Revenue Service;

NOW, THEREFORE, the members hereby adopt the following resolution by and on behalf of the \_\_\_\_\_ Association:

RESOLVED, that any excess of membership income over membership expenses for the year ended \_\_\_\_\_, shall be applied against the subsequent tax year member assessments as provided by IRS Revenue Ruling 70-604.

This resolution is adopted and made a part of the minutes of the meeting of \_\_\_\_\_  
(Date)

By \_\_\_\_\_  
President or Secretary

*Financial Q&A*

***I was just talking with our community association manager on the phone, and she said to remind the board to include the “seventy dash six-oh-four” in the annual meeting agenda. I asked what that was and she said it was a tax election that the CPAs recommend. Could you explain this further?***

The “seventy dash six-oh-four” is a shortcut way of referring to IRS Revenue Ruling 70-604. This is a ruling issued by the Internal Revenue Service in 1970 which is an effective and powerful tax planning tool. Unfortunately, many

associations do not fully understand the reasons and ramifications of this ruling. It is good that you asked and are interested in further information about it.

Basically, it is a tax election that states that any excess membership income remaining at the end of the year is carried over into the next year, or is refunded to owners. This election may allow the Association to file form 1120 (rather than form 1120-H) for its Federal taxes and pay tax at 15% on the first \$50,000 of taxable income rather than 30%. (Note: taxable income is generally interest and possibly other nonmember income).

The IRS has not issued much in the way of official guidance on the use of Revenue Ruling 70-604, but based upon audit activity across the nation, informal communications with IRS personnel, and a draft audit guide for IRS auditors, we know somewhat of their thinking on this matter. Below are a few of the issues involved and the information we have available at this time. It is our firm's opinion that an Association should be conservative in its financial practices, so we do not encourage Association's to take undue tax risks. However, with the lack of absolute guidance from the IRS there are some practitioners and some Associations which feel comfortable with taking more risk on their tax returns. This should be done with caution and knowledge of the ramifications.

### ***Who Must Make This Election?***

The original ruling stated "the membership" made the election. In audits and in the draft audit guide, the IRS has upheld that the members must make this election using whatever approved voting process is allowed by law – thus, it can be at an annual meeting using proxies, by mailing ballots, etc. Some associations argue that the board is an agent of the membership and they should have the right to make the election. This may be valid if taken to a court of law, but at this time the IRS has not agreed with this stance. In the San Diego audits of several years ago, the CPA was making this election for the membership and this was disallowed.

### ***When Does the Election Need to Be Made?***

The IRS has been entirely silent on this matter. It appears reasonable that the election should be made before the tax return is filed, and many of us believe that it is better if the election is made before year-end.

### ***Can the Election be Made Every Year?***

Most CPAs agree that an Association should make the election every year, then the accountant will determine whether or not it is in the best interest of the Association to use such an election.

The IRS issued correspondence that indicates that the 70-604 election cannot be used two year's in a row. Also, in the recent draft audit guide the ruling is consistently referred to as a "one year carryover". That is, the excess from year

one must be “absorbed” in year two. Thus, it appears that 70-604 must skip a year between usage. Our firm feels that there is much less risk in taking this position.

### ***How are the Association financial statements affected?***

This is a tax only election, so does not affect how the financial statements are presented to the owners. However, some CPAs recommend that the next year’s budget should include a “shortfall” which is absorbed by the prior year excess income. The difficulty in this is that the election is made and the budget prepared before the amount of the excess income is known. Thus, this is not a reasonable reality. If there is significant excess income, at the time the tax returns are prepared the association may want to address this matter and record in the minutes where the excess will be used. Another possibility may be to transfer some of this excess to the replacement fund (reserves), but be aware that the 70-604 election does not allow that the excess be transferred to reserves. It requires it to be carried over to the next year or refunded. Thus, to transfer the amount to reserves requires two steps 1) to make the election to carryover from the prior year, then 2) in the subsequent year to make an additional contribution to capital reserves – based upon a reserve study or other justification and notification to the membership. The Association should consider consulting with their accountant to ensure that this properly done.

To recap:

- 1) Have the membership make the election
- 2) Make the election before the end of the fiscal year
- 3) Use only one year, then either “absorb” the excess membership income the next year or change to form 1120-H for one year
- 4) Consider documenting usage of net membership excess if the amount is material

If the above items are considered, Revenue Ruling 70-604 can be an effective tax planning tool for the majority of community associations

### ***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 1 – 3 months of operating expenses).
- 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 in compliance with California Civil Code?

### ***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.