**Audits - 20 questions**

**AKA Stump the Auditor!**

*Cagianut, CPAs/CWD October 20, 2015 Manager’s Meeting*

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**Let’s Play 20 Questions!**

* 20 most commonly asked questions about the audit and tax process
  + Same presentation given to your Boards in September
* We have about 1-1.5 hours, so we cannot cover the topics in detail. Our website has FAQs, articles, our presentations, and we are available for questions
  + [www.hoacpa.com](http://www.hoacpa.com)
* TIPS Brochures! (CAI – hot off the press)
* Ask questions anytime! This will be informal and free-flowing
* Jot down your questions here to see if you can stump us ☺

**#1 – WHAT is an Audit?**

* Independence (CPA)
  + Audit needs to be done by a CPA and not another Association Board, etc.
  + CPA cannot provide detailed bookkeeping services
    - * We can post certain audit adjustments that are standard “cash to accrual”, fund accounting reclassifications, etc. (“non-attest” services, which are “non-audit” services)
  + CPA cannot perform management functions or make management decisions for an attest (audit) client
  + We can perform other “non-attest” services but the Board needs to assume ultimate responsibility (ex: tax return)
  + Management company/Board need to have someone with “suitable skill, knowledge and/or experience” to oversee our services and evaluate the work we do, so that we can remain independent
* MATERIALLY correct financial statements
  + We don’t look at EVERYTHING- would take all year!
  + Establish “scopes” and “random” items to look at
  + Based on RISK
    - Management company accounting practices
    - Internal control
    - Board oversight
    - Declarant controlled?
    - Change in condition: accounting system/management
* GAAP - Generally Accepted Accounting Principles – “In accordance with”
  + Uniform accounting principles used throughout the US whether it is GM or an HOA
  + Full accrual, adequate disclosures
* Adequate Disclosures in the Footnotes
  + Readers are current and FUTURE members
  + What is in the re-sale certificate? Likely in the footnotes
  + Contingencies, litigation, etc.

**#2 – WHY have an Audit?**

* State Requirement (in some cases) - See #3
* BOD Duty – Accountable to Membership, Oversight
  + Board members will occasionally think it is a “good thing” that they were able to have the membership waive the audit (If under 50 unit condo). However, should those charged with oversight ask the membership to waive the audit of those charged with oversight?
* Run it like a business – Internal Controls, Accounting practices
  + Washington- Business Judgment standard (not fiduciary)
  + Sometimes Board members forget that this is similar to their “day jobs” even though they are volunteers
  + Internal Control reports protect the BOD
* Error and Fraud prevention/awareness
  + Deterrent
* Materially correct financial statements and impact on owners/potential owners
  + Disclosures
  + Reserve study supplementary information

**#3 – When is an Audit REQUIRED?**

* New Act (1990) Condo – WA RCW 64.34.372 50 or more units (Under 50 waiver/60%)
  + Annual waiver
* Old Act (pre-1990) Condo - Defaults to New Act, EXCEPT, Governing Docs over-ride if an audit is required
* HOAs – 64.38.045 - ASSESSMENTS $50,000 Over or under $50,000 can be waived/67%
  + Note this is assessments and not income. It would be possible to have a large amount of income and not have an audit requirement if assessments are less than $50,000
* Developer Transition - 64.34.308 Required at “transfer of control” – (waived 2/3 other than Declarant units)
  + Not required in the HOA act
  + See WSCAI Journal December 2015 for our article on Developer Transition audits

#**4 – When is an Audit RECOMMENDED?**

* Large Settlement (Defect, Insurance, or otherwise)
  + May span 2-3 years – should start at the beginning
  + Track costs even before the funds initiate
* Large Reserve Fund projects
* Management Company Change
  + Annual or short period audits
* Suspected Fraud (FORENSIC, NOT GAAP Audit)
  + We refer to Forensic accountants
  + Sometimes it is lack of understanding, or incompetence - not fraud
* Board politics, changes
* Little or no Internal Controls
  + Former self-managed
  + Lack of segregation of duties
* Accounting System change
  + More time involved to audit two systems
  + Sometimes, transactions drop off the system in the conversion
* Large special assessment
  + May span several years – usually important to audit all of the years as otherwise may not be able to “opine” on the fund balance
* Loans
  + Bank requirements/deadline

**#5 – WHAT does an Auditor DO?**

* “Walk through the Balance Sheet”
* Need support for all material items on the Balance Sheet
* Cash - Accuracy of Bank Records
* ALL ACCOUNTS including CDs
* Fraud DOES occur with CDs – very material assets
* Ask Bank for other quarterly reports from their system if they don’t produce quarterly statements
* Test for old/unusual reconciling items
* Assessments Receivable/Assessment Income
* AR Aging, Bad Debts
* Bad debt “allowance” should be determined by Assn
* 0-50-100% collectible
* All AR – Ops and SA, etc.
  + FAQ on site
* Assessment Income – Compare to Budget
  + - * If accrual basis, assessment income should match budget
        + Exception is phasing where assessment income increases throughout the year

We look at independent phasing information from Developer, etc.

* Special Assessment Income/testing
  + We follow the Management Company accounting
    - If the company “grosses up” the income for the entire life of the SA, we record that AR/Income
    - If the company records the income as it is billed (monthly), then we leave it and the full SA AR (over the life of the SA) is not recorded on the Balance Sheet
      * GAAP allows both

**#6 – What does an Auditor DO?**

* Prepaid Insurance
  + Recalculate asset & test expense
    - * Ask for insurance invoices/financing statements
      * Sometimes missed payments/double payments occur during change in carriers or mgmt. companies
      * Don’t test coverages or conformance with CCRs
* Accounts Payable
  + Are accruals materially complete?
    - We look at subsequent year transactions
    - Test CWD accruals if no invoices
* Federal Tax Payable
  + Test the expense, liability
  + Evaluate any issues/contingencies
    - Disclosures re: open tax positions, unpaid tax, contingencies
  + Prepare the tax return after the audit (extend the return for March 15)
    - Prepare the tax return ahead of the audit if not done by September 15

**#7 – What does an Auditor DO?**

* Reserves – (Replacement Fund) - Largest risk area:
  + Budgeted Allocation – Compare to Budget and Reserve Study
    - If differs from budget, it is a “Due Between Funds” or “Permanent Transfer Between Funds” depending on the circumstances
    - If budgeted allocation materially differs from the Reserve Study recommendation, this is a footnote disclosure
  + Trace the cash in and out for the audit year
    - All reserve cash accounts
  + Compare BOD minutes to reserve expenses
    - Res expenses should be Board approved
      * Fraud control
      * Corporate record - “sacred money”
  + Compare reserve expenses to Reserve Study
    - We realize plans change
  + Examine reserve expense invoices
    - Check for approvals
  + Check expense coding between res/ops/SA
    - Follow the cash account
  + Adjust Due to/Due From Reserves if necessary
    - Based on Board minutes, Board intent
    - Will the amount be repaid? If not, not a “liability”
    - Transfer between funds?
  + See #13 re: Reserve Study report presentation

**Note: Similar procedures apply to any type of “3rd Fund” such as Special Assessment, Construction Defect Settlement, etc.**

**#8 – What does an Auditor DO?**

* Income:
  + Compare to prior year and budget
  + Test unusual items e.g. Insurance settlement, leases, cell tower income
  + Completeness: Is it all there?
    - Move in/out fees, guest suite fees, rec center fees, etc.
      * Independent checks and balances from the accounting function
      * Comparison to non-financial measures such as an appointment calendar, cleaning schedule/costs
      * Board review of reports quarterly, documentation
* Expenses:
  + Compare to prior year and budget
    - Ratified budget is a strong audit tool – and the fact that Boards should be looking at actual to budget
  + 12 months?
    - We review the GL for all recurring expenses and count for 12
  + Examine selected invoices
    - Over materiality scopes
    - Random
    - Reserve/SA costs – scopes are lower
  + NOT “value auditing”
    - Can’t comment on how well the landscaping was done with the money paid

**#9 – What does an Auditor Do?**

* Yes, more…..OTHER ITEMS:
  + Read governing docs (selected financial impact sections)
  + Evaluate Internal Controls
    - For the purpose of designing audit procedures
    - Not an Internal Control “engagement”
  + Read BOD Minutes including Exec
    - Learn the “story” of the Association
      * Missing key items/issues without Board minutes
    - Approval of financial transactions
      * See CAI tips brochure
      * C&C website has a “minutes checklist” in the “Forms” section
    - Information for Footnotes (e.g. Litigation)

**#10 – Why does an Auditor look at the months AFTER Year End?**

* Responsible for material events up to DATE of the Audit Report (e.g. 9/30/15 for 12/31/14 year end)
* Called “Subsequent Events”
* Similar to what may be disclosed in re-sale certificate - these items are in the Footnotes
* Litigation, loans, SAs, Settlements, Uninsured damage/claims

* These types of events have a significant impact on current and future owners

**#11 – What does an Auditor look at for Subsequent Events?**

* Minutes up to report date
* Year-to-date Financial statements
* Year-to-Date General Ledger
* Representations from Management/BOD

#12 **–** **What does Auditor’s Report SAY?**

* “Opinion” - Only thing we “own”
  + The rest are the Financial Statements and Disclosures – Association’s
  + “Clean Opinion”
    - Materially Correct Financial Statements
    - In accordance with GAAP
    - Adequate Footnote Disclosures
  + “Qualified Opinion”
    - Clearly Stated in sub-titles
    - Opinion is “clean”, “except for” the issue noted
    - Lack of evidence to support balance(s)
    - Will always reference a footnote for more information
    - Be sure to ask questions if you see this and don’t understand it
  + Other forms of “Modified Opinion”
    - Disclaimer, Adverse
    - If you see anything other than a “clean” opinion, make sure you understand the issue

**#13 – Is the Reserve Study a Required Disclosure?**

* YES
  + “Required Supplementary Information” (RSI)
  + Referred to in the audit report, but no opinion given
  + Back of the footnotes
* If NOT disclosed:
  + Statement in the Auditor’s Report that the information has been OMITTED

#**14 – Do we AUDIT the RS information?**

* NO!
  + We are not reserve professionals
* We cannot change the information
* We DO compare components and assumptions for material changes from year to year and disclose if necessary
  + $300,000 of window component dropped off the RS from audit year 1 to audit year 2
  + Last year study used “future estimated costs” and this year study uses “current costs”

**#15 – What else is disclosed from a Reserve Study?**

* % Funded
* Components
* Estimated Lives
* Replacement cost (current or future)
* Minimum required annual allocation if materially higher than budget
* Recommended large Special Assessments
  + Recent ex: RS stated $3.5MM SA needed, BOD member tells us that was “only in there to support the defect case - actual cost is $1.4MM”

**#16 – Why does the BOD sign a “Letter of Representation”?**

* Financial Statements are the responsibility of “Management”
  + CPA firm cannot be responsible; that “impairs our independence”
* “Management” is defined by those “charged with governance” (BOD and Management Company)
* Current BOD asked to sign “to the best of their knowledge”
  + Board in place at the point the audit report is sent
* Dated the same as the Auditor’s Report
  + May be several months after year end
  + Responsible for events up to the date of the audit report
* Signifies the BOD is ready to Issue the Report “Final”
* C&C “FAQ” on Representation Letters you may send your Boards

**#17 – What are SOME Financial Matters that should be documented in the Minutes?**

* Opening/Closing Bank Accounts
* Major Contracts – Approval
* Reserve Expense approval (amount/description)
* Collections/AR write-offs
* Financial Statement review - Budget/Actual
* Approval of Budget, Assessments, SA, Large Projects

**See TIPs brochure**

**See C&C Website: Forms/Minutes Checklist**

**#18 – Do Auditors LOOK for Fraud?**

* Not specifically
* However - need to evaluate risk, modify procedures as appropriate
* If find fraud, notify next level up of Management
  + Not required to report elsewhere
* This is a financial statement (GAAP/GAAS) audit, not a “forensic audit”

**#19 – How do we PREVENT fraud?**

* Corporate culture – Ethical, policies
  + Tone at the Top
    - Ex: TIPs brochure/Marshall/BOD Treas class
* Segregate duties
  + Bank reconciliations: different staff from issuing checks
  + Bank deposit separate from AR posting
* Rotate duties, random checks
* Boards and managers need to review the financial statements/information!
  + See SoCal Kristin Davis case – WSCAI article, Feb, 2014

**#20 – Do HOAs file tax returns and pay taxes?**

* YES!
* What else do I need to know about taxes?
  + That’s a whole different class!
  + See FAQs hoacpa.com

If time allows:

2 types of tax returns:

* + 1120 – Regular corporate return
    - Taxes “net membership income” AND “net non-membership income”
    - 15% graduated rates
    - 70-604 election may be used to move the excess “net membership income” from year 1 to year 2
      * 70-604 cannot be used 2 years in a row
    - Much riskier return, several “qualifiers”
  + 1120-H For Homeowners Associations
    - Taxes “Non-exempt” income only
    - 30%
    - Interest income, cell tower, easements, rental income, user fees
    - 70-604 not needed for an “H”, but we recommend it be done each year