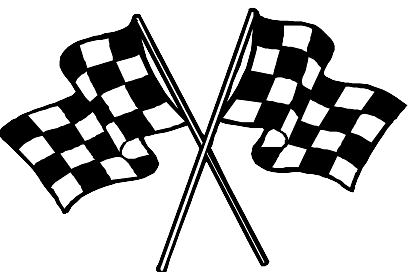
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***Start your engines!!***

***Before the Audit Process Begins***

***Getting ready…Do’s & Don’ts***

***DO:***

* Make sure you have documentation or explanation for all non-trivial balances on the financial statements.
  + We must have audit evidence that is sufficient and appropriate to provide a basis for our audit opinion.
* Have year-end statements for ALL (that means ALL) cash and investments.
  + This is still the #1 issue that holds up audits! One of the audit “assertions” is EXISTENCE. We must verify that the asset exists. You, the manager and the Board should also want to know that the asset exists. At least quarterly the Association should receive some type of verification of the asset balance. And, at the very minimum, get documentation at year-end.

***DON’T:***

* Expect the auditor to “fix” the financial statements.
  + This are YOUR (the Association’s) financial statements. The Association is responsible to ensure that the financial statements are free from material misstatement.
    - We must maintain our independence and cannot be the bookkeepers.
* Do NOT make adjustments after issuing reports.
  + IF you make changes after you have issued the reports to the Board and/or for audit, then you must retract those reports and re-issue.
* Do not give us reports that don’t agree.
  + This is closing in as the #2 issue. We have to comment in the Report of Internal Control when this happens. This is something directly under the control of the Accounting Department (unlike some of the other audit issues that come up).

Some additional tips:

□ **Cash**

□ Verify that there are statements, passbooks or printouts for every cash account as of the end of the year – including certificates of deposit  
□ Research any old (> 90 days), outstanding items on bank reconciliation and resolve or make note of pending resolution

□ **A/R**

□ Ensure that A/R aging report and Prepaid A/R report agree with balance sheet  
□ If on cash basis, ensure that all monthly activity reports are available and all write-offs are documented  
□ Write off any uncollectible accounts, provide bad debt allowance estimates and/or indicate collection status for old/large $$ accounts

□ **Other Balance Sheet Accounts**

□ If amortizing prepaid insurance, provide amortization schedule  
□ Ensure that AP report agrees with balance sheet. Consider accruals  
□ Ensure there is documentation for any other asset or liability (e.g. Deposits, Fixed Assets).

□ **Members Equity/ Operating Fund Balance**

□ Ensure that beginning members’ equity agrees with prior year audit if auditor’s adjusting entries were booked or that member’s equity has not changed since prior year if auditor’s adjusting journal entries not booked

□ Segregate any adjustments to equity into a “Prior Period” account and provide documentation of those adjustments

□ **Replacement Fund/Reserves** **or 3rd Fund (e.g. Special Projects, Special Assessment)**

□ Reconcile fund balance with reserve/special project cash.

□ If amounts are Due Between Funds, document repayment plan

□ If not using fund balances, segregate reserve expenses

□ **Income/Expense Statement**

□ Ensure assessments agree with budget and/or phasing schedule

If phasing, provide schedule that agrees with general ledger

If there are working capital contributions, reconcile with phasing schedule

□ Provide documentation for any special assessments

□ Provide documentation/reconciliation for any unusual income items, especially as related to per use fees

□ Explain large budget to actual variances

□ **Other**

* □ Provide documentation and reconciliations for insurance claims

***Getting the green flag!!***

***Starting the Audit Process***

***Getting documents to the Auditor:***

Let us know upfront what options are available. Provide necessary passwords and protocols. Most importantly – take the time to ensure that the files are complete.

**Electronic**

* Using C&C DropBox
* E-mail
* Allowing C&C Access to Systems:
  + AP Vendor (e.g. Strongbox)
  + File Document System
  + Website
    - Minutes
    - Governing Documents
  + Other vendor sites
    - Reserve Study
    - Water Billing

**Paper Files**

* Shipped at C&C expense
* In a few cases, picked up by C&C

***Communication during the audit process:***

* Who – your end??
  + We try and ask the right questions of the right people. If we miss it – let us know!
* Who – our end?
  + Tax extension, starting audit process, preauditor, auditor & reviewer
* Timeliness is VERY important
  + Let us know if this is not a good time for you so we can put the audit aside and not keep bugging you.
  + Within 2-3 days seems reasonable to us

We know that you have your “real” work to do. We know you are being pulled in many directions. We truly try and not be a bother. If at any time during the process you have suggestions to make it work better, be more efficient or less annoying, please let Cathy Kuhn or Gayle Cagianut know! We respect your time and efforts and hope that you also respect ours.

Sidenote – the availability and completeness of documents, prompt answers to questions and cooperation during the audit process has a DIRECT effect on the next year’s audit fee. There are other factors, such as the complexities of the transaction, but you can make a difference in the fee!

***Caution!! Yellow Flag***

***(Warning: Crash Ahead or Debris on the Track)***

***Those Accounting Issues that Get Us Off-Track***

***What brings out the yellow flag?***

* Bad Debts
* Foreclosures, etc.
* Per Use Fees
* Fixed Assets
* Insurance Claims
* Management Transitions
* Fund Reconciliations
* Special Assessments & Loans

We will discuss each of these in some detail. These are topics that were requested from various accountants, as well as items that we see as being troublesome.

HOA/Condo accounting is very unique! Give yourself credit for working through some very unusual accounting issues that are not in any textbook. And, in the almost 30 years that I have doing this, I still see something new several times a year.

***Bad Debts***

* Determining the Allowance for Bad Debts
  + It is an ESTIMATE
  + Must be made by the Association, not us

This must be estimated at the end of each and every year. In your firm or Association, decide who is in charge of this and have it ready for the audit process. While it does not need to be computed on a unit by unit basis, this seems to be the easiest to understand. Additionally, IF the Association is filing form 1120 the Association must be able to individually identify the bad debt amounts by units.

* Writing off the Bad Debt
  + Board decision

Make sure that the Board has approved the write-off of non-trivial bad debts. This is an internal control requirement. Not only is it a fraud and error protection, it also ensure that the Board is making the determination when to remove an asset from the books of the Association.

* + Write off to expense or against allowance?

It depends. Generally we find that it is written off to expense. This especially makes sense if the Association has significant bad debts and the allowance is not expected to decrease. See next question for follow-up.

* Adjusting the Allowance During the Year

It depends. IF you are writing off bad debts to bad debt expense and the allowance is no longer reasonable, then “yes” you should either 1) adjust the write-off against the allowance and/or 2) revise the allowance. Otherwise, you may end up with a situation where the Allowance is more than the Receivable balance.

Remember, financial statements during the year are management tools. IF it makes more sense for the Board to see all bad debt write-offs in the bad debt expense account, then do so. Boards tend to pay more attention to the Income Statement than the Balance Sheet. In this case, you would wait and adjust allowance just at year end.

* Bad Debt Recovery
  + Current year income

IF the Association ultimately ends up collecting on an account that has been written off, that becomes Bad Debt Recovery income. It is recognized in the current year – even if the amount was written off in a prior period. The reasoning – the prior year estimate was based on the best information known at the time.

Bad Debt Recovery income is also a possibility when the Allowance for Bad Debt is computed at the end of each year. If the Allowance is less in the subsequent year, there is Bad Debt Recovery income.

***Foreclosures, Etc.***

There are more questions than answers with regards to accounting for foreclosed units and there is little in the way of absolutely accounting guidance. Many of the questions surrounding Sheriff Sales, Foreclosures and other ways that the Association obtains possession of a unit, are legal in nature. We cannot address the legality of the various options. What we, as accountants, are concerned about is how to record the financial transactions. Below are our recommendations (taken from FAQ on our website, with some additional comments):

***Does the Foreclosed Unit get recorded on the financial statements as an asset?***

In most cases the Association does not have an asset of value. The unit is still subject to a mortgage that most likely exceeds the fair market value of the unit. GAAP (Generally Accepted Accounting Principles) states that the FMV (Fair Market Value) must be used to record the asset. GAAP also states that the mortgage cannot be included on the financial statements because it is not an obligation of the Association. However, the holder of the mortgage will ultimately foreclose on the unit to satisfy that mortgage. Thus, there may need to be a reduction in value as the asset is “impaired”. In our opinion, often the “true” value is zero as the mortgage payoff and foreclosure costs exceed the FMV. If the value is determined to be zero – that is, the Association will not ultimately receive cash for the unit – then we believe that the unit should not be included on the financial statements. The Board would want to document their understanding of this matter. For example, the minutes might say “The Association received a unit in a Sheriff’s Sale that has a FMV of $250,000. However, it is our belief that the mortgage and other costs associated with the unit equal or exceed $250,000; thus, the FMV asset value is impaired. The result is that there is no net asset value that should be recorded on the books of the Association.”

If the Association feels that they have received a foreclosed unit and there is value in excess of the receivable and the impairment, GAAP states that a gain must be shown on the financial statements. The following assumes a $25,000 A/R, $175,000 impairment and $50,000 gain:

DR Foreclosed Unit (Asset) $250,000

CR A/R $ 25,000

CR Foreclosed Unit – Impairment $175,000

CR Gain on Acquisition of Foreclosed Unit $ 50,000

Some Associations want to record the outstanding receivable as the asset value. As discussed in the next section, this seems reasonable; however, there needs to be an impairment or bad debt allowance to offset that amount.

***What does the Association do with the outstanding receivable once the Unit is in the Association’s possession?***

We find that often the Association will want to keep track of the amount owed on the foreclosed unit in case there is even partial excess equity in the future or they may pursue collection in some other manner. The Association can either leave that amount in their regular AR balance or transfer it to a separate account – e.g. A/R – Foreclosed Unit. However, the Association should consider setting up an allowance for bad debts for the total amount if collection is uncertain. The adjustments were look something like this (example assumes $25,000 A/R balance):

DR A/R - Foreclosed Unit $25,000

CR AR (Regular) $25,000

DR Bad Debt Expense $25,000

CR Allowance for Bad Debt-

A/R – Foreclosed Unit $25,000

Note: Whether the amount is left in regular AR or segregated into a separate account, a reasonable allowance for bad debt should be recorded.

***What about monthly assessments on foreclosed units?***

It is our recommendation that the monthly assessments continue to be recorded per the budget for all units – even the foreclosed unit. Then the Association can expense the nonpayment of the assessment. The assumption is that the assessment amount is the allocated percentage of all expenses for that unit. The accounting entries would be as follows:

Assessment Billing (This would be included in the normal monthly billing cycle)

DR A/R $ 300

CR Assessment Income $ 300

Writing off A/R to Foreclosed Unit Assessment

DR Foreclosed Unit Expenses

(Or Rental Expense – Assessment) $ 300

CR A/R $ 300

We suggest that this be assessment write-off segregated from bad debt, especially in the case where the Association decides to rent out the foreclosed unit (see next section).

***What about when the Association decides to rent out a foreclosed unit?***

Most importantly, this is a legal question. The Board and management should obtain legal advice before renting out the unit. Also, contact the Association’s insurance agent.

From an accounting standpoint, be sure and segregate rental income and all direct costs specifically associated with the rental of the unit – insurance, repairs, utilities, etc. The net rental income will be taxable so set up your account categories from the beginning to capture these costs. The Association should consider the following separate account categories:

* Rental Income
* Rental Expense – Assessment (see above)
* Rental Expense – Utilities
* Rental Expense – Repairs
* Rental Expense – Property Taxes
* Rental Expense – Insurance
* Rental Expense – Other

Some management companies choose to apply the rental income directly to the receivable balance. We suggest that this may not be best way to handle the situation for a few reasons:

* Lack of transparency to the Board and membership regarding rental income
* Difficulty in re-constructing the activity for tax return purposes
* IRS cannot match up rental income
  + This is a VERY new issue that came up just this year. The Association rented out a unit using another property management company. That property management firm issued a 1099 to the Association showing the amount of “Rents” collected. In this case the tax return did segregate Rental Income on the tax return; however, it was a NET amount (the proceeds from the property management firm, not the gross rents). The IRS could not match up the rental income with the 1099, so they issued a tax deficiency notice. This one was even more bizarre in that the IRS made it a final determination only adjustable if appealed.

We recommend the following accounting entries, assuming a $1,000 monthly rent and an offset to the AR or AR - Foreclosed Unit:

DR Cash $1,000

CR Rental Income $1,000

DR Foreclosed Unit Expenses $1,000

CR AR $1,000

Additionally, if the Association uses an outside property management firm and there are expenses of $250 taken out of the $1,000 rent:

DR Cash $ 750

DR Foreclosed Unit Expenses 250

CR Rental Income $1,000

DR Foreclosed Unit Expenses 1,000

CR AR $1,000

***What about monies received from a bank to clear the title?***

We have had several instances where the Association has received monies from the bank to clear the title and release the unit to the mortgage holder. These monies are above and beyond AR balances. In these cases, the net proceeds (after expenses) are taxable. Examples below:

DR Cash $10,000

CR Bank Settlement Income $10,000

These monies must be clearly segregated as they would be taxable as “nonmember” or “nonexempt function” income.

***What if an Association truly obtains a unit with equity and makes a profit selling the unit – is this taxable income?***

In general, the net gain is taxable to the Association. In very limited circumstances, with the approval and understanding of the Board it may be possible for the income to be membership income and potentially non-taxable. This is only a possibly option if form 1120 is filed. Many associations either do not qualify to file form 1120 or there may be too much risk to file form 1120. Contact the Association’s CPA.

***Per Use Fees***

**Types of Per Use Fees**

A “per use” fee is any fee that is not ratably charged to the membership; instead is based on usage or is specific to an event or occurrence. The significance of these types of fees are that they may be subject to taxation, are easily a target for fraud, are difficult to control and may or may not be an offset to specific expenses.

We don’t consider the following in this discussion:

* Late fees, interest and fines – while those are specific to an event and they may be difficult to control, we consider them to be ratably charged to membership whenever the same set of circumstances occur. Also, these tend to be recorded in the Receivable accounts of the unit owners, so the control is the unit owner themselves. As long as the Board is involved in the write-off of any nontrivial balances, the fraud and error risk is reduced.
* Reimbursable expenses – those are specific to an event; however, they should be a pass-through of specific expenses (e.g. collection costs, utilities, landscape, etc.) and those should be reconciled accordingly.

Some common examples of Per Use Fees:

* Move In/Move Out Fees
* Guest Suite Rentals
* Parking/Storage Rentals
* Other Amenity Usage
* Laundry

Accounting for Per Use Fees

* Separate income category for significant amounts
* Offsetting expenses should clearly be identified in a separate expense account

Internal Controls

* Completeness is the objective
  + As auditors we must be able to assert that the income is COMPLETE – that it is all there an accounted for. That is very difficult with many per use fees. We are testing to a negative – MISSING information
    - How many move ins occurred that were not billed?
    - How many guests spent the night and were not billed?
    - How many people attended the art class and did not pay?
* The shortfall in income could be from fraud or error
  + The concierge receives cash for the guest suite and doesn’t turn it over to the Association – fraud
  + There were move ins of tenants (or sales without an escrow) where the Association was not notified – error
* Independent verification
  + To ensure completeness there must be INDEPENDENT source of verification.
    - Examples include:
      * Guest Suite – Online calendar
      * Guest Suite – Cleaning service invoices
      * Move In Fees – Name change requests on directory
      * Move In Fees – Welcome committee packets
      * Parking – Map of parking spaces, parking agreements
  + Every situation is different. Think about what the fee is. How can you be sure that all monies are billed? What outside document, activity or person could verify or confirm that all amounts were billed?
    - Getting a list from the person who is in charge of collecting the money is NOT independent verification of completeness.
* Reconciliation, Review and/or Random
  + Then the independent source of verification must be reconciled with the actual activity – NOT by the person in control of the source document. For example:
    - Guest suite calendar is compared with actual receipts
    - Rental agreements for number of parking spaces are reconciled with actual billings
  + When independent reconciliations are not appropriate or available, another control can be Board review and approval. Because the Board usually does not have control of the receipt of the monies or activity, they are independent. And, between all of the Board members they may (or should) have an awareness of what is happening at the Association.
  + Random verification can be an alternate control. Someone unrelated to process randomly does a comparison or verification of the activity. This is especially effective as a fraud deterrent.
* Document
  + The accounting process
  + The verification that will be used
  + The reconciliation, review and/or random controls

Taxation of Per Use Fees

* If form 1120-H is filed – Net per use fee income is taxable UNLESS it is charged annually
  + Consider whether some taxable income could be assessed annually rather than monthly
* If form 1120 is filed – Net per use fee income from nonmembers is taxable (renters are considered members). Thus, it is important to segregate member and nonmember per use income if the Association is a candidate for form 1120.

Sidenote – Laundry income is considered to be net nontaxable. In years past there have been cost studies and taxing agencies have agreed that the costs are equal to or exceed the income.

***Fixed Assets***

**GAAP – Real Property**

GAAP is unusual for CIRAs in that options are given for REAL PROPERTY. Below are extracts from Financial Accounting Standards Board (FASB) which controls GAAP:

***FASB – Cooperatives shall recognize real property as assets. Because of their legal structure, cooperatives have title to all their common property and have the authority to dispose of it and retain the proceeds. Other common interest realty associations, such as condominiums and homeowners associations, have adopted other practices for recognizing common real property.***

***Real Property Directly Associated with the Units***

***FASB – Most common interest realty associations other than cooperatives, regardless of whether they have title, do not recognize as assets real property directly associated with the units.***

***Real Property Not Directly Associated with the Units***

***FASB – Most common interest realty associations other than cooperatives recognize real property not directly associated with the units as assets when the common interest realty association has title or other evidence of ownership of the property and any of the of the following conditions are met:***

1. ***The common interest realty association can dispose of the property, at the discretion of its board of directors, for cash or claims to cash, with the common interest realty association retaining the proceeds.***
2. ***The property is used by the common interest realty association to generate significant cash flows from members on the basis of usage or from nonmembers.***

***However, some common interest realty associations recognize as assets all real property to which they have title or other evidence of ownership that is not directly associated with the units, regardless of whether either of the above conditions is met.***

The original CIRA Guide published by AICPA defined these two types of real property as follows:

***“Common real property falls into two broad categories:***

1. ***Property that is directly associated with the unit. This category includes common property without which the units could not be occupied and exterior property that is normally part of a freestanding unit. Examples include exterior walls, roofs, public hallways, underlying land, sidewalks, driveways, roads, some parking spaces and greenbelts.***
2. ***Property that is not directly associated with the unit. This property includes community resource property that is not necessary for the primary use of the unit, although the individual unit owners may benefit from its use. Examples include recreational facilities, such as swimming pools or clubhouses; managers’ apartments, properties that are primarily used for commercial operations directed at non-unit owners or at unit owners for which they pay a fee based on usage.” (2.07)***

As many of us know, this was the section that held up the publication of the CIRA Guide for 10 years! AICPA and FASB could not agree on the concept of what real property should be capitalized. Thus, the CIRA Guide was issued with “prevalent industry practice”. When GAAP was codified, FASB took the wording from the CIRA Guide and here we are.

Most CIRAs do not recognized any real property – unless:

* The Association has title
* The Board can dispose of the asset

OR

* The CIRA generates significant per-use or nonmember income.

But, an Association is not precluded from capitalizing real property if they so choose.

At times we find that an Association has assets that should be capitalized and have not been.

What we most often find is that there are assets on the books from eons ago and there is no real use to having them there. They are not a management tool and because most CIRAs do NOT include real property (except in the above situations), there is no consistency from Association to Association. We may then suggest that the assets are removed.

A change in accounting principle results when an entity adopts a generally accepted accounting principle different from the one it used previously. Thus, if there are assets that should be removed from the books it is an equity transaction. The Board should approve this transaction.

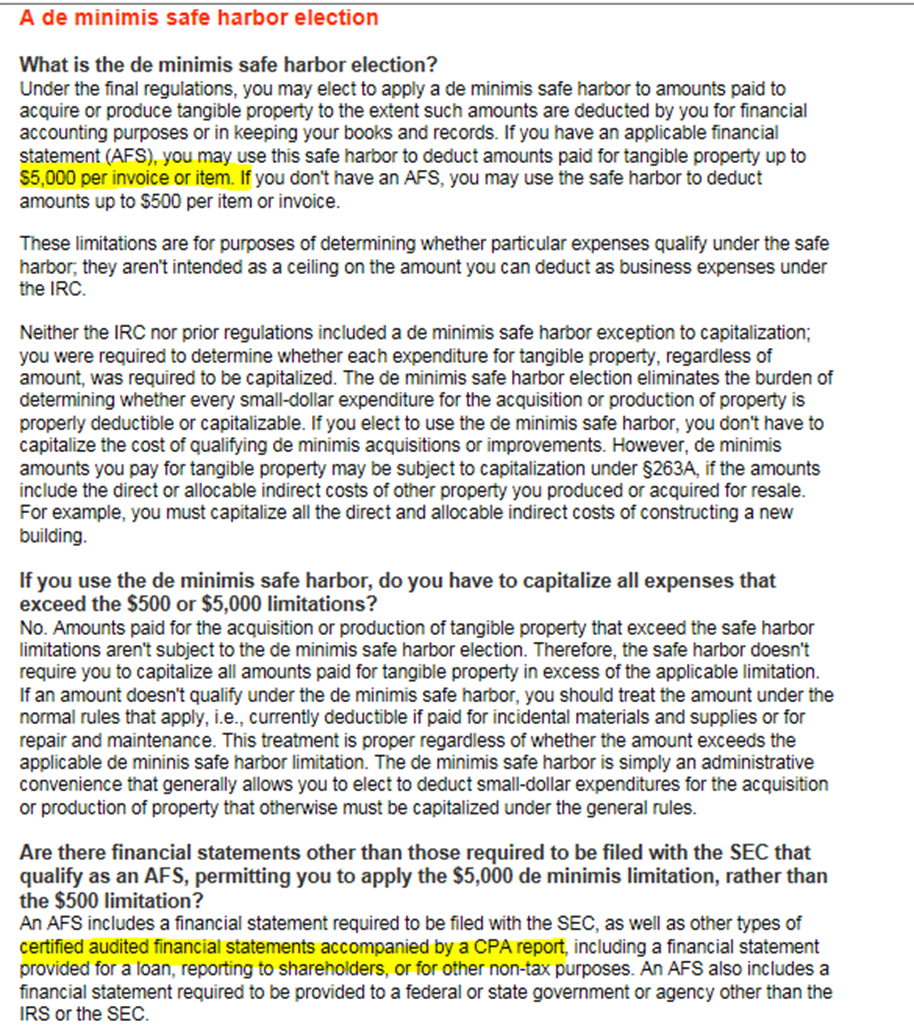
**GAAP – Personal Property**

However, for PERSONAL PROPERTY (e.g. trucks, equipment, office furniture, computers, etc.), there is no option. Those must be capitalized. Here is the FASB extract:

***Personal Property***

***FASB – Common interest realty associations shall recognize common personal property, such as furnishings, recreational equipment, maintenance equipment, and work vehicles, that is used by the common interest realty association in operating, preserving, maintaining, repairing and replacing common property and providing other services, as assets.***

What is an option is the minimum dollar that will capitalized. While GAAP and Tax often follow two different set of rules, a recent “de minimis safe harbor election” was issued by the IRS. It seems that there would be some justification to using this $5,000 amount for capitalization purposes. See extract of election below:



**Accounting for Assets**

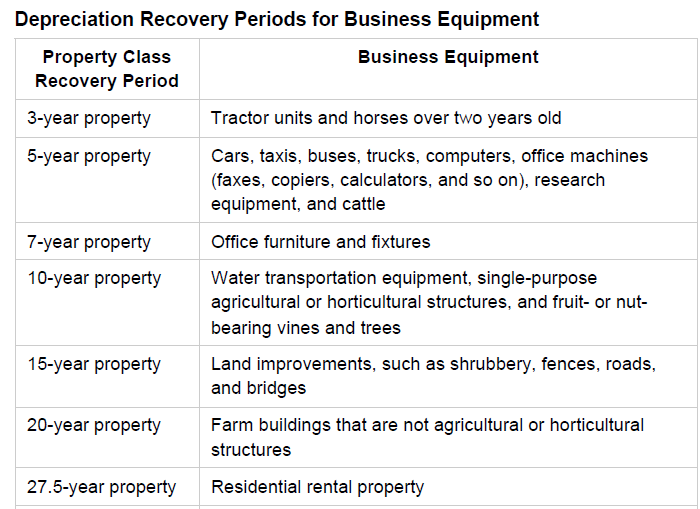
Per GAAP fixed assets must be accounted for in the Operating Fund (or a separate Property Fund). The justification is that the “use” of the asset is for operating purposes.

What about when a personal property asset is purchased out of the Replacement Fund? Per

**FASB -**If an expenditure from the major repairs and replacement fund relates to **common property** recognized as an asset, the amount expended shall be reported as a transfer to the operating fund (or property fund, if such a fund is established).

**Depreciation**

If you have an asset on the books, it must be depreciated over its estimated useful life. Generally, straight line depreciation is used. Below is one suggested table of useful lives:



Quite frankly, there is little value to depreciation on an Association’s financial statements. This is especially true when the Association is reserving for replacement of the asset. But, it is GAAP.

**Capitalization Policy**

Each Association should have a capitalization policy to determine what assets should be capitalized.

SAMPLE CAPITALIZATION POLICY

**Association Capitalization Policy**

The Board of Directors of \_\_\_\_\_\_\_\_\_\_ Association hereby states its capitalization policy with regards to association assets as of \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_(date). This will be included in the Board meeting minutes of that same date. (Alternately this is kept in a Resolutions Book for the Association).

The following is in keeping with industry standards as defined in the Financial Standards Accounting Board’s Codification (FASB), which contains generally accepted accounting principles (GAAP) – section 972, et seq. While GAAP allows additional items to be capitalized outside of the following guidelines, it is not industry standard to do so.

* The Association will not capitalize **real property** **directly associated with the units.**
* The Association will capitalize those **real property assets not directly associated with the units** only when the Association has title and the Board maintains control. Board control is defined to mean that the Board can dispose of the asset without a vote of the membership and the Association can keep the proceeds from the sale of the asset. The other reason to capitalize real property not directly associated with the units is when significant cash flows are generated from members on the basis of usage or from nonmembers.
* The Association shall recognize **common personal property**, such as furnishings, recreational equipment, maintenance equipment, and work vehicle, that is used by the Association in operating, maintaining, repairing, and replacing common property and providing other services. (It is assumed in this case that the Association has title and the Board maintains control of these assets)

The association will capitalize those items which meet the requirements above and which comply with the following:

* The value of the individual asset exceeds the amount of $x,xxx
* The life of the asset exceeds X years

Capitalized assets will be recorded on the balance sheet of the financial statements of the association in the operating fund (FASB 972-10-45-7).

The Board will designate whether to purchase the capitalized assets from the replacement fund (reserves) or operating fund and document that decision in their minutes. Either is acceptable. For accounting purposes, if the asset is purchased from reserve monies it will be transferred to operating fund to be held as an asset of the operating fund (FASB 972-10-25-1)

The capitalized assets will be depreciated over their estimated useful lives based upon the straight line method of depreciation. (FASB 972-10-35-1)

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ SECRETARY

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_DATE

**OPTIONAL ADDENDUMS TO THE CAPITALIZATION POLICY**

LISTED BELOW ARE THE ASSETS (OR A GENERAL SUMMARY OF THE ASSETS) THAT THE ASSOCIATION CURRENTLY HAS CAPITALIZED ON THE FINANCIAL STATEMENTS AND AS OF THE DATE OF THIS CAPITALIZATION POLICY THAT THEY WISH TO **REMOVE FROM THEIR FINANCIAL STATEMENTS**

**\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

LISTED BELOW ARE THE ASSETS THE ASSOCIATION CURRENTLY POSSESSES WHICH MEET THE REQUIREMENTS LISTED ABOVE. AS OF THE DATE OF THIS CAPITALIZATION POLICY THE ASSOCIATION WISHES TO **ADD THESE ASSETS TO THE FINANCIAL STATEMENTS**. INCLUDED IN THE FOLLOWING LIST MUST BE THE ITEM DESCRIPTION, WHETHER IT WAS DONATED OR PURCHASED, AN ESTIMATED DATE ACQUIRED, AN ESTIMATED AMOUNT AND HOW THAT ESTIMATION WAS DETERMINED (ACTUAL PURCHASE COST, ESTIMATED PURCHASE COST OR FAIR MARKET VALUE). IF THE ASSET WAS ACQUIRED IN A NONMONETARY TRANSACTION (E.G. TRANSFER FROM THE DEVELOPER), THE ASSOCIATION SHALL MEASURE THE PROPERTY USING THE FAIR VALUE AT THE DATE OF ACQUISITION. IT MAY ALSO BE HELPFUL TO CONSIDER THE DEVELOPER’S COST,IF KNOWN, IN DETERMINING THE FAIR VALUE (FASB 972-10-30-1)

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

***Insurance Claims***

Insurance claims are another source of frustration for you and for us. In this case it is not that the accounting is complicated, it is getting all the information from the manager and piecing together the pieces to the puzzle.

* Segregate Accounting
  + Gross insurance proceeds
  + Unit owner deductibles
  + Expenses associated with claim
* Reconcile to Insurance Claim Documents
  + If there are separate claims, reconcile separately
* Defer Insurance Proceeds when appropriate
  + GAAP requires when specific amounts are received and not used by end of the year, the income must be deferred.
* Excess Insurance Proceeds

We have seen scenarios where the insurance company payment exceeds the actual cost. The company bases their claim payment on a certain underwriting estimate/invoice, and they pay based on their estimates rather than the actual cost.  We have not seen that the excess is refunded back to the insurance company and in fact have seen situations where the Association has asked about it, and the insurance company has said the Association is entitled to the amount the insurance company estimates the amount to be, and they won’t accept the refund. We have been told that it is similar to an individual that makes a claim for damage to their car or home. The insurance company pays off based on the claim; however, the individual is under no obligation to fix the dented fender or replace the broken window.

From an auditing standpoint, the extra amount would be recorded as income/gain at the point that all costs have been incurred, and the collection of the extra amount is certain.

From a tax standpoint the IRS rules for excess insurance reimbursements states that when the proceeds exceed the basis in the property, there is a taxable gain. That seldom happens. But, in an HOA/Condo, the unit owners are usually not notified to reduce their basis. In the past when we have generally seen this occur, the amounts are not material and we assume that there are costs that were not appropriately captured and applied against the claims. When there are large excess insurance settlements (which did occur after the Northridge CA earthquake when insurance carriers were sued and were required to pay a second settlement years after the event which far exceeded the actual costs), we took the same position as that involving excess settlement funds. See below (and it is also on our website FAQ). If this is the case, disposition of the funds should be documented in the Board meeting minutes. If the amount is large enough and if the monies are not to be used in the Replacement Fund, a tax attorney may need to be consulted.

**What Should the Association Do With This Unexpected Windfall?**

**Use of Excess Reconstruction Settlement Funds**  
by Thomas S. Gatlin, Esq.,  Epsten Danow Howell & Gatlin Attorneys at Law

**Question**  
The repairs to the construction defects are finally completed and there is still money left. What should our Association do with this unexpected windfall? Should it be refunded to the owners, be deposited into reserves, be used to pay operating expenses or treated in some other fashion?

**Answer**  
In a Private Letter Ruling a few years ago, the IRS determined that excess litigation/construction funds could be returned to the homeowners without adverse tax consequences to the Association. Such a refund, however, would reduce the owner’s basis in his or her home, which might have a tax impact upon the sale of the home. It should be noted however, that a Private Letter Ruling is not a legally binding precedent, but is often used as guidance for how the IRS will interpret similar issues in the future.

Refunds to homeowners can also present the problem of who should receive the refund – the unit owner during the litigation or reconstruction, or the owner at the time the refund is made. It is not uncommon for previous owners to claim a right to a refund made after the sale is completed, and the Association must consider this issue before the refunds are made.

The IRS has stated that a transfer into the Association’s long-term capital reserve, such as Roofing, is an appropriate use of excess funds. Conversely, the IRS has determined that it is not appropriate to use excess litigation/construction funds for operating expenses or for reserves that are not long-term reserves. Examples of these types of short-term reserves are Painting and Contingency. Using excess money for operating expenses or transferring the money into one or more short term or contingency reserves could result in the excess money becoming fully taxable.

An Association may prudently and safely decide to maintain the excess funds to be used for construction defect repairs not completed during the initial repair program. The possibility of future problems developing is common and creating a “latent defect fund” to handle these situations helps the Association stay financially strong.

There is no one correct treatment of excess litigation construction funds. However, there are consequences for selecting the wrong treatment, and all Boards of Directors should consult with their attorney and accountant before finalizing its decision.

***Management Transitions***

It is very important that the accounting transition between management companies is very clean.

Here are some specific things to do:

* The last financial statement issued by the old management company must agree with the beginning balances in the new management company.
  + We suggest that the new management company run a financial statement after beginning balances are entered – before anything else is done.
  + If there are significant differences in how the financial statements are set up (e.g. Nonfund to Fund, Accrual to Cash, etc.) document how the old balances were entered into the new format.
* The ending A/R from the old management company must agree with the beginning A/R from the new management company.
  + Put old, delinquent accounts on the new management company’s books
  + IF the new management company really doesn’t want to set the balances up in their AR/aging system, then put those accounts in another asset account, not part of the AR system
* Verify that equity agrees
* Enter year-to-date income statement amounts
* Any transition adjustments should be in a separate equity account
* Keep documentation and backup of the transition reports (what you used to enter the balances), reconciliations and adjustments

Things NOT to do:

* Enter the bank statement balance and not the reconciled bank balance.
  + Get a copy of the last bank reconciliation from the prior management company.
  + Checks may need to be voided and/or duplicate expenses backed out.
* Use the wrong “final” financial statement. IF you find out that the prior management company processed additional transactions after your setup, consider inputting those adjustments separately.

Accounting departments…let’s agree to cooperate with one another. What goes around, comes around. We all lose and gain clients. As professionals, let’s forward on the information that the new management company needs to properly set up the books and records.

As auditors, we generally only work with the new management company. Very seldom will we go back to the old management company to ask for assistance. We don’t want to impose on your time. If we do ask, please know that we have tried every other option. We are working for the Association – not the management company – so we are attempting to assist them in getting a clean audit.

***Fund Reconciliations***

Fund reporting is not required by GAAP. But FASB states the following:

**972-10-45-4** Nonfund reporting is an alternative to fund reporting. However, fund reporting is more informative to users, because financial statements using nonfund reporting often do not disclose whether assessments have been used for purposes other than those for which they were designated. For example, if nonfund reporting is used, a user of financial statements may be unable to determine whether assessments for future major repairs and replacements have been used in current operations.

**972-10-45-5** Because this Subtopic primarily addresses the fund reporting approach, readers should substitute the term members' equity for the term fund balance if financial statements using nonfund reporting are presented. Furthermore, the fund for major repairs and replacements would be presented as an appropriation of retained earnings in such financial statements.

Fund reporting is universally recognized as being “more informative to users” and is recommended by CAI and most CPAs.

It is often missed that FASB/GAAP states that even when fund accounting is not used the Replacement Fund activity should be an appropriation of retained earnings.

In addition to the Replacement Fund (Reserve Fund or Fund for Major Repairs and Replacements), it is common, and recommended, to consider third fund to account for special assessments, settlements, loans, etc. That fund will be discussed in the next section.

**Accounting Basics for Replacement Fund**

The replacement fund is a self-balancing set of books separate from the operating fund, if fund balance accounting is used. However, how associations actually account for reserve transactions is extremely varied. In a “perfect world” there would be two sets of books. Some accounting programs will allow two separate income statements, others show the funds in columns. When only one income statement can be generated, in our opinion, the most useful interim financial statements are those where the income statement only shows operating fund activity rather than combined reserve and operating fund activity. Since the operating is usually based on a break-even budget, it is important to be able to review the operating fund activity on a monthly activity and make adjustments, as needed. When reserve activity is included it distorts the financial statements considerably, as the reserve fund is a 20-30 year budget and not an annual budget.

Here are the standard, most common, accounting entries for recording Replacement Fund activity.

Assessments to Owners (Full Assessment Amount)

DR Assessments Receivable

CR Assessment Income

This is automatically generated from the billing/AR system. Each billing cycle increases AR with an offset to assessment income, in accordance with the budget

Allocating Budgeted Portion of Assessment to the Replacement Fund

DR Reserve Allocation Expense or Contra Income Account

CR Replacement Fund

This is the budgeted reserve allocation – not cash. This should be a recurring journal entry for each billing cycle (generally, monthly).

Budgeted Allocations Cash Transfer

DR Reserve Cash

CR Operating Cash

As the reserve transfer takes place, Reserve cash is increased and Operating cash is decreased. This generally occurs though the cash disbursement system.

Budgeted Allocation Cash Transfer Does Not Occur

DR Due from Operating

CR Due to Replacement Fund

If fund basis of accounting, the Due Between Funds journal entry will be necessary to keep the funds in balance. But, for nonfund accounting the Due Between Funds journal entry is even more important – to clearly show that monies were not transferred.

Interest Earned on Reserve Cash

DR Reserve Cash

CR Interest Income

DR Reserve Interest Allocation Expense or Contra Income Account

CR Replacement Fund

In the vast majority of cases reserve interest stays in the Replacement Fund.

Reserve Expenses – if paid directly from reserve cash

DR Replacement Fund expenses

CR Reserve Cash

Reserve Expenses – if paid temporarily by Operating Cash

DR Replacement Fund expenses

CR Operating Cash

DR Due from Replacement Fund

CR Due to Operating Fund

If fund basis of accounting, the Due Between Funds journal entry will be necessary to keep the funds in balance. But, for nonfund accounting the Due Between Funds journal entry is even more important – to clearly show that monies are due. The same is for the next example:

Borrowing from Replacement Fund for Operating Expense or Shortfall

DR Operating Cash

CR Reserve Cash

DR Due from Operating Fund

CR Due to Replacement Fund

Repayment of Expenses Paid Originally by Operating Cash or Repayment of Borrowing

DR Operating Cash

CR Reserve Cash

DR Due to Operating Fund or Due to Replacement Fund

CR Due from Replacement Fund or Due from Operating Fund

It is very important that the EXACT amount be repaid. If “rounded” there will still be an amount Due To/From Funds.

If repayment is for a group of invoices, clearly list those invoices so that it can be reconciled.

**Due Between Funds**

As noted in the journal entries above, the result can be an amount remaining as an interfund payable and receivable. In summary, this can occur in situations such as these:

1. One cash account pays for the obligation of another. For example, the expense is coded to reserve expense/replacement fund correctly the by accounting department, but they incorrectly write the check out of the operating bank account. Thus, the reserve fund owes the operating fund for this payment.
2. All checks are written out of the operating cash account, and reserve expenses are to be reimbursed at the end of the month by one check written from reserve cash to operating cash. However, the wrong amount is reimbursed, no reimbursement occurs, or the reimbursement is not in a timely manner.
3. Miscoding of expenses. The expense may be a reserve item and is correctly paid out of reserves, but the expense is charged to an operating type of expense. This is similar to #1 above, but in that example the coding was correct, but the payment was not. Here is the payment is correct, but the account coding is not.
4. Interest is earned in one fund but posted in another fund.
5. Budgeted reserve allocations are not transferred or not transferred at the correct amount.
6. Actual borrowing of monies to meet short term needs.

The Association’s accounting should clearly reconcile the reason for the Due Between Funds.

**Due Between Funds – Writing Off with a Transfer Between Funds**

GAAP states that if the Association does not have the intention and/or the ability to repay the amount due between funds, then a permanent transfer between funds must be recorded.

DR Replacement Fund or Transfer Between Funds (Equity)

CR Replacement Fund or Transfer Between Funds (Equity)

DR Due to/from

CR Due to/from

If Transfer Between Funds (Equity) accounts are used they should be separate from other equity accounts in order to fully disclose the activity.

This should be resolved and reconciled at least at year-end. The manager and Board should be involved in the process and the determination. Accounting should provide the necessary information and record the transactions as approved.

To repeat – These are the Association’s financial statements! They need to be involved in these decisions. Our job, as auditors, is to assess whether the financial statements are materially correct and in compliance with GAAP. Thus, in this discussion, we have to assess whether there truly is a payable and receivable that we can document and justify. If not, we cannot opine on the amounts.

**Additional Transfers Between Funds**

There are times that a Board approves a Transfer Between Funds – monies to be moved to or from the Replacement fund – in addition to regular assessments and expenses.

These Transfers Between Funds are to be equity transactions (as noted above). During the year in the interim financial statements it may be appropriate to show the transfer as “Gifts to Funds” or other such name in the Income Statement in order to bring the action to the Board’s attention.

***Special Assessments & Loans***

There is probably no more convoluted accounting nor diversity in recording of transactions than when there is a loan secured by special assessments. In addition to the accounting issues that are raised, there are legal requirements. We will not address those.

***Basic Scenario***

* The Association has a major project.
* It is decided that there will be a special assessment to the membership.
* The members have the option of paying their portion in full or paying it off over time.
* The Association gets a bank loan for those members that are financing the special assessment.
* The unit owners who pay over time pay interest equal to the bank loan.
* The bank loan is repaid at the same rate as the special assessments are billed/paid.

***Accounting Basics***

* A 3rd Fund should be considered.
* Separate cash account and chart of accounts set up (at a minimum)
* Loan is recorded on books.
* Additional principal payments are sent to the bank to reduce the loan.
* Amortization schedules are required for EACH owner

YES – really…amortization schedules should be set up for each owner to do it right. The next best alternative is to set up amortization schedules for each percentage of ownership (those who all pay the same amount). BUT…if one of those owners does not pay exactly as planned (e.g. pays late, makes an additional payment, bounces a check, etc.) then their amortization schedule must be revised. It is imperative that these schedules be kept from the onset as when the unit sells, the owner goes bankrupt, the owner decides to pay in full or the auditor asks (☺) this information must be readily available.

***Perfect World***

If all of this works as it should (read “perfect world”), the following will occur:

* The special assessment amount agrees with the loan amount at the onset.
* The loan date agrees with the date of the special assessment.
* As payoffs are made, the loan is reduced and/or monthly loan payments are made at the same time as the special assessment payments ~ the loan and special assessment receivable will be reducing at the same rate and they will agree.
* The loan automatically re-amortizes
* The loan interest coming in agrees with the loan interest being paid out.
* A true “matching” of monies in and monies out occurs.

***Real World***

These are some of the things that really will happen:

* The loan and special assessment dates and amounts do not agree.
* The expenses are over a period of time and the loan is on a draw system; thus, special assessment is being paid ahead of or behind the actual expenses.
* The interest rates are not the same – either at the beginning or the loan resets and the special assessment does not.
* The Board decides to pay down the loan but the special assessments keep going on.
* An additional principal payment is made and is missed being sent to the bank.
  + Interest continues to accrue.
* There is a bad debt write-off and that additional amount is not paid to the bank.
  + Interest continues to accrue.
* A unit pays off (either “just because” or at escrow) and accounting misses it and keeps billing the unit.
* Etc., etc., etc. – many more things can occur!

***Accounting Methods when Loans are Secured by Special Assessments***

There are two basic schools of thought with regards to accounting for loans secured by special assessments. We will call them the “Full Receivable Method” and the “Annual Assessment Method”. Below is a brief discussion of both methods and the pro’s and con’s of each. There are variations within each method. At the end of the discussion, there will be a discussion about the lack of guidance on the matter.

**Full Receivable Method**

This theory is based on the fact that the entire assessment is approved and assessed. The total amount is an obligation, even though there is a payment plan. Thus, at the time of the special assessment the total special assessment amount is recorded as a receivable.

DR Special Assessment Receivable (Full Assessment Amount)

CR Special Assessment Income (Full Assessment Amount)

The loan when received would be booked as any normal loan.

DR Cash in Bank

CR Bank Loan

As the money is spent on the project, cash would be reduced and the special assessment expense account charged.

DR Special Assessment Expense

CR Cash in Bank

If the unit owner pays their assessment in full, the receivable is reduced.

DR Cash in Bank

CR Special Assessment Receivable

At that time the loan should be paid down for that payoff amount.

DR Bank Loan

CR Cash in Bank

If the membership is making payments on the special assessment, usually there is a payment plan set up using the same terms and interest rate as the loan. Each month, the unit owner would be assessed for that month’s interest in accordance with the amortization schedule

DR Special Assessments Receivable

CR Special Assessment Income – Loan Interest

The Association then makes the normal monthly payment to the bank for the loan.

DR Bank Loan Principal

DR Special Assessment Loan Interest Expense

CR Cash in Banks

The “pro’s” of this method of accounting:

* No negative fund balance/equity (“perfect world”).
* The receivable is on the books so that everyone is aware of the responsibility of the owner to pay this assessment over time.

The “con’s” of this method of accounting

* Requires an elaborate accounting system – especially when there are various amortization schedules for units
* AR systems may not be able to handle inclusion of the full AR on the books – without trying to assess late fees, lien, etc.

**Annual Assessment Method**

This theory is based on only booking the amount of the billed annual special assessment each year. The amount billed to members is the monthly assessment amount, including principal and interest. Usually this includes that any payoff amounts are included in the “billed” income.

DR Special Assessment Receivable (Billed Assessment Amount, including interest)

CR Special Assessment Income (Billed Assessment Amount, including interest)

The loan when received would be booked as any normal loan.

DR Cash in Bank

CR Bank Loan

As the money is spent on the project, cash would be reduced and the special assessment expense account charged.

DR Special Assessment Expense

CR Cash in Bank

If the unit owner pays their assessment in full, special assessment income is recognized.

DR Cash in Bank

CR Special Assessment Income

At that time the loan should be paid down for that payoff principal amount.

DR Bank Loan

CR Cash in Bank

The Association then makes the normal monthly payment to the bank for the loan.

DR Bank Loan Principal

DR Special Assessment Loan Interest Expense

CR Cash in Banks

The “pro’s” of this method of accounting:

* Bookkeeping is much easier.
* The financial statements may be easier to understand for non-accountants.
* The assessment amount received should be what is budgeted (except for payoffs).

The “con’s” of this method of accounting

* There is a large negative fund balance for the life of the loan, reduced by net income from the total assessments billed, less the interest paid.
* The total receivable does not show on the financial statements nor on the A/R ledger, so separate “off books” ledgers must be kept to ensure payoff at the time of sale of the unit and/or to disclose to potential owners.
* A separate reconciliation of remaining AR to loan balance should be kept, or prepared at least annually, to ensure that there are adequate monies to repay the loan and to ensure that payoffs have not occurred and not been sent to the bank.

**Which Method is Correct??**

There is no GAAP standard. It has been debated extensively. There is a new Revenue Recognition GAAP coming out in a few years that may resolve this matter. Until then, the most important thing is to choose the method of accounting and reconcile the accounts according to that method.

What is NOT acceptable is just bill special assessments and not reconcile the account activity. We have seen this way too often. There is really no idea what is being billed, what should be billed, what is remaining to be paid, who paid off, etc. This is the #1 reason we have to qualify our audit opinions.

***Checkered Flag***

***(Taking It to the Finish Line)***

***What to do at the end of the Audit***

Finishing the Race (Audit):

* Review the Internal Control Points
* Make sure the tax return is filed
* Post the adjusting journal entries
  + Use One Balance Sheet Only Method
  + Post ALL or NONE of the AJEs
  + What to reverse
  + RECONCILE EQUITY IF AJES ARE POSTED!
  + If not posting AJEs look at carryover balances that make no sense.

***Review the Internal Control Points***

Over 99% of the audits our firm issues include a Report of Internal Control (so…you are not the only one!). Not only is it required by auditing standards, it is an educational tool for the Board, manager, and accounting staff. At least the CFO and/or lead accountant should be receiving and reviewing the internal control points.

Many of the items may be out of the accounting department’s control. Ignore those.

But for those items that involved accounting issues consider the following:

* Is there a process that needs to be revised?
* Are there controls that are missing?
* Does the staff need additional training?
* Did the auditor make an error in fact or judgment?
* Is there additional information that we neglected to provide for the auditor?
* Are there subsequent events that could mitigate the point?

While the report is in the draft stage, consider whether the auditor needs to revise or clarify any points.

For those items that where there were errors, lack of controls or untrained staff, use this report as an educational tool.

***Make Sure the Tax Return is Filed***

And…

* Taxes are paid, if needed
* Estimated tax payments are set up to be paid, if appropriate

***Post Adjusting Journal Entries…or NOT***

# 1 Rule – Post ALL or None of the Entries – in the current year.

If you post ALL entries reconcile equity to agree with the audit report.

Why do we say post to the current year? The key is that the audit trail is there to roll-forward retained earnings.  Often, if management companies post the adjustments to the prior period, they don’t restate the financial statements and adjust the beginning balances 1/1/14, thus, leaving no audit trail for the 12/31/14 audit. Additionally, if the audit adjustments are not posted 100% correctly; this still leaves the financial statements distorted. IF the adjusting journal entries are posted to the prior period, equity must be agreed and balanced to the audit report.

Our preference is that you use our One Balance Sheet Only Method using a current year’s date. With this method only the Balance Sheet is affected.

,Here are the reasons that we recommend the One Balance Sheet Entry Only Method:

* The budgets have been prepared months and months ago. Thus, the audit adjustments will have no impact on the current year’s budget.
* The year-end financial statements were issued to the Board and often available to membership. Thus, if the prior year financial statements are re-issued, distribution must be complete – that is, anyone who received that financial statement should be notified that there is a revised financial statement.
* The single entry to Equity highlights to anyone looking at the general ledger that beginning equity was revised.
* Interim financial statements are not GAAP – in many ways – not full accrual, no reversal of accruals, no disclosures, funds often not reconciled, no tax adjustment, etc.
* In most cases, the impact to the operating expenses is not material, with the exception of bad debts or one/two other items. Thus, we feel that the Board can manage to the exception rather than re-stating the prior year reports.

There are occasions where it is appropriate to only post a few of the journal entries (see examples following). In those cases, do NOT post to beginning equity. Post to a separate equity account and clearly document and identify which adjustments were made and why.

* When on a cash basis set of books but there are some old, incorrect balances still one the books. In this case you may not want to adjust for the accrual entries, but you should consider removing those obvious balances that are in error.
* When you want to reverse one large adjustment that will distort the subsequent year’s financial statements.
* When the Board has specifically directed you to do so.

“What/When to reverse?” Depends on your accounting policies and practices. Some options:

* Leave on books all year. This is the most common option. Explain to Board that these are year-end audit entries. Some financial statements actually have a separate account category, e.g. AP – Audit
* Reverse all accruals and then accrue as necessary
  + Prepaid Insurance
  + Accounts Payable
  + Prepaid Expenses
  + Other Liabilities
  + Deferred Income

(Caution – take care that you don’t distort the next year’s income by reversing and not accrue – where appropriate)

* Reverse specific adjustments as determined – but remember to post to a separate equity account.

***Winners Circle***

***Some interesting facts about this industry we are involved in!***



