Hurts So Good:
With Proper Research and Planning, Transition Audits Need Not Be a Pain

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We once had a management company accountant tell us that he would "rather have a root canal than go through another developer-transition audit." If some of you have similar sentiments, perhaps learning more about the process will alleviate some of that pain.

There are some financial requirements related to developer (a/k/a declarant) control and the transition of that control. Included in the Washington Condominium Act, RCW 64.34 et seq., is a CPA-audit requirement. Specifically, RCW 64.34.312 states:

> *Upon the transfer of control to the unit owners, the records of the association shall be audited as of the date of transfer by an independent certified public accountant in accordance with generally accepted auditing standards unless the unit owners, other than the declarant, by two-thirds vote elect to waive the audit. The cost of the audit shall be a common expense unless otherwise provided in the declaration. The accountant performing the audit shall examine supporting documents and records, including the cash disbursements and related paid invoices, to determine if expenditures were for association purposes and the billings, cash receipts, and related records to determine if the declarant was charged for and paid the proper amount of assessments.*

This article will address:

- When is the transition audit performed?
- What period of time does the audit cover?
- What are three key areas the audit addresses?
- How does the Association prepare for the audit?
- What happens at the conclusion of the audit?

When is the transition audit performed?

We can't give you an exact answer because the law is not specific. The statute states that the audit is performed "upon the transfer of control to the unit owners..." Once the majority of the board positions transfer to the unit owners, an audit is required. (For this article, we refer to this transfer in control as "Legal Transition." This is distinguished from "Accounting Transition" discussed later.) Typically, the audit is conducted at the next regular-year-end date after Legal Transition. A short-year transition audit may also be performed that may end at any month-end date after Legal Transition. However, this "month-end" audit will typically result in higher fees, because often the association also has an annual audit at the regular year end date, regardless.

What period of time does the audit cover?

The transition audit period may encompass multiple years. We believe it is appropriate to start as of the first of the year that the association began charging assessments to all owners, including unsold units held by the declarant. We use the term "Accounting Transition" for the assessment start date. Then the audit period generally concludes at the fiscal year end of the Legal Transition year.

What are the three key areas the audit addresses?

The transition audit addresses multiple areas beyond the scope of this article. However, the following are three key areas involving significant audit time:

- **Assessment billings**

  According to most governing documents, the declarant has the option of:

1) Paying for all association operating costs, or
2) Charging assessments to *all* unit owners, including the units still owned by the declarant.

   The audit procedures include checking to see that all units, including the declarant-owned units, are billed in accordance with the budget for the entire audit period starting with the Accounting Transition date.

- **Declarant and association expense cutoff**

  Before Accounting Transition, all association expenses are a declarant responsibility and should not be recorded in the association books. If expenses are recorded in the association books, they should be offset by a receivable from declarant. After Accounting Transition, all association expenses should be recorded in the books of the Association. The audit procedures include testing of the expense cutoff and allocations at the Accounting Transition date. They also include testing the nature of "material" expenses posted to the books after Accounting Transition, to ensure no declarant costs, such as selling expenses, are paid by the Association.

- **Initial Capital Contributions (ICCs)**

  Often, the governing documents require a certain number of months of assessments be paid by the unit owner at the time of unit purchase. This payment is typically for association "working capital" and contingency purposes, is two months and is *in addition to* the regular assessments billed at Accounting Transition. The word "capital" can be a misnomer, as frequently the funds are to be used for the operating fund and not the reserve fund. The governing documents should confirm this treatment. Transition audit procedures related to ICCs include:

1) Testing to ensure that all unit owners are billed the proper amount of ICCs according to the governing documents requirement;
2) Testing to determine that the declarant was billed for ICCs on all unsold units at the Legal Transition date if required by the governing documents; and
3) Testing to determine that the ICCs are held for association use, rather than absorbed by declarant costs prior to Accounting Transition.

How does the association (and management company) prepare for the audit?

The association should:

1) Review the governing documents. Understand how assessments are to be billed, costs are to be allocated, and ICCs are to be billed. Understand transition requirements such as the process for transfer of control.
2) Ensure that all relevant financial records that are necessary to adequately test the transition time period are in the possession of the association.
3) Prepare a spreadsheet (or clearly designate amounts within the financial reports) that summarizes costs paid during the period surrounding Accounting Transition and allocates costs to the declarant and association for proper expense cutoff at Accounting Transition.
4) Determine the relevant dates:
   - When was the corporation formed?
   - When was the first unit sold?
   - When was the Accounting Transition?
   - When was the transfer of control (Legal Transition)?
   - What is the time period to be audited?
   - When should the audit start?
5) Engage a CPA firm that has condominium-transition audit experience.
6) Budget appropriately for the audit fee. Often audits span two to three years and are more complex than the traditional annual audit, and accordingly, are more expensive.

What happens at the conclusion of the audit?

When the CPA firm concludes the audit, it will issue one or more "draft" reports for board and management company review. Ensure the entire board has reviewed the draft. If appropriate, ask legal counsel to review it as well. Discuss your questions with the CPA. Often, as a result of the audit, there will be a receivable from, or, payable to the declarant on the balance sheet. Obtain the audit work-paper that supports this balance, and settle the account with the declarant as appropriate. If this amount is disputed, resolve that matter prior to finalizing the audit report. Follow up on internal control issues and other "findings" noted in the report(s).

With proper research and planning, the developer (declarant) transition audit can go smoothly and does not need to be as painful as a root canal!