Efficient Homeowners Association Audits

Jeremy Newman, CPA

Associations with December 31st year ends make up a very disproportionate share of annual audits and tax returns compared to associations with fiscal years ending in any other month of the year. There is often intense pressure on managers, accounting departments and audit firms to complete accurate and complete audits and audited financial statements in a timely fashion. For the purposes of this article, we will not differentiate between an audit and a review. We will use the term “audit” throughout. Completing an efficient audit includes multiple steps, as described below.

Signed engagement letter (“proposal”)

An engagement letter (commonly referred to as a “proposal”) prepared by a CPA should be presented to the board for approval and signature for all engagements with CPAs. Returning an approved engagement letter to the CPA before the association’s year end will provide more time for the CPA to plan and prepare for the audit. The management company’s accounting department will also know which firm is performing the audit.

Documents and reports needed for an audit

Most required information is usually consistent for all associations; however additional information will be needed in other circumstances. Auditors will require background information about an association, including:

1. Governing documents, including articles of incorporation, bylaws, covenants, conditions and restrictions (CC&Rs)
2. Prior year audit
3. Prior year tax returns
4. Communication with the previous auditor as applicable
5. Reserve study
6. Budget
7. Board meeting minutes

Some additional documentation may include communication with the Association’s legal counsel, shared cost agreements, cost center details, correspondence with governmental agencies, and loan agreements.

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Management company accounting departments generally provide the following reports, and access to information:

1. Financial reports for the last month of the year
    a. Balance sheet
    b. Statement of revenue and expenses (often referred to as budget variance reports)
    c. Bank statements and bank account reconciliations
    d. Aged receivables report
    e. Prepaid assessments report

2. General ledger for the whole year
3. Check register for the whole year
4. Financial reports, including check register and general ledger for the period after the year end date.
5. Insurance certificates
6. Paid and unpaid invoices for the year being audited; and since the year end

Accrual versus non-accrual

Presenting audited financial statements in accordance with U.S. Generally Accepted Accounting Principles often requires auditors to record certain adjustments to the financial reports prepared by a management company. Management companies prepare monthly financial reports using the cash basis of accounting, modified accrual basis, or the accrual basis.

Under the cash basis of accounting, income reflects money received and expenses represent money spent. Assessments receivable and accounts payable are not presented on the balance sheet. As part of the audit, the CPA proposes adjusting journal entries to include balances receivable from owners for unpaid assessments, and any amounts payable to vendors for unpaid invoices.

Modified accrual basis accounting generally records assessment revenue when assessments are billed (accrual basis). Expenses are generally accounted for on the cash basis (as above).

Using the accrual basis, financial reports include assessment income when billed, and expenses using invoice dates rather than payment dates.

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Completeness of records for the audit

Generally, the success of an audit can be measured by the completeness, accuracy, and timeliness of the audit and audited financial statements. In order to complete a successful audit, CPAs require access to full and complete documentation, in a timely manner. Completing the audit within a reasonable timeline in order for the Association's board of directors to comply with the Davis-Stirling Act requires full and complete documentation to be made available to the auditor shortly after the Association's fiscal year end. Article 7, Section 5305 of the Davis-Stirling Act states that "A copy of the review of the financial statements shall be distributed to the members within 120 days after the close of each fiscal year…".

Cash!

One of the most critical audit areas is cash. Cash, meaning all petty cash, bank accounts, and investment accounts. Together with the general ledger, bank and investment account statements can act as a roadmap of an association's financial activity for a defined time period, i.e., a fiscal year. For accounts where statements are not provided by the banking institution, an auditor will generally require an independent confirmation of the account balances as of the year end date. In terms of efficiency, this situation is often one of the main hurdles to completing audits on time. CPA's can verify account balances in various ways. The most common method is to send an account confirmation form to the institution, either using a standard confirmation form, or via an online service. Banks require confirmations to be signed by an authorized signer on the account. It is therefore imperative that signature cards are updated whenever signers change. Excessive time can be spent transmitting the confirmation forms to the board, waiting for a signature, sending the form to the bank, then waiting for a response from the bank. Many times, audits are nearly complete, but cannot be released until the banking institution returns a signed completed confirmation to the auditor.

Representation letter and final audit

Upon completion of the draft audited financial statements, the board reviews the audit report together with a representation letter. The client representation letter confirms management's and the board's representations, oral or implied, during the audit, and upon signature, the auditor will release the final audit report for distribution.

Jeremy Newman, CPA is principal at Newman & Associates CPA, PC, with offices serving all of California, Washington/Pacific Northwest, and other western states.