AUDIT COMMITTEES

By: Gary A. Porter, CPA

The use of audit committees within the Homeowners Association industry is relatively rare. We generally encounter it only with the large-scale associations that have an active board and committee structure. However, the use of an audit committee can be a very beneficial tool to the Association. It relieves some burden from the Board of Directors, and allows participation by individuals who generally have an interest in financial matters only, but not in serving on the Board with all of the duties that are encompassed by such service.

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The use of audit committees is an issue not only in homeowners associations industry, but also in many other industries. It is prevalent throughout governmental entities and large private companies. The Securities and Exchange Commission (SEC) recently issued a "Notice of Filing of Proposed Rule Change Amending Nasdaq's Audit Committee Requirements" (Release # 34-41982, 10/6/99) that will affect all companies listed on the NASDAQ exchange, from Microsoft on down.

The reason for this change is that audit committees have not been perceived in that (Nasdaq) environment as doing the job that they were intended for. So, the guidelines were laid out to provide a more rigid structure to all companies listed on the Nasdaq. While these rules are not completely transportable to the homeowners association industry because of the difference between membership organizations and for-profit businesses, the rules set forth by the SEC make sense. The portion of the rules that are not transportable to this industry are the requirements that a minimum of two directors on the board of each Nasdaq-listed company must be independent directors. That is, not otherwise connected to the company on whose board they serve. Another requirement is that the members of the audit committee be must be independent directors. The reason for this is very simple. The audit is intended to be an independent examination by an outside auditor of the company. To make sure that this process remains independent, use of independent directors is imperative. Such directors have no personal axe to grind and are less inclined to manipulate the audit process in any manner.

Within the homeowners association industry, governing documents of these membership organizations generally prohibit election of directors who are not members of the association. This makes it virtually impossible to elect independent directors. An attempt by many associations to resolve this dilemma, the desire for independence and the requirement to select from members, has caused boards to appoint audit committees that have no direct connection to the board, but with the treasurer acting as liaison to the board. Several permutations of this model exist.

In summary, the rule changes set forth by the SEC are:

1. At least two members of the audit committee shall be independent directors. (Independent means a person other than an officer or an employee of the company (association), which in the opinion of the company's board of directors would interfere with the exercise of independent judgement in carrying out the responsibilities of a director.

2. The company must adopt a written audit committee charter that specifies the audit committee's responsibility for :

   - Ensuring receipt of independence statement form the auditor
   - The auditor's accountability to the board and audit committee as representatives of the shareholders (members).

The SEC Notice also indicated that the following persons shall not be considered independent for purposes of serving on the audit committee:

- Any director who is employed by the corporation or any of its affiliates during the current year.
- Any director who accepts compensation …
- Any director who is a member of the immediate family of any individual who is, or has been, during the last three years had been employed by the corporation as an officer.
- Any director who is a partner or shareholder executive of any business organization to which the corporation has made or received from substantial payments.
- Any directors employed as an executive of another entity where any of the company's executives serve on the compensation committee.

These rules are clearly intended to make sure that the members of the audit committee are independent. The first bullet point above, as stated by the SEC, is applicable only to employees. However, the counterpart in the homeowners association industry is that member who volunteers so much time that they actually become a part of the accounting process, rather than relying upon their paid staff. Unfortunately, we have observed several examples of this over the years. We recently observed a volunteer member, who as chair of the audit committee, completely subverted the audit process for personal reasons. The association and audit firm both suffered as a result. The board of directors failed to exercise appropriate oversight of this committee, and completely abdicated their responsibility, which is what allowed the incident to occur.

The fourth bullet point above is also encountered in the homeowners association industry where a member owns, or is employed by a company that conducts business with the association. Again, that member would not be considered independent in a for-profit setting, and should not be considered independent in a not-for-profit setting.

In conclusion, the recent SEC Notice reminds us that audit committees are a good idea, and for those associations that have an audit committee, independence to the highest degree possible should be considered mandatory.

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