ONE ASSOCIATION'S ACCOUNTING/AUDIT NIGHTMARE

By Gary A. Porter, CPA and Michelle Pope, CPA

The stage was set for disaster. The controller of a 1,500+ unit association with a $4,000,000 + budget had recently been terminated by the board because of his inability to interact favorably with other association employees and association members. This guy just had a bad attitude. However, he did have reasonably good accounting skills. The books and records of the association were in good shape and had been subject to annual audits for several years. A new CPA firm had just taken over the account and completed their first audit of the association. The CPA firm had no particularly difficulties with the audit of the financial statements, nor in dealing with the controller.

Recipe for Disaster

- Unstable accounting system
- Bad backup procedures
- Changed procedures
- New controller
- Inadequate supervision
- Lack of consistent reporting

However, the personnel problems were overwhelming, and the controller was terminated. The association began a search for a new controller, advertising in local newspapers, and receiving a large number of applications for the position. The general manager and finance committee reviewed each of the many applications received and narrowed down the finalists to three individuals. They even asked the independent CPA for the association to sit in on the final interviews along with the finance committee to help screen the applicants for the position. The CPA, at the finance committee's request, reviewed the applications of those individuals who were not selected as finalists, agreed with the finance committee's assessment that these individuals did not appear have adequate background or skills to handle the position. In the interview of the three finalists, it became clear that one candidate who had excellent personnel interaction skills was very weak on technical skills. It was clear that she did not have the technical background to handle the position of controller, and there was no other person with sufficient accounting expertise in the department to bolster any this candidate's weaknesses. One of the other two candidates stood out as having a superior background and range of technical skills, and this individual was hired. The association had now been without a controller for approximately four weeks.

As the new controller was hired, the independent CPA communicated in confidence with the finance committee that even though this was the strongest individual <u>of those interviewed</u>, there were reservations about his overall ability to handle the position. It was suggested to the finance committee that this individual's performance be reviewed and evaluated carefully during the first few months. If he was not performing adequately during the first few months on the job, he should be terminated immediately and the search resumed for another individual.

The new controller started the position and immediately began making some changes to the accounting system, both in the manner in which information was processed, and the reports produced. The general manager did not have sufficient accounting technical skills to oversee this aspect of the operations. Rather, he was forced to rely upon the reports he received. The finance committee did not have sufficient involvement at a low enough level of detail to determine whether the new controller was performing adequately in the position. Since this individual was hired nine months into the fiscal year, the accounting that was performed under his direct control and supervision affected only the final 3 months of the year.

The CPA's communications with the controller, in preparation for the annual audit, did not indicate anything abnormal. Based on detail discussions, it appeared that the controller had adequately handled the specific issues discussed. When the controller indicated that he was ready for the audit, the CPA firm came into the field with a staff of three to start the annual audit. It fell apart starting with the first day. First of all, the CPA discovered that the general ledger was not in balance. In order to generate income statements that appeared to be accurate, the controller had made one-sided journal entries to the accounting system, and the accounting system was such that it would accept a one-sided journal entry. However, this threw the entire general ledger out of balance. To compound this error, the controller never communicated this to anyone, nor were balance sheets presented to the finance committee, board of directors, or general manager. This is not unusual, since the entire focus of association accounting is based upon a comparison of actual results to budgeted performance. Since many board members are not astute at reading financial statements, they elect not to see a balance sheet, but to focus simply on the income statement. Their primary concern is, "What is the bottom line? Have we performed O.K. in relation to the budget that we approved?"

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Next, as the CPA dug just a little bit further, it was discovered that bank reconciliations had not been prepared for any of the final three months of the year. At this point, the CPA identified the items that had been discovered, put those comments into writing to both the controller and general manager stating that the firm would pull out for a one week period, giving the controller time to correct the situation. One week later, the CPA discovered that the bank reconciliations did now exist, and the general ledger did now balance. However, both had been "plugged". The bank reconciliations were not accurate. The "plugs" to the general ledger were simply arbitrary amounts posted to make it balance, and were posted to accounts that didn't even make any sense. The CPA spoke confidentially to the general manager and requested authorization, outside of the scope of the audit, to look over the general ledger to see if the extent of the damage caused by the new controller could be determined. The performance of limited tests, such as attempting to reconcile bank accounts and performing a search for unrecorded liabilities to determine the accuracy of the recorded accounts payable, disclosed other very unusual transactions. For instance, checks written up to one month before year end had never been released. Some of these were listed on the outstanding check list, and some were not, which further eroded the confidence in reports and documents that had been presented as being ready for audit. An examination of check registers discovered that there were as many as three different versions of a check register for a given month, and none of them were the same. What had happened was that the computerized accounting system had "bombed" and the controller had simply regenerated the report, as no backup of the lost data existed. The reports were not checked for accuracy to make sure that it agreed with the prior report. Some information was not entered at all, and some information was double or triple entered into the system as a result of this process.

As realization of the extent of the damage set in, it was felt the best course of action would be to restore the last backup for month nine, and reenter data (from original documents) for the final three months of the year. Unfortunately, it was discovered that the new controller had overwritten <u>all</u> backup tapes from the first nine months of the year, so that <u>no good backup existed</u> of the transactions that occurred prior to the new controller starting. There was no option of restoring old data that was known to be good and reconstructing the final three months transactions. At this point, the CPA firm reported to the finance committee, general manager, and board of directors that they had a major disaster on their hands. The CPA reminded them of his advice that the new controller should be closely supervised and evaluated.

While the CPA firm opined that this individual should be terminated, the finance committee felt that it would be better to wait until after the audit was completed before terminating him. The CPA firm had incurred over $3,000 of cost in determining the extent of the damage, but that had done nothing towards reconstructing accurate financial information for the association. As various options were discussed, it really boiled down to two options, (1) scrap <u>everything</u> that was in the current accounting system, restore <u>the balances only</u> for the first nine months of the year, and then reconstruct the last three months of the year, or (2) attempt to correct balances. The finance committee opted for the latter option. In retrospect, it was the wrong decision.

The association spent over $40,000 attempting to reconstruct the information for this time period. This amount was not excessive for the work performed, but it certainly was excessive in relation to the benefit gained. It would probably have been less expensive to scrap the entire year's activity and reenter data for all twelve months, than in correcting the work that had been done. The results would certainly have been more reliable.

The auditor's perspective is that there was a "blown" accounting system which could not be relied upon. Therefore, the CPA had to look at a much larger number of detail transactions to make sure that they were accurately recorded. The approach taken was to audit the balance sheet in detail to determine accuracy of the balances recorded. This approximately doubled the audit effort, raising the fee to the $20,000 range. The outside consultants who had been hired by the association to fix the mess that the controller had created had posted all "unknown" amounts into a single account. This account, which was a miscellaneous income account, totaling $60,000, could not be reconciled to anything. However, based upon the work performed by the consultants and the CPA's audit, the CPA's were satisfied that the balance sheet was accurately stated, and that on an <u>overall</u> basis, the income statement was accurately stated.

The association elected to condense the income statement to very broad categories rather than presenting any detail as was normally done. The CPA firm felt they could render a clean opinion on the financial statements, since they were expressing an opinion on the overall financial statements, not on specific lines of the financial statements.

The cost to the association was approximately $55,000 more than it should have been to get this opinion. This is the amount of damage caused by the controller in the three months before year end and the two months after year end that he was employed by the association. So he cost the association more than $10,000 a month by his lack of competence in accounting for transactions. The

One Association's Accounting/Audit Nightmare (continued):

CPA observed that the new controller's temperament and attitude played far bigger parts in his poor performance than any lack of skills.

After completion of the audit, the association made a decision to scrap the old accounting system and change to new accounting software. That change was made retroactive to the first of the year, so the entire first two months worth of transactions were reentered into the new system. This meant that the next year's audit would be relatively clean and all on single system. Further, the association did hire a new controller who was, and is, very capable at her tasks and has proven to be an excellent employee for the association.

As the CPA firm recently completed the subsequent year's audit, they were forced to readdress the assumptions made in the prior year's audit as to the disposition of the "unknown" amounts, because any mistakes of the prior year would obviously flow through into the current year. As it turns out, there was less than $2,000 of errors in the prior year that affected the current year.

Associations should be aware that they have a responsibility for adequate oversight of employees. If the association is unable to judge whether an individual is acting in an appropriate manner and adequately performing their tasks, the CPA is generally available as outside consultants to assist them in this determination. The finance committee's mistake was that they felt it was important that they show confidence in their new controller, and not subject him to outside supervision.

The above is an example, more like a horror story, of what can go wrong in an association and how easy it can happen. The association may have been complacent, as it had been operating on a clean basis for many years. One new employee made the entire difference. But, that could have been avoided if proper procedures were followed. His inadequacies could probably have been caught within the first month. So what would it have taken to avoid this scenario? Simply paying attention to detail, and performing those very boring, repetitive tasks associated with accounting: (1) make sure you have a stable computerized accounting system, (2) make sure you have good back up tapes, (3) don't allow a new employee to change procedures without due consideration by others, (4) make sure that all employees have adequate supervision, and (5) make sure that financial reporting is complete and consistent.

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