

# AUDITING WHEN A SERVICE ORGANIZATION IS IN PLACE SAS No. 88

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In 1994, the American Institute of CPAs (AICPA) issued statement on Auditing Standards No. 70 reports on the processing of transactions by service organizations. The purpose of that statement was to provide guidance to the CPA who is auditing on and reporting on the service organization.

In December 1999, the AICPA issued Statement of Auditing Standards (SAS) No. 88 "Service Organizations and Reporting on Consistency." The focus of Statement of Auditing Standards No. 88 was to provide guidance to the CPA who was performing an examination of an organization that is served by the service organization. SAS No. 88 provides certain amendments to SAS No. 70 and SAS No. 1.

SAS No. 88 amends SAS No. 70 to indicate that the guidance provided by SAS No. 88 relates to an entity that obtains services from another organization that are part of its information system. A service organization's services are part of an entity's information system if they affect any of the following:

- a) How the entity's transactions are initiated.
- b) The accounting records, supporting information, and specific accounts in the financial statements involve processing and reporting of the entity's transactions.
- c) The accounting processing involved from the initiation of the transactions is to be included in their financial statements.
- d) The financial reporting process used to prepare the entity's financial statements including significant accounting estimates and disclosures.

The above would clearly place a management company into the role of a service organization and the association as the entity being served by that service organization. Therefore, SAS No. 88 applies to the homeowners association industry and CPA's should consider the guidance of SAS No. 88 in planning their audits of associations that are managed by management companies.

SAS No. 88 provides two examples of the effect of the use of a service organization (management company) on a user organization's (association's) internal control. SAS No. 88 indicates that when the association initiates transactions and the management company executes and does the accounting processing for those transactions, they are at a higher degree of interaction between the activities of the associations and the

management company. In these circumstances, it may be practicable for the association to implement effective controls of these transactions. However, when the management company initiates, executes, and does the accounting processing of the association's transactions, there is a lower degree of interaction and it may not be practicable for the association to implement effective controls for these transactions. Given the passive nature of many association boards, particularly those that rely heavily on their management company, the second situation is more likely to occur. However, in almost all instances that I have seen, the association board does retain the final control of

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approving invoices for payment and signing checks. This may constitute sufficient control. The revenue cycle for most associations is relatively easy to monitor. For instance, if there are 100 units with monthly dues of \$200 per unit, then the monthly association income should be \$20,000 or \$240,000 for a one-year period.

Professional standards require that the auditor consider internal control in a financial statement audit and state that the auditor should obtain an understanding of each of the five components of an association's internal control sufficient to plan the audit. This understanding may encompass controls placed in operation by the association and by the management company, which services are part of the association's information system. The auditor needs this information to gain knowledge used to 1) identify types of potential misstatements, or 2) consider factors

## **SAS No. 88 (cont'd)**

that affect the risk of material misstatements, and 3) design substantive tests.

For many auditors this may not actually be such an onerous task as appears to be described above because, if the auditor has prior experience with the management company, he will already be familiar with the services provided by the management company and will be aware of the internal control features. If the management company has highly standardized procedures, and most do because that is the only means by which they can achieve efficiency necessary to meet the competitive fee pressures within the industry, then understanding and documentation can be spread over several associations.

In any case, the auditor should document their understanding of the internal control structure. Again, this may done quite easily if the auditor has prior experience with the management company and familiarity with their operating system.

Very few management companies have audits performed on their financial statements or on their operating procedures. However, if a report under SAS No. 70 should exist for a management company, then the auditor for any association managed by that management company may rely upon such report as part of their consideration of internal control and planning of the engagement of the subject association.

It is also possible that an association may have more than one service organization that provides services. As an example, a bank that provides deposit and lock box services and assessment receivable and control information may also constitute a service organization. Likewise, a service bureau that provides payroll services, or a broker-dealer providing security services may also constitute a service organization, controls of which should be considered by the auditor in the planning and performance of the audit engagement. The key to reaching this determination lies in the extent of services provided by the service organization and the control of cycled transactions that may exist within the service organization.

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