

RETURNING RESPONSIBILITY TO THE CLIENT

By Gary A. Porter, CPA

The association board member states in a meeting with the association's CPA, "How come you never told us about our internal control weaknesses, and why didn't you inform us previously about the fact that we failed to comply with state laws on transfer of monies between our reserve and operating funds? You're the financial brains, we are inexperienced volunteer board members. We rely upon you."

This type of an exchange is not exactly music to the CPA's ears, but unfortunately is relatively common, particularly after an association has discovered that one of their trusted employees has embezzled funds, or that members are causing problems because of the association's failure to comply with state law on handling funds, particularly in light of the board's recent decision to raise dues.

In the homeowners association industry, most volunteer board members generally do not want to accept much responsibility with respect to the financial actions of their association. The reasons for this are pretty straight forward:

- they are volunteer members
- they are not generally involved in the day-to-day activities of the association's financial operations
- they've hired staff or retained a management company to perform all of the day-to-day financial transactions of the association
- they are not knowledgeable about the accounting system.

However, they are responsible. They may delegate to the authority, but they may not delegate the responsibility. Most of them don't want to hear this. And who better to pick on than the CPA, the person they believe they hired to perform this function for them?

If you ask most board members what an audit is, they would tell you that it is an examination by the CPA of 100% of the association's financial transactions with the specific purpose of uncovering financial fraud or embezzlement. Nothing could be further from the truth. The annual audit performed by the CPA is an examination of the association generated financial statements.

It relies upon selective testing of transactions. Further, the CPA is not even required to test the system of internal accounting controls. If the CPA makes a determination that the audit effort required to test the system exceeds any benefit to be gained therefrom, the CPA may reasonably make the decision to instead rely upon year end substantive testing of balances rather than

Communication is the Name of the Game

The CPA should communicate internal control issues of which he is aware, even if not relying on the internal control system.

Likewise, if the CPA becomes aware of compliance issues, these should be communicated to the client, even if the issues have no impact on the audit.

All communications should be in writing. Such communications place the client on notice that you have found something, and it is their responsibility to resolve it.

testing of the system.

An audit cannot be relied upon to expose financial fraud or embezzlement. While the CPA has an obligation to perform tests considering the possibility that such events may occur, there is no guarantee that they will be discovered. If a person who is embezzling money is reasonably smart about it, it may not be detected by the auditor at all, particularly if collusion occurs between either two employees or one employee and an outside vendor. The receipt of kickbacks, which is something that would never even be detected in the financial statement audit or something that would not be recorded in the financial statements of the association, is particularly too difficult to detect in a normal annual recurring financial statement audit. What this boils down to is that most association clients have unrealistic expectations of their CPA, particularly to the point that the association assumes the CPA is doing more work than he or she was engaged to do.

This is why CPA's need to protect themselves. The CPA's need to return some of the responsibility to the client. The primary way to do this is by identifying and communicating internal control weaknesses or unusual transactions or transactions that violate state laws and regulations even if they have no impact upon the financial statements themselves.

Fraud and Embezzlement

With respect to fraud and embezzlement, these activities generally are most prevalent in associations with weak internal accounting controls. Early identification of these weaknesses is the key to prevention of this type of activity. Consistent internal controls are important because management decisions, financial reports, and



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association taxes rely upon management's accurate portrayal of the association's accounting information. If the internal accounting controls are weak, then one cannot rely upon the information being generated to be accurate.

Adequate internal controls also give board members control of the cash flow, help to standardize good management practices, reveal errors and omissions as well as discourage employee theft and protect the assets.

Many board members do not understand the role internal accounting controls play in protecting association assets. Many assume that this function is being covered by their CPA as part of the annual audit. To counteract this, CPA's must first educate their association clients of the importance of internal controls. Once the board members understand the importance of good control, the CPA can then help detect deficiencies in and suggest improvements to the association's internal procedures. Further, if the association agrees, the CPA can even become a part of the controls by offering additional services such as reconciliation of cash balances on a monthly basis.

By offering this type of internal control services, CPA's not only help minimize the association's risk that they themselves benefit by increasing firm revenues gaining additional standing in the eyes of their client and protecting themselves against any misunderstanding with their clients.

Compliance Issues

Regarding compliance with state and local laws and regulations, several states have laws on the book relating to the handling of reserve funds and operating funds, and particularly with the intent of prohibiting collection of reserve monies that are later expended for operating purposes. Some states go so far as to completely prohibit the transfer of monies from one fund to another fund. However, if an association encounters a situation where they have some very large unexpected event which requires immediate additional operating funds, it's very difficult to go to the members for a special assessment to help raise the monies, and it's very easy to simply borrow the monies from one's reserve funds. While such a borrowing may occur and may not violate any accounting standards, such transaction may be a violation of state law. The CPA would be well advised to prepare a checklist of crucial compliance issues and make sure that the association has complied with these issues as they relate to financial transactions. If any violations were detected, they should be immediately communicated to the board of directors so that they may take corrective action.

Even if corrective action is not taken, a written communication will at least serve as permanent documentation that the CPA did recognize the event and did communicate to the board. The board has the responsibility for that action as they have been duly notified. This may become extremely important when, three years down stream, with a completely new set of board members, nobody has recollection of any oral communication, or even worse, any failure to communicate by the CPA. This may generate action against a CPA by that subsequent board, even though the CPA had no responsibility to inform the board of such item. The board members expectation is that the CPA is the only one who possesses the expertise to know that information, and therefore it was incumbent upon him to communicate that information to the board of directors.

Clear written communications are the key to this entire issue. Many CPA's bemoan the fact that audits for the homeowners association industry have been reduced to a level below that which exists in other area of practice. In auditing within other industries, the CPA is generally viewed as a trusted, long-term financial advisor to the business or nonprofit organization. However, within the homeowners association industry, the CPA is viewed much differently. This is due primarily to fiscal restraints, budget issues, and the fact that the boards often change on almost an annual basis. Adding to that, the insertion of a management company in between the board of directors and the CPA, the board may have no contact with the CPA. Therefore the audit, instead of being viewed as a vital financial service provided by a trusted financial advisor, becomes simply a commodity, and the only value that is ascribed to that commodity is the annual fee paid to the CPA. The board members therefore assume that all CPA's are performing exactly the same level of service. This simply isn't true. But because that is what a very significant part of the industry believes, the CPA must take steps to not only protect himself, but to provide a vital service to his association clients by clearly communicating weaknesses noted and placing the responsibility where it belongs, with the board of directors, for taking corrective action on these items.

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