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## QUESTIONS

*I Have Always Wanted  
to Ask the Auditors*

## 1 What is the purpose of an audit?

The purpose of an audit is for the auditors to express an opinion on whether or not there are any material misstatements in the Association's financial statements.

## 2 What are the key areas to look at in the audit?

- **Opinion Page:** Make sure there is an unmodified opinion. This is good news for the Association. If the opinion is modified, make sure you understand the reason for the modification. If there is an emphasis of matter paragraph, make sure you understand the reason for this also.

- **Balance Sheet:**

*What are the Association's delinquent owner balances?* Is an allowance for doubtful assessments recorded? If delinquencies are over 3% of annual assessments, this indicates that the Association is having problems with collections.

*Does the Association have excess operating funds?* Look at unappropriated members' equity. This number should not be a deficit and should be equal to 10% - 20% of annual assessments.

- **Statement of Income:** Did the Association end the year with net income or a loss?
- **Statement of Members' Equity:** This page shows the replacement reserve contributions and expenditures for the year. This is a good summary page of what happened in replacement reserves.
- **Notes to the Financial Statements:** The financial statements and the notes are the responsibility of the Association. The auditors draft the notes for the Association, but the Board can revise the notes.

- **Representation Letter:** This is a letter from the Association to the auditors and contains certain standard wording. The representation letter needs to be reviewed by the Board. This letter needs to be signed by the President or Treasurer, and returned to our office within 60 days from the date the draft was issued in order for us to finalize the audit.

- **Management Letter:** The Board should read the management letter. Our firm puts general comments as well as specific comments and recommendations in the management letter. Often, the management letter can be looked at as a checklist of items that need to be followed up on as a result of the audit.

- **AU-C §260 Letter:** This letter describes the audit process and lets the Board know if there were any disagreements with management, difficulties in doing the audit, significant disclosures to the financial statements, significant estimates in the financial statements, or if material adjustments were proposed to the Association's financial statements.

- **AU-C §265 Letter:** The auditors are only required to issue this letter if the auditors find control deficiencies that rise to the level of a material weakness or significant deficiency.

## 3 What is the AU-C §265 letter and why is it issued?

The AU-C §265 letter is a 'Communication of Significant Deficiencies and/or Material Weaknesses'. Under auditing standards, the auditors are required to communicate in writing any significant deficiencies and/or material weaknesses in the Association's internal controls.

- **Significant Deficiency:** a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
- **Material Weakness:** a deficiency or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Examples of what might be included in this letter would be if the auditors proposed material adjustments to the Association's financial statements; if the Association's financial statements were maintained on the cash basis of accounting throughout the year; if inadequate segregation of duties existed in the Association's internal controls; if the Association's bank accounts were not being reconciled; or if fraud on the part of senior management of the Association was discovered.

Use of this letter is restricted to the Board and management. If the auditors did not note any significant deficiencies or material weaknesses, no letter would be issued.

## 4 What is Unappropriated Members' Equity?

Unappropriated Members' Equity (also known as Prior Year Owners' Equity, Excess Operating Funds, or Operating Reserves) represents the Association's net income or loss since inception. It is like a retained earnings account for a regular business. It provides a cushion for operations and protects replacement reserves. If the Association has unanticipated operating expenses that exceed the annual budget, this net loss can be funded from Unappropriated Members' Equity instead of replacement reserves.

## 5 If the Unappropriated Members' Equity is positive, can the Board spend it?

Yes, if the Association has greater than 20% of annual assessments in Unappropriated Members' Equity, the Association can use the amount over 20% of annual assessments. However, this account is not a bank account and it is possible that the Unappropriated Members' Equity is funded by assets other than cash (such as fixed assets).

## 6 What does 'fully funded' versus 'fully supported by cash' mean for the status of the reserve funds?

A portion of the Association's equity is earmarked for replacement reserves. This is done through the annual budget and the amount allocated is based on the annual contribution to reserves. Replacement reserve expenditures are coded against the replacement reserve equity account and reduce the amount of equity earmarked for reserves. If replacement reserves are fully supported by cash, this means the Association has enough cash to support the earmarked equity. In order to determine if the Association's replacement reserves are fully funded, the Association needs to look at the replacement reserve study. The study should indicate the amount of reserves the Association should have on-hand to be fully funded. Our firm compares both the annual contribution to reserves and the replacement reserve balance to the recommendations in the replacement reserve study. If there is a significant shortfall in either the contribution or balance, we will make a management letter comment to communicate this to the Association.

## 7 What is a Service Organization and how does our Association using one affect our audit?

A service organization is an entity that the Association may use to outsource aspects of its operations, such as payroll functions, sub metering utilities or collecting laundry income. In these instances, the internal control functions are being performed by an entity other than the Association or the management agent of the Association.

As the auditors for the Association, we are required to obtain an understanding of the Association's internal controls. If the function being performed by the service organization is significant to the Association's financial statements, then we are required by auditing standards to obtain an understanding of the service organization's internal controls.

This is a requirement of auditing standard AU-C Section 402, which went into effect for periods ending after December 15, 2012.

If a Service Organization Control (SOC) report is available, then we can use this report to obtain an understanding of the internal controls. If this report is not available, then our options would be to obtain an understanding on our own of the service organization's internal controls, have another auditor obtain an understanding, or modify our audit opinion. The audit opinion modification would specifically state that we were unable to obtain an understanding of the internal controls of the service organization.

## 8 What is the difference between an Engagement Letter and Representation Letter?

The Engagement Letter is the contract between our firm and the Association to perform requested services (i.e. conducting the annual audit and preparing tax returns). The Board and Management need to sign and return the Engagement Letter to our office before we may commence the work.

The Representation Letter is issued with the draft audit and is required by auditing standards to finalize the audit. The Representation Letter is a letter from the Association to our firm

confirming responsibilities of the board and management for the financial statements, as well as confirming information provided to us during the audit. The President or Treasurer and Management need to sign the Representation Letter and return it back to our office within 60 days from the date the draft audit was issued. Representation Letters received after the 60-day mark may result in additional auditing procedures in order to finalize the audit and comply with auditing standards at an additional expense to the Association.

## 9 Is the Operating Contingency actually a funded separate account?

No, the Operating Contingency is a budget tool that should be used to provide a cushion in the current year operating budget or to build up the balance in Unappropriated Members' Equity (if the balance is below 10% of annual assessments).

The manager should not code any expenses to the Operating Contingency. As mentioned before, this account is a budget tool. The invoices should be coded to the appropriate expense accounts and if a budget overage or net loss results, this will be offset by the amount budgeted in the Operating Contingency.

## 10 What is the role of the auditor beyond the audit itself?

Even though we audit the Association's financial statements on an annual basis, we are available throughout the year for questions. We do not charge for routine questions and are happy to be a resource for Board members and managers.



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