



By Jeremy Powell

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You Received the Draft Audit Report – WHAT'S NEXT?



Being a member of an association's board of directors can be a rewarding experience of serving your community and making the association a better place to live for all members. As a volunteer, each board member brings their own knowledge and expertise to the association. Not all board members have financial backgrounds and the financial decisions that board members must handle can be daunting. Some of those decisions include:

- Adopting budgets
- Deciding whether to raise assessments
- Developing a long-term replacement reserve savings program
- Taking collection actions to resolve delinquent homeowner balances

Fortunately, the annual audit report is a resource which can be invaluable in assisting the board of directors in making appropriate and favorable decisions to ensure the financial stability and health of the association.

The association's independent auditor completes an examination of the financial statements and underlying supporting documentation for the purpose of expressing an opinion on whether or not there are any

material misstatements in the association's financial statements. Essentially, the auditors are opining that the amounts in the financial statements are reasonable and accurate, in all material respects. Once the auditor completes their examination, a draft audit report is issued for the board of directors to review and accept.

Once the board receives the draft audit, all board members should read the report in its entirety. It is important to have all board members engaged in the process, because the board members have different backgrounds and points of view and this will lead to a more meaningful review process. Reviewing and understanding the audit report can be intimidating. It is important to ask questions if you do not understand something in the draft audit report. The audit report includes a significant amount of information, the terminology is very technical and unless you are specifically trained or have previous experience, accounting and auditing standards may seem like a foreign language. We created the following list of key areas that will assist the board of directors in reviewing the draft audit report:

1. **Opinion Page:** The board of directors should make sure there is an unmodified opinion which means that the financial statements are fairly presented. The phrase "the financial statements referred to above present fairly" should be included in the auditor's 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.

2. Balance Sheet:

a. *Are the association's funds maintained in FDIC insured accounts and/or are they backed by the full faith and credit of the U.S. Government? If they are not, the funds should be immediately transferred to other insured institutions.*

b. *Does the association have adequate cash on hand to fully fund the designated replacement reserve balance and meet existing operating obligations? If not, resolve these cash flow shortages during the next budget cycle, or if a crisis exists, consider a special assessment.*

c. *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 may be having problems with collections. The association should be reviewing the monthly delinquent account listing and working closely with legal counsel to resolve any delinquencies. The association's ability to raise and collect sufficient funds from its members is one of the primary functions of any association.*



d. *Is the association's designated replacement reserve balance sufficient to meet future expected needs? Is the association's reserve program based on a comprehensive replacement reserve study and are the reserve study's recommendations being followed? The association should compare its designated replacement reserve balance to the recommendations provided in the reserve study. If a deficit exists, the association should take immediate action to correct the funding shortage. This may require an increase in the general assessment and future reserve contributions or a special assessment if the shortage is too significant to make up in a relatively short period of time. Maintaining an adequate replacement reserve program is essential to the financial stability of the association. Also, the association should update the reserve study periodically, but at least every five years.*

e. *Does the association have excess operating funds? Typically, the association should look at unappropriated members' equity and/or the operating reserve balance, if applicable. The combined amount should not be a deficit and should be equal to 10% - 20% of annual assessments. This funding level should provide a reasonable operating cushion should the association experience an unexpected budget overage or contingency in the future. Also, these funds may be available to supplement replacement reserve funding as needed. If a deficit exists, the association should add a deficit funding expense line item in next years' budget.*

3. **Statement of Income:** Did the association end the year with net income or a loss? Any net income may be retained by the association and added to excess operating funds for use in subsequent years or transferred to replacement reserves. A net loss should be evaluated and the reasons for the net loss identified. This will help to ensure proper budgeting techniques moving forward and should be considered when approving next years' assessment rates. An increase in assessment income may be necessary if the association does not have adequate excess operating funds accumulated.

4. **Statement of Members' Equity:** This statement shows the replacement reserve contributions and expenditures for the year as well as any net income or loss from operations. This is a good summary page of what happened in replacement reserves and in excess operating funds for the year. Any unusual transactions should be investigated.

5. **Notes to the Financial Statements:** These disclosures are meant to support and further explain the association's audited financial statements and provides relevant information about the association not contained in the financial statements themselves. The auditor drafts the notes for the association, but the board of directors can revise the notes as they are the responsibility of the association.

6. **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 of directors. This letter needs to be signed by the president or treasurer and the management agent, if applicable, and returned to the auditor in order

to receive the final, signed audit report. The final audit report may be distributed to the membership, to potential owners, lending institutions, insurance underwriters or agents, etc.

7. **Management Letter:** The management letter is not a required communication, but rather a by-product of the audit process. This letter provides general comments as well as specific comments and recommendations about the association's financial status and operations. Typical comments may include an analysis of the association's key financial areas found in the audited financial statements, areas where operational improvements can be made, details about pending financial items, action items, and certain internal control matters. Often, the management letter can be looked at as a "to do list" of items that need to be followed up on as a result of the audit. The board of directors should review this letter in detail, discuss and resolve any pending items and implement changes as appropriate.

8. **AU-C §260 Letter:** This letter describes the audit process and lets the board of directors know if there were any disagreements with management, difficulties in conducting 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. There should not be any surprises in this letter and generally there are no action items presented.

9. **AU-C §265 Letter:** The auditor is only required to issue this letter if control deficiencies that rise to the level of a material weakness or significant deficiency are found. The board of directors should review this letter in detail, in connection with its management company, and discuss ways to implement changes to avoid future findings and improve control procedures.

The board treasurer and/or the management agent will typically take the lead during the discussion of the draft audit report at the board meeting. One individual should be designated to work closely with the auditor to address any questions or concerns and resolve any open items. The board should determine if there are any pending recommendations that the auditor has suggested and should evaluate the merits of those recommendations and develop a plan for implementation.

Finally, once all pending items are resolved, board questions answered, the president or treasurer and the management agent should sign and return the representation letter to the auditor so that the final audit report can be issued. Also, at this time, the board of directors should ensure that the auditor's proposed adjusting journal entries are recorded in the accounting records. This will ensure that the association's financial statements are up-to-date and accurate.

It is important for the board of directors to have an annual audit conducted by a firm with experience and knowledge of condominiums, homeowners associations and housing cooperatives. It is also important for the board of directors to read the audit report and understand the professional financial advice from the auditors and determine if any changes in the association's operations need to be made. 