By Anne Sheehan, CPA

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Breaking Down the Annual Audit

An annual audit is an essential document for every association. The association's legal documents may or may not require an annual audit. Sometimes management companies will require an annual audit of an association's financial statements as part of their management contract. Even if an annual audit is not a requirement for your association, you should have one conducted every year. The auditors are often the last ones to look at the association's financial records and may find duplicate payments of invoices. Also, auditors verify that the association's funds existed at year end. In addition, having an annual audit helps to financially protect management, the association and its board of directors. It is a formal document that can be provided to current owners in the association and is especially helpful if owners have questions about the association's financial statements. The audit is also provided as part of the resale documents to any potential owners. The annual audit should be maintained permanently for the association.

The audit includes the auditor's report, the financial statements, the notes to the financial statements and supplementary information.

The Auditor's Report

The auditor's report actually consists of one to two pages titled "Independent Auditor's Report." This is the document where the auditors express their opinion on the financial statements. The goal for every association should be to obtain an unqualified opinion, which is also known as a clean opinion. With an unqualified opinion, the auditors express that, in their opinion, there are no material misstatements in the association's financial statements. There are other opinions that auditors can express which would include the following:

Qualified–the auditor's opinion would state that except for certain aspects of the financial statements, there are no material misstatements in the association's financial statements. For example, if the auditors were not able to confirm a bank account, their opinion would state that except for that specific bank balance, there are no material misstatements in the association's financial statements.

Disclaimer–auditors may issue a disclaimer of opinion when many of the association's financial records are not available to them and the auditors have not been able to obtain enough audit evidence to support an unqualified or qualified opinion.

Adverse–under an adverse opinion, the auditors have found material misstatements in the association's financial statements that are not corrected. An adverse opinion states that the financial statements are not presented fairly.

In addition, the auditors may add an explanatory paragraph to any of the above opinions to emphasize a matter, such as to emphasize when an association has high delinquencies or a large deficit in operations.

The Financial Statements

The financial statements consist of a balance sheet, a statement of income, a statement of members' equity and a statement of cash flows. The financial statements belong to and are the responsibility of the association.

Balance Sheet–the balance sheet is a statement that summarizes the association's assets, liabilities and equity as of a specific date. The balance sheet is typically presented as of the association's year end. It is a snapshot of the association's financial position as of that date. Two important factors to look at on the balance sheet are the association's delinquent owner balances and the association's excess operating funds. If the delinquent owner balances equal more than 5 percent of annual assessments, this indicates that the association is having a problem with collections. The excess operating funds represent the association's net income or loss since inception. The account may be titled "Unappropriated Members' Equity." The association should maintain excess operating funds between 10 percent and 20 percent of annual assessments. These funds are available for unbudgeted or unforeseen operating expenses. Many associations avoided special assessments for the high 2010 snow removal costs because they maintained adequate excess operating funds.

Statement of Income–the statement of income presents the association's income and expenses for a period of time and shows the association's net income or loss for the period. The important thing to remember with the income statement is that it is for a period of time where the balance sheet is as of a specific date.

Statement of Members' Equity–the statement of members' equity shows the changes in the association's equity accounts and is for a period of time. The most typical equity accounts for an association are replacement reserves and unappropriated members' equity. Changes in replacement reserves would include the contri-

butions to reserves and replacement reserve expenditures. Changes in unappropriated members' equity would normally be limited to the association's net income or loss.

Statement of Cash Flows–the statement of cash flows reconciles net income or loss to changes in cash and cash equivalents. The reconciliation consists of the changes in the balance sheet accounts. The analysis on the statement of cash flows is broken down to operating, investing and financing activities.

Notes to the Financial Statements

The notes to the financial statements belong to the association. The notes provide additional information about the association, which includes information about the organization of the association, the significant accounting policies and details on balance sheet and income statement accounts.

Supplementary Information on Future Major Repairs and Replacements

Accounting principles require the association to present certain information about the most recent replacement reserve study as supplementary information to the financial statements. If the association has a reserve study, this information will be presented as unaudited, supplementary information. Generally, the common property components, the estimated useful lives of the components and the replacement costs of the components will be presented as supplementary information.

Other Letters

The auditors may include other letters with the audit report. Those letters include the representation letter, management letter, Statement on Auditing Standards (SAS) No. 114 letter and SAS No. 115 letter. Some of these are restricted to the board and management and should not be given out to the owners with the final audit report.

Representation Letter

The representation letter is a letter from the association to the auditors confirming that to the best of their knowledge and belief all information was provided or disclosed to the auditors. The auditors are required to obtain a signed representation letter before they can finalize the audit. The representation letter is considered part of the audit evidence because of the representations in the letter that are made by the board of directors and management.

Management Letter

The management letter is not a required communication under auditing standards, but is a by-product of the audit. Auditors generally use a management letter to communicate comments and recommendations about the association's financial statements and records. Use of this letter is usually restricted to the board of directors and management.

Communication with Those Charged with Governance under SAS No. 114

Under SAS No. 114, auditors are required to communicate audit matters that, in their professional judgment, may be significant and relevant to those charged with governance of the association. For example, the auditors would use this letter to communicate if there were any significant disclosures in the association's notes to financial statements, if there were any significant estimates in the association's financial statements or if any difficulties were encountered in dealing with management during the audit fieldwork. Use of this letter is generally restricted to the board of directors and management.

Communication of Significant Deficiencies and/or Material Weaknesses under SAS No. 115

Under SAS No. 115, the auditors are required to communicate in writing any significant deficiencies and/or material weaknesses in the association's internal controls. A significant deficiency is 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. A material weakness is 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 generally restricted to the board of directors and management. If the auditors did not note any significant deficiencies or material weaknesses, no letter would be issued.