



Audits of Financial Statements and Income Tax Considerations

by Jeffrey L. Ducker, C.P.A.

With year-end approaching, thoughts naturally turn to the holiday season and hopes for a happy and healthy new year. Shortly thereafter, most community associations (that is, those associations with a calendar year-end) close their books and prepare their year-end financial statements. As we know, those associations with annual revenues from all sources of at least \$400,000 (and which operate at least fifty units) are required, by Florida Statute, to have their financial statements audited by a certified public accountant (CPA). That same CPA will generally prepare the association's income tax return(s) as well. It is important to note that, although the financial statements on which the CPA expresses an opinion are prepared by the CPA, the

financial statements are those of the association and for which the association must take responsibility. Similarly, while the association relies on its CPA to prepare the association's income tax return(s), the association is ultimately accountable for the return (after all, it is signed by an officer of the association). The purposes of this article are (a) to present an overview of the financial statement audit process, with emphasis on some of the areas in which the association's manager and board of directors (collectively, the management of the association) are directly involved; and (b) to offer some income tax considerations particular to community associations.

Audits of Financial Statements

Beginning with calendar year 2007 audits, the CPA is required (under generally accepted auditing standards) to utilize a risk-based approach in conducting an audit of financial statements. The standards are designed to result in more effective audits as a result of better risk assessments and the execution of audit procedures responsive to the risks. This process includes the documentation and assessment of controls over financial reporting, and is generally accomplished through inquiry of association management at a formal meeting in the audit planning phase. The CPA performs tests of the controls and prepares an audit program that considers the information obtained from management, as well as the

results of the testing of the controls. The auditor is also required under professional standards to make inquiries related to fraud (this is generally accomplished by the completion of a questionnaire, supplemented by face-to-face inquiries, as necessary).

During the planning and preliminary stages of the audit, the auditor will request that the association provide copies of various types of information, including the following:

Financial statements and supporting schedules for balance sheet accounts (for example, bank reconciliations to support cash; delinquency reports to support receivables—more on delinquency reports, below)

- Contracts
- Insurance information
- Loan agreements

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The procedures in connection with auditing assessments receivable has recently taken on a new wrinkle. Because of increased delinquencies, the auditor must support the amount that has been recorded as allowance for doubtful accounts (“allowance”), if any, and, frequently, must record an adjustment to establish or increase the allowance. Inasmuch as the allowance is an estimate made by association management, the auditor must obtain reasonable support for such estimate.

The auditor will also make inquiries about matters of litigation and, in most cases, request that a letter, signed by an officer of the association, be sent to the association’s counsel to supplement the association’s response.

During the course of the audit, matters may come to the attention of the auditor that require further explanation and support than had been previously provided. It cannot be overemphasized that timely communication between the auditor and association management is vital in the resolution of such matters.

At the conclusion of the audit, the auditor will normally issue a draft of the audited financial statements for the association’s approval. Accompanying the draft is a management representation letter, which the association and, unless the association is self-managed, its management company is required to sign. Among other things, management of the association will represent to the best of its knowledge, that (a) the association has responded honestly and completely to all inquiries; (b) all financial information, related data, and minutes have been made available to the auditor; (c) the association is not aware of any fraud which may have occurred or any violations of laws or litigation that would have an effect on the financial statements; and (d) that the association is responsible for presenting its financial statements in accordance with generally accepted accounting principles.

Upon the receipt of the signed management representation letter, the audited financial statements are issued, together with the auditor’s report on the financial statements. The report contains an opinion as to



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whether the financial statements are presented fairly "in accordance with accounting principles generally accepted in the United States of America." Unless the scope of the audit has been limited for one reason or another, or the auditor is unable to obtain sufficient support for a material financial statement balance or amount, the auditor's opinion on the financial statements will be unqualified. If, for any reason, the auditor believes that he or she is unable to issue an unqualified opinion, the reason(s) should be discussed in advance with management.

Besides the audited financial statements, the association should expect to receive a letter of recommendation (or management letter) in connection with the audit.

This letter offers suggestions for the improvement of internal controls and operating efficiencies. A letter communicating the results of the audit (referred to in the standards as "Communication with Those Charged with Governance") and, if applicable, a letter of significant deficiencies, are also issued to management. The letters referred to in this paragraph are for the information of the board of directors only and are not intended to be distributed to the membership.

Income Tax Considerations

Condominium and homeowner associations are generally organized as not-for-profit corporations, rather than non-profit, or tax exempt. As a not-for-profit corporation, the association is liable for income taxes. An association that is substantially residential has essentially two methods to determine the amount of tax, if any, it must pay. Under one method (filing Form 1120, under Section 277 of the Internal Revenue Code), the excess of revenues from members over related expenses is subject to taxation unless such excess is returned to the unit owners or applied to the following year's assessments (more on this below). The other method (filing Form 1120-H, under Section 528 of the Internal Revenue Code) enables the association to elect to exclude from taxation exempt function income, which generally consists of revenue from unit owner assessments. Under either method, the association may be subject to tax on investment income and other non-exempt income, but at different tax rates.

Associations that typically do not qualify to file Form 1120-H are those that (a) do not derive more than 60 percent of their annual revenues from residential sources; and (b) those for which the square

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footage of the residential units is less than 85 percent of the total square footage of all units. Hotel condominiums, mixed use condominiums, and associations which include the operation of a large club generally do not qualify to file Form 1120-H.

Substantially residential condominium associations may file either Form 1120-H or Form 1120 (along with Florida Form F-1120). In filing Form 1120-H, the association makes an annual election (simply by filing Form 1120-H, or extending the time to file and indicating that the association intends to file Form 1120-H.) The CPA that prepares the tax return for the association should normally perform a calculation to determine which form (1120-H or 1120) is preferential for that year. The calculation, which includes an allocation of expenses against taxable income, should be presented to the association for approval, since the ultimate responsibility for the return is that of the association.

Around the end of the third quarter, associations that have managed to operate at a surplus may wish to request their CPA to project an estimated surplus, if any, for tax purposes. The estimated surplus, if refunded to the unit owners or credited to next year's assessments, and properly approved by the membership, would not be taxable to the association. The approval by the membership is mandatory and must be made pursuant to IRS Revenue Ruling 70-604. Associations should consult with their CPA and legal counsel in adopting this resolution, which should be included in the annual meeting as standard practice.

Conclusion

While the conduct of the annual audit is the responsibility of the auditor, the collaboration with the management of the association

will contribute to the timely completion of the audit. Association management must recognize the financial statements are theirs. The auditor's role is the rendering of an opinion as to whether the financial statements are presented in accordance with generally accepted accounting principles. Association management should also be concerned about the preparation of its income tax return and should be able to feel confident that its CPA has taken into account all of the relevant tax considerations in preparing the association's income tax return.

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