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INTERNAL CONTROLS Checks & "Balances"

By Ed Guttenplan, CPA, MBA

Note: This article is adapted from Ed Guttenplan's seminar "Who Is Watching Your Money?" presented at the September 2004 CAI-NJ Conference and Expo. Portions of this article rely on CAI's GAAP Report #22—The Role of the Association Treasurer—3rd Edition—which may be obtained from CAI.

Our two most recent issues of the CPA (Spring, 2004 and Summer 2004) addressed fraud related topics, to provide visibility to an (unfortunately) all-to-frequent topic appearing in the news. In order to discuss fraud's relevance to Community Associations, and potential strategies to minimize fraud risk, this article continues

the "fraud-related" theme, but from a different perspective.

I frequently stress to Community Association Boards that they cannot "take for granted" that certain procedures or processes occur-or can be delegated to others. A prime example relates to thoroughly reviewing, and understanding, financial statements.

For example, The Sarbanes-Oxley Act (SOX), which specifies a variety of disclosure and compliance requirements for publicly-traded companies' financial practices, is being used with increasing frequency as a benchmark for not-for-profit boards.

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More specifically, SOX actually requires that key officers or publicly-traded companies personally attest to the fact that they reviewed their company's financial statements, and that these statements accurately reflect the company's financial position. SOX also requires these individuals to assume personal liability for the financial representations they make. In fact, some states are adopting SOX as part of their state Law. Accordingly, these mandates are now being widely used to develop/enhance systems and procedures for fraud detection and prevention, as well as, financial disclosure/reporting. One key aspect of this effort is to ensure that an effective system including internal controls is implemented and monitored as part of an organization's "fraud defense system."

Given the potential negative ramifications of fraud, is it possible for an organization to have "too much" internal control? While on the surface the answer would seem to be "no", the associated expense and resource requirements of establishing procedures and controls must be determined to be cost/beneficial. Let me stress that there is no "formula" which can readily be applied consistently to all Associations. In an environment of budget pressures and other fiscal/operational realities, **I believe the correct approach is to ensure that the organization, or in this case, the Association, must determine the correct balance of internal controls that best serves the specific needs of its Community.**

The remainder of this article discusses some essential concepts of internal controls, along with practical considerations for their use in Association operations. This discussion of internal controls is divided into 3 topics:

- ◆ **Internal Controls: What Are They and What Should Boards Understand About Them?**
- ◆ **Types of Internal Controls**
- ◆ **Balancing the Cost/Benefit.**

Internal Controls: What Are They and What Should Boards Understand About Them?

I frequently stress that Board Members need to feel comfortable that they are properly discharging their fiduciary duty, and I welcome questions related to this important issue. Key facets of this responsibility relate to the Board's awareness of, and the actions taken to ensure the fiscal well being of the Community. Internal Controls play an integral role in this process. Specifically, the American Institute of Certified Public Accountants' (AICPA) Auditing Standards Board in SAS (Statement of Accounting Standards) #78 defines Internal Controls as: "... a process – effected by an entity's board of directors, management, and other personnel – designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- ◆ **Reliability of financial reporting**
- ◆ **Effectiveness and efficiency of operations**
- ◆ **Compliance with applicable laws and regulations.**

Using this framework, the Standard discusses five interrelated concepts a Board and Management Company should understand related to internal controls. These include:

- ◆ **Control environment**—which refers to the tone set by the Board and Management to reflect organizational structure

and discipline, as well as, factors such as the culture of integrity, competence and responsibility/accountability

- ◆ **Risk assessment**—to identify types of potential misstatements and designing control policies and procedures to prevent or promptly detect those misstatements. A key aspect here is identifying organizational changes, to personnel, procedures, technology, etc., and ensuring that a process is in place to maintain control, given that change is a reality of all organizations
- ◆ **Control activities**—to provide the mechanisms to ensure that management's policies are implemented
- ◆ **Information and Communication**—to provide a system to accurately and fairly report the Association's financial condition/position, while ensuring that there is an "organization-wide" understanding of all internal controls, and mechanisms to effectively provide for communication of accounting issues (and potential problems) to management so they can be addressed and rectified
- ◆ **Monitoring**—to consistently and systematically assess the appropriateness of the organization's controls and processes based on the changes that occur over a period of time.

I believe the correct approach is to ensure that the organization, or in this case, the Association, must determine the correct balance of internal controls that best serves the specific needs of its Community.

Since Communities vary in size (and budget), the resources available to their Boards to address these issues will vary as well. The key point is that Association Boards should coordinate their activities in this area with their Management Company (or in-house professional staff, if applicable) and CPA when establishing/reviewing and updating their internal controls.

It is also important for Associations to recognize these key aspects of internal controls:

- ◆ Consider them as part of a process and "a means to an end"—not the end in itself
- ◆ Remember that they are effected by *people* at every level—not just manuals, forms and procedures
- ◆ Realize that they can provide only reasonable—not absolute—assurance and protection against fraud and deception
- ◆ Recognize that they are part of an Association's "best practices" and are geared towards achievement of the objectives of sound fiscal operations of the Community.



Types of Internal Controls

Internal Controls fall into several broad classifications:

- ◆ Administrative
- ◆ General
- ◆ Application.

Let's briefly explore each of these in a little more detail:

- ◆ **Administrative**—many of which are covered in Association documents, as well as
 - **Code of conduct**—defining how the Board, professionals and volunteers are expected to conduct themselves
 - **Recruiting practices**—to ensure the highest integrity of staff
 - **Defining responsibilities of the Management Company**—to ensure there is an appropriate segregation of duties. For example, if Management and/or in-house staff wishes to approve invoices, there must be appropriate “checks and balances” so that the same entity is not also required to be responsible for funds disbursement *and* financial reporting
 - **Personnel manuals**—to eliminate confusion regarding staff responsibilities/expectations
 - **Conflicts of interests**—to ensure these situations are prevented or are defined to ensure staff, Management and Board members are not compromised in their ability to discharge their respective responsibilities.
- ◆ **General**—which apply to overall information and accounting systems to ensure their integrity and accuracy
 - **Computer access**—to address and limit access to the information systems, as well as backup-to provide access to current accounting information is both available, and recoverable in the event of system crashes, power outages, fires, etc.
 - **Record security**—to minimize the risk of record theft/tampering
 - **Employee access to data**—to provide access to limit capabilities to view/change data and conduct transactions
- ◆ **Application**—which relates to issues of error detection, data corruption, data reporting/notification, etc.

- **Procedural**—to ensure transactions are recorded properly— such as elimination of duplication of invoice payments
- **Accounts Receivable follow-up process**—to verify that amounts collected were credited properly, or were in fact even due
- **Check signing**—to ensure segregation of responsibilities and prevent diversion of funds to employee or other inappropriate accounts
- **Bank records**—to ensure that these records are transmitted to multiple parties for review/reconciliation to minimize the risk of falsification.

Balancing the Cost/Benefit

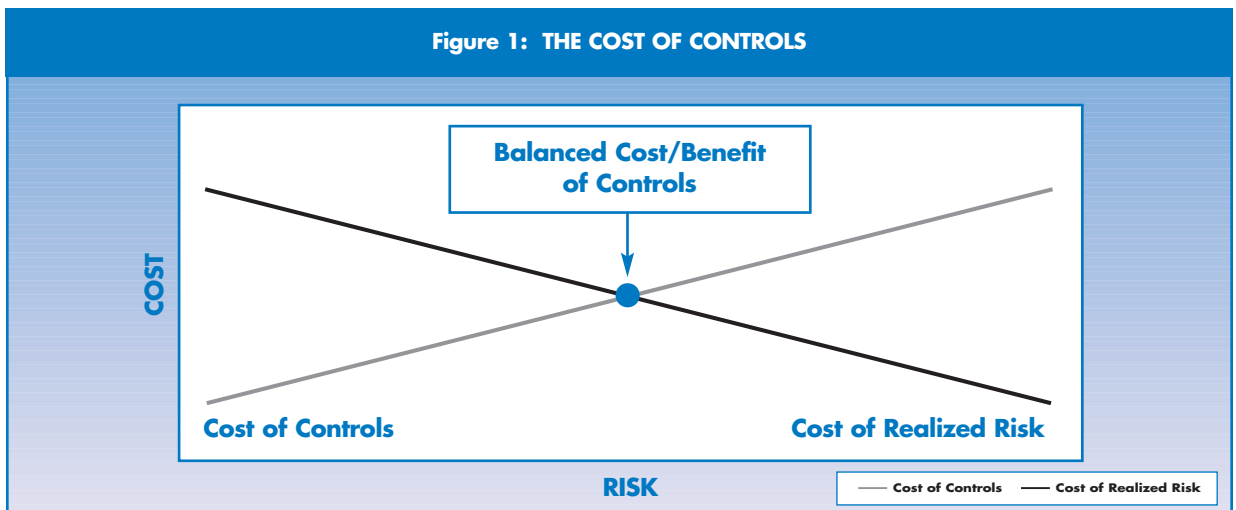
Earlier in this article I posed the question about the possibility of organizations having “too much internal control.” The issue is simply one of cost/benefit. Boards must recognize that the expense associated with internal controls can mount quickly, so it is crucial for a Board to conduct risk assessments to identify processes/procedures which, if violated, would present the greatest threat to the Association’s financial well-being. **Figure 1** illustrates this point in terms of the cost/benefit of internal controls.

The essential point is that Associations need to set priorities so that a fundamental and satisfactory level of operational integrity is assured through the use of internal controls, to be supplemented as circumstances warrant and resources allow. In general, there are some controls, which we believe are essential to all organizations. These are:

- ◆ Reconciliation of bank statements
- ◆ A written budget
- ◆ Monthly/quarterly financial statements with budget to actual comparisons reviewed by the Board
- ◆ Determination/implementation and monitoring of signatory controls
- ◆ Requirement of a disclosure of actual, and potential conflicts of interest
- ◆ A thorough understanding/documentation of controls currently in use by the Association and its Managing Agent (as applicable).

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Figure 1: THE COST OF CONTROLS





The “bottom line” is that even using these basic and relatively straightforward controls, Associations can limit the risks posed by fraud and other forms of criminal activity, as well as more “benign” issues such as incomplete recordkeeping.

Summary

Association Boards have a fiduciary responsibility to safeguard their Community’s assets and ensure its well being. This responsibility can seem daunting at a time when it would appear that fraud and deception are receiving increased media attention and organizations are being required to submit to ever-greater levels of scrutiny. There are many strategies and practices that are easily implemented to ensure that these responsibilities are being properly discharged. At the heart of effective administration of the Association’s operations is an effective system of internal controls, properly tailored to meet the Association’s specific situation and budget. With a thorough understanding of the concepts and cost/benefit of selecting the right controls, along with related policies and procedures, Board members can feel far more comfortable that they are properly discharging their fiduciary duty and sleep better in the process. For more information, please feel free to contact me, or, your Wilkin & Guttenplan advisor.

UPCOMING ISSUES:

- A Discussion of the Merits and Drawbacks of Including the “Immunity Clause” in Association By-Laws
- What are “Benefits Derived?”

This publication is prepared quarterly by Wilkin & Guttenplan, P.C. For further information or for complimentary copies or subscriptions, you may contact Jules C. Frankel at:

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NEWS AT THE FIRM

ANNIVERSARIES (October–December)

Congratulations to the following W&G staffers celebrating anniversaries:

20 years	Annette Murray	7 years	Victoria Foody
19 years	Janine Zirrieth	6 years	Daniel Manning
18 years	Margot Julis		Vinay Navani
	Susan Klimcsak		Donna Peskin
15 years	Carol Rosenvinge	5 years	Jill Carvalheira
			Joseph Zanna

AWARDS & CERTIFICATIONS

Congratulations to:

William J. McDevitt, Shareholder, who recently earned the prestigious *Certified Valuation Analyst (CVA)* designation from the *The National Association of Certified Valuation Analysts*. This important credential is especially relevant for clients requiring business valuations, litigation support and consultation/expertise in fraud-related issues.

Janine M. Zirrieth, Administrator, on the receipt of the *Distinguished Service Presidential Citation* from the *Association of Accounting Administration (AAA)*. Janine earned this distinction for outstanding support and contributions to the organization in the development of AAA’s New Jersey Chapter.

APPOINTMENTS, COMMITTEES, PRESENTATIONS, PUBLICATIONS...

Gary Rosen, Shareholder has been selected to write the “Ask the Expert” Column of *The Reporter: Real Estate*— a new weekly real estate publication focusing on central New Jersey.

NEW HIRES

We are pleased to welcome our new hires:

Danielle Delesky	Kristen Hardy	Anne Gracia Nathan
Stacey Nixon	Hannelore Opela	



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