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Why Your Auditors Should be Asking More Questions (or SAS #99 on Fraud Implemented by CPAs)

By Jules C. Frankel, CPA, MBA

Introduction

In an audit performed in compliance with generally accepted auditing standards (GAAS), Certified Public Accountants have always had the responsibility to plan and perform the audit to obtain reasonable assurance that an entity's financial statements are free of material misstatement, including material misstatements caused by fraud. When the American Institute of Certified Public Accountants issued its Statement on Auditing Standards (SAS) #99, the auditor's responsibilities did not change; rather it revised and expanded the specific guidelines for auditors to use to better fulfill their responsibility.

At the outset, it is important to note the difference between "reasonable" and "absolute assurance"—particularly in situations where fraud may be present. Believe it or not, no CPA can ever be 100% certain of detecting fraud, especially if collusion is involved. However, through continued improvement of auditing processes, practices and procedures, the probability of fraud detection is increased. While it is logical to think that SAS #99 was promulgated as a reaction to scandals such as Enron or MCI, the reality is that the process of updating and reviewing audit guidelines for fraud detection actually pre-dates public knowledge of those incidents.

SAS #99 has a two-fold objective:

- ◆ To improve fraud detection
- ◆ Improve audit quality, and correspondingly, client service.

To explain some of the practical implications and processes of the implementation of this Standard, the remainder of this article is divided into 3 sections:

- ◆ Understanding Fraud
- ◆ Auditor Requirements under SAS#99
- ◆ Implications of the New Standard.

Understanding Fraud

What is fraud—and how can it occur? Fraud can take many forms and can range from employee theft or misappropriation of assets, to fraudulent financial reporting. Unfortunately, new methods and strategies are devised constantly by individuals, who for a variety of reasons, wish to defraud a company, or in our case, an Association. To assist them in the process of fraud detection, auditors commonly use a framework known as the *Fraud Triangle*, pictured in **Figure 1**.

The fraud triangle depicts the three conditions present within an organization that increase its susceptibility to fraud. The concepts illustrated by the triangle should frame the auditor's fraud detection efforts, in gathering information, analyzing and assessing fraud risk and in communications both with the audit team and members of the Association's Management, Board and/or Finance Committee.

**Figure 1:
THE FRAUD TRIANGLE**

Incentive/Pressure: Management/Employees have a reason to commit fraud; i.e., personal greed, overextended financial commitments, etc.

Opportunity: Existence of circumstances such as weak internal controls or lack of oversight which provide an "environment more conducive to fraud"

Rationalization/Attitude: Individuals lack ethics, or rationalize their actions, thereby allowing themselves to believe, "This behavior is OK"



Auditor Requirements Under SAS#99

Under the new Standard, which aligns audit guidelines with the conditions illustrated by the fraud triangle, auditors have significantly expanded a variety of audit functions, with the most meaningful changes affecting:

- ◆ Renewed emphasis on professional skepticism
- ◆ Information gathering/Brainstorming
- ◆ Inquiries of organization personnel.

Let's explore each of these in more detail:

- ◆ *Renewed emphasis on professional skepticism*—so that auditors conduct their analyses, inquiries and evaluations with the proper degree of skepticism. *This is not intended to antagonize clients, but rather to protect the organization from those who wish to cause financial harm*
- ◆ *Information gathering/Brainstorming*—to preface the information gathering process, a brainstorming meeting at which all audit team members must be present is a new requirement under the Standard. The purpose of this meeting is to discuss scenarios under which fraud could occur within the client organization. This approach is intended to improve fraud detection processes, as well as, controls to minimize fraud risks by examining issues such as:
 - ◆ Financial statement susceptibility to material misstatements
 - ◆ Methods which can be used by management or employees to commit/conceal fraud
 - ◆ Capacity/inclination of management/employees to misappropriate assets
 - ◆ *Inquiries of organization personnel*—to expand/broaden the interviews of management and other key individuals in the organization. Historically, the interview process was limited to an organization's management, and accounting/finance departments. However, Because

“fraud can occur at any level, or in any department”, the inquiry process recommended by the Standard requires that inquiries be made, as appropriate and necessary, of individual employees. The practical implication for Associations is that:

- ◆ In addition to the questions auditors have typically asked Management and Boards in the past, new, and more direct, questions not asked previously will likely be included, such as “Are you aware of any fraud?”
- ◆ Associations should expect that auditors will also be seeking to interact directly with Board Members and asking questions of them.

None of the questioning/interviewing process should be viewed as confrontational, but rather that the auditor must ask “the hard questions” to ensure that the audit achieves its objective.

Other areas covered by the new Standard which auditors should consider as part of their fraud detection efforts include, *Revenue Recognition, Review of Internal Controls and Management*

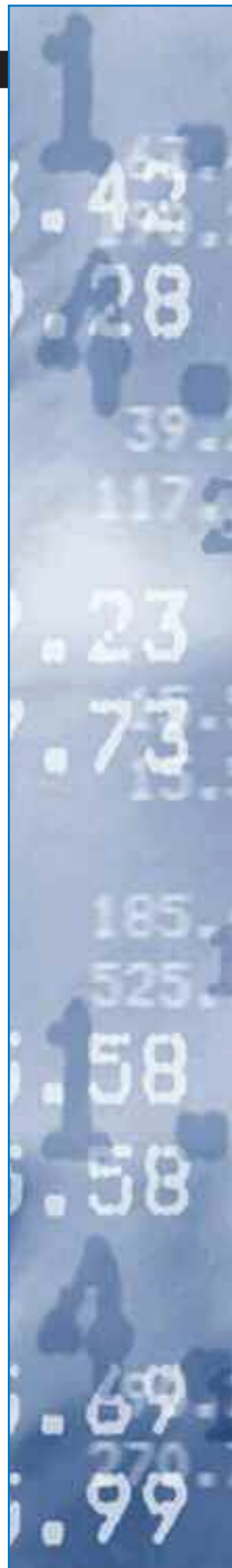
Override of Controls.

Implications of the New Standard

Auditors need to communicate with their clients to ensure that they have a basic understanding of the scope and importance of the new Standard's guidelines for fraud detection. It should not be taken for granted that even after so many public scandals, clients fully understand the role, and limitations, of audits. Additionally, a very practical implication with which Associations must become comfortable is the expanded and more comprehensive interview/inquiry process. As we have said on many previous occasions, Wilkin & Guttenplan believes that part of our role as an industry leader extends to education of our clients and colleagues on trends and issues in Community Association accounting. Accordingly, articles such as this are a useful and timely medium for communicating key issues/changes affecting the Association auditing process.

Additionally, application of the new Standard is as much an iterative, as it is a sequential, process. That is, pertinent information discovered at the mid, or latter stages of the audit can't be discarded or minimized “because it emerged too late in the process to be useful.” Also, the specific application of the guidelines may vary in some instances based on unique, client-specific circumstances.

The new Standard is effective for audits of financial statements for periods beginning on or after December 15, 2002, and provides extensive guidelines to maximize the effectiveness of an audit, with visible changes that broaden the scope of inquiry and analysis necessary to detect fraud. So, don't be surprised, alarmed or upset if you find that your auditors are asking many more questions than in previous engagements; as the capability to commit fraud becomes more sophisticated, so too must the process of fraud detection and prevention. As always, feel free to contact me, or your Wilkin & Guttenplan advisor, with any questions or concerns.



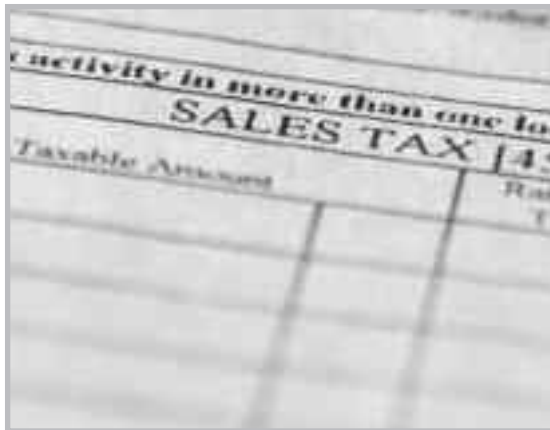


Sales Tax Audits of Large Associations: Are You "At Risk"?

By Vinay Navani, CPA

The New Jersey Division of Taxation is increasing its efforts in sales and use tax audits of large Communities. Accordingly, all Community Associations should be vigilant in sales/use tax compliance. Although there may be a perception to the contrary, purchases of goods and services originating outside of New Jersey are not exempt from sales/use tax. Given this, as well as other potential misconceptions regarding sales/use tax payments, we felt that it would be an appropriate time for Associations to take a self-assessment to:

- ◆ Ensure compliance with sale/use tax regulations
- ◆ Minimize the risk of an audit and its potential consequences to the Association.



To assist Associations with these issues, this article clarifies some common misconceptions regarding sales/use tax obligations, and offers some guidance regarding compliance.

Correcting Common Sales/Use Tax Misconceptions

1. **The notion that CIRA's are exempt from sales and use tax is incorrect.** While certain income tax exemptions exist, this does not translate into an exemption from sales and use tax
2. **If sales tax is not charged for repairs or maintenance-it is still due.** Repairs and maintenance (for example, plumbing repairs or painting) are among the most common circumstances in which tax may not be charged at the time the service is performed. Accordingly, if the tax is not collected by the vendor, the Association must still file a use tax return and remit the necessary tax to the State of New Jersey
3. **On retail transactions, sales tax is due to the State of New Jersey, regardless of whether or not the merchant charges the tax-and whether or not the transaction occurs in New Jersey.**
 - ◆ If a Community purchased a large screen TV for its clubhouse from a New Jersey retailer, sales tax is due. The tax would be collected by the merchant at the time of the transaction and forwarded to the State of New Jersey

- ◆ For a purchase made in another state, let's hypothetically assume that the merchant says at the time of the transaction, "If I ship the item to New Jersey, I won't have to charge sales tax". Again, the issue is that the tax due is a sales/use tax. **Accordingly, the Association still has tax liability even if the merchant does not collect the tax.** This means it is actually the *purchaser's responsibility* to pay the tax, regardless of whether or not the merchant collects it.

For applicable situations in which sales/use tax was due but not collected, the Association should file a return and ensure the payment of a 6% sales/use tax.

Some other situations in which sales/use tax should be charged, but is often overlooked by vendors include:

- ◆ Cleaning
- ◆ Other miscellaneous non-capital improvement transactions.

However, if the service performed results in a capital improvement, the CIRA should provide the vendor with, and retain a copy of, Form ST-8, *Certificate of Capital Improvement*. This form documents that sales tax should not be charged because capital improvements are not subject to sales/use tax. The distinction between a repair and a capital improvement can sometimes be difficult. A capital improvement increases the capital value or useful life of the property, and is permanently attached to the real property. For example, paving of driveways would be considered a capital improvement, in contrast with patching a driveway, which would be considered a maintenance item.

Compliance Suggestion

For Associations with potential sales tax liabilities, audit risk can be reduced by filing Form ST-50, *State of New Jersey Quarterly Sales and Use Tax Quarterly Return*. The filing starts the Statute of Limitations, which restricts the time period that the State can retroactively audit and assess the Association for tax obligations, as well as, interest and penalties.

Summary

Clearly, given the potential risk of a sales/use tax audit, as well as, the current situation in our industry, which reflects an increasing number of these audits, it is a good practice for Associations to be cognizant of, and comply with, the preceding recommendations to limit potential audit-related exposure. **Accordingly, we urge that the appropriate timing and procedures for filing a Form ST-50, as well as, the extent to which a particular Association may be "at risk" of a sales tax audit, be determined by consulting an Accountant with CIRA expertise.** As always, for further information on this complex subject, please feel free to contact your Wilkin & Guttenplan advisor.



Jules C. Frankel—CAI-NJ's Speaker of the Year for 2003

Wilkin & Guttenplan, P.C., is pleased to congratulate Shareholder Jules C. Frankel, CPA, MBA, who was recognized at the recent Community Associations' Institute-New Jersey (CAI-NJ) awards banquet as the organization's *Speaker of the Year for 2003*. Jules, a former CAI-NJ president, received recognition for the 3rd consecutive year. Two years ago, he received the organization's *Author of the Year* award and last year was honored for his many years of distinguished service with his induction into the CAI-NJ *Hall of Fame*. A past Chairman of the Community Associations' Institute National Accountants' Committee and frequent Reviewer of the AICPA *Audit and Accounting Guide for Common Interest Realty Associations*, Frankel is considered one of the industry's leading experts on CIRA accounting.



Wilkin & Guttenplan, P.C. shareholder Jules C. Frankel receives the *Speaker of the Year* award at the annual CAI-NJ awards banquet. Pictured with Jules are outgoing CAI-NJ President Russel Fernandes, RS (l), and CAI-NJ Executive Vice President Curtis Macysyn.



NEWS AT THE FIRM

Wilkin & Guttenplan is proud to congratulate our employees who have recently passed their CPA exam:

Sarah Lilley Cristina Czerwinski
Tom Pedersen Stacey Nixon

ANNIVERSARIES (January—June)

Congratulations to the following W&G staffers celebrating anniversaries:

20 years	Gary Rosen	11 years	Carol Koransky
18 years	Sefi Silverstein	7 years	Brian Geissler
17 years	Sara Gierloff		Bill McDevitt
	Michael LoVerde	5 years	Amanda Brady
16 years	Aurelia Hughes		Karen Davis
	Kristine Flores		Len Nitti

APPOINTMENTS, COMMITTEES, PRESENTATIONS, PUBLICATIONS...

Congratulations to Ed Guttenplan, *Managing Shareholder*, for being appointed as Chair of the New Jersey Society of CPAs Human Resources Committee.

UPCOMING ISSUES:

- Questions to Ask Your Engineer
When You Receive a Draft Reserve Study
- Representation Letters
- Tax Impact of a Superintendent

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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