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In this Issue...

FRAUD:
What We've Seen. What We Recommend.

By Gary B. Rosen, CPA, CFE

In our previous issue of the *CPA* (Spring, 2004) we discussed Statement on Auditing Standards (SAS) #99. This Standard revised and expanded the specific guidelines for auditors to fulfill their responsibility with respect to planning and performing audits to obtain reasonable assurances that an entity's financial statements are free of material misstatements, including material misstatements caused by fraud. We tend to associate fraud with highly visible, public scandals such as *Enron, MCI-Worldcomm* or *Parmalat*. But, fraud and misappropriation of assets can happen in virtually any organization that lacks proper internal controls and fraud prevention/detection practices. Furthermore, perpetrators of fraud seem to have a virtually limitless imagination, so this crime can take on a variety of forms. With this issue, we would like to move from the "conceptual to practical"; that is, instead of focusing on the guidelines and their implications, we would like to review a number of incidents with which we have familiarity to provide "real world" illustrations of situations in which fraud can occur.

Using our comprehensive audit procedures, our firm has identified and quantified a number of instances in which fraud occurred in the past few years **and subsequent to its discovery, notified the Board, and explained our audit or other agreed upon procedures**. Although inappropriate and unprofessional to "name names", I would like to provide a representative sample of these fraud occurrences in order to:

- Better educate/sensitize our readers about the significance of properly audited operations and financial statements
- Highlight the necessity for implementing and monitoring internal controls and appropriate fraud prevention practices.

In addition to indicating the method used to detect/identify the fraud, this article provides some general guidelines that Associations can use to help reduce their susceptibility to this crime.

Synopsis of Recent Fraud Occurrences We've Seen

"Unearned Income"

Situation: As part of their transition to unit owner control, a Community Association had obtained several units from the Sponsor for the purpose of reselling them to 3rd parties. As part of each sales

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transaction, the Manager was siphoning a portion of the sale proceeds from the Association's bank account into their own account.

Clue: What initially appeared to us as the inability to reconcile an Association's bank account ultimately proved to be a case of fraud.

Detection Method: Using rigorous cash account audit procedures, along with a thorough reconciliation and examination of all of the Association's bank accounts, we identified the misappropriation of assets and quantified the problem.

Fraud "Technique": The missing funds were recorded as *deposits in transit* and some bank statements were obtained by the Manager and altered.

Recommendation: **Review the bank statements and the bank reconciliation on a monthly basis and agree the reconciled balance to the monthly financial statement.**

Fraud and misappropriation of assets can happen in virtually any organization that lacks proper internal controls and fraud prevention/detection practices

It's All in the Delivery (or it wasn't—actually!)

Situation: A former Association Board Member established an "ad hoc" committee and represented to the Association that they had an agreement with a company to provide certain "quality of life enhancements" which could produce revenue for the Association. The Board agreed to the enhancements, which never materialized.

Clue: In reviewing the Association's disbursement records, we noticed that we were unable to match the disbursements and invoices to actual materials deliveries.

Detection Method: As we reviewed the invoices, we requested permission to conduct a physical inspection of the materials to determine if in fact they had been delivered as indicated by the invoices. When confronted with this situation, the individual who committed the fraud confessed.

Fraud "Technique": The Association's cash was diverted for the personal use of the former Board Member; we also ultimately determined that the invoices were falsified.

Recommendation: **Have the Board authorize all invoices which are outside of the normal course of operations or for which a contract does not exist.**

A New Meaning to "Making a Statement"

Situation: We were asked to provide expert assistance to an Association outside of this region whose Management Company was collecting maintenance assessments from all of its Association clients and depositing them into an account controlled by the Management Company. The Management Company then depleted that account (in fact it was diverting the funds for its own use).

Clue: The Management Company encouraged its clients to conduct reviews instead of actual audits as a method of saving money on accounting fees.

Detection Method: The Association ran out of money to pay its bills.

Fraud "Technique": To "cover their tracks", the Management Company falsified bank statements and presented them to the Board as part of their regular financial reporting process. During litigation, it was observed that a rather routine procedure involving the confirmation of cash balances would have prevented this particular fraud from persisting for as long as it did.

Recommendation: **Review the monthly bank statements and agree them to the monthly bank reconciliation. In addition, all accounts receivable balances over 60 days should be reviewed and analyzed.**

Just these 3 examples indicate that Associations, and Auditors, must be vigilant in both conducting a thorough audit, as well as, in instituting and monitoring effective fraud prevention/detection methods and procedures.

How Associations Can Protect Themselves

At a minimum, I would suggest that all Association Boards address the following issues with a combination of personal oversight, proper internal control procedures and reporting:

- Direct approval and authorization of all vendor contracts and associated invoices
- Personal review of monthly proof of *Maintenance Assessments, Accounts Receivable, Assessments Received in Advance,* and *Bad Debt Expense*
- Direct review of Accounts Payable listings, along with inquiries regarding inconsistencies of the timeliness of vendor payments
- Awareness of transfers between bank accounts by means other than a check. This can be done with a monthly bank statement review
- Reconciliation of bank statements performed by someone who does not have check signing authority
- Review/Verification (for Associations using petty cash or "house" accounts/ credit cards) of monthly statements and disbursement to ensure the appropriateness/proper authorization of expenditures.

Summary

Clearly, situations and procedures may vary among individual Associations. However, Associations need a system of effective internal controls and fraud prevention/detection procedures to minimize the potential risk of being victimized by fraud. In addition to becoming more aware of the many ways in which fraud can occur, by using:

- The general guidelines suggested in this article
- An auditor with the specific expertise to provide effective fraud prevention/detection methods and processes

Boards can help minimize their susceptibility to fraud. Please feel free to contact me, or your Wilkin & Guttenplan advisor with any specific issues, questions, or concerns.

UPCOMING ISSUES:

- **Unique Attributes of Mid- and High-Rise Buildings**
- **Tax Impact of a Superintendent**

What Associations Should Know About Audit Representation Letters

By Daniel Manning, CPA


ABC Community Association

Community Associations produce audited financial statements so that members, prospective unit buyers, lenders, and Associations can assess the Association's financial condition. An essential component of the process of assuring the integrity of these financial statements is the Audit Representation Letter. Given that this is the time of year when a significant number of Board Members are asked to sign Representation Letters, we felt this would be a timely topic. However, prior to reviewing the specifics of the Representation Letter, an overview of the financial statement preparation process will be helpful.

Financial Statement Roles & Responsibilities

Typically, there are three parties involved in the process of generating audited financial statements, each with specific roles and responsibilities:

- The entity
- A recordkeeper
- The auditor.

In the CIRA industry, the entity is a Community Association, and its Board is ultimately responsible to ensure the Association's books and records are maintained. However, in contrast with corporations, in which the recordkeeper is typically an employee, a unique aspect of the CIRA industry is that often, the Association subcontracts the recordkeeping function to a professional Management Company. Regardless of the Management Company's role in financial statement administration/preparation, the Association still retains responsibility for the accuracy of its financial statements.

The other party involved in the process is the auditor, whose role is to ensure that the financial statements are free from material misstatement. For the auditor to render an opinion attesting to the accuracy of the presentation of the financial statements, a Representation Letter must be obtained. To help our readers become better informed on this subject, the remainder of this article discusses the following important issues related to the Audit Representation Letter:

- Description
- Importance & Necessity
- Contents
- Preparation & Signature.

Description

The Audit Representation Letter is a written communication from the Association (via the Board) to its auditor, containing a series of statements to document pertinent information provided to the independent auditor during the audit process. Additionally, the letter outlines the information on which the auditor relied, and has used to render an opinion on the financial statements. During the course of an audit, both oral and written representations are made to the Association's independent auditor to corroborate other evidential matter obtained by the auditor. There may also be instances in which the auditor could not perform procedures sufficient to corroborate information that was provided. Accordingly, a representation should be included in the Audit Representation Letter to document positions or intentions with respect to such situations.

Importance

Why is it necessary to provide an Audit Representation Letter? An auditor must obtain these written representations to document:

- That the Association understands the financial statements are its responsibility. Although often the auditor prepares the financial statements and related disclosures, this does not transfer responsibility for financial statement integrity from the Association to the auditor
- Any significant information provided to the auditor, or that was relied upon in order to render an opinion on the financial statements.

Additionally, an auditor is required to obtain a written representation in order to be in compliance with Generally Accepted Auditing Standards (GAAS). The American Institute of Certified Public Accountants issued ***Statement of Auditing Standard No. 85***, which states, *This section establishes a requirement that the independent auditor obtain written representations from management as a part of an audit of financial statements performed in accordance with generally accepted auditing standards...* If the representation cannot be obtained, the auditor cannot issue an unqualified opinion, and, depending on the circumstances, the auditor may disclaim an opinion or consider withdrawing from the engagement.

Contents

There are a number of standard representations that appear in virtually every letter. However, the letter should be tailored to fit each Association's particular situation. The auditor determines which representations need to be included in the letter based on:

- An evaluation of the information gathered during the course of the audit
- A determination of whether or not suitable corroborative evidential matter has been collected to support the auditor's opinion based on a comprehensive view of the financial statements.

Various sample representations include, but are not limited to:

1. Acknowledgement by the Board of its responsibility for the fair presentation of the financial statements
2. Availability of all financial records and related data
3. Proper recording or disclosure in the financial statements of related party transactions, if applicable

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4. Confirmation that there:
   a. have been no communications with regulatory agencies concerning non-compliance with, or deficiencies in, financial reporting practices
   b. is no knowledge of any fraud or suspected fraud that could have a material effect on the financial statements
   c. are no material transactions that have not been properly recorded in the accounting records underlying the financial statements
   d. are no events which have occurred subsequent to the balance sheet date and through the date of the Representation Letter that would require adjustment to or disclosure in the financial statements
   e. have been no unasserted claims or assessments that the client's attorney has advised are probable of assertion and must be disclosed.

Preparation and Signature(s)

In most cases, the Representation Letter is prepared by the independent auditor and presented to a representative of the Board during a review of the draft financial statements. If the Association uses a Management Company to administer its books and financial statements, a representative of Management should also be present for the review.

Representation letters are to be signed "by members of the Board whom the Auditor believes are responsible for and knowledgeable, directly, or through the organization, about the matters covered by the representations." Generally, this would be the Association's President and/or Treasurer. When a Management Company maintains the financial records, typically an Officer of the Management Company will also sign in conjunction with the Board's representative(s). It is important to re-emphasize that the Management Company's signature on the letter does not change the Association Board's responsibility for the financial statements.

In the event of the Board's refusal to provide and sign the letter, the situation would be considered what auditor's term a "scope limitation" sufficient to preclude an unqualified opinion.

Conclusion

The Representation Letter is a professional audit standard required of CPAs, which documents the roles and responsibilities of both the auditor and the Community Association, and reduces the possibility of misunderstanding concerning the matters that are the subject of the representations. Please feel free to contact your Wilkin & Guttenplan advisor with questions or for additional information.

NEWS AT THE FIRM

ANNIVERSARIES (July—September)

Congratulations to the following W&G staffers celebrating anniversaries:

21 years **Ed Wilkin**
Ed Guttenplan
18 years **Jeannette Everett**
Jules Frankel
14 years **Doreen Gordon**
16 years **Melissa Marsicano**
Deborah Norwicke
11 years **Lauren Jablonski**

Congratulations to **Abdul & Nasia Hassan** on the birth of their son, Muazum, born May 4, 2004.

Congratulations to **Amanda Brady** on passing the CPA Exam.

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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