



COMMUNITY PROPERTY ADVISOR

VOLUME XXIII

WINTER 2009

NUMBER 1

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SAS 115 – Communicating Internal Control-Related Matters Identified in an Audit

By Joseph A. Chorba

What's the first thing that comes to your mind when you hear "SAS 115 – Communicating Internal Control Related Matters Identified in an Audit"? I asked a few people and this is what I heard. "Oh no not another one!" "Great, something else for the auditors to look for." and "What's a SAS?" All common reactions adding to the misconception that auditors are "looking for something". So if you don't know what SAS 115 is all about, or if you think the auditors are trying to "find something", hopefully by the end of this article your reaction to my question will be much different.

First of all, "SAS" stands for Statement on Auditing Standards and yes, there are 115 of them. The latest standard issued by the AICPA is "SAS 115 – Communicating Internal Control Related Matters Identified in an Audit." The standard was released in October 2008 and supersedes SAS 112 of the same title. SAS 115 establishes standards and provides guidance to auditors on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. Say that five times fast!

For a long time, auditors have been assessing both the design and operating effectiveness of an entity's internal controls during the course of an audit, but until recently there hasn't been a requirement to communicate that assessment to management. SAS 115 now requires the auditor to communicate, in writing, certain internal control deficiencies identified during the course of an audit to management and those charged with governance. In addition, the auditor is required to evaluate the severity of the deficiencies in internal control based on the likelihood and magnitude of the potential

misstatements. The standard uses some scary words like "deficiency", "material weakness" and "significant deficiency", which are defined as follows:

- "Deficiency" – A deficiency in internal controls exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct financial misstatements on a timely basis
- "Material Weakness" – A deficiency, or 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.
- "Significant Deficiency" – A deficiency, or 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.

Although these words may seem like an attack on the entity's internal controls, they are really intended to be a way of identifying and categorizing areas in the internal controls that need improvement. The intention of the standard is not to get anyone in "trouble" but rather its intention is to have the auditor provide useful information to management that would only be available when an audit is being performed. Many of the deficiencies noted in the standard are common deficiencies found in many small organizations. The reason being that these standards don't always have small organizations in mind when providing guidance on such matters.

Where Two or More are Gathered...Community Association Clubs: Challenges and Perspectives (Part I)

By Edward Guttenplan, CPA, MBA & Jennifer A. Loheac, Esq.

It is Wednesday night in late November. The clubhouse at one age-restricted community association is bright with light and buzzing with activity from every corner. As the Board of Trustees conducts its monthly meeting in the main hall, several other groups gather to exercise, play cards and socialize. In a society where, sadly, alienation is pervasive, the idyllic scene is a glowing testament to the successful side of community association living.

Larger community associations, in particular, are home to dozens of private clubs, existing for social, political, philanthropic or recreational value. Distinct from committees assisting the Board of Trustees for corporate business, these clubs exist as independent organizations, collecting fees, organizing events and even exercising selectivity in membership qualifications. Yet, private clubs present any number of challenges for any community association in its effort to optimize the cultural value of resident assemblages at minimum risk to the association.

There are, among community association professionals, two schools of thought: on one hand, it seems prudent for agents of the association to stick with managing the property and steer clear of attempting to regulate the private clubs and their resident members. The United States Supreme Court has continually recognized that American citizens enjoy a constitutional right to associate freely. The Court regards freedom of association of this kind as “an indispensable means of preserving other individual liberties.” Accordingly, it is messy business for a non-profit corporation to begin poking around in the affairs of resident gatherings. The reasoning follows that the perceived risks flowing from an aberrant club are overstated since the association insures the property and already has plenty of enforcement mechanisms in place through the governing documents. It was just never intended that the association, as mere facilitator of the common property, should also become gatekeeper and guardian to the community’s clubs.

Other professionals, including many attorneys, accountants and insurance agents, are risk-averse, fearful of significant liability due to the one club that negligently manages funds for other residents, gathers at the community clubhouse for a reckless purpose or regularly fails to abide by federal, state and local tax or liquor laws. The thinking holds that where a dozen or more clubs freely use the association’s name, tap association resources and host events on the association’s common property, the corporate entity of the association is ultimately responsible or will pay dearly trying to prove that it is not at fault. Moreover,

the concern is that the association’s insurance coverage does not extend to clubs and their numerous unregulated activities. Further, unsuspecting volunteer “officers” of an unincorporated club may be completely unaware that, in the event of a lawsuit, they may be personally liable. It is difficult to altogether ignore club activities in a day and age when associations actively engage prospective purchasers with promises of “lifestyle.”

There is no question that specialists will continue to discuss, analyze and debate the precarious balance of private property rights with first amendment considerations as these tensions exist in the community association setting and are most particularly challenged with any community’s many resident clubs. In attempts to find a practical balance, we frequently advise our clients of the following:



Distinguishing between larger and smaller clubs

Although the association should not involve itself with establishing membership criteria or making judgments as to the validity of any club’s purpose, the association should know of all of the formal clubs existing on the property. Some associations prefer to separate clubs into two categories, allowing smaller clubs to exist under a department within the association while acknowledging that other clubs exist wholly independent of the association. For those clubs that do not desire to incorporate, establish bylaws or file their own taxes, subordinating to general standards of an activities department may be a preferable option. This way the association can manage the parameters of the club’s activities to ensure that they conform to association standards. Meanwhile, the club is in no way discouraged from pursuing its independent purpose. For those larger clubs that intend to raise money, host events or take trips, the association should maintain a “club file” for its records.

Creating the “club file”

For private clubs, the association should annually request the following documentation:

- Copies of documentation with club’s legal name, current bylaws and a membership list.



Clubs *(continued from page 2)*

- A certificate of insurance evidencing general liability and naming the association as an additional insured.
- Copies of any necessary licenses or permits (e.g. alcoholic beverage, bingo).
- An annual list of proposed activities requiring reservation of association property.
- Annual certification by the club board acknowledging compliance with all legal and tax requirements.

Recognizing the scope of the association's insurance coverage

Clubs may not be covered by their insurance policies for lawsuits arising out of bodily injury or property damage. The association's policy covers the "named insured." Liability policies cover only entities and activities owned, controlled and managed by the named insured. Even though a list of clubs may be provided to the association's insurer, coverage would only extend to those club members who are "acting on behalf of and at the direction of the named insured." Additionally, insurance companies require knowledge of the insured's activities and also include exclusions, limitations and conditions. Clearly, where private clubs are existing independent from the association, under most policies, neither the club nor the association would be protected for the club's activities. The association's concern is that where there is a lawsuit, the association as owner and facilitator of the property may be named in the suit.

As clubs develop and grow in membership, they frequently schedule trips or host outings off-site. Most associations' insurance coverage does not extend to activities held off of the property. Similarly, certain clubs venture into activities that include hiring performers or workers who may not be covered under the association's worker's compensation policy.

We advise clients to inform residents that certain club activities, and most particularly those events held off-premise, are likely not covered under the association's policy. As always, clients are advised to speak directly with their insurance professionals for guidance.

Protecting the association when clubs serve alcohol

The Division of Alcoholic Beverage Control ("ABC") in New Jersey establishes and enforces compliance with Alcoholic Beverage Control Laws and regulations. Clubs that elect to serve alcoholic beverages at their events must elect one of the following options: (a) include "alcoholic beverages" as a line item in the club's annual budget and refrain from charging for alcohol at the event; (b) have club members supply their own beer and wine; (c) hire a caterer with a liquor license that may be utilized at the association premises; or (d) obtain a special events or club license. The association should advise that if these steps are not followed, alcohol may not be served on the premises by any club. Independent clubs, as well as the association, should always confer with an attorney or with the ABC directly prior to hosting an event involving liquor.

Look for Part II of this article in the Spring 2009 edition of Community Property Advisor

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NEWS AT THE FIRM

Employee Anniversaries (Jan. – March)

23 years	Sefi Silverstein	10 years	Amanda Brady
22 years	Michael LoVerde	9 years	Len Niti
21 years	Kristine Flores	8 years	Patty Pfaff
16 years	Carol Koransky		Mohammed Salyani
12 years	Brian Geissler	6 years	Kristina Solan
	Bill McDevitt		

Welcome

Welcome to our new staff members, **Carol Donatiello Iocca, Joanne Trautwein, Sam Kang, Thomas Hasard, Reeta Van Eck** and **Leslie Sola**.

W&G will also host an internship program this winter for students from The College of New Jersey, Rider University and Rutgers University.

Appointments, Committees, Presentations, Publications...

On December 9, 2008, **Edward Guttenplan** presented at a seminar on reserve studies, capital loans and association budgets in Atlantic City. He also spoke on "Whose Club is it Anyway? Exploring the Complex World of Private Clubs in Community Associations" at CAI's 30th Annual Community Association Law Seminar. ■



SAS 115 (continued from page 1)

In any event, the deficiencies noted by your auditor should be addressed and management should work to strengthen the Association’s internal controls. Some of the common deficiencies, identified by the AICPA that are found in small organizations include but are not limited to:

- Absence of or inadequate segregation of duties within a significant account or process.
- Employees or management who lack the qualifications and training to prepare financial statements in accordance with generally accepted accounting principles.
- Inadequate design of internal control over a significant account or process (i.e. payroll).
- Inadequate design of internal control over the preparation of the financial statements being audited. (The number of adjustments made by the auditor could be an indication of inadequately designed controls.)
- Failure in the operation of effectively designed controls over a significant account or process.
- Management override of controls.

Keep in mind that if the auditor determines that one or more of these “deficiencies” exist, it does not mean that a misstatement has occurred in your financial statements. It simply means that the likelihood of a misstatement is increased. The stronger your internal controls, the less likely a misstatement will occur.


Now that your auditor has identified deficiencies and has issued a SAS 115 letter, what happens next? Communication with your auditor is key! I know you’ve probably heard that before, either from your mother, your spouse, your boss, your therapist or just about any other relationship you’ve ever been in. But the same goes for the client/auditor relationship. You need to work together as a team to evaluate the circumstances that prompted the letter to be issued and determine if any action would be appropriate. If action is appropriate, management should take steps to strengthen its internal controls and eliminate the deficiencies disclosed by the auditor. At the end of the day, everyone’s goal is accurate financial reporting and hopefully SAS 115 will help achieve that goal.

So now that you know a little bit more about SAS 115, hopefully your reaction will be a little different than those I’ve heard before.

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