Was She Auditing Those Financial Statements
Or
Was She Preparing Them?
By Tom Weidner

This month's column focuses on the questions: Can a CPA's audit of financial statements become preparation of financial statements? Who cares if that happens? And finally, how can these situations be addressed?

Community Association Managers, Board Members, and their CPAs have unique exposure to this issue because Associations are typically smaller accounting entities. A CPA's inputs to the financial statements of those entities can easily become material to those financials.

<u>**The Ground Rules:**</u> A CPA who does the bookkeeping and then prepares a set of financial statements is not independent with respect to those financial statements. Because of this lack of independence, the CPA is precluded from auditing those financials. (Note: these <u>Ground Rules</u> apply to <u>reviews</u> too – so whenever the word <u>audit</u> appears, think both audits <u>and</u> reviews!)

<u>**Can A CPA's Audit of Financial Statements Transition to Become Preparation of Those Financial Statements?**</u> Yes, an audit of financial statements can segue into preparation of those financial statements. The transition from <u>audit</u> to <u>preparation</u> can occur when the CPA prepares a large number of adjustments, many of which are significant to the financial statements. This is a gray area – but if there are a lot of significant adjustments coming from the CPA, that should constitute a warning for all parties. The CPA is clearly preparing financial statements when he is preparing numerous significant accounting entries that are not corrections of previously entered data, but are instead the originating entries for routine accounting data. This is not a gray area – it's warning lights and sirens. In this situation, the CPA is doing the bookkeeping. Bookkeeping is fine work, but it's not fine if the CPA is doing the bookkeeping and the engagement is intended to be an audit of those financials by that CPA.

<u>**Who Cares if That Happens?**</u> All parties involved should be concerned when an audit of financial statements segues to preparation of financial statements. Those charged with responsibility of maintaining the books find their accounting talents or efforts questioned. The auditor (whose signed engagement letter - or draft engagement letter - specifies that she will do an audit or review, often at an agreed upon fee and by a defined date) is placed in a challenging professional and public relations situation. And the Board and the Association's Managers - who have ultimate oversight responsibility for the process - find themselves dealing with issues that may be very foreign to them.

<u>**How Can These Situations be Addressed?**</u> Avoidance of the audit-to-preparation-of financial-statement segue is the best solution. Avoidance is best achieved by having sufficient accounting skills brought to the task before the CPA shows up. Avoidance is the best solution for auto accidents too – but they still happen, even to careful drivers. So: How can these situations be addressed once they are identified? Quick communication is essential. Usually it's the CPA who focuses on the situation first. He finds major accounts not posted for the full year, or finds essential reconciliations undone. These problems and other clues usually surface early in the CPA's efforts, sometimes during the CPA's pre-engagement planning stages. The CPA will initiate communication with the Association's Board of Directors. The Board will likely include the Association Manager in the resolution process. The resolution process includes a discussion of the problem, identification and discussion of options, and a decision concerning the course of action.

One option: the CPA can assist client personnel in identification of accounts that need work. If the accounting personnel can then complete the bookkeeping for those areas, the audit can proceed. For example, if the trial balance does not balance, that's a problem to be resolved. Last year's compilation, review or audit adjustments may be a good source of information regarding accounts that need work. CPA's can typically articulate criteria to be applied to various accounts. Implementation of this option assumes that sufficient accounting expertise is resident or can be acquired.

A second option is to recast and re-contract the engagement to be a compilation (a note to CPA's to minimize heart attacks: See SSARS section 100.44 – 49). Reverting to a compilation may not be done easily if the rules of the Association require an audit or review.

A third option exists. Second opinions can be sought from doctors - and from CPA's. The Association is not bound by the conclusions of the CPA initiating the observations.

Proper resolution of the situation can produce continuing benefits for an Association. For example, if accounting procedures can't produce auditable year-end financial statements, then those procedures are not likely to produce excellent interim financial data. Resolution of this year-end accounting issue will likely contribute to improvement in the interim accounting information.

Was She Auditing Those Financial Statements Or Was She Preparing Them? Doing an audit differs from preparing the financial statements. Community Associations have exposure to the audit-to-preparation-of financial-statement segue because Associations are often small accounting entities. Various options are available to deal with the problem. Ultimately, the interests of the Community Association are best served when all parties focus on the causal factors leading to this situation.