Condo Insights

#38 – Condominium Associations Need Annual Financial Statements

Condominium, community and homeowners association boards should include an expense allowance for accounting services when preparing the annual operating budget. Accounting services include preparation of the Association's annual tax return and annual financial statements.

Some board members view minimizing accounting expenses as one way to demonstrate fiscal discipline to Association members. Boards may save money by choosing not to have financial statements prepared, opting for a much less expensive option just to prepare and file a tax return.

On one hand, spending less for accounting services can be seen as a way to control condo fees. However, the costs for preparation of annual financial statements by an accountant not otherwise involved with the Association fulfills the Board's duty to be transparent in its management of fiscal obligations by having an independent outside third party review the Association's fiscal activity.

Associations are corporations and are required by law to file an annual tax return. Most associations file either a form 1120 or a form 1120H. An 1120 is typically used by C-Corporations while the 1120-H is a tax form specifically designed for qualifying associations. An association manages and maintains the common property and is not taxed on these activities and can file an 1120-H if it meets certain standards for income and expenses to manage and maintain the Association common property. In most situations filing form 1120-H makes most sense. The Association's accountant is most qualified to make that determination on behalf of the Association.

The typical cost for preparation of the annual tax return is no more than a few hundred dollars while the cost for preparation of annual financial statements can be several thousand dollars depending on whether the Association accountant performs a compilation, review, or audit.

A compilation is a basic summary of the Association's financial records written by a CPA using data provided by the Association without any level of assurance on the accuracy of the financial statements. A compilation includes a statement that the accountant did not review the bookkeeping or accounting records or financial statements and does not express an opinion or assurance on them.

A review provides the basic level of assurance on the accuracy of financial statements. The accountant performs analytical procedures to obtain limited assurance of the accuracy of bookkeeping records and financial statements. The accountant should have some basic understanding of the accounting principles and practices used by condominiums and homeowner associations. The accountant will issue a formal report that includes a conclusion or opinion whether the financial statements are in accordance with the appropriate and applicable financial reporting framework.

An audit is the highest level of assurance on the accuracy of financial statements. The accountant performs procedures in order to reach a reasonable assurance that the financial statements are free from material misstatements. The accountant should understand condominium, community and homeowner association's internal controls, accounting principles and business practices. The accountant is required to corroborate the amounts and disclosures by obtaining evidence through inquiry, physical inspection, and examination, third party confirmations and analytical procedures. The accountant will review meeting minutes, major expenditures and contracts and confirm the operating and reserve fund balances. The accountant will examine the internal control procedures such as the process for approving bills and authorization of expenses for major repair and replacement of association assets. The goal is to make sure that the Association has effective controls and proper procedures in place for accurate reporting of financial information. The accountant issues a formal report and expresses an opinion whether the financial statements are presented fairly in all material aspects and in accordance with the applicable reporting framework.

Many condominium owners believe that their association is audited every year. In many situations, this is simply not the case. While associations must file tax returns, they are not necessarily required to perform annual audits. An association's bylaws will typically spell out if an audit is required.

Some very small associations probably don't need annual financial statements if all owners participate in all financial decisions and regularly receive copies of the association bank statements. But almost all associations should have annual financial statements prepared by a CPA and the annual financial statements should be distributed to all association members once finalized. Potential purchasers and mortgage companies frequently request association financial statements as part of their due diligence. Audited financial statements are required by banks in the event the Association seeks outside financing for major repairs and extraordinary projects.

Board members are volunteers charged with managing association assets, yet many board members do not have any accounting or financial background or experience. Preparation of annual audited financial statements are part of best practices for condominium, community, and homeowner associations, insulating a board from potential liability. Incurring the expense for annual audits and preparation of annual financial statements is a reasonable and responsible board action for condominium, community, and homeowner associations.

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