Internal Controls For The Income Producing Real Estate Industry

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ABSTRACT

The current paper focuses on internal controls in the income producing real estate industry. The industry is unique in that most revenue is generated from contractual lease agreements. Since the revenue cycle is a principal area of waste, fraud and abuse, revenue-related internal controls are critical. An industry-specific list of controls is presented and can be used by accounting professionals and managers of income producing real estate firms to benchmark the appropriateness and sufficiency of their own internal controls. The paper can also be used in training settings to demonstrate the manner in which internal controls are often industry-specific.

Keywords: Internal Control; Control Objectives; Control Procedures; Income Producing Real Estate

INTRODUCTION

The recent downturn in the real estate industry, coupled with today's difficult economic climate, requires business managers to carefully consider all aspects of business operations to minimize waste and increase efficiency.[1] The revenue cycle continues to be the primary area of waste, fraud and abuse requiring a comprehensive system of internal controls (AICPA, 2002). Similar to Kizirian et al. (2011), this paper focuses on the high risk area of revenues. Internal controls assist management in producing accurate and reliable information, adhering to management's policies and procedures, and safeguarding assets.[2] Therefore, internal controls in the revenue cycle are of critical importance. The current paper provides a control review checklist for the revenue cycle of the income producing real estate industry. Extant studies on internal controls are typically more generic in nature and neglect the predominant characteristic of revenue generated from lease agreements. This unique characteristic distinguishes the income producing real estate industry.

The paper's checklist can be used as a general benchmark for management's preliminary evaluations of a company's internal control system in the income producing real estate industry. Auditors can compare their client's control objectives to the presented objectives. During preliminary investigations of the company's internal control system, auditors may review whether key control objectives have been omitted and whether the omission invites heightened risk. The checklist provides management with a review of internal controls that external, independent auditors consider significant.

A REVENUE CYCLE REVIEW CHECKLIST FOR INCOME PRODUCING REAL ESTATE FIRMS

Tables 1 and 2 present a checklist of control objectives and activities that should be referenced when conducting a preliminary audit of real estate industry revenue. Table 1 lists significant revenue cycle control

[1] A monthly national index for all properties set at 1.0 for the year 2000 peaked in October 2007 at 1.91118. In March 2011 the index was 1.017119 (Moody's 2011).
[2] Companies use internal controls as checks on a variety of processes, including financial reporting, operating efficiency and effectiveness, and compliance with applicable laws and regulations (PCAOB, 2007).

objectives. The objectives are followed by alpha numeric characters that reference the control activities listed in Table 2. The numeric portion of the reference explicitly refers to the control activities (listed numerically in Table 2), and the alpha portion ("F" or "P") indicates whether or not the referenced activity "fully" or "partially" meets the given objective's requirements.

Table 1
Control Objectives and Suggested Control Activities

Control Objectives	Control Activities Listed in Table 2
Leases are not executed if the tenant's credit worthiness does not meet management's established standards.	13P, 15F, 37F
Lease and lease amendments are approved by management prior to execution.	16F, 22F, 32P, 34P
All leases and lease amendments are documented and filed.	20F, 41P, 45P
Invoices are accurately calculated and recorded.	5P, 19P, 29F, 35P, 38P
Adjustments to accounts receivable are accurately calculated and recorded.	5P, 7F, 9P, 36P
Invoices relate to valid lease agreements.	4F, 12P, 42P, 43P
All invoices issued are recorded.	3P, 21F, 45P
Invoices are recorded in the appropriate period.	3P, 23P
Accounts Receivables reflect the existing business circumstances and economic conditions in accordance with the accounting policies being used.	8F
Cash receipts are recorded in the period in which they are received.	10F, 24F, 28P
Cash receipts data is entered for processing accurately.	12P, 24P, 25P, 26P, 27F, 28P, 30P, 31P
All cash receipts data is entered for processing.	12P, 24P, 26P, 27F, 28P, 30P, 31P
Cash receipts data is valid and is entered for processing only once.	24P, 27P, 28P, 34P
Timely collection of accounts receivable is monitored.	1P, 2F, 30F, 40F
Only valid changes are made to property rent rolls.	6P, 11F, 14P, 17P, 18F, 39F, 46P
All valid changes to tenant lease files are input and appropriately processed in property rent rolls.	14P, 17P, 18F, 39F
Changes to tenant lease files are accurately input in property rent rolls.	11F, 14P, 17P, 18F, 33P, 39F, 46P
Changes to tenant lease files and property rent rolls are processed timely.	14P, 17P, 18F, 39F
Tenant lease files and property rent rolls remain relevant to the current business environment.	14P, 17P, 18F, 39P
Lease data is transferred completely and accurately to the system which generates the property rent roll, accounts receivable aging and general ledger postings.	19F

Table 2
Suggested Control Activities

Numerical Values	Control Activities
1	Accounts receivable aging reports are prepared regularly and analyzed.
2	Collection procedures established by management for overdue accounts are performed as intended.
3	Recorded rental revenue, tenant reimbursement revenue, and other income are compared to budgeted values regularly; management reviews and approves significant variances.
4	Data input to the invoicing component of the information system is compared to source documents or system reports generated from source documents; differences require management approval before invoices can be processed.
5	Invoices are edited and validated; identified errors are corrected immediately.
6	Significant changes to tenant leases and property rent rolls are approved by management. Management clearly defines a material or significant change.
7	Management approves bad-debt write-offs and other adjustments to accounts receivable.
8	Management reviews and approves the allowance for doubtful accounts receivable.
9	Management monitors the nature, volume, and amounts of recorded write-offs and other adjustments to accounts receivable.
10	Cash receipts are periodically scrutinized and/or reconciled to ensure complete and consistent recording in the appropriate accounting period.
11	Recorded changes to property rent rolls are compared to tenant leases to ensure that data was entered into the system accurately.
12	Accounts receivable statements are mailed periodically to tenants.

13	Prospective tenants' financial position and creditworthiness are obtained and reviewed prior to lease execution.
14	Property rent rolls are periodically compared to tenant leases by management for accuracy and ongoing appropriateness.
15	Leases are only signed subsequent to review of prospective tenant's credit worthiness.
16	Leases and lease amendments are approved by management prior to execution.
17	Lease entry and lease termination data is edited and validated; identified errors are corrected promptly.
18	Recorded lease initiation and lease termination data is compared to source documents by an individual who is independent of the lease entry process.
19	Data in the property rent roll is compared to lease agreements for accuracy; identified errors are corrected promptly.
20	Property rent rolls and tenant lease files are periodically compared to tenant spaces by an individual independent of the lease signing process.
21	Invoices are sequentially pre-numbered. The sequence of invoices processed is accounted for. "PPN" – preprinted, pre-numbered, numerically sequenced.
22	Significant or unusual lease agreements are specifically approved by management as to rates and terms.
23	Data input to the property rent roll is compared to lease agreements for accuracy on a timely basis; identified errors are corrected promptly.
24	Bank statements are reconciled to the general ledger regularly.
25	Cash receipts input data is edited and validated; identified errors are corrected promptly.
26	Cash receipts transactions are batched and batch input data is balanced; out-of-balance batches are corrected promptly.
27	Tenants are provided with a form acknowledging receipt of any cash payments (i.e., a cash receipt form) and cash receipts forms are balanced to cash deposited to the bank. Cash receipt forms are sequentially pre-numbered and the sequence of such forms is accounted for. (PPN).
28	General ledger balances are reconciled to the accounts receivable subsidiary ledger and differences are resolved in a timely manner.
29	Invoiced amounts, including tenant recoveries of common costs and contingent rent, are independently recalculated.
30	The accounting information system tenant open items report is prepared and analyzed regularly.
31	The accounting information system does not allow processing of cash receipts outside of approved bank accounts.
32	The accounting information system restricts to authorized personnel the ability to create, change, or delete lease agreements, and any other contracts or agreements.
33	The accounting information system edits and validates changes to property rent records in real time.
34	The accounting information system restricts to authorized personnel the ability to modify the lease pricing information.
35	The accounting information system automatically calculates invoices based on system configuration data.
36	The accounting information system restricts to authorized personnel the ability to create, change, or delete "sales order returns" (from lease changes) and credit note requests and subsequent credit note transactions.
37	The accounting information system does not allow processing of lease agreements that exceed tenant credit limits.
38	The accounting information system posts invoices to general ledger accounts based on rent invoice configuration data.
39	The accounting information system reports changes to tenant master data and tenant credit information are compared to authorized source documents and/or a manual log of requested changes to ensure they were input accurately and timely.
40	The accounting information system accounts receivable aging reports are prepared regularly and analyzed.
41	The accounting information system regularly produces rent reports that management analyzes.
42	The accounting information system triggers an open order to produce a lease for leases initiated. Management closes each open order in a timely manner, thereby preventing further lease production for the same lease agreement.
43	The accounting information system restricts to authorized personnel the ability to create, change, or delete leases or receivables.
44	The accounting information system defines tolerance levels for allowable cash discounts and cash payment differences; amounts in excess of such levels are not allowed to be entered into the information system.
45	The accounting information system reports gaps in document numbering which are reviewed regularly by management.
46	The accounting information system edits and validates financial documents in real time.

CONCLUSION

The current paper provides an internal control checklist for income producing real estate revenue that, when used as a benchmark, will aid managers and independent auditors in assessing a firm's control policies and procedures. Specifically, the checklist will be useful in preliminarily assessing whether the appropriate revenue-related internal controls are in operation. In light of today's competitive global economic environment and the increasing importance of revenue-related internal controls, the checklist is both important and timely. In addition to use by professionals, the checklist can be used in the classroom to highlight the importance of revenue-related internal controls.

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