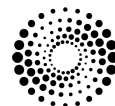


**CHECKPOINT LEARNING®**

**SELF-STUDY CONTINUING PROFESSIONAL EDUCATION**

**Companion to PPC's Guide to**

# **Homeowners' Associations and Other Common Interest Realty Associations**



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**Companion to PPC's Guide to  
Homeowners' Associations and Other Common Interest Realty Associations**

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## INTRODUCTION

*Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* consists of three interactive self-study CPE courses. These are companion courses to *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com/ogs** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **September 30, 2018**. Complete instructions for grading are included below and in the Test Instructions preceding the Examination for CPE Credit.

### Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of homeowners' associations and other CIRAs. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions at the end of the course**. You may record your answer choices by printing the **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

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You may fax your completed **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation** to **(888) 286-9070** or email them to [CPLGrading@thomsonreuters.com](mailto:CPLGrading@thomsonreuters.com). The mailing address is provided on the Overview and Exam Instructions pages.

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### Retaining CPE Records

For all scores of 70% or higher, you will receive a *Certificate of Completion*. You should retain it and a copy of these materials for at least five years.

## COMPANION TO PPC'S GUIDE TO HOMEOWNERS' ASSOCIATIONS AND OTHER COMMON INTEREST REALTY ASSOCIATIONS

### COURSE 1

### PERFORMING SUBSTANTIVE PROCEDURES AND CONCLUDING THE AUDIT (HOATG171)

#### OVERVIEW

**COURSE DESCRIPTION:** This interactive self-study course discusses elements of the audit of a homeowners' association or other common interest realty association (CIRA). Lesson 1 covers substantive procedures and discusses topics including tests of details, substantive analytical procedures, substantive audit procedures for CIRAs, and special considerations for interim audits. Lesson 2 examines topics related to concluding a CIRA audit, including commitments and contingencies, accounting estimates and fair value, summarization and evaluation, and client communications.

**PUBLICATION/REVISION DATE:** September 2017

**RECOMMENDED FOR:** Users of *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*

**PREREQUISITE/ADVANCE PREPARATION:** Basic knowledge of auditing

**CPE CREDIT:** 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **[www.nasbaregistry.org](http://www.nasbaregistry.org)** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

**FIELD OF STUDY:** Auditing

**EXPIRATION DATE:** Postmark by **September 30, 2018**

**KNOWLEDGE LEVEL:** Basic

#### Learning Objectives:

#### Lesson 1—Performing Substantive Procedures

Completion of this lesson will enable you to:

- Determine the best methods for performing substantive procedures in a CIRA audit, including how to address tests of details, substantive analytical procedures, substantive audit procedures, and other elements of the audit that may require special consideration.

#### Lesson 2—Concluding the Audit

Completion of this lesson will enable you to:

- Identify how to approach the following elements of concluding a CIRA audit: commitments and contingencies, accounting estimates and fair value, subsequent events, and related parties.

- Recognize how to deal with the following elements of concluding a CIRA audit: going concern considerations, management representation letters, considering the accumulated results of audit procedures, analytical procedures, review of workpapers, and summarization and evaluation.
- Determine the best methods for drafting the financial statements and auditor's report, dealing with group financial statements, communicating the correct information with clients in a CIRA audit, and using an engagement summary memorandum.

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# Lesson 1: Performing Substantive Procedures

## INTRODUCTION

Obtaining a solid, in-depth understanding of the CIRA's business and how it operates is fundamental to audit effectiveness and efficiency. This topic and other audit-related topics beyond the scope of this course are discussed in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

This lesson discusses substantive procedures and considerations specific to designing and performing substantive procedures for a CIRA audit. Lesson 2 discusses the general procedures that are necessary during the concluding phase of the audit.

Further audit procedures performed for the purpose of detecting material misstatement at the relevant assertion level are referred to as substantive procedures. For each relevant assertion within a material account balance, class of transactions, or disclosure, the auditor needs to determine the nature, timing, and extent of substantive procedures necessary to obtain sufficient appropriate audit evidence to express an opinion on the financial statements. Substantive procedures consist of tests of details and substantive analytical procedures, both of which are discussed later in this lesson.

### Learning Objectives:

Completion of this lesson will enable you to:

- Determine the best methods for performing substantive procedures in a CIRA audit, including how to address tests of details, substantive analytical procedures, substantive audit procedures, and other elements of the audit that may require special consideration.

### Authoritative Literature

The authoritative pronouncements establishing requirements that most directly affect designing substantive procedures are as follows:

- a. AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to identify and assess risks of material misstatement due to fraud, and to design the audit to provide reasonable assurance of detecting fraud that results in the financial statements being materially misstated.
- b. AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, discusses how the results of substantive procedures may affect the preliminary risk assessment and planned audit procedures.
- c. AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, addresses designing and performing audit procedures that are responsive to risks at the relevant assertion level.
- d. AU-C 500, *Audit Evidence*, describes audit procedures used to obtain audit evidence.
- e. AU-C 505, *External Confirmations*, explains the auditor's use of external confirmation procedures to obtain audit evidence.
- f. AU-C 520, *Analytical Procedures*, explains the use of analytical procedures as substantive tests to obtain sufficient appropriate audit evidence.

## Substantive Procedures Required in Every Audit

Because of the judgmental nature of the auditor's risk assessments and the inherent limitations of internal control, particularly the risk of management override, the auditing standards prescribe certain substantive procedures that should be performed in every audit. According to AU-C 330.18, no matter what the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions for each material class of transactions, account balance, and disclosure. The additional substantive procedures that are needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances.

AU-C 330.21 requires the auditor to perform the following substantive procedures related to the financial close and reporting process in every audit:

- Agree or reconcile the financial statements, including the accompanying notes, to the underlying accounting records. (AU-C 330.33 notes that the auditor's documentation should demonstrate that agreement or reconciliation.)
- Examine material journal entries and other adjustments made during the course of preparing the financial statements.

AU-C 240.32 also requires certain substantive procedures in all audits to address the risk of management override of controls. These required procedures are as follows:

- Examine journal entries and other adjustments for evidence of possible material misstatement due to fraud.
- Review accounting estimates for biases that could result in material misstatement due to fraud.
- Evaluate the business rationale for significant unusual transactions.

Both AU-C 330.21 and AU-C 240.32 require examining journal entries and other adjustments, but the requirement of AU-C 240.32 is focused on identifying fraudulent journal entries. As discussed in Paragraph 6.89 of the AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit*, the nature, timing, and extent of procedures required by AU-C 240 are different from those required by AU-C 330. AU-C 330 focuses on journal entries made during the course of preparing the financial statements, and AU-C 240 requires the auditor to consider reviewing journal entries made throughout the year. Auditors should ensure that their audit procedures satisfy both requirements.

There are also other presumptively mandatory requirements for substantive procedures for particular account balances. Examples include the following:

- Confirmation of accounts receivable. (AU-C 330.20)
- Inventory observation, that is, being present at the time of the count and, by suitable observation, tests, and inquiries being satisfied about the effectiveness of the methods of inventory taking. (AU-C 501.11)

In addition, there are other specific requirements to perform procedures, typically called *general procedures*, that do not relate to particular account balances, such as performing a review for subsequent events and reading minutes of board of director meetings.

Significant risks are risks that require special audit attention. When the audit approach to significant risks consists only of substantive procedures (that is, the auditor does not plan to rely on controls), the substantive procedures should be tests of details only or a combination of tests of details and substantive analytical procedures. The use of only substantive analytical procedures is not permitted (AU-C 330.22).

AU-C 330.30 and AU-C 240.44 require the auditor to document the following items relating to substantive procedures, including responses to fraud risks:

- The nature, timing, and extent of substantive procedures.
- The linkage of those procedures with the assessed risks at the relevant assertion level.
- The results of the procedures, including procedures to address the risk of management override of controls.

**Considering the Sufficiency and Appropriateness of Audit Evidence.** Even if the auditor concludes that the risk of material misstatement is low for a particular assertion related to a material account balance, transaction class, or disclosure based on performing risk assessment procedures and tests of controls, some substantive procedures are still required. The additional substantive procedures that are needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence to be obtained in the circumstances. AU-C 500.05 describes these characteristics of audit evidence as follows:

- *Sufficiency* is the measure of the *quantity* of audit evidence.
- *Appropriateness* is the measure of the *quality* of audit evidence, that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

The quantity and quality of audit evidence needed are interrelated and are dependent on the risk of material misstatement. As the residual risk of material misstatement increases, the quantity and quality of necessary audit evidence from substantive procedures also increases.

The auditor performs risk assessment procedures to obtain an understanding of the CIRA and its environment, including its internal control, to assess the risks of material misstatement. This assessment includes consideration of the effectiveness of management's responses and controls to address risks. The auditor evaluates the quality and quantity of the evidence obtained from the risk assessment procedures and, if applicable, tests of controls to determine the further audit procedures necessary to obtain sufficient appropriate evidence to afford a reasonable basis for expressing an opinion on the financial statements.

An important quality of audit evidence is its reliability, which is affected by both the nature and source of the evidence. AU-C 500.A32 provides the following generalization about the reliability of audit evidence:

- a. Audit evidence is more reliable when it is obtained from knowledgeable independent sources outside the entity.
- b. Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.
- c. Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- d. Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium. For example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed.
- e. Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies, faxes, or electronic images. Electronic images include documents that have been filmed, digitized, or otherwise transformed into an electronic form. The reliability of electronic images may depend on the controls over their preparation and maintenance.

AU-C 500.10 states that if audit evidence obtained from different sources is inconsistent or doubt exists about the reliability of information to be used as audit evidence, the auditor should determine what changes or additions to audit procedures are necessary to resolve the matter and consider the effects on other aspects of the audit. The auditor needs to be wary when explanations obtained from different sources conflict; management's explanations for significant fluctuations differ from the auditor's expectations; or responses to inquiries about analytical relationships are vague, implausible, or inconsistent with the auditor's knowledge or other audit evidence. In this area, the main ingredients for effectiveness are healthy doses of common sense and professional skepticism.

### **Choosing between Substantive Analytical Procedures and Tests of Details**

The authoritative literature does not explain how to apportion reliance on substantive procedures between tests of details and analytical procedures except for the prohibition against using substantive analytical procedures alone when testing significant risks, as discussed above. Analytical procedures may be used to reinforce conclusions based on the results of other substantive procedures or as the sole source of evidence. That decision is primarily based on the effectiveness of the procedures. Efficiency also may be a factor in deciding between analytical procedures and tests of details. That is, given two procedures of equal effectiveness, the auditor chooses the one that is most efficient. Therefore, the auditor would ordinarily use an analytical procedure rather than a test of details if the analytical procedure is at least as effective in reducing detection risk to the desired level as the test of details and is easier to apply.

According to AU-C 520.05, in designing substantive analytical procedures, the auditor should consider matters such as the following:

- a. The suitability of using substantive analytical procedures, given the assertions.
- b. The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed. [AU-C 500.09 indicates that the auditor should obtain audit evidence about the accuracy and completeness of information (both financial and nonfinancial) used in performing substantive analytical procedures.]
- c. Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance.
- d. The amount of any difference between recorded amounts and expected values that is acceptable.

Generally, the higher the assessed risk of material misstatement of a particular assertion, the more effective analytical procedures need to be before they can be relied on instead of tests of details. Accordingly, auditors tend to use tests of details more extensively in high risk audit areas (such as areas containing fraud risks or other significant risks) and analytical procedures more often in low risk areas or as secondary rather than primary auditing procedures. However, if the auditor performs highly effective analytical procedures, it may be possible to reduce the extent of detail testing, even in areas in which significant risks exist. The effectiveness of analytical procedures in reducing detection risk in comparison with the effectiveness of tests of details generally depends on the evaluation of the considerations listed in the previous paragraph. The following general observations are useful in evaluating the suitability of using substantive analytical procedures given the assertion to which the procedures are directed:

- a. Analytical procedures are generally not effective in testing assertions about rights or obligations or assertions related to presentation and disclosure because those assertions do not lend themselves to testing through comparisons with expectations. For example, analytical procedures would not be effective responses for risks related to matters such as parties to transactions lacking in economic substance or intentional ambiguity in financial statement disclosures.
- b. Relationships involving transactions over a period of time (that is, revenue and expense accounts) tend to be more predictable than relationships at a point in time (that is, balance sheet accounts). Because of the difficulty in developing expectations about a balance at a point in time with sufficient precision, analytical procedures are often not as effective as tests of details for assertions about the existence of assets and liabilities. For example, analytical procedures would not be as effective as tests of details when responding

to risks such as potentially recording false receivables or including items in inventory that are false or mislabeled.

- c. Analytical procedures are often equally or more effective than tests of details for assertions about the completeness of assets, liabilities, revenues, and expenses. When testing for completeness, misstatements would often not be apparent from inspecting detailed evidence in the accounting records.
- d. Analytical procedures are often equally or more effective than tests of details for assertions about the occurrence of revenues. For example, comparing recorded revenue with the amount expected, based on a reliable record of member units and average assessments, may be as likely to detect a material misstatement of assertions about the occurrence of revenues as inspecting supporting documentation for a sample of recorded revenue. Analytical procedures are more reliable if they are based on reliable data produced outside the accounting system (for example, approved assessment cost per unit or operating data used to manage the CIRA).
- e. Analytical procedures are often equally or more effective than tests of details for assertions about the occurrence of certain expenses. For example, comparing recorded labor costs with the amount expected, based on the number of people employed and the average hours worked, may be as likely to detect a material misstatement resulting from errors as looking at supporting documentation for a sample of recorded compensation expense. However, if fraud is a concern, analytical procedures may not be effective. For example, if management is able to manipulate expense accounts so that ratios appear reasonable, ratio analysis would not be an effective analytical procedure for detecting material misstatements.
- f. Analytical procedures may be as effective as tests of details for assertions about the valuation of some assets and liabilities but not for others. Generally, whether an analytical procedure is as effective as a test of details for a valuation assertion depends on whether an expectation can be developed. For example, an analytical procedure may be as effective as a test of details for assertions about the valuation of member receivables that are made up of a large number of relatively small balances. However, a test of details may be more effective when some account balances are disproportionately large. In that situation, failure to record an allowance for uncollectible amounts resulting from a deterioration in the financial condition of one of those members either before or after year-end would most likely not be detected by an analytical procedure.
- g. Substantive tests of details may be more effective for valuation assertions in an unstable environment. The ability to develop an expectation that approximates the recorded amount is greater when the environment is stable. For example, when interest rates are fluctuating widely, it is difficult to develop a precise expectation about interest expense. Similarly, when transactions involve management discretion, such as the choice of repairing versus replacing equipment, there is also less predictability in expected relationships.

AU-C 330.A65 notes that an important consideration in the effectiveness of audit evidence from tests of details is selecting the items to test. Items need to be selected in a way that is effective in meeting the purpose of the test. Alternatives in selection of items to test include—

- *Selecting All Items.* Generally, an entire population is selected when either the population contains a small number of large-value items or a significant risk exists and other means do not provide sufficient appropriate audit evidence.
- *Selecting Specific or Individually Significant Items.*
- *Audit Sampling.* In-depth discussions of selecting specific or individually significant items and audit sampling are beyond the scope of this course, but more information is available in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

Auditors may use one or a combination of those alternatives in selecting items for testing. Considerations for the method used include efficiency and the risks of material misstatement related to the account or transaction being tested.

## PERFORMING TESTS OF DETAILS

Tests of details may be applied to transactions or to balances. Those tests can be described as follows:

- a. *Tests of Transactions.* These are tests of the processing of individual transactions by inspection of the documents and accounting records involved in processing, e.g., tracing a sample of invoices to the purchase journal or other accounting records to see whether invoices have been recorded as expenses.
- b. *Tests of Balances.* These are tests applied directly to the details of balances in the accounting records, e.g., confirming investments held by others, such as a broker.

Tests of transactions and tests of balances are related because each class of transactions affects a related account balance. For example, assessment revenue affects the assessments receivable balance. An auditor may test the transactions that enter an account balance, the individual items included in the ending balance, or both. Generally, tests of balances are more efficient and effective than tests of transactions because transaction tests are applied to individual transactions and may be more time-consuming than direct tests of a balance that results from many transactions.

### Confusion about Tests of Details

Inspection of documents and accounting records may be involved in both tests of controls directed toward operating effectiveness (if controls leave a documentary trail) and tests of details of transactions. For that reason, some auditors have equated tests of details and tests of controls. The difference is in the objective of the test and the nature of any exceptions. The mere fact that a transaction or balance is being tested does not make the test a test of controls. For example, the inspection of invoices in support of additions to equipment is a *substantive* test. The objective of the test is to substantiate the transaction, i.e., the addition. The same principle applies to other types of transactions or balances. For example, if revenue transactions are tested to substantiate total revenue without testing the effectiveness of control policies and procedure for processing member assessment transactions. It is the objective of the test and not whether it is applied to a class of transactions or a balance that determines whether the test is a test of controls or a substantive procedure. Additionally, exceptions when performing tests of details of transactions or balances are monetary in nature and result in a misstatement in terms of dollars. Material exceptions generate a proposed audit adjustment entry. In contrast, exceptions when performing tests of controls are measured as rate of noncompliance with the control procedure. When the rate of exceptions is too high, the control is not effective. The auditor's assessment of control risk would be changed and the auditor would determine an appropriate response to the modified risk assessment. Substantive procedures, including tests of details, are normally applied after the auditor has obtained an understanding of internal control, but substantive tests of details in the current period may contribute to the auditor's understanding in subsequent periods. Tests of details can be performed concurrently with tests of controls.

### Required Documentation

Items tested in a test of details should be documented. An in-depth discussion of audit documentation is beyond the scope of this course, but more information can be found in *PPC's Guide to Audits of Homeowners' Associations and Other Common Interest Realty Associations*.

## PERFORMING SUBSTANTIVE ANALYTICAL PROCEDURES

### What Are Analytical Procedures?

Analytical procedures are evaluations of financial information made by a study and comparison of plausible relationships among both financial and nonfinancial data. GAAS identifies three categories of analytical procedures: preliminary (planning) analytical procedures, substantive analytical procedures, and overall review analytical procedures. Both preliminary and overall review analytical procedures are required in an audit. Preliminary analytical procedures are performed in the planning stage of the audit. Overall review analytical procedures are performed in the final review stage of the audit. Use of substantive analytical procedures is discretionary. A discussion of choosing between substantive analytical procedures and tests of details appeared earlier in this lesson. The following paragraphs further discuss substantive analytical procedures in an audit engagement.

Analytical procedures include trend analysis, ratio analysis, and predictive or reasonableness tests. *Trend analysis* compares either the absolute dollar amount or percentage change in accounts over time. When the auditor reads comparative financial statements and questions the fluctuations in accounts between years, the auditor is applying a form of trend analysis. Exhibit 1-1 provides common financial statement trends.

### Exhibit 1-1

#### Common Financial Statement Trends

Most entities exhibit relationships in the increases and decreases of financial statement amounts. Unexpected increases or decreases may indicate that the information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory.

The following accounts often exhibit a direct relationship (that is, if the primary account increases, the related accounts can also be expected to increase):

**Assessment Revenue and**

Assessments Receivable

**Wages and Salaries Expense and**

Payroll Taxes

Health Insurance

**Interest Expense and**

Long-term Debt

**Assessments Receivable and**

Bad Debt Expense

Legal Expense (for bad debt collection)

**Cash and Investments and**

Investment Income (such as interest and dividends)

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*Ratio analysis* involves the study of the relationship between two financial statement amounts or between financial and relevant nonfinancial amounts. Most ratios are less meaningful to CIRAs because of their simple financial structure and lack of a profit motive. However, ratios and relationships considered for CIRAs may include the following:

- Relationships among balance sheet accounts, such as between the allowance for uncollectible accounts and the balance of assessments receivable.
- Relationships between balance sheet and income statement accounts, such as interest expense and long-term debt, and assessment revenue and average assessments receivable.
- Relationships among income statement accounts, such as bad debt expense and assessment revenue.

*Reasonableness tests* estimate a financial statement amount or the change in an amount from the prior year. Some reasonableness tests involve ratios. For example, the reasonableness of interest expense can be evaluated by dividing the average principal amounts outstanding during the period by the contractual or average interest rates. Other reasonableness tests involve estimating account balances by using nonfinancial data. For example, the reasonableness of assessment revenue can be evaluated by multiplying the number of members by approved member assessments.

Using analytical procedures generally involves:

- a. Developing an expectation of what an account balance should be.

- b. Comparing the expected amount with the recorded amount.
- c. Determining whether any difference between the recorded and expected amount is significant.
- d. Investigating the cause of any unexpected significant difference.
- e. Evaluating the likelihood of material misstatement.
- f. Documenting the analytical procedures.

As indicated by items a. and b., analytical procedures involve comparisons of recorded amounts, or ratios of recorded amounts, to expectations developed by the auditor. These expectations can be developed from a variety of sources of financial and nonfinancial information, but the most important aspect of developing expectations is having a thorough knowledge and understanding of the CIRA and its industry and the risks the CIRA faces in doing business.

Most explanations of analytical procedures focus on the steps involved in comparing the recorded amount to the expectation, but most prefer to think of analytical procedures as a coordinated family of procedures that include scanning and inquiry as well as computations and comparisons. Scanning accounting records to identify unusual or unexpected relationships or the absence of expected relationships is an integral aspect of applying analytical procedures. What account balances have increased significantly since the prior year? Are there new accounts? Inquiry is also a critical companion procedure in all aspects of applying analytical procedures. Inquiry procedures are a crucial part of the process of identifying all of the following: useful analytical procedures, worthwhile sources of information for developing expectations, and explanations for differences between recorded amounts and expectations.

### **Designing Substantive Analytical Procedures**

According to AU-C 520.05, when designing substantive analytical procedures, the auditor should consider whether:

- The use of substantive analytical procedures is appropriate considering the relevant assertions. The appropriateness of analytical procedures with respect to various assertions was discussed earlier in this lesson.
- The data from which the expectation of recorded amounts or ratios is developed is reliable. The discussion about the reliability of audit evidence that appeared earlier in this lesson included considerations that are relevant with respect to the reliability of data used in substantive analytical procedures.
- The expectation is sufficiently precise to identify the possibility of a material misstatement at the desired level of assurance. This is discussed below.
- The amount of any difference in recorded amounts from expected values is acceptable. Evaluation of differences is discussed later in this lesson.

Exhibit 1-2 provides factors that affect the expected effectiveness of an analytical procedure.

#### **Exhibit 1-2**

##### **Factors Affecting the Expected Effectiveness of an Analytical Procedure**

- *Nature of the Account.* (Revenues, expenses, and changes in fund balance accounts are generally more favorable to the use of analytical procedures as substantive tests than are balance-sheet accounts. Also, substantive analytical procedures generally are more effective for accounts that have a large volume of transactions that are predictable over time.)
- *Nature of the Assertion Being Tested.* (Analytical procedures can be more effective than tests of details for testing the completeness assertion.)



- *Likely Cause of Potential Misstatement.* (Analytical procedures tend to be more effective when the risk of misstatement is assessed as being primarily from error rather than from fraud.)
- *Degree of Relationship among the Data to Which the Analytical Procedure Is Applied.* (Analytical procedures are more effective when there is a close relationship between the account and the data used to predict the balance. For example, for a CIRA, there is likely a close relationship between the number of owners and assessment revenue.)
- *The Stability of the Client Environment.* (Analytical procedures are generally more effective in a stable environment.)
- *Existence of Offsetting Factors* that affect the amount being tested, for example, if product mix affects total sales. (Analytical procedures are generally more effective when offsetting factors are taken into consideration. For example, analytical procedures that predict total assessment revenue based on units owned times average assessment rate will be less precise if there are significant variations in rates by unit size and significant changes in the unit mix during the period.)
- *The Source and Reliability of Data Used in the Test.* (Examples of reliable data include internal financial information from comparable prior periods, budgets, extrapolations from interim or annual data, or data developed under a reliable system with adequate controls; internal nonfinancial or operating data from sources independent of those responsible for the amount being audited; and external industry statistics or comparable company data.)
- *The Level Aggregation of Information Used to Develop the Expectation.* (For instance, a more effective test generally results from use of monthly and/or budget rather than annual data.)

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**Precision of Expectation.** *Precision* is the term used to describe the expected degree of accuracy of the prediction of the amount or the account balance developed by the auditor. The auditor's expectation becomes more precise as the range of expected difference between the prediction and the true amount of the account balance narrows. When an auditor is combining the evidence from substantive analytical procedures with evidence from tests of details, a less precise expectation may be appropriate. However, a more precise expectation may be necessary when the substantive analytical procedure is the only procedure planned to address a particular risk of material misstatement. Other things remaining equal, the larger the recorded amount, the more difficult it is to develop a precise expectation. This is because a small percentage of a very large recorded amount can be material to the financial statements taken as a whole. In some cases, to develop a precise expectation, the auditor might need to break the recorded amount down into more predictable components. Expectations developed at a more detailed level have a greater chance of detecting a misstatement of a given amount. For example, expectations developed concerning monthly amounts are generally more precise than annual amounts. Comparisons by location or department are generally more precise than entity-wide comparisons. Sometimes, an account balance can be separated into different categories of transactions. For example, assessment revenue might be separated by type of unit in a mixed-use association (for example, residential, timeshare, and commercial), or compensation expense might be separated by salaried and hourly employees.

**Evaluating the Results of Analytical Procedures.** Results of analytical procedures are usually evaluated against a CIRA's past operations, taking into account expected operations. Professional judgment needs to be applied in deciding when the results of analytical procedures indicate significant fluctuations from expected amounts that need to be investigated further. AU-C 520.A24 states that the amount of difference that can be accepted without further investigation is influenced by materiality and the level of assurance desired from the analytical procedures while taking into account the possibility that a misstatement may cause the financial statements to be materially misstated. It is a good idea for auditors to determine the magnitude of changes that will be considered significant

before applying analytical procedures so that those judgments will be as objective as possible. In making that decision, the following factors usually are considered:

- a. *Expected Size of the Fluctuation.* Some fluctuation from prior years (or expected results) often would be considered reasonable based on the CIRA and the circumstances. However, fluctuations in excess of expected amounts generally should be considered significant.
- b. *Materiality.* Fluctuations should be considered in light of materiality for the financial statements, by financial statement line as well as in the aggregate, rather than being evaluated in terms of the percentage of the account balance.
- c. *Percentage Change.* Usually the percentage change rather than the absolute amount of the change should be considered in deciding whether a change in an account balance is significant, especially in smaller accounts.
- d. *Precision of the Analytical Procedure.* Relationships that are more direct and involve fewer variables can be expected to provide more accurate estimates of actual account balances.

An important consideration when evaluating the results of analytical procedures is the evaluation and corroboration of management's explanation for significant differences from the auditor's expectation. In this regard, the main ingredient for effectiveness is a healthy dose of common sense and professional skepticism. In corroborating explanations, the auditor ought to be wary when information that should be readily available is not supplied promptly or when explanations obtained from different sources conflict. For example, explanations from management or the managing agent might be inconsistent with information provided by CIRA employees or reflected in minutes of the board of directors' meetings.

### Limitations of Analytical Procedures

Applying analytical procedures can be an effective method of identifying misstatements in financial statements. However, they do have certain limitations (in addition to the limitations discussed at the beginning of this lesson).

- a. Inquiries may be more effective for certain assertions or accounts. For example, analytical procedures are ineffective when accounts are subject to significant management discretion, such as those involving certain estimates, because relationships are unpredictable.
- b. Analytical procedures are ineffective when factors affecting accounts are not constant over time.
- c. Analytical procedures are less precise and accurate as account relationships become more remote.
- d. Reasonableness tests, to some extent, usually depend on operating data, which may not be available.
- e. Ratios may not be comparable with industry averages, with ratios computed for similar CIRAs, or within the same CIRA over time because of changes in accounting principles or because of differences in the way they are computed.

### Required Documentation

When analytical procedures have been performed, the auditor should document (AU-C 520.08):

- The expectation and the factors considered in its development (unless readily determinable from the work performed).
- The results of comparing recorded amounts to the expectation.
- Any additional procedures performed to address significant unexplained differences and the results of those procedures (for example, the amount of any misstatement quantified as a result of the analytical procedures performed).

Although not required by authoritative literature, documentation might also include information about the auditor's approach to evaluating the significance of the difference between the recorded amount and the expectation (for example, a percentage of performance materiality). Also, many auditors document analytical procedures, particularly the results of ratio and trend analysis, in carryforward workpapers or in a permanent file to facilitate historical comparisons.

## SUBSTANTIVE AUDIT PROCEDURES PERFORMED SPECIFICALLY FOR CIRAS

AU-C 300.09 requires preparing an audit plan, commonly referred to as a written audit program. The audit programs in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* provides detailed guidance on designing substantive tests. For each audit area, the programs link the financial statement assertions with audit objectives. Those objectives are in turn linked with a detailed list of procedures to consider. This section discusses general considerations in designing audit procedures to test the major accounts unique to CIRAs.

### Cash and Cash Equivalents

Cash is often more material to a CIRA's balance sheet than is the case for a typical commercial business and may require proportionately more audit time. CIRAs are notorious for maintaining numerous bank accounts and for opening and closing accounts frequently. Separate accounts in a financial institution may be required for replacement funds, but multiple discretionary accounts also may exist. Particularly when a managing agent is used, a CIRA may maintain separate accounts, such as pool key deposits or social fund accounts, that are unknown to the managing agent and not recorded on the accounting records it maintains.

**Confirmation of Accounts.** Auditors ordinarily inquire about the existence of accounts in financial institutions that are not reflected in the accounting records and review the minutes of board of directors' meetings for accounts opened or closed during the period. Once all accounts that were open during the period are identified, the auditors need to decide which ones to confirm. If the CIRA uses only a few accounts, the auditors may decide to confirm all of them. However, valuable time can be saved by confirming only the primary accounts and relying on statements from financial institutions to substantiate the balance of other accounts if they are numerous and relatively small. In some states, it has become increasingly difficult to obtain accurate confirmation responses without one or more follow-up requests. If the CIRA has a simple depository relationship with a financial institution, it may be more efficient to verify balances by performing alternative procedures on year end statements in lieu of sending standard financial institution confirmations. In addition, some financial institutions no longer respond to paper confirmation requests. Instead, they only respond to electronic confirmation requests submitted via designated third-party providers. Such providers serve as intermediaries who provide a secure link between the auditor and a validated financial institution. Currently, numerous financial institutions have designated Confirmation.com as the third-party provider for submitting electronic confirmation requests. Additional information on Confirmation.com can be obtained via its website at [www.confirmation.com](http://www.confirmation.com). Auditors need to be alert for other financial institutions that might also choose to only process electronic confirmation requests.

If a CIRA holds funds in trust for members, such as in a social fund account, the cash may not be an asset of the CIRA. However, if the amount is material, the auditors may want to treat the account the same as other accounts as a matter of client service. The volunteer board members of a CIRA are normally financially unsophisticated and may expect the auditors to apply procedures to material cash balances even if those balances are not included in the CIRA's financial statements.

State laws or governing documents may specify who can sign checks on CIRA bank accounts. Some auditors may consider it worthwhile to confirm authorized check signers because CIRAs often have frequent turnover of directors and managing agents who are authorized to sign checks and, in some cases, the CIRA's procedures for notifying the financial institutions of changes in authorized check signers may be lax.

**Restrictions and Uninsured Balances.** State laws or governing documents may restrict the types of accounts in which CIRAs may invest excess cash. Auditors ordinarily obtain an understanding of those matters during the risk assessment process and consider them in determining the nature, timing, and extent of further audit procedures.

Restrictions on accounts holding replacement funds are common. Transfers between restricted and unrestricted accounts may be prohibited, and use of interest earned may be designated. GAAP requires restrictions or designations of cash balances to be disclosed. Also, auditors need to consider whether the CIRA has material amounts of cash in certificates of deposit or money market accounts that are uninsured or that exceed insurance limits. FASB ASC 815 requires that such concentrations of credit risk be disclosed.

**Commingled Cash.** When the CIRA uses a managing agent, the auditors need to consider whether the agent commingles the funds of the various CIRAs managed. (However, state laws may prohibit CIRAs from commingling funds.) A managing agent may deposit collections into one central account (sometimes called a sweep account) and later disburse funds to separate accounts for each CIRA. Also, a managing agent may deposit cash from all CIRAs into a common account and account for the funds separately only in the accounting records. If funds are commingled, there is a greater risk of material misstatement, and the auditors may need to expand cash procedures to test more cash transactions during the period. Expanded testing of transactions is necessary when funds are commingled because the cash balance cannot be confirmed with an independent source. Control activities in the cash area are particularly important in those circumstances. The auditors have to be concerned that the managing agent may pay the bills of one CIRA with the funds of another. The auditors need to be satisfied that the expenses charged to the CIRA client were authorized and incurred.

**Single Brokerage Accounts.** A trend in cash management is the use of a single, managed brokerage account. Funds in the account are invested by the broker in certificates of deposit or other types of investments at more than one bank or other financial institution. Advantages of such an arrangement to the association are as follows:

- The association deals with only one “institution”—the broker.
- Diversification of investments means the CIRA runs less risk of exceeding the FDIC's insured deposit limit. The current insurance limit is \$250,000 per depositor and per FDIC-insured institution.
- With the help of a knowledgeable broker, the CIRA can maximize interest earned by matching long-term deposits with its replacement funding program.

A single brokerage account generally enhances the auditors' ability to obtain confirmation of the year-end balance. However, disadvantages of using single brokerage accounts may include the ability to transact business over the phone on a single individual's authority, thereby losing protection of dual authority over cash management. Furthermore, certain state laws may require two board members or officers to authorize transactions. Auditors have an additional responsibility with single brokerage accounts to determine that the brokerage accounts' underlying investments are owned by the CIRA, not the brokerage house.

## Investments and Derivatives

A CIRA's governing documents or state or local statutes may restrict the types of investments CIRAs are permitted to make. Auditors need to obtain an understanding of those matters as part of the risk assessment process and consider them in determining the nature, timing, and extent of further audit procedures relative to investments. Frequently, a CIRA's investments are limited to certificates of deposit, which may be substantiated as part of cash work. Thus, a separate audit program for investments may not be needed.

AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, provides requirements and application guidance for certain aspects of auditing the valuation of investments in debt and equity securities measured at fair value. Specifically, AU-C 501.06–.09 require the auditor to—

- Determine if GAAP specifies a method for measuring fair value.
- Evaluate whether fair value is measured in accordance with that method.

- For fair value based on a valuation model, test management's determination of fair value, or if applicable, understand the method used by a broker-dealer or other third party to determine fair value and consider the guidance for use of a management's specialist.
- Evaluate management's conclusion about the need for an impairment loss and test any impairment adjustment, including compliance with GAAP.

Specific requirements related to auditing fair value accounting estimates can be found in AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, which is discussed in Lesson 2.

Key considerations when auditing investments in debt and equity securities include evaluating whether securities are properly classified as trading, available-for-sale, or held-to-maturity; whether they are properly valued at fair value or amortized cost; and the proper treatment of unrealized gains or losses. In evaluating whether investments are properly classified, auditors may obtain evidence supporting management's intent and, if the securities are classified as held to maturity, the entity's ability to hold the securities to maturity. In evaluating management's intent, FASB ASC 320-10 requires an entity's historical experience to be considered. Auditors also need to be alert for signs that investments are impaired. Additionally, the auditor ordinarily determines whether the CIRA's investments are insured or otherwise protected and whether an appropriate accrual of interest receivable has been made. The AICPA Audit Guide, *Special Considerations in Auditing Financial Instruments* provides interpretive guidance for auditing financial instruments, including investments and derivatives, and includes suggested procedures to clarify and illustrate the application of auditing standards. That Audit Guide is available online at [www.aicpastore.com](http://www.aicpastore.com).

When determining whether an other-than-temporary impairment in value exists for investments in debt securities, the auditor ordinarily evaluates whether management has considered relevant information to determine the existence of the following factors:

- Fair value is significantly below cost and—
  - The decline in fair value can be attributed to adverse conditions specifically related to the security or to specific industry or geographic conditions.
  - The association does not have the ability or intent to hold the investment for a sufficient time period to allow for any anticipated recovery in fair value.
  - The decline in fair value has existed for an extended period of time.
- A rating agency has downgraded a debt security's rating.
- The financial condition of the security's issuer has deteriorated.
- Scheduled interest payments on debt securities have not been made.
- Losses from the security have been recorded subsequent to year-end.

Evidence may be obtained about those factors, and the auditor considers whether the evidence corroborates or conflicts with management's conclusion about whether an other-than-temporary impairment exists.

Most CIRAs do not hold derivative instruments. For those CIRAs that do have such investments accounted for under FASB ASC 815, *Derivatives and Hedging*, key audit considerations include identifying derivative instruments; evaluating whether derivative instruments are properly designated as hedging instruments and, if so, the type of hedge; evaluating whether derivative instruments are properly valued at fair value; and assessing the proper treatment of changes in fair value.

**Evaluating Fair Value.** AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, provides requirements and application guidance for certain aspects of auditing the fair value of derivative instruments. For specific requirements related to auditing fair value accounting estimates, the auditor would turn to the guidance in AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, which is discussed in Lesson 2.

Some fair values are readily determinable because there are relevant quoted market prices. For such items, published price quotations in an active market are the best evidence of fair value. When there is no observable market price or items have characteristics requiring an estimate to be made, the best estimate of fair value may be determined using a valuation method.

If the fair value estimates are obtained from broker-dealers or other third-party sources based on valuation models, the auditor needs to understand the method they used to develop the estimates and consider the relevance and reliability of the information to be used as audit evidence. Guidance on the work of specialists when their work will be used as audit evidence is provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*. If the fair value estimates are determined by the client using a valuation model, the auditor performs procedures to obtain sufficient audit evidence to support management's assertions about fair value. Procedures the auditor may perform to assess the reasonableness of the client's fair value estimate include:

- Assessing the reasonableness and appropriateness of the client's model. For example, the auditor determines whether the market variables and other assumptions used by the client are reasonable.
- Calculating the fair value using a model developed by the auditor or a specialist as an independent expectation to corroborate the reasonableness of the client's valuation.
- Comparing the fair value with the exchange price for recent or subsequent transactions.

As a practical matter, it seems likely that CIRAs generally can obtain estimates of the fair value of most of their derivatives from banks and broker-dealers.

In the absence of quoted market prices, the auditor will need to either test the client's fair value estimate or develop an independent estimate. Guidance on auditing accounting estimates, including fair value estimates, is discussed in Lesson 2.

**Use of a Custodian.** Investment portfolios for CIRAs may sometimes be held by a custodian, such as a broker-dealer or bank trust department. In some cases (depending on the nature of transactions processed by the custodian and the other functions performed by the custodian), the auditor may need to consider obtaining a service auditor's report on the custodian's internal controls in order to gain an understanding of controls sufficient to assess the risks of material misstatement and design further audit procedures. A discussion of using a service organization is beyond the scope of this course, but the topic is discussed in more detail in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

### **Prepays, Deferred Charges, and Other Assets**

CIRAs frequently keep their accounting records on a cash basis, and the auditors' primary concern with respect to prepaids is identifying items that require accounting recognition. Common types of prepaids are insurance expense and service contracts, such as landscaping or snow removal.

If the client does not prepare a detailed summary analysis of prepaid insurance, the auditor can simply apply the procedures to the supporting documents and summarize the work done in memorandum form. Often the insurance agent can furnish an analysis that can be used as a workpaper in lieu of preparing a workpaper analysis.

An issue that sometimes arises in practice is the auditors' responsibility for assessing the adequacy of insurance coverage. Accounting standards do not require disclosure of the adequacy of insurance coverage. However, GAAP does not discourage disclosure of uninsured or underinsured risks, if appropriate. Thus, assessment of adequacy of coverage is not necessary to form an opinion on the CIRA's financial statements and is not ordinarily a part of the auditors' responsibility. Some auditors do advise their CIRA clients in that area strictly as a matter of client service. Also, a cooperative housing corporation may have a mortgage agreement that mandates certain insurance coverage. In that case, consideration of insurance coverage is a normal part of assessing compliance with debt requirements.

### **Receivables**

Member assessments represent the primary source of revenues for a CIRA. There may be both regular assessments and special assessments. Auditors need to consider whether member assessments have been allocated in

conformity with the CIRA's governing documents and recorded as revenue and receivables when assessed, whether the allowance for uncollectible assessments is reasonable, whether the CIRA's policies and procedures for late fees and liens and foreclosures are being followed, and whether any assessments have been prepaid by members and should be reclassified as a liability. Also, particularly during the initial operating period, auditors need to consider whether amounts due from the developer/sponsor related to unsold units have been properly recorded and are collectible.

**Confirmation of Assessments.** It is generally not a common practice to confirm assessments receivable from members for a variety of reasons. Frequently when confirmations are used, the members either do not return the confirmations or return inadequate replies. Thus, alternative audit procedures are necessary. Normally receivables are collected shortly after assessment. Those balances that are uncollected for longer periods are usually delinquent accounts that are often in foreclosure, and no confirmation response can be obtained. For those reasons, the normal audit approach for assessments receivable from members is to test subsequent cash collections to substantiate recorded amounts, if material. Examining subsequent cash collections and collectibility are discussed later in this lesson.

AU-C 330.20 prohibits substituting effective alternative procedures, such as testing subsequent receivables collections, for confirmation of accounts receivable unless one of the following criteria exists:

- The balance is immaterial.
- Using confirmations would be ineffective.
- The risk of material misstatement (the combined assessment of inherent and control risk) is low, and other substantive procedures will be adequate to provide sufficient appropriate audit evidence for relevant assertions.

Confirmation procedures might be ineffective, for example, if the auditor determines that (a) the response rate to confirmation requests will be inadequate or (b) responses are known to be unreliable. As noted above, based on their previous experience, auditors of CIRAs generally believe that one or both of those conditions may be true for their CIRA clients. Auditors who omit confirmation procedures are required by AU-C 330.32 to document the reasons they were able to do so. It is not sufficient to merely assert in the workpapers that the use of confirmations would be ineffective without providing some type of evidence or analysis to substantiate that assertion. In that case, the auditor also needs to design effective alternative procedures.

However, it is possible that in some cases, confirmation of assessments receivable from members may be a more effective auditing procedure than testing subsequent cash collections to substantiate recorded amounts (for example, if a managing agent commingles funds of the CIRAs to which it provides services). When assessments are confirmed, the auditor should document the extent of confirmation work performed and summarize the results of those confirmation procedures. (Exhibit 1-3 provides a format that can be used to reconcile CIRA confirmed balances.) AU-C 505.14 indicates that the auditor should investigate exceptions to confirmation requests to determine if they represent misstatements. As long as an auditor maintains control over selection, mailing, and receipt of confirmations as required by AU-C 505.07, it may be efficient to have the CIRA's personnel help in clearing confirmation exceptions. Generally, the auditor will make a copy of a confirmation that has been returned with an exception or a copy of the original confirmation request, in cases of nonresponding confirmations, and request the client to provide the original documents that support the transaction (such as validated deposit slips). The auditor will examine the original documents to determine if the account is misstated.

If the CIRA objects to sending a confirmation to a particular party, the auditor should inquire about the reason for the refusal, obtain corroborating evidence to support the CIRA's reasoning, and evaluate the implications on the risk assessment, including fraud risk, and planned audit procedures. If the auditor considers the CIRA's reason to be valid, alternative procedures should be applied to obtain sufficient appropriate audit evidence related to the receivable account. The auditor might also consider obtaining a representation in the management representation letter regarding the reasons for not confirming. Auditors ought to be alert to the fact that a CIRA's request that an account not be confirmed because it is in dispute may be intended to divert the auditor from an inappropriate transaction. If the CIRA's reason is not considered valid or sufficient evidence cannot be obtained from alternative procedures, the auditor should communicate with those charged with governance and consider the possible effect

on the audit, such as the ability to rely on management's representations. In most cases, when the auditors do not consider the CIRA's request to be reasonable or they are unable to obtain sufficient appropriate audit evidence from alternative procedures, it seems logical to assume that a scope limitation has been imposed by the client. Under these circumstances, it may be a good idea for the auditors to disclaim an opinion on the financial statements. If the auditors believe that the CIRA's request has implications regarding management integrity or might indicate the possible existence of fraud, the auditors should evaluate the circumstances in accordance with AU-C 240, *Consideration of Fraud in a Financial Statement Audit*.

**Exhibit 1-3**  
**Reconciliation of Confirmations**

	<u><b>AMOUNT</b></u>																												
1. Balance per confirm reply (vendor or customer)	_____																												
2. Deduct items recorded by vendor/customer; not by client:																													
<table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 5%;"></th> <th style="width: 20%; text-align: center;">Ref. Number</th> <th style="width: 15%; text-align: center;">Date</th> <th style="width: 60%; text-align: center;">Comments (items in transit, disputed, etc.)</th> </tr> </thead> <tbody> <tr><td>a.</td><td>_____</td><td>_____</td><td>_____</td></tr> <tr><td>b.</td><td>_____</td><td>_____</td><td>_____</td></tr> <tr><td>c.</td><td>_____</td><td>_____</td><td>_____</td></tr> <tr><td>d.</td><td>_____</td><td>_____</td><td>_____</td></tr> <tr><td>e.</td><td>_____</td><td>_____</td><td>_____</td></tr> <tr><td>f.</td><td colspan="3">Total</td></tr> </tbody> </table>		Ref. Number	Date	Comments (items in transit, disputed, etc.)	a.	_____	_____	_____	b.	_____	_____	_____	c.	_____	_____	_____	d.	_____	_____	_____	e.	_____	_____	_____	f.	Total			_____
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f.	Total																												
4. Balance per client																													
5. Client researcher: _____																													

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AU-C 230.08 requires the auditor's documentation to include the identifying characteristics of the specific items selected for confirmation. Returned confirmations ordinarily are retained in the workpapers, even when a schedule of confirmation results is prepared for the workpapers.



AU-C 505.15 provides guidance about the appropriate use of negative confirmations. That guidance applies to CIRAs and other entities if auditors decide to confirm receivables. According to AU-C 505.15, negative confirmations may be used as the sole substantive procedure only when *all* of the following criteria are met:

- The assessed risk of material misstatement is low, and relevant controls have been tested for operating effectiveness.
- A large number of small, homogeneous balances is involved.
- A very low exception rate is expected.
- The auditor believes the confirmation recipients will consider the requests.

Since the first criterion is rarely met in CIRA audit engagements, negative confirmations usually are not an option. However, if all of the above criteria are met, the auditor may want to consider using negative confirmations. When using negative confirmations, auditors need to bear in mind that negative confirmations do not provide any evidence that the requests were actually received or verified by the recipient. Therefore, negative confirmations provide only limited evidence. In addition, the use of negative confirmations is not a sampling application, and the results cannot be projected to the population. Because of the limited evidence provided by negative confirmations, they are best used as a supplement to evidence obtained from other auditing procedures. For example, negative confirmations may be used as a supplement to positive confirmations. Generally, only positive confirmations are used to confirm individually significant items.

**Examining Subsequent Cash Collections.** AU-C 505.A24 suggests that alternative procedures to confirmations include examining specific subsequent cash receipts. As mentioned above, testing subsequent cash collections to substantiate assessments receivable ordinarily is performed only when receivable balances are material. When examining subsequent cash collections, auditors consider whether the specific payment being tested relates to the year end receivable balance. That is, it would be inappropriate to conclude that a year end receivable balance was collected if the payment was actually for an assessment for a period after year end. Consequently, if there is some question as to how the client is applying subsequent payments, subsequent collections may not provide reliable audit evidence about the existence of year end receivable balances. Also, auditors examining subsequent cash collections as a primary substantive test in lieu of confirmation procedures, consider the need to obtain evidence that the source of the payment was, in fact, the CIRA member, and the cash collected was neither cash remitted by a different CIRA member nor cash transferred from a different CIRA's account by the managing agent.

**Collectibility.** Auditors need to consider whether the allowance for uncollectible assessments is reasonable. Managing agents may be lax about enforcing collection of assessments. Also, many CIRAs make no attempt to evaluate the collectibility of assessments receivable because a lien can be filed against units. However, a lien does not ensure collectibility. For example, CIRAs may not be able to enforce liens in some circumstances (for example, the unit owner files for bankruptcy), or amounts realized from liens may not be sufficient to satisfy balances due. As a result, there might be little or no equity remaining in units after a settlement is reached with tax authorities and secured creditors with priority liens, or the collection costs might be more than the assessed charges. Thus, auditors need to consider the CIRA's enforcement process for late fees, liens, and foreclosures. That can be coordinated with obtaining a legal representation letter. Auditors consider collectibility of assessments in light of the CIRA's prior experience, the opinion of legal counsel, local economic and real estate market conditions, and the status of the CIRA's claims relative to other creditors.

**Developer Receivables.** When amounts are due from the developer/sponsor related to unsold units, auditors may obtain written confirmation of the amount owed. However, the use of confirmations may be ineffective if there is a dispute between the CIRA and the developer/sponsor. In that case, the audit work can be coordinated with obtaining the legal representation letter from the CIRA's attorney.

**Special Assessment Receivables.** CIRAs may levy special assessments for items such as major repairs. Such special assessments may be payable over longer periods. Auditors should consider the earlier discussions of confirmations and collectibility in light of any extended collection periods.

**Assessments Received in Advance.** It is fairly common for members to pay assessments in advance. Thus, auditors need to identify prepaid assessments and, if they are material, propose reclassifying of them as a liability.

## Property and Equipment

Most CIRAs other than cooperatives do not capitalize common real property directly associated with the units (for example, exterior walls, roofs, public hallways, underlying land, sidewalks, driveways, roads, some parking areas, and greenbelts). However, those CIRAs typically capitalize common real property not directly associated with the units (for example, recreational facilities, managers' apartments, and properties that are primarily used for commercial operations) if specific conditions are met. Since a cooperative housing corporation owns the land and building, audit procedures for those CIRAs are similar to procedures for commercial businesses. Furthermore, according to FASB ASC 972-360-25-5, all CIRAs should capitalize common personal property (for example, furnishings, recreational equipment, maintenance equipment, and work vehicles).

If common property is capitalized in accordance with FASB ASC 972-360-25 and the auditors have not previously applied auditing procedures to those amounts in the financial statements, their procedures will need to be directed to evidential matters concerning existence, title to the property, and the amount recorded in the financial statements. Generally, CIRAs' governing documents are not sufficient to determine title to real property, and auditors may examine properly filed deeds or similar evidence of title rather than rely on those internal documents. In addition, they should review the basis used to record the assets. If appraisals have been used, auditors should follow the guidance for the use of specialists. In subsequent years, the auditors consider the need for auditing procedures aimed at determining whether capitalized common property continues to exist and be used by the CIRA. The auditor also needs to be alert for signs that any significant assets may be impaired.

**Interior Furnishings.** There are differences of opinion regarding whether the interior furnishings of certain timeshare developments should be capitalized. If the timeshare development treats their interior furnishings as common personal property, the auditor ordinarily should determine whether applicable capitalization procedures are being followed. The auditors need to:

- Understand the CIRA's policies on capitalizing assets.
- Inquire of management as to whether there are internal furnishings and in which property and equipment accounts they are recorded.
- Review expense accounts for internal furnishings that should be capitalized.

All CIRAs may be affected by asset retirement obligations and impairment or disposal of long-lived assets.

## Accounts Payable, Accrued Liabilities, and Other Liabilities

**Confirmation of Accounts Payable.** Most auditors believe it is not necessary to confirm accounts payable because the search for unrecorded liabilities is the primary procedure for testing completeness of accounts payable. Many CIRAs account for expenses on a cash basis during the year and convert to the accrual basis only at year end. There is no listing of accounts payable during the year and, in some cases, not even at year end. Often auditors propose the entry to record accounts payable as a by-product of the search for unrecorded liabilities. However, it may be a good idea for accounts payable to be confirmed in the following situations:

- There is a high risk that accounts payable are incomplete, and the period for conducting the search for unrecorded liabilities is not considered long enough to detect material unrecorded liabilities.
- The CIRA has extended payment terms with vendors.
- There are significant debit memos included in the accounts payable balances.
- The auditor, based on consideration of identified fraud risks, decides to modify procedures related to accounts payable balances.

When confirmation procedures are necessary, auditors should comply with the provisions of AU-C 330 and AU-C 505. Accounts selected for confirmation need to include primarily major suppliers of goods or services. "Blind" requests that do not state the client's balance in the letter are preferable. Also, auditors may want to consider having the confirmation letter request the vendor to return a copy of a vendor statement supporting the confirmed

balance. Since the accounts usually are selected after the year-end general ledger is closed, but before the accounts payable listing is prepared, the auditor selects vendors based on a review of purchase journals, disbursement journals, and knowledge of the CIRA's operations. The selection also ordinarily includes some accounts of new vendors, accounts expected to have a small or zero balance, and accounts payable to officers/related parties.

Confirmation request letters may be sent via physical mail or via email. Whether paper or electronic, the auditor should control the mailing of the confirmation request and should consider validating the addressee information in response to assessed fraud risk. Some audit firms choose to use online confirmation services as part of their confirmation procedures. Using email or online confirmation services may improve the response rate, as it is more convenient and less likely to get lost than a physical letter. In addition, some entities, especially larger companies, have a central "clearinghouse" for confirmation letters that online confirmation services have on file and contact directly. However, there is additional risk to consider when using electronic communications. AU-C 505.A14 states that the validity of responses received electronically (e.g., via email) may be subject to additional risk because proof of respondents' identities may be difficult to determine and alterations to responses may be difficult to identify. As such, the auditor may consider performing additional procedures, such as contacting respondents directly via telephone, to further validate the source and the contents of the response.

If the client objects to a confirmation with a particular supplier, the guidance on such objections provided earlier in this lesson will apply.

For confirmation procedures, AU-C 230.09 requires the auditor's documentation to include the identifying characteristics of the specific items selected for confirmation.

**Search for Unrecorded Liabilities.** The audit approach to search for unrecorded liabilities is to (a) review disbursements after the balance sheet date and open purchase orders, (b) review vendor invoices and statements above a specified cutoff amount, and (c) inquire of responsible client personnel about their knowledge of unprocessed invoices and whether accruals have been made for such items. To meet the documentation requirements of AU-C 230, the workpapers should identify the characteristics of the specific items inspected. For example, the auditor may identify the source and selection criteria, such as "all disbursements exceeding \$2,000 from the cash disbursements journal for the period 1/1/X3 through the date of the auditor's report."

Many CIRAs account for expenditures on a cash basis during the year and convert to accrual basis at year end. Auditors often assist in that conversion by accumulating and proposing a journal entry to record accounts payable at year end. To improve efficiency, the auditor might request that the CIRA accumulate accounts payable at year end. Auditors can then set a cutoff amount instead of inspecting every vendor invoice or disbursement after the balance sheet date. Other transactions below that amount can be scanned for reasonableness.

Auditors use their knowledge of the CIRA's industry and operations to identify unrecorded liabilities. Many disbursements are for routine, recurring items such as utilities and landscape maintenance. Auditors ordinarily consider whether all of those items are recorded and whether they are recorded in the proper period. Other annual expenditures are for local taxes or fees (for example, water and sewer taxes, rent taxes, and vault taxes). Based on an awareness of the local taxes and fees levied against CIRAs, the auditors consider whether all of those items are properly recorded.

If a managing agent is used, invoices are often forwarded to the board of directors or an officer of the CIRA for approval. Particularly if the search for unrecorded liabilities is performed shortly after year end, it may be necessary for the auditors to determine whether the board of directors or officers of the CIRA are holding any unpaid invoices.

**Refundable Security Deposits.** Many associations maintain refundable security deposits on their books for deposits received from their members. Security deposits are commonly required for keys, clubhouse rentals, recreational activities, commercial leases, etc. Refundable security deposits represent a liability since the CIRA is generally obligated to eventually return these funds to their members. Auditors need to review their clients' activities with respect to accounting for deposits, as failure to adequately account for refundable security deposits or turn over unclaimed deposits to the state may result in a material unrecorded liability. Auditors need to be informed about the laws applicable to these deposits to help assess the proper accounting for them and to provide advice to their CIRA clients.

## Debt and Related Liabilities

More associations are incurring debts, often a result of incurring significant reconstruction costs after suffering natural disasters or repairing major construction defects. Increasingly, aging associations are now borrowing after discovering that they are severely underfunded in reserves. This underfunding of reserves often occurs either because of failing to set aside enough money for reserve components identified or discovering that major building components, such as in-wall and under-slab plumbing, electrical, and sewer systems, have never been identified on reserve studies until they begin to fail. Since these items are so expensive to replace and generally have lives of 30–50 years, replacing or repairing these items often creates funding situations that require borrowing.

Most loans (other than mortgage loans to cooperative associations) cannot be secured by real estate, as it is most often owned in common by the members of the association individually. Accordingly, banks specializing in serving the CIRA industry usually secure the loans by special assessments or future assessments on the association members. Loan repayment terms vary from interest only to fully amortized, while interest rates vary from fixed to customized rates based on prime.

Many associations will approve special assessments to provide for repayment of loans. Accounting for the proceeds related to the members' loan payments often results in difficulties for the association, as associations sometimes arrive at creative ways to provide their members with "easy options" to pay the assessments. Unfortunately, these options are often the source of accounting problems. Common repayment terms include—

- Immediate payment in full to avoid future interest charges.
- Immediate payment in full to allow the payor a discount.
- Interest added to periodic payments.
- No interest added to periodic payments.
- Payoff required prior to property transfer.
- No payoff required prior to property transfer.

Difficulty often occurs because special assessments may be designed to generate, for example, \$10,000 per month to support loan payments of \$8,000 per month. However, if one-third to one-half of the members takes an immediate lump-sum payment option, the monthly special assessment payments from remaining members will be insufficient to service the debt. Most associations will not apply the proceeds of lump-sum special assessment payments to the loan because these loans generally cannot be reamortized. Additionally, some loans, notably from the Small Business Administration, prohibit early payments.

**Cooperative Mortgages.** A cooperative housing corporation normally has a mortgage on the real property of the corporation. In some cases, the sponsor/developer will guarantee the rate on a variable rate mortgage (for example, the sponsor/developer will reimburse the cooperative for amounts paid in excess of a specified mortgage interest rate). In that case, auditors may wish to confirm the terms of the guarantee and any payments under the guarantee during the period directly with the developer.

**Governing Document and Loan Restrictions.** Auditors ordinarily should determine that the CIRA has complied with any restrictions related to debt. For example, the governing documents of some CIRAs require member approval prior to incurring any debt. Auditors can review the CIRA's articles of incorporation, bylaws, declarations, covenants, and other governing documents to determine that the documents allow the CIRA to incur debt. Also, the debt may contain covenants. Auditors determine the CIRA has complied with the covenants, and procedures may include confirming compliance with the financial institution.

**Small Business Administration (SBA) Loans.** CIRAs may apply for low-interest, long-term loans from the SBA. The loan contract is between the association and the SBA. However, repayment is the unit owners' responsibility. Participating in the SBA loan program requires the association to keep subsidiary receivable records that clearly show the account history for each unit. For convenience, CIRAs generally record annual interest expense based on

the most recent amortization schedule. Since not all CIRAs account for SBA loans the same, auditors need to discuss the accounting method used by the CIRA during the risk assessment phase of the audit. The SBA sends monthly statements showing the application of payments between principal and interest. Auditors need to consider whether the monthly statements provide adequate audit evidence or if confirmations with the SBA are necessary. These procedures may also be relevant to other types of debt.

**Loan Fees.** GAAP requires loan fees (if material) to be amortized over the life of the loan and reported as interest expense. Many associations expense the loan fees in the first year of the loan because the amount is not material.

### **Income Taxes**

Auditors need to consider whether the CIRA has complied with tax laws and regulations that could have a direct and material effect on the financial statements in the event of noncompliance. The CPA firm performing the audit will often also have tax return preparation responsibilities, even if the CIRA uses a managing agent. Usually auditors do not need to apply any additional audit procedures in that area beyond the work involved in preparing the tax return and considering the information from other audit areas. It is unusual for CIRAs to recognize deferred income taxes. Generally, a CIRA will not have material differences between financial and tax reporting unless it has significant nonmember activity (for example, significant commercial operations or unrealized gains and losses on investments classified as available for sale) or net nonmembership losses. However, deferred taxes may be necessary if CIRAs interpret Revenue Ruling 70-604 as allowing only a one-year carryover of excess membership income.

Auditors are required to obtain sufficient appropriate audit evidence about material assertions in the financial statements or else issue a qualified opinion or disclaim an opinion on the financial statements. Audit documentation to support tax accounts and related disclosures includes copies of the client's documents, schedules, or analysis (or auditor-prepared summaries thereof) sufficient to support the auditor's conclusions about the accounting and disclosure for income taxes. Documentation should indicate the audit procedures performed and conclusions reached. If the client's support for a tax accrual is based on the opinion of an outside tax advisor, audit documentation needs to include either the actual advice or opinion or other documentation of the facts and conclusions reached by the client and advisor. Documentation needs to be sufficient for the auditor to form an independent conclusion. Tax documentation for CIRAs ordinarily needs to include documenting the decision to make a Revenue Ruling 70-604 election. Additionally, CIRAs can consider documenting their decision why Form 1120 or Form 1120-H was chosen in a given year.

For efficiency, the auditor ought to obtain all information needed to prepare or review the tax return or tax computations during the conduct of the audit. Some of the more common types of information needed are:

- Reconciliation of financial statement captions to exempt function transactions, nonexempt function transactions, and IRC 118 capital transactions required by the income tax return.
- CIRA resolution for Revenue Ruling 70-604 election.
- IRC 277 carryover information.
- Property acquisitions or dispositions identified as to specific assets, dates acquired or sold, cost, depreciation method, life, amount of accumulated depreciation, gain or loss involved.
- Listing of amounts and dates of income tax prepayments.

### **Equity**

The shareholders' equity section of the balance sheet of a cooperative housing corporation is essentially the same as any other corporation, and the auditing considerations are similar. Often, there is very little activity. Many associations, particularly those that prepare internal financial statements on a modified cash basis, will not record the auditor's adjusting journal entries because the journal entries distort the financial statements that the associations use internally. Consequently, the auditor will often discover that equity balances will not agree to the prior year audit report. Therefore, it is advisable for the auditor to review the equity accounts as one of the first steps of the audit process each year to determine whether the association recorded the prior year journal entries correctly.

When a CIRA uses fund accounting, the auditors need to obtain or prepare an analysis of the transactions affecting fund balance and inspect appropriate support for any changes in the balance. It is generally efficient to coordinate audit work on the replacement fund with procedures applied to major repairs and replacements.

## **Revenues, Operating Expenses, and Major Repair and Replacement Expenditures**

**Substantive Procedures for Income Statement Accounts.** A common approach to testing CIRA revenue and expense accounts has been to rely heavily on substantive analytical procedures to test income statement accounts. This approach may not give sufficient consideration to the differences that can exist among revenue and expense accounts. The following overall approach to testing income statement accounts in an efficient and effective manner and designing tests of details of individual transactions is recommended:

- Identify risks of material misstatement on the assertion level with as much specificity as possible.
- Consider the quality and extent of evidence provided from tests of other related accounts relevant to the assertion, particularly balance sheet accounts.
- Consider the evidence from substantive analytical procedures.
- Consider the efficiency and effectiveness of testing controls.
- Design and apply tests of details of selected individual transactions based on the above considerations.

The individual transactions selected would include individually significant transactions and, if necessary, a sample of remaining transactions.

**Assessment Revenue.** As explained earlier in this lesson, member assessments represent the primary source of revenues for a CIRA. Because the legal documents creating most CIRAs require that assessments be based upon budgets, the budget becomes the financial defining structure of how the CIRA is expected to operate. Thus, auditor comparison of recorded revenue to the CIRA's budget is a key analytical tool. Any significant difference between recorded revenue and the budget needs to be investigated.

Auditors will generally also compare recorded assessment revenue with the prior year's actual amounts as part of audit planning. In addition, as part of risk assessment, AU-C 240.22 requires auditors to perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. The results of those procedures should be considered when identifying the risks of material misstatement due to fraud. As discussed in Lesson 2, the analytical procedures related to revenue should be updated during the final review stage of the audit, that is, the procedures should be performed through the end of the reporting period. To perform a predictive test of assessment revenue, auditors can determine the number of units, the frequency of assessments, the assessment rate or amount in effect during the period, and whether, and if so when, the assessment rate or amount changed during the period. Also, auditors can determine whether special rates or amounts apply to any units. With that information, auditors are able to determine the expected assessment revenue for the period. Any difference between recorded revenue and that amount needs to be explained. A fairly common reason for the difference when recorded revenue does not agree with analytical expectations stems from a unit or units that have inadvertently not been billed. This could occur when a new unit opens and the initial assessment billing has not been set up. Auditors who encounter this situation need to consider if the association has inadequate procedures for initial assessment billings and whether the circumstance is a significant deficiency that should be communicated to management and those charged with governance. Another possible reason for a difference between recorded revenue and expected revenue could be late fees that are recorded as regular assessment revenue.

In certain special situations, a predictive analytical test will not be sufficient to test the reasonableness of recorded assessment revenue. An example of such a situation is an association that calculates member assessments as a factor of property tax assessments levied by the county. For example, assume a vacant lot had an assessed property tax valuation of \$50,000 (although market value of the lot had increased to \$1,000,000) and was assessed association dues of \$200, while the lot next door, which had recently sold and on which a house had been built, had an assessed property tax valuation of \$4,250,000 and was assessed association dues of \$17,000. Each member

received identical services from the association. In that case, the only way for the auditors to satisfy themselves about the reasonableness of recorded assessment revenue is to perform detailed tests of assessment calculations, in addition to inquiring about the process of calculating and recording assessment revenue.

CIRAs may levy special assessments for various purposes. Auditors review documents such as minutes of the board of directors, legal documents, governing documents, etc., to determine how the CIRA should levy special assessments, for example, whether developers that own unsold units are to be assessed. Auditors also review special assessments to determine that the CIRA has recognized the assessment revenue in the appropriate accounting period; for example, special assessment revenue may be deferred if it is designated for specific expenditures that have not yet been incurred. Auditors also consider examining expenditures, if any, related to special assessments. Relevant expenses, including allocable costs, whether incurred or budgeted, need to be directly associated with the assessment.

Auditors consider whether late fees are being properly computed and assessed. The arrangements for late fees often are found in the minutes or house rules. For many CIRAs, late fees are not material, and the auditors can test the late fee revenue through analytical procedures. If the CIRA has material late fees, the auditors can scan the deposits to the bank account in which assessments are deposited. The monthly deposits for assessments can be computed based on the same information used to analytically predict total revenue as described above.

Auditors ordinarily consider whether there are sources of revenue other than assessments based on knowledge of the CIRA's operations. For example:

- *Revenues from Garage Operations or Other Commercial Tenants.* The amount of those revenues is usually specified in contracts or other agreements.
- *Fees Collected by the CIRA for Managing a Pool of Rental Units.* Those fees are common in resort locations. The monthly fee is usually either a flat monthly fee or a per unit fee based on either the total number of units in the rental pool or the number of units actually rented. The auditors verify the contractual arrangement, and, if the amounts are material, perform tests to satisfy themselves about the reasonableness of the recorded revenue.
- *Clubhouse Restaurants or Bars.* Restaurants and bars have audit considerations that may be much different than those related to member assessment revenue. Auditors can consider performing an analytical review of the monthly revenue from the restaurant or bar. For those CIRAs with significant restaurant or bar operations, *PPC's Guide to Restaurants and Bars* provides guidance on the financial and operational issues related to those operations.
- *Laundry or Concession Vending Machines.* Generally, laundry and vending income is not material to the CIRA's financial statements. If it is significant, auditors should obtain an understanding of the internal controls over coin collections, if applicable, and perform further audit procedures such as an analytical review of the monthly revenue for any unusual items. If a third party is responsible for operating the laundry or vending machines, the auditor may be able to confirm with the service provider the revenue due to the CIRA.
- *"Unusual" Income, e.g., Oil and Gas Royalties.* There is one CIRA in Louisiana that collects more in oil and gas royalties than it previously collected through member operating assessments. The auditors should inquire about, and examine documentation of, any type of "unusual" income, if significant. The tax consequences must also be determined. (For tax purposes, oil and gas royalty income appears to be nonexempt function income for Form 1120-H filers and nonmembership income for Form 1120 filers.)

When a new source of revenue occurs during the year under audit and no budgeted data exists, analytical procedures alone would not ordinarily be sufficient.

**Presumption of Revenue Recognition as a Fraud Risk.** AU-C 240.26 requires auditors to make the rebuttable presumption that improper revenue recognition is a risk that may result in material misstatement of the financial statements due to fraud and to evaluate which types of revenue, revenue transactions, or assertions give rise to the risks. The auditor may be able to overcome that presumption, but, if so, should document how the presumption

was overcome. If the auditor is unable to overcome the presumption, then a response to the risk of improper revenue recognition is required.

Auditors may respond to a risk of improper revenue recognition by increasing the extent of the basic audit procedures or performing additional procedures related to revenue recognition the auditor may perform in response to identified fraud risks. Because revenue recognition practices vary by type of CIRA and are dependent on the particular facts and circumstances, auditors ordinarily develop procedures related to revenue recognition based on their understanding of the CIRA and its environment, including the composition of revenues, specific attributes of revenue transactions, and unique CIRA considerations.

In obtaining an understanding of the CIRA and its environment, including its internal control over revenue, the auditor gains an understanding of the CIRA's accounting policies and procedures related to revenue recognition. Well-designed analytical procedures can help the auditor identify situations that may require additional detail audit testing to ensure revenue recognition is proper. Depending on the circumstances, auditors may want to also consider the need for increased supervision and the assignment of more experienced audit staff.

Auditors may find it helpful to obtain representations from management concerning specific revenue recognition issues. This can be done using a management representation letter. Because of the potential for significant audit risk, auditors need to approach this area with an appropriate degree of professional skepticism.

**Operating Expenses.** Auditor comparison of actual expenditures to budget is equally as important as the revenue comparison to budget discussed earlier. Since the operations of CIRAs are generally based upon the budget, this comparison is a key performance indicator for whether the CIRA is controlling the use of its resources as planned and obtaining its financial goals. Differences between the current budget and actual expenditures need to be investigated.

The auditor will normally also compare recorded operating expenses with the prior year's actual amounts. This comparison and the budget comparison discussed in the previous paragraph generally improve the auditor's understanding of operations during the period. Additionally, since many expenses of CIRAs are standard amounts each month, auditors can multiply the standard monthly amount by 12 to determine whether the association has recorded a full year of expense. This procedure allows certain expenses, such as management fees, landscaping, pest control services, utilities, etc., to be quickly reviewed and identifies those expenses that need additional testing. (This *times 12* test can also be used to review assessment revenue for many established associations.)

Certain major expenses can be substantiated by analytical procedures such as predictive tests (for example, mortgage interest of a cooperative housing corporation) or by reference to contracts or agreements (for example, management fees). It may be useful to review a list of approved vendors with appropriate board members or management before reviewing support for expenditures.

Additional substantive procedures may be necessary to test operating expenses that are considered significant, unusual transactions. Auditors should obtain an understanding of the business purpose of significant unusual transactions. AU-C 240.32c requires the auditor to evaluate significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual based on the auditor's understanding of the entity, its environment, and other information obtained during the audit. The auditor is specifically required to consider whether the lack of business rationale suggests that transactions may have been entered into to perpetrate fraudulent financial reporting to conceal misappropriation of assets. AU-C 240.A54 provides the following indicators of transactions that require such an evaluation:

- Transactions that appear overly complex in relation to their stated purpose.
- Transactions in which management has placed more emphasis on the need for a particular accounting treatment than on the underlying economics.
- Transactions involving previously unidentified related parties (or nonconsolidated related parties).
- Transactions with inadequate documentation for which management has not discussed the nature of, and accounting for, such transactions with those charged with governance.



- Transactions involving parties lacking substance or the financial strength to support the transactions independently of the audited entity.

### **Special Considerations—Subsidy Agreements**

Developers will often enter into subsidy agreements with the associations they are developing. Such agreements may be necessary because developers often create significant common area amenities that can only be supported adequately by the full membership of the association (at build-out). Consequently, during initial phase-in periods, there is frequently an insufficient number of members and cash flow to support the amenities already constructed. In large communities, the time period from initial sales to complete build-out may take several years.

The primary reason that associations participate in developer subsidy agreements is to obtain at least breakeven funding during the initial phase-in periods. The primary incentive from the developer's viewpoint is to limit its cash outflow to the minimum amount required as it is generally less expensive for the developer to pay for a subsidy agreement than for the full cost of assessments on unsold lots.

Subsidy agreements may take many forms and are limited only by the ingenuity of the parties involved. Accordingly, the discussion here is limited to the basic issues generally considered in a subsidy agreement. Those issues include duration of the subsidy agreement, the amount of operating subsidy, and the amount of reserves subsidy.

**Subsidy Agreement Duration.** The duration of a subsidy agreement is generally variable, but may be fixed. The most common subsidy agreement is based upon a combination of number of lots sold and the passage of time. For instance, the agreement may provide that the developer pays a subsidy until two-thirds of the lots are sold, or for a fixed period of time (for example, seven years), whichever occurs first. However, it is not uncommon for subsidy agreements to state that the subsidy is paid until the later situation occurs.

**Operating Subsidy.** The amount of the operating subsidy is usually tied directly to operating costs required to maintain association common areas and operations to a stated level. In its most simple form, this means that the developer makes up the shortfall of revenues compared to operating expenses. Accordingly, the association may have zero profit or loss, since it is mandated by formula.

**Reserve Subsidy.** The amount of reserve subsidy is usually a more complex situation as not all amenities may be completed or turned over to the association during the subsidy period. Consequently, reserve calculations generally are made at least on an annual basis or may be tied to completion dates of specific common area components.

In one significant example, the county refused to allow the developer to turn over control of the streets within a large development to the association because the county felt that an insufficient number of lots had yet been sold. The county's position was that continued construction would severely damage the streets, and that homeowners should not be burdened with that cost. Thus, the developer was forced to retain the streets until a very large majority of the lots had been sold, then to resurface the streets to new condition in order to obtain permission to turn over the streets to the homeowner association board. The streets were removed from the association's reserve study until turnover occurred.

**Audit Procedures.** Auditors need to carefully read and understand any subsidy agreement in order to determine the accuracy of recorded receivable from, or payables to, the developer. Based on the risk assessment, the auditor may determine the need to confirm the receivable or payable balance. Legal counsel for both the association and the developer are often involved in rendering opinions regarding interpretation of the subsidy agreement. The auditor may want to consider obtaining written representations from both the developer and association management that the subsidy agreement has been properly interpreted, and that any revenues, receivables, or payables are accurately recorded. In addition, assessment revenue attributable to the developer typically is shown separately from assessment revenue from other unit owners in the statement of revenue and expenses, if material. The auditor may need to perform additional procedures to determine that amount, as many computer applications associations use to account for assessments do not segregate assessment revenue by unit owner.

**Financial Statement Considerations.** Associations subject to a subsidy agreement generally will have line items in the financial statements that report asset, liability, and/or revenue amounts related to the subsidy agreement.

Associations with a separate replacement fund may show amounts in both the operating and replacement funds. Examples of financial statement line items may include:

- Assessments receivable, developer (asset account)
- Maintenance fee receivable, developer (asset account)
- Amount due to developer (liability account) [Liability balances may result when the developer, by estimating amounts needed to achieve the association's zero profit, has overpaid the association.]
- Maintenance agreement income, developer (revenue account)

The notes to the financial statements should disclose the nature of the subsidy agreement and explain the impact of the subsidy agreement on the financial statements. A financial statement note example for an association with both an operating and reserve subsidy is illustrated below:

The Association and the Developer have entered into maintenance agreements that provide that in lieu of paying the non-replacement portion of regular assessments for annexed lots owned by the Developer, the Developer contributes to the Association any deficiencies in operating funds to the extent that the homeowners non-replacement portion of regular assessments cannot cover the operating costs of the Association, up to the amount it would otherwise be required to contribute if it was paying the non-placement portion of regular assessments. As a result, the operating expenses are always fully funded and the operating fund will not be allowed to fall into a deficit balance or retain contributions in excess of expenses.

The Developer is also required to contribute assessments to the replacement fund to the extent that the replacement fund is not funded by homeowners. A receivable in the amount of \$ \_\_\_\_\_ with respect to the replacement fund was outstanding from the Developer as of the balance sheet date .

Additionally, the developer generally is considered a related party and accordingly, the notes to the financial statements should include the required related party disclosures. Related party considerations are discussed more in Lesson 2.

### **Special Considerations—Ancillary Operations**

As part of gaining an understanding of the CIRA's operations, if a CIRA has ancillary operations, the auditor identifies each type of ancillary operation conducted by the association. If significant, auditors need to make reasonable inquiry of the association to determine the scope of operations, the accounting controls employed, and the method of allocating indirect costs to such activities, if any. If the financial results of the ancillary operations are material, auditors should design and conduct audit tests to determine the accuracy of reporting of revenues and expenses. Associations may not enter into these activities to generate a profit, but to provide services to their members. As a result, it may not be relevant to compare statistics from an association ancillary activity to an identical activity in a for-profit business. For example, the labor and food costs of an association-operated restaurant generally would compare unfavorably to industry statistics of for-profit restaurants, simply because the association's primary goal is not to make a profit. Consequently, auditors may often need to rely on other tests to determine if revenues and expenses are accurately recorded.

Tests of expenses related to ancillary operations are generally no different than tests of expenses for the association as a whole. The auditors' most significant challenge generally will be in determining the reasonableness of allocations. While there are many possibilities of tests that auditors could employ in this area, generally the auditor needs to consider:

- Making inquiries to gain a general understanding of expenses and document how expenses are recorded.
- Designing and conducting analytical tests of expenditures, for example, determining the average cost per round of golf, and comparing that amount to budget and to other time periods, and comparing expense categories to budget and other time periods.

- Conducting substantive tests of balances, such as reviewing invoices for large purchases for specific expense accounts.

Tests of revenues related to ancillary operations generally are custom-designed based upon the nature of the activity. In general, auditors consider performing procedures, such as the following, to test ancillary revenues (although other types of tests could be employed also):

- Making inquiries to gain an understanding of the ancillary operation revenue cycle and document how revenues are recorded.
- Designing and conducting analytical tests of revenues, for example, comparing round of golf counts to rate schedules, recalculating anticipated revenues, and comparing the calculated revenues to budget and to prior time periods.
- Conducting substantive tests of balances, such as reviewing documentation of ancillary operations revenues recorded for specific transactions in selected revenue accounts.

**Internal Control Considerations.** It is a fairly simple process to account for the operations of a traditional CIRA that does not engage in ancillary activities. For associations without ancillary operations, many of which are professionally managed, internal control at the association level is generally not a significant issue.

However, as associations become larger, with many on-site staff personnel, internal control becomes an important issue. Internal control becomes more important when associations have ancillary operations, as there are even more staff personnel involved, and ancillary operations often include cash handling activities that by their nature are more susceptible to misappropriation.

The association is responsible for designing and maintaining an adequate system of internal control to limit the risk of loss to the association. For an association with a limited number of appropriately skilled staff personnel and inherently high risk cash transactions exist, this can be a challenging situation. If the association is unable to maintain adequate segregation of duties over cash, it may be necessary for the association to design mitigating review and oversight procedures. It is not uncommon for associations to accept a risk of internal control system design deficiencies that cannot be reasonably overcome by the association, merely due to lack of appropriate personnel. In that situation, the auditor should consider AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, in evaluating whether control deficiencies are significant deficiencies or material weaknesses, as discussed in Lesson 2.

**Major Repairs and Replacements.** If the CIRA accumulates funds for major repairs and replacements, audit testing of expenditures needs to be coordinated with testing of the related replacement fund. Auditors may test the clerical accuracy of the replacement fund balance and trace beginning and ending fund balances to the trial balance. Changes posted to the fund balance account, such as increases for assessments, decreases for expenditures, and interfund transfers, ordinarily are reconciled to the trial balance and tested by inspecting supporting documents. Interfund transactions and similar transactions should be approved by the board of directors or the members, depending on the provisions of the CIRA's governing documents.

Based on the risk assessment, auditors may examine the support for all significant replacement fund expenditures that have not been examined in connection with other audit areas.

As part of gaining an understanding of the CIRA and its environment, auditors obtain an understanding of the CIRA's policy on funding major repairs and replacements and whether there are any requirements of state statutes or governing documents to accumulate funds for that purpose. If noncompliance with those requirements could have a direct and material effect on the CIRA's financial statements, the auditors should perform the following audit procedures specified in AU-C 250 that may identify instances of noncompliance with applicable state statutes or rules specified in governing documents:

- Inquire of management and, when appropriate, those charged with governance about whether the CIRA is in compliance with such laws and regulations.

- Inspect correspondence, if any, with the relevant licensing or regulatory authorities.

Some CIRAs may be in violation of funding requirements because of economic developments and natural disasters. For example, reserve funds may be earning lower returns on investments, and some CIRAs may forego assessments for future repairs and replacements due to economic difficulties in the area or region. In addition, natural disasters (such as hurricanes and floods) may have depleted the reserve funds so that violations of funding requirements have occurred. Lastly, due to economic conditions, some CIRAs may be using reserve funds to finance current operations.

FASB ASC 972-235-50-2 requires disclosure of two broad categories of information concerning major repairs and replacements. First, the notes to the financial statements should describe the CIRA's funding policy and disclose whether there are requirements in state statutes or the CIRA's governing documents (or mortgage on governmental bodies funding requirements, such as FHA) concerning funding, compliance with the policy and requirements, and certain related information. If the CIRA funds major repairs and replacements as the need occurs rather than accumulating funds, that policy also should be disclosed.

The second category of information concerns the estimated cost of future major repairs and replacements. FASB ASC 972-235-50-2 requires CIRAs to present estimated costs and funding of major repairs and replacements as unaudited supplementary data outside the basic financial statements. Auditors are required to apply certain limited procedures to the required supplementary information as discussed Lesson 2.

Associations may also consider making two additional disclosures:

- Disclosing the type of funding plan goal that was used in the reserve study.
- Disclosing the level of service used to perform the reserve study.

Disclosing the type of funding plan goal used in the reserve study allows financial statement readers to understand the implications of the method chosen and make informed and educated decisions. Three types of non-statutory funding plans are baseline funding, full funding, and threshold funding. The funding plan goal used could contribute to significant fluctuations in assessment levels.

The National Reserve Study Standards discuss three levels of service used to prepare a reserve study and the levels vary greatly in detail. These levels of service are (a) full, (b) update—including a site visit and on-site review, and (c) update—without a site visit or an on-site review. Disclosure will allow financial statement readers to know what level of service was performed in preparing the reserve study.

## **TRANSFER OF CIRA CONTROL TO PROPERTY OWNERS**

The first audit of a CIRA is usually an audit of the financial statements for the initial operating period. The initial operating period is normally a partial annual period that includes the time of conversion of a rental building to cooperative or condominium ownership, or the transition of new or renovated buildings or units from control by the developer/sponsor to owner control. During at least a portion of that transition period, the CIRA's board of directors is controlled by the developer/sponsor. The developer/sponsor is considered a related party. Therefore, developer/sponsor control of the board of directors should be disclosed in the financial statements. It is not unusual for the new owner-controlled board to request an initial audit, and some states mandate that CIRAs be audited when control is transferred from the developer to the property owners.

There are certain audit procedures that are unique to the initial operating period of a CIRA. Auditors need to review documents such as closing statements to establish the exact date the CIRA's operations began and the proper recording of initial working capital contributions such as membership fees and/or escrow deposits collected from unit owners on behalf of the CIRA. Among the most important audit procedures for the initial operating period are procedures directed to the transactions between the developer/sponsor and the CIRA.

### **Assessment Income**

The auditors need to determine if the developer has paid assessments on the developer-owned units through the date that control was transferred to the new board of directors. Reviewing state statutes and association documents

will help the auditor determine the amount that should have been paid by the developer/sponsor. In many instances, the developer/sponsor must begin paying dues, fund operating deficits, and/or contribute to the replacement fund based on unsold units at the close of the first escrow. (Many new planned unit developments are built in phases. For example, in a 100-unit planned unit development, there may be 10 phases of 10 units each. This may allow the developer to only pay on nine units of a phase after one unit is sold, rather than paying on 99 units.) Or, there may be a subsidy agreement that allows the developer/sponsor to pay an amount less than the full assessment for new unit owners if the developer/sponsor is paying CIRA expenses under a subsidy agreement.

In direct contrast to the audit of a mature development where the budgeted assessment income is known and will agree with the final income, in a developer transition audit the build out is often not complete, so the number of units billed member assessments during the year, and the resulting assessment income, is an estimate. The final assessment income may be substantially different than the estimate, depending on the timing of units being completed and when the related member assessments actually begin. Occasionally, a developer may also pay assessments on units sold as a sales incentive to induce buyers to purchase units or lots. In this situation, the auditor generally performs tests to determine whether assessments are being collected on all lots sold.

### **Developer Receivables**

In many cases, a developer receivable at year end exists because the developer/sponsor is having cash flow problems, or there may be a dispute between the CIRA and the developer/sponsor over the correct amount owed. Whether confirmation of developer receivables is appropriate when such a dispute exists was discussed earlier in this lesson.

### **Common Areas**

The auditors ordinarily consider whether common area assets received from the developer/sponsor are given proper accounting treatment. An inventory of all personal property that has been transferred can be obtained from the CIRA (or prepared by the auditors). From that list, it can be verified that title to real property has been transferred to the name of the CIRA. As an additional service, auditors may verify that local or state property tax rolls carry the property at the correct taxable status. In many jurisdictions, property taxes are not assessed on CIRA common area property.

### **Expenses**

Auditors ordinarily perform procedures to determine whether the CIRA has paid any expenses that are actually obligations of the developer/sponsor under the terms of the offering document. During the transition period, it is critical to properly segregate those expenses that apply to the CIRA from those of the developer/sponsor. For example, a landscape company may submit one invoice that includes charges for installation services that were incurred by the developer/sponsor and for maintenance services performed for the CIRA. It is not uncommon for developers to be delinquent in getting vendor billings switched over at time of transition due to neglect or error in the developer's accounting department. Generally, the developer will later come back and collect these amounts from the association. Accordingly, auditors need to question when there are no expenses in a particular category after developer transition has occurred.

### **Contracts**

Contracts and agreements entered into by the developer on behalf of the CIRA often are affected by statutory or similar guidelines. (For example, certain states prohibit developers from obligating the CIRA for more than a certain number of years.) Accordingly, the auditor needs to obtain copies and review all contracts and agreements signed by the developer that will obligate the CIRA into the future to ensure that the contract or agreement meets statutory restrictions.

## **INITIAL AUDITS WITH A PREDECESSOR AUDITOR**

Audits of CIRA financial statements are normally required by state statutes, CIRA bylaws, or, in the case of a cooperative, a financial institution holding the mortgage on the property. It is rare for a first audit to occur in other

than the initial year of operations. That means that an incoming auditor usually will be auditing financial statements of the initial operating period or will be following a predecessor auditor. When there is a predecessor, the considerations are essentially the same as in other audits. Communication with a predecessor auditor is discussed in more detail in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

Auditors accepting a new engagement of a CIRA that has been in operation for a while need to carefully review accounting for property and equipment and potential income tax exposure from prior years.

- CIRAs often fail to properly record common property. Thus, it is a good idea for the auditors to question management about the existence of capitalizable fixed assets that have not been properly recorded and review the reserve study to see if reserves are being accumulated to replace them.
- Auditors generally need to review tax returns for several prior years (even if the statute of limitations is closed) to determine if there is any unrecorded income tax exposure. That exposure may arise from improper characterization of membership versus nonmembership income or capital versus operating transactions, incorrect calculation of membership loss carryovers under IRC Section 277, or inappropriate use of the election under Revenue Ruling 70-604.

## MANAGEMENT COMPANY TRANSITION AUDIT

When a CIRA changes management companies, it may be prudent for the CIRA to request a transition audit. In some cases, the change of management companies is caused because the CIRA's relationship with the management company has deteriorated. Among the most important audit procedures for a management company transition audit are those directed to assessment income, assessment receivable, cash, and expenses.

Management company "transition audits" may actually be agreed-upon procedures engagements performed under the attestation standards rather than audits because of the nature of the procedures performed. The attestation standards are included in SSAE No. 18, *Attestation Standards: Clarification and Recodification*. *PPC's Guide to Nontraditional Engagements* includes guidance on performing agreed-upon procedures engagements. Many of the procedures discussed in the following paragraphs would be appropriate in both an agreed-upon procedures engagement and in a financial statement audit of a period in which the CIRA changed managing agents.

### Assessment Income

Auditors ordinarily need to determine that all assessment income was properly recorded during the transition between the two management companies by performing analytical tests. During the transition period, members of the CIRA will frequently send their payments to the predecessor management company for a period of time, until they realize that a change of companies has occurred. Auditors typically also determine that all cash receipts have been properly recorded and credited to the appropriate members' accounts. This may require additional testing of the accounts receivable listing.

### Cash

Special attention usually is paid to the transfer of cash accounts from one management company to the other. The auditors ordinarily determine whether all cash accounts have been transferred to the successor management company. Signature cards should have been updated, removing the signature of the former managing agent and adding the signature of the new one. Also, all in-transit items on accounts of the predecessor management company should have cleared within a reasonable period of time after the transition.

### Expenses

Auditors typically determine that the accounts payable listing at the date of transfer is complete and accurate. This may include reviewing cash disbursements for a more extended period of time after the transition period (that is, the search for unrecorded liabilities) if there were problems in transferring unpaid invoices from one managing agent to another. Also, auditors ordinarily consider whether all expenses reported by the former managing agent are those of the CIRA and not those of another CIRA client of the former managing agent.

## General Ledger

Some managing agents maintain their CIRA clients' records on a cash basis of accounting, while others may use the accrual basis of accounting. Auditors need to be alert for problems in transferring general ledger balances from one managing agent's accounting system to another's if the former and new managing agents use different bases of accounting. Also, sometimes the former managing agent may transfer incomplete or inaccurate general ledger balances to the new managing agent.

## INTERIM REVIEWS

### Standards and Conditions for Performing the Review

AU-C 930, *Interim Financial Information*, applies to reviews of interim financial information of nonpublic entities. *Interim financial information* is defined as financial information or statements covering a period less than a full year or for a 12 month period ending on a date other than the entity's fiscal year end. Interim financial information may be condensed or in the form of complete financial statements.

**Applicability.** AU-C 930 applies when auditors of nonpublic entities are engaged to perform a review of interim financial information and *all* of the following conditions are met:

- a. The auditor or a predecessor has audited the CIRA's latest annual financial statements.
- b. The auditor either (1) has been engaged to audit the CIRA's current year financial statements or (2) audited the CIRA's latest annual financial statements and, when it is expected that the current year financial statements will be audited, the appointment of another auditor to audit the current year financial statements is not effective prior to the beginning of the period covered by the review.
- c. The CIRA prepares its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements (for example, GAAP or a special purpose framework).
- d. When the interim financial information is condensed information, all of the following conditions are met:
  - (1) The condensed interim financial information purports to conform with an appropriate financial reporting framework, which includes appropriate form and content of interim financial statements. This course assumes the interim financial information will be prepared following U.S. GAAP.
  - (2) The condensed interim financial information includes a note that the financial information does not represent complete financial statements and should be read in conjunction with the CIRA's latest annual audited financial statements.
  - (3) The condensed interim financial information accompanies the latest audited annual financial statements or the CIRA makes such audited annual financial statements readily available. (For example, financial statements on the CIRA's website may be considered readily available.) Being available on request is not considered readily available. (AU-C 930.A3)

The most likely circumstances when an audit firm will be applying AU-C 930 are when the firm has performed an annual audit and then performs the review or when the firm has been engaged to perform the audit, but performs the first review before the audit is completed.

If the conditions in the preceding paragraph are not met, the auditor cannot perform a review under AU-C 930. In that case, the review of interim financial information of a nonpublic entity should be performed under SSARS, following the guidance in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* and *PPC's Guide to Compilation and Review*. Examples of when the SSARS apply are:

- When the CIRA's latest annual financial statements were reviewed rather than audited.

- When the CIRA's latest annual financial statements were audited by another auditor and the accountant is engaged to review interim financial information without any expectation of being engaged to audit the next annual statements.
- When the interim financial information is prepared in conformity with a different financial reporting framework than the annual financial statements (i.e., cash basis interim financial information and GAAP basis annual financial reports).

Interim financial information of nonpublic entities may be condensed or in the form of complete financial statements. However, GAAP does not provide minimum requirements for what should be included in condensed interim financial statements of nonpublic entities. FASB ASC 270, *Interim Reporting*, provides accounting and disclosure guidance related to recognition and measurement in interim financial information, but does not contain guidance on the form and content of condensed interim financial statements. A nonauthoritative AICPA Technical Question and Answer to the guidance in Q&A 1900.01 indicates that nonpublic entities providing condensed interim financial statements may analogize Article 10 of SEC Regulation S-X for form and content guidance when preparing those financial statements. Therefore, some auditors consider GAAP for condensed interim financial information of nonpublic entities to consist of Article 10 of SEC Regulation S-X, *Interim Financial Statements*, for form and content and FASB ASC 270, *Interim Reporting*, for recognition and measurement.

**Reporting.** The auditor is required to issue a written review report when engaged to report on interim financial information, even if third parties may choose not to require that a written auditor's review report on such information be provided to users of the CIRA's interim financial information.

### Interim Review Steps and Procedures

A review of interim financial information is substantially less in scope than an audit and, therefore, does not provide a basis for expressing an opinion about the fairness of presentation of the interim financial information in conformity with GAAP by performing limited procedures. A review consists primarily of performing analytical procedures and making inquiries of CIRA personnel responsible for financial and accounting matters. The overall approach is influenced by the fact that the review is performed by auditors who either have or will perform an audit of the annual financial statements. As a result, some of the steps in a review can be combined with similar steps for the annual audit, and various efficiencies can be achieved by performing some audit work in the course of performing the interim review.

The steps and procedures that are ordinarily appropriate for the review of interim financial information are as follows:

- a. Assess engagement acceptance or continuance.
- b. Agree on the terms of the engagement.
- c. Obtain or update an understanding of the CIRA and its internal control.
- d. Perform analytical procedures, inquiries, and other review procedures.
- e. Obtain a management representation letter.
- f. Evaluate the results of the review procedures performed.
- g. Communicate to management and those charged with governance.
- h. Issue the review report.

Because review steps and procedures can be combined with related steps and procedures in the annual audit, some of the same forms and checklists may be used. Using the same forms and performing some audit procedures in the course of a review does not elevate the engagement to an audit. If the auditor was engaged to perform a review, the responsibility for the interim financial information remains a review and not an audit responsibility.



## Review Reports

As discussed earlier in this lesson, a written review report is required. Interim review reporting examples and guidance can be found in *PPC's Guide to Auditor's Reports*. Exhibit 1-4 provides an illustration of an unmodified review report on interim financial information.

### Exhibit 1-4

#### Example of a Standard Report on a Review of Interim Financial Information

##### Independent Auditor's Review Report

##### To ABC Homeowners' Association

We have reviewed the accompanying balance sheet of ABC Homeowners' Association as of September 30, 20X1, and the related statements of revenues and expenses and cash flows for the three-month and nine-month periods then ended.

##### Management's Responsibility for the Financial Information

Management is responsible for the preparation and fair presentation of the interim financial information in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control sufficient to provide a reasonable basis for the preparation and fair presentation of interim financial information in accordance with accounting principles generally accepted in the United States of America.

##### Auditor's Responsibility

Our responsibility is to conduct our review in accordance with auditing standards generally accepted in the United States of America applicable to reviews of interim financial information. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial information as a whole. Accordingly, we do not express such an opinion.

##### Conclusion

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information for it to be in accordance with accounting principles generally accepted in the United States of America.

Auditor's signature

City, State

Date

\* \* \*

## OTHER SPECIAL AUDITS OR ATTEST ENGAGEMENTS

CPAs are often engaged to perform procedures in other specialized circumstances relating to activities such as litigation or insurance settlements. These engagements may take the form of a special stand-alone audit, be performed in conjunction with the normal year-end audit, or be the application of agreed-upon procedures to

specified elements of financial statements. It is not uncommon for the activities that underlie such special audits to span multiple years. Reporting often encompasses both current year and inception-to-date time periods. The procedures discussed below may be applicable in such an audit or an agreed-upon procedures engagement. When performing an agreed-upon procedures engagement, the practitioner should also follow the attestation guidance in SSAE No. 18, *Attestation Standards: Clarification and Recodification* (specifically AT-C 105, *Concepts Common to All Attestation Engagements* and AT-C 215, *Agreed-Upon Procedures Engagements*). Additionally, *PPC's Guide to Nontraditional Engagements* provides detailed information on performing agreed-upon procedures engagements.

### **General Understanding**

The CPA needs to discuss the goals of the engagement with the association prior to accepting the engagement and ensure that the firm possesses the necessary skills to perform the engagement and that reporting requirements are clearly understood. The CPA needs to conduct inquiry procedures and review necessary documents to understand the transactions that are the subject of the engagement.

### **Income and Expense**

The CPA ordinarily determines that all income and expense is properly recorded by reviewing the necessary documents and comparing to activities already completed and yet to be completed. Income records (such as billing or collection records) and any expense records (such as accounts payable or disbursement records) can be reviewed to ascertain that there was a proper cutoff at the end of any specific time period.

### **General Ledger**

The CPA needs to ascertain that transactions are recorded in the proper general ledger accounts and to be alert for (a) any state laws that may govern reporting on litigation or construction defects projects and (b) possible interfund transactions. It is not uncommon for associations to borrow from reserves to finance litigation, settlement, or construction defects projects. Such interfund borrowing may be restricted by state law.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following procedures must be performed in every audit to address the risk of management override of controls?
  - a. Evaluating the business rationale for any significant unusual transactions.
  - b. Reconciling financial statements to underlying accounting records.
  - c. Confirming accounts receivable.
  - d. Performing a subsequent events review.
2. Which of the following auditors had performed a *test of balances*?
  - a. Annie traces a sample of the CIRA's invoices to the purchase journal to see how they were recorded.
  - b. Bob confirms investments held by the CIRA's broker.
  - c. Cleo performs procedures to test assertions about the completeness of the CIRA's assets.
  - d. Don performs ratio and trend analysis.
3. When performing a CIRA audit, the auditor is more likely to determine fewer substantive audit procedures are needed in which area?
  - a. Confirming bank accounts.
  - b. Evaluating investments.
  - c. Testing receivables for member assessments.
  - d. Addressing debt and related liabilities.
4. All CIRAs should capitalize which of the following?
  - a. Interior furnishings.
  - b. A unit's roof.
  - c. Recreational facilities.
  - d. Work vehicles.
5. The following auditors are performing substantive audit procedures for CIRA audits. Who has correctly addressed an issue related to this type of audit?
  - a. Evan reviews disbursements for unrecorded liabilities during the last three months of the year.
  - b. Felicia disclaims an opinion on the financial statements because the CIRA's tax return is filed by a managing agent rather than Felicia's firm.
  - c. Greg prepares an analysis of transactions affecting fund balances because his CIRA client uses cash basis accounting.
  - d. Hannah compares her CIRA client's revenue to its planned budget and investigates significant differences.

6. Joe is engaged to audit the Glendale Association. In addition to being a homeowners' association, this CIRA runs a country club. Everyone who lives in the Glendale development can use the golf course, pool, gym, and restaurant, and the services are also open to the public. How will these ancillary operations affect Joe's audit engagement?
- a. He needs to compare statistics from the Glendale country club to other for-profit country clubs.
  - b. He needs to make inquiries of the association to determine items such as the scope of the ancillary operations.
  - c. He needs to both design and conduct audit testing on each of the association's ancillary operations.
  - d. Conducting analytical tests is the preferred way for Joe to test the ancillary operations' expenses and revenues.
7. Which of the following is one of the conditions that must be met for AU-C 930 to apply to the interim audit of a nonpublic entity, such as a CIRA?
- a. The entity has never undergone a financial statement audit.
  - b. The auditor is engaged to perform an audit of the entity's current financial statements.
  - c. The entity uses a special purpose framework for its interim financial information but presents its annual financial information using GAAP.
  - d. The entity provides condensed financial information.
8. Jack is performing an agreed-upon procedures engagement for a CIRA related to a litigation claim. Which of the following actions should Jack take?
- a. Follow the guidance in the FASB Codification.
  - b. Finalize engagement goals with the CIRA after accepting the engagement.
  - c. Determine that expenses related to the claim were recorded properly.
  - d. Contact any predecessor auditors for information related to the litigation.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following procedures must be performed in every audit to address the risk of management override of controls? **(Page 4)**
  - a. **Evaluating the business rationale for any significant unusual transactions. [This answer is correct. AU-C 240.32 requires certain substantive procedures in all audits to address the risk of management override of controls. One such procedure is to evaluate the business rationale for significant unusual transactions.]**
  - b. Reconciling financial statements to underlying accounting records. [This answer is incorrect. AU-C 330.21 requires auditors to agree or reconcile the financial statements, including the accompanying notes, to the underlying accounting records in order to test the financial close and reporting process in every audit. This substantive procedure is not related to management override of controls.]
  - c. Confirming accounts receivable. [This answer is incorrect. Confirmation of accounts receivable is a presumptively mandatory requirement for substantive procedures for a particular account balance required by AU-C 330.20. Management override of controls is not related to this substantive procedure.]
  - d. Performing a subsequent events review. [This answer is incorrect. Auditors have a specific requirement to perform general procedures that do not relate to particular account balances, such as performing a review for subsequent events and reading the minutes of board of director meetings. This, therefore, is not a substantive procedure related to the risk of management override of controls.]
2. Which of the following auditors had performed a *test of balances*? **(Page 8)**
  - a. Annie traces a sample of the CIRA's invoices to the purchase journal to see how they were recorded. [This answer is incorrect. Tracing a sample of invoices to the purchase journal or other accounting records to see whether invoices have been recorded as expenses is a test of transactions, not a test of balances.]
  - b. **Bob confirms investments held by the CIRA's broker. [This answer is correct. Tests of balances are applied directly to the details of balances in the accounting records. An example of this kind of test of details is confirming investments held by others, such as a broker. Therefore, in this scenario, Bob has performed a test of balances.]**
  - c. Cleo performs procedures to test assertions about the completeness of the CIRA's assets. [This answer is incorrect. Analytical procedures are often equally or more effective than tests of details for assertions about the completeness of assets, liabilities, revenues, and expenses. When testing for completeness, misstatements would often not be apparent from inspecting detailed evidence in the accounting records. Therefore, in this scenario, Cleo is not performing a test of balances, which is a type of test of details; she is performing analytical procedures.]
  - d. Don performs ratio and trend analysis. [This answer is incorrect. Analytical procedures include trend analysis, ratio analysis, and predictive or reasonableness tests. Therefore, in this scenario, Don is performing analytical procedures instead of tests of details, and a test of balances would be a test of details.]
3. When performing a CIRA audit, the auditor is more likely to determine fewer substantive audit procedures are needed in which area? **(Page 14)**
  - a. Confirming bank accounts. [This answer is incorrect. CIRAs are notorious for maintaining numerous bank accounts and for opening and closing accounts frequently. Therefore, this is an area that may require more attention from the auditor.]

- b. **Evaluating investments.** [This answer is correct. A CIRA's governing documents or state or local statutes may restrict the types of investments CIRAs are permitted to make. Frequently, a CIRA's investments are limited to certificates of deposit, which may be substantiated as part of cash work. Thus, a separate audit program for investments may not be needed. It depends on the facts and circumstances of each individual CIRA, of course, but if such restrictions exist, the auditor will need fewer substantive procedures in this area.]
- c. Testing receivables for member assessments. [This answer is incorrect. Because member assessments are important to CIRAs, auditors will need to give them plenty of attention during the audit. Auditors need to consider whether member assessments have been allocated in conformity with the CIRA's governing documents and recorded as revenue and receivables when assessed, whether the allowance for uncollectible assessments is reasonable, whether the CIRA's policies and procedures for late fees and liens and foreclosures are being followed, and whether an assessments have been prepaid by members and should be reclassified as a liability.]
- d. Addressing debt and related liabilities. [This answer is incorrect. More associations are incurring debt, often a result of incurring significant reconstruction costs after suffering natural disasters or repairing major construction defects. Because this is a high-growth area, the auditor is likely to need to devote a significant amount of time to it during a CIRA audit.]
4. All CIRAs should capitalize which of the following? **(Page 20)**
- a. Interior furnishings. [This answer is incorrect. There are differences of opinion regarding whether the interior furnishings of certain timeshare developments should be capitalized. If the timeshare development treats their interior furnishings as common personal property, the auditor ordinarily should determine whether applicable capitalization procedures are being followed. However, these are specific circumstances applied to timeshares and not all CIRAs.]
- b. A unit's roof. [This answer is incorrect. Most CIRAs other than cooperatives do *not* capitalize common real property directly associated with the units (for example, exterior walls, roofs, public hallways, underlying land, sidewalks, driveways, roads, some parking areas, and green belts.)
- c. Recreational facilities. [This answer is incorrect. Most CIRAs other than cooperatives typically capitalize common real property not directly associated with the units (for example, recreational facilities, managers' apartments, and properties that are primarily used for commercial operations) if specific conditions are met. However, since this is not general practice for cooperative CIRAs, which require procedures similar to those for a commercial business, the capitalization requirement is not uniform to all CIRAs.]
- d. **Work vehicles.** [This answer is correct. FASB ASC 972-360-25-5 requires all CIRAs to capitalize common personal property (for example, furnishings, recreational equipment, maintenance equipment, and work vehicles). Therefore, this capitalization requirement will affect all CIRA audits that own such property and equipment.]
5. The following auditors are performing substantive audit procedures for CIRA audits. Who has correctly addressed an issue related to this type of audit? **(Page 24)**
- a. Evan reviews disbursements for unrecorded liabilities during the last three months of the year. [This answer is incorrect. The audit approach to search for unrecorded liabilities is to (1) review disbursements after the balance sheet date (not only during the last three months of the year) and open purchase orders, (2) review vendor invoices and statements above a specified cutoff amount, and (3) inquire of responsible client personnel about their knowledge of unprocessed invoices and whether accruals have been made for such items. Therefore, Evan has not performed this additional audit procedure at the correct time.]
- b. Felicia disclaims an opinion on the financial statements because the CIRA's tax return is filed by a managing agent rather than Felicia's firm. [This answer is incorrect. Auditors need to consider whether the CIRA has complied with tax laws and regulations that could have a direct and material effect on the financial statements in the event of noncompliance. The CPA firm performing the audit will often also have tax return

- preparation responsibilities, even if the CIRA uses a managing agent. However, simply because the managing agent, not the firm, files the CIRA's income taxes is not a reason for Felicia to disclaim an opinion. It would, however, be appropriate for Felicia to disclaim an opinion if she could not obtain sufficient appropriate audit evidence about material assertions in the financial statements related to income taxes.]
- c. Greg prepares an analysis of transactions affecting fund balances because his CIRA client uses cash basis accounting. [This answer is incorrect. When a CIRA uses fund accounting (not cash basis accounting), the auditors need to obtain or prepare an analysis of the transactions affecting fund balance and inspect appropriate support for any changes in the balance. Therefore, Greg will not need to perform this substantive audit procedure if his CIRA client uses cash basis accounting.]
  - d. **Hannah compares her CIRA client's revenue to its planned budget and investigates significant differences.** [This answer is correct. Because legal documents creating most CIRAs require that member assessments be based upon budgets, the budget becomes the financial defining structure of how the CIRA is expected to operate. Thus, auditor comparison of recorded revenue to the CIRA's budget is a key analytical tool. Any significant difference between recorded revenue and the budget needs to be investigated. Therefore, in this scenario, Hannah has appropriately performed the necessary substantive audit procedures for her CIRA client related to budgets and revenue.]
6. Joe is engaged to audit the Glendale Association. In addition to being a homeowners' association, this CIRA runs a country club. Everyone who lives in the Glendale development can use the golf course, pool, gym, and restaurant, and the services are also open to the public. How will these ancillary operations affect Joe's audit engagement? **(Page 28)**
- a. He needs to compare statistics from the Glendale country club to other for-profit country clubs. [This answer is incorrect. Associations may not enter into these activities to generate a profit, but to provide services to their members. As a result, it may not be relevant to compare statistics from an association ancillary activity to an identical activity in a for-profit business. Consequently, Joe will likely need to rely on other tests to determine if revenues and expenses are accurately recorded.]
  - b. **He needs to make inquiries of the association to determine items such as the scope of the ancillary operations.** [This answer is correct. As part of gaining an understanding of the CIRA's operations, if a CIRA has ancillary operations, the auditor identifies each type of ancillary operation conducted by the association—in this scenario, Joe would identify all the revenue producing aspects of the country club. If significant, auditors need to make reasonable inquiries of the association to determine the scope of operations, the accounting controls employed, and the method of allocating indirect costs to such activities, if any. Therefore, to make this determination of significance, it is important for Joe to make the applicable inquiries as part of his CIRA audit.]
  - c. He needs to both design and conduct audit testing on each of the association's ancillary operations. [This answer is incorrect. If the financial results of the ancillary operations are material, auditors should design and conduct audit tests to determine the accuracy of reporting of revenues and expenses. Therefore, if Joe is designing and performing such tests for every ancillary operation, including the immaterial ones, he is overauditing.]
  - d. Conducting analytical tests is the preferred way for Joe to test the ancillary operations' expenses and revenues. [This answer is incorrect. There are many possibilities of tests Joe could perform for either of these areas, including (1) inquiry and documentation, (2) analytical tests of expenses or revenues, and (3) substantive tests of balances. Joe is not limited only to analytical tests; neither are analytical tests preferred by the authoritative guidance.]
7. Which of the following is one of the conditions that must be met for AU-C 930 to apply to the interim audit of a nonpublic entity, such as a CIRA? **(Page 33)**
- a. The entity has never undergone a financial statement audit. [This answer is incorrect. AU-C 930 applies when the auditor or a predecessor *has audited* the CIRA's latest annual financial statements.]

- b. **The auditor is engaged to perform an audit of the entity's current financial statements. [This answer is correct. AU-C 930 applies when auditors of nonpublic entities are engaged to perform a review of interim financial information and all of the prescribed circumstances are met. One of those circumstances is that the auditor either (1) has been engaged to audit the CIRA's current year financial statements or (2) audited the CIRA's latest annual statements and, when it is expected that the current year financial statements will be audited, the appointment of another auditor to audit the current year financial statement is not effective prior to the beginning of the period covered by the review.]**
  - c. The entity uses a special purpose framework for its interim financial information but presents its annual financial information using GAAP. [This answer is incorrect. For AU-C 930 to apply, the CIRA must prepare its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements. Therefore, both would have to either use the special purpose framework or GAAP.]
  - d. The entity provides condensed financial information. [This answer is incorrect. Condensed financial information is not required for AU-C 930 to apply. However, if the interim financial information is condensed, certain conditions must be met for AU-C 930 to apply to the interim engagement.]
8. Jack is performing an agreed-upon procedures engagement for a CIRA related to a litigation claim. Which of the following actions should Jack take? **(Page 36)**
- a. Follow the guidance in the FASB Codification. [This answer is incorrect. When performing an agreed-upon procedures engagement, the practitioner should follow the attestation guidance in SSAE No. 18, *Attestation Standards: Clarification and Recodification* (specifically AT-C 105, *Concepts Common to All Attestation Engagements* and AT-C 215, *Agreed-Upon Procedures Engagements*). Therefore, the attestation guidance would be more applicable to Jack's engagement than the FASB Codification.]
  - b. Finalize engagement goals with the CIRA after accepting the engagement. [This answer is incorrect. The CPA needs to discuss the goals of the engagement with the association prior to accepting the engagement and ensure that the firm possesses the necessary skills to perform the engagement and that reporting requirements are clearly understood. The CPA needs to conduct inquiry procedures and review necessary documents to understand the transactions that are the subject of the engagement. Therefore, if Jack waits to finalize the goals until after the engagement is accepted, he may find out that his firm cannot complete the engagement to the CIRA's satisfaction.]
  - c. **Determine that expenses related to the claim were recorded properly. [This answer is correct. The CPA ordinarily determines that all income and expense is properly recorded by reviewing the necessary documents and comparing activities already completed and yet to be completed. Income records (such as billing or collection records) and any expense records (such as accounts payable or disbursement records) can be reviewed to ascertain that there was a proper cutoff at the end of any specific time period. Therefore, making this determination will allow Jack to correctly deal with expenses in his agreed-upon procedures engagement for the CIRA.]**
  - d. Contact any predecessor auditors for information related to the litigation. [This answer is incorrect. When performing an initial audit for a CIRA that had a previous auditor, the CPA will need to follow the guidelines for dealing with a predecessor auditor. However, since that is not the case for Jack in this scenario, contacting any predecessor auditors would be unnecessary.]



# Lesson 2: Concluding the Audit

## INTRODUCTION

In addition to the audit procedures for specific account balances or transaction classes discussed in Lesson 1, other procedures that are more general in nature are necessary. This lesson discusses the following general and concluding procedures:

- Commitments and contingencies, including the legal representation letter, environmental remediation liabilities, and risks and uncertainties.
- Accounting estimates and fair value.
- Subsequent events.
- Related parties.
- Going concern considerations.
- The management representation letter.
- Considering accumulated results of audit procedures.
- Analytical procedures.
- Review of workpapers.
- Summarization and evaluation.
- Drafting financial statements and the auditor's report.
- Group audit considerations.
- Client communications, including internal control related matters, communication with the audit committee (or those charged with governance), and communication of fraud and other illegal acts.
- Engagement summary memorandum.

The authoritative pronouncements that establish requirements or provide guidance that most directly affect the matters discussed in this lesson are as follows:

- AU-C 230, *Audit Documentation*.
- AU-C 240, *Consideration of Fraud in a Financial Statement Audit*.
- AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.
- AU-C 260, *The Auditor's Communication With Those Charged With Governance*.
- AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.
- AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.
- AU-C 450, *Evaluation of Misstatements Identified During the Audit*.

- AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*.
- AU-C 520, *Analytical Procedures*.
- AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.
- AU-C 550, *Related Parties*.
- AU-C 560, *Subsequent Events and Subsequently Discovered Facts*.
- AU-C 570 and AU-C 570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.
- AU-C 580, *Written Representations*.
- AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.
- AU-C 700, *Forming an Opinion and Reporting on Financial Statements*.
- AU-C 720, *Other Information in Documents Containing Audited Financial Statements*.
- AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*.
- AU-C 730, *Required Supplementary Information*.

**Learning Objectives:**

Completion of this lesson will enable you to:

- Identify how to approach the following elements of concluding a CIRA audit: commitments and contingencies, accounting estimates and fair value, subsequent events, and related parties.
- Recognize how to deal with the following elements of concluding a CIRA audit: going concern considerations, management representation letters, considering the accumulated results of audit procedures, analytical procedures, review of workpapers, and summarization and evaluation.
- Determine the best methods for drafting the financial statements and auditor's report, dealing with group financial statements, communicating the correct information with clients in a CIRA audit, and using an engagement summary memorandum.

**DEALING WITH COMMITMENTS AND CONTINGENCIES**

The primary audit objectives for commitments and contingencies are to determine whether all significant commitments and contingencies have been identified (completeness), to assess their financial effect (valuation), and to evaluate presentation and disclosure (completeness, understandability, and valuation). Examples of commitments and contingencies of concern to a CIRA auditor are as follows:

- Pending or threatened litigation or unasserted claims, including developer lawsuits.
- Communications from regulatory agencies regarding violations or possible violations of laws or regulations.
- Commitments related to expansion or rehabilitation of facilities.
- Possible losses on long-term contracts.
- Long-term leases with required fixed payments for several years.
- Financial transactions or arrangements with financial institutions, for example, oral or written guarantees, endorsements, open letters of credit, etc.

- Other oral or written guarantees.
- IRS examinations in progress related to tax elections or taxes on nonmembership/non-exempt functions.
- Environmental remediation liabilities, including designation as a potentially responsible party by the Environmental Protection Agency.
- Fraud involving CIRA management or personnel that could affect the financial statements.

## Audit Procedures

The auditor may be aware of possible commitments or contingencies from (a) knowledge of the CIRA's activities gained during audit planning; (b) reading minutes, contracts, agreements, or similar documents; (c) reviewing communications from relevant local, state, and federal agencies such as the Environmental Protection Agency; and (d) reviewing transactions subsequent to the balance sheet date. Some commitments or contingencies may be discovered as a result of audit procedures applied to specific financial statement components. For example, an income tax dispute may be identified in the audit of income tax expense and lease commitments may be discovered during the audit of rent and other lease payments. The auditor may become aware of compensating balances or details of financing arrangements, such as debt guarantee arrangements or other contingent liabilities, through confirmation responses received from lenders. Litigation, claims, and assessments are also often the cause of significant contingencies. An auditor's search for those contingencies is accomplished through inquiries and communications involving the client's management and lawyers.

In addition, the auditor generally questions management about the possibility of unrecorded contingencies or commitments and documents the inquiries and responses in the management representation letter.

## Legal Representation Letter

AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, addresses, among other topics, the procedures that auditors should follow for identifying an entity's litigation, claims, and assessments that may result in a risk of material misstatement. The authoritative and related application guidance related to litigation, claims, and assessments is found in paragraphs AU-C 501.03; AU-C 501.16–.24; and AU-C 501.A39–.A65. In addition, AU-C 501.A69 provides an illustrative audit inquiry letter to legal counsel.

To identify litigation, claims, and assessments that may give rise to risks of material misstatement, AU-C 501.16 requires auditors to design and perform procedures, including the following:

- Inquiring of management and, when applicable, others within the entity, including in-house legal counsel.
- Obtaining from management a description and evaluation of litigation, claims, and assessments that existed at the date of the financial statements and during the period from the date of the financial statements to the date the information is furnished, including an identification of matters referred to legal counsel.
- Reviewing minutes of meetings of those charged with governance; documents obtained from management concerning litigation, claims, and assessments; and correspondence between the entity and its external legal counsel.
- Reviewing legal expense accounts and invoices from external legal counsel.

AU-C 501.18 requires the auditor to seek direct communication with the entity's legal counsel (including in-house legal counsel, if any) unless the procedures performed to identify litigation, claims, and assessments do not indicate any actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement. If the auditor does not seek direct communication with the entity's legal counsel, the auditor should document the basis for that decision.

Some CIRAs may use more than one lawyer, and AU-C 501 recognizes that communicating with some lawyers may not be necessary. For example, communication would not be required with lawyers involved only with collections,

lawyers representing the CIRA at exchanges of ownership interests, lawyers involved with litigation by the CIRA, unless counterclaims are involved, or lawyers contacted last year who performed no services this year. (However, auditors may want to consider whether, because of the general lack of sophistication of many CIRA officers, the CIRA's attorney may be the only reliable source of information for discovering litigation in which the CIRA is involved.)

As noted above, if a lawyer on the board of directors serves as the CIRA's counsel, communication is required when the lawyer has responsibility for the CIRA's litigation, claims, and assessments. In such circumstances, in-house legal counsel may be in the best position to know and describe the status of litigation, claims, and assessments or to corroborate the information provided by management.

Some small CIRAs may have no need to consult a lawyer about pending or threatened litigation or claims. (However, the CIRA may have consulted a lawyer for other reasons, such as matters related to collection of assessments, exchanges of ownership interests, etc.) As long as the CIRA has no material litigation, claims, or assessments, it is generally not necessary to request a legal representation letter from the client's attorney. An auditor can rely on other audit procedures, as described earlier in this lesson, to disclose the existence of contingencies, including litigation, claims, and assessments. If an auditor's other procedures do not identify the existence of material claims or assessments, nor indicate that a lawyer was consulted regarding such matters, no additional procedures are necessary. However, it is a best practice for the written representation obtained from management to state that management is not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments and that a lawyer has not been consulted about such matters.

If the auditor believes that actual or potential material litigation, claims, or assessments possibly exist but the CIRA has not engaged external legal counsel relating to such matters, the auditor may discuss with the CIRA the need to consult legal counsel to appropriately determine the effect to the CIRA's financial statements. If the auditor believes the matter may be significant, refusal by management to consult legal counsel may result in a scope limitation sufficient to preclude an unmodified opinion.

**Content of the Letter.** The legal letter asks the lawyer to provide or corroborate information about pending or threatened litigation, including, for each individual case, its nature and progress to date; how the CIRA is responding or intends to respond; the likelihood of an unfavorable outcome, and an estimate, if one can be made, of the amount or range of potential loss; and a statement that the list of matters is complete or an identification of the omission of any pending or threatened litigation, claims, and assessments. With respect to unasserted claims, the lawyer is asked to comment on any possible unasserted claims specifically identified by management and to confirm that the lawyer will notify management of any unasserted claims that come to the lawyer's attention that, in the lawyer's judgment, must be disclosed in accordance with the requirements of FASB ASC 450.

The letter generally specifies a materiality limit so that the lawyer knows what items are to be considered material, individually or in the aggregate, for purposes of the response. The materiality amount should be some fraction of performance materiality computed in audit planning. The specific amount used is a matter of auditor judgment based on knowledge of the client and other factors.

When a "long form" request for legal representation is used, the lawyer is asked to comment on the completeness of client-prepared information about the details of each matter listed as pending or threatened litigation. This approach may be more efficient if the CIRA has both inside and outside legal counsel. The inside legal counsel may be able to prepare the information and thus reduce the cost of obtaining outside counsel's representations. (The "long form" request also can be used if the client represents that there are no unasserted claims or assessments that are probable of assertion and should be disclosed in accordance with FASB ASC 450.) When a "short form" request for legal representation is used, the lawyer is asked to prepare information rather than comment on management's list. A short form letter also may be used when the client represents that there are no unasserted claims or assessments that are probable of assertions and must be disclosed in accordance with FASB ASC 450. The "short form" is usually best suited for a small CIRA, especially if the CIRA does not have inside counsel.

**Evaluating Lawyers' Responses.** In reviewing the lawyer's response, the auditor should make sure it reflects the materiality limit specified, is as of the specified response date, and that the attorney's response is complete, that is, for each case or asserted claim or assessment the attorney identifies, all of the items in the "Content of the Letter" paragraph are addressed. If the date of the response significantly differs from the date requested, the auditor

should obtain an updated letter. Also, the auditor should carefully evaluate how the lawyer words the assessment of the probability of an unfavorable outcome. The auditor should decide whether the response is clear regarding a probable or remote outcome. Wording such as "the CIRA believes there is absolutely no merit to the litigation," "the CIRA has a substantial chance of prevailing," or "the CIRA will be able to assert meritorious defenses," are not clear as to likelihood of outcome. In addition, lawyers' responses that are unclear or amount to talking around the point without taking a solid position should be carefully evaluated by the auditor. For example, terms like *substantial chance* and *reasonable opportunity* indicate more uncertainty than an opinion that the CIRA will prevail. The term *meritorious defenses* means only that the defenses will not be summarily dismissed by the court.

In some instances, the attorney's response may be limited in ways other than that specified by the original request. For example, instead of limiting the response based on a specified materiality limit, the attorney may limit the response to cases in which six or more hours have been billed. In that situation, the auditor needs to assess the potential effect of the limitation on the attorney's response. A limitation based on billable hours is generally not appropriate because it does not necessarily correlate to the amount of the contingent liability. Consequently, if an attorney's response has a billable hours limitation, the auditor will generally need to ask the client to have the attorney respond based on the materiality limits specified in the original request.

Some lawyers add statements in their responses to emphasize retention of the attorney-client and attorney work product privileges. An example of such statements follows:

[Name of CIRA] has advised us that the request made in its letter to us is not intended to be a waiver of the attorney-client privilege relating to any information the Association had furnished to us. Furthermore, be advised that our response to you should not be interpreted as a waiver of the work product privilege relating to any of our files involving [Name of CIRA].

According to AU-C 501.A61, such comments in lawyers' letters are not limitations on the scope of their responses. Thus, those comments should not affect the auditors' evaluations.

With respect to unasserted possible claims or assessments, some attorneys also include language such as the following in their responses to emphasize the preservation of attorney-client privilege:

Please be advised that pursuant to clauses (b) and (c) of Paragraph 5 of the ABA Statement of Policy and related Commentary referred to in the last paragraph of this letter, it would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving the association. We can only furnish information concerning those unasserted possible claims or assessments upon which the association has specifically requested in writing that we comment. We also cannot comment upon the adequacy of the Association's listing, if any, of unasserted possible claims or assessments or its assertions concerning the advice, if any, about the need to disclose same.

According to AU-C 501.A62, such language is not a limitation on the scope of the audit as long as the lawyer's response includes a confirmation of the understanding that the lawyer, under certain circumstances, will advise and consult with the client concerning the client's obligation to make financial statement disclosure with respect to unasserted claims or assessments.

If the auditor obtains an oral response concerning matters covered by the audit inquiry letter, the auditor should document conclusions reached concerning the need to account for or disclose litigation, claims, and assessments.

**Dating of Lawyer's Response.** The legal representation letter should request the lawyer to respond as of a date reasonably close to the date of the auditor's report, for example, within two weeks of the anticipated report date. If particularly volatile litigation proceedings exist, the auditor may decide to confirm the continued appropriateness of the lawyer's response as of a date nearer to the report date. This follow-up may be oral or written. If the lawyer's response does not specify an effective date, the auditor can assume that the date of the response is the effective date. If the lawyer's effective response is dated too long before the date of the auditor's report, the auditor needs to consider getting an updated response. If the update is obtained orally, it should be documented in the workpapers. If significant matters (such as new litigation or significant developments relating to old litigation) are discovered in the oral update, it is a best practice to obtain a written update from the attorney.

**Scope Limitations Related to Litigation, Claims, and Assessments.** If an external legal counsel refuses to furnish the information requested in an audit inquiry letter, either in writing or orally, according to AU-C 501.A58, that may cause a scope limitation of the audit sufficient to preclude an unmodified opinion. The limitations inherent in the form of inquiry described by AU-C 501.22 are not scope limitations. Information on pending or threatened litigation, claims, and assessments is appropriately limited to matters as to which the legal counsel has been engaged and to which the legal counsel has devoted substantive attention.

As explained above, the legal counsel does not provide information on the existence of unasserted claims and might further include language in the response to preserve lawyer-client privilege. This language does not constitute a scope limitation. Maintaining privilege is the same reason the legal counsel is not requested to provide a list of unasserted claims and to comment only on such matters the client has already disclosed to the auditor.

Because of the lawyer-client privilege, the client might identify certain documents as subject to the lawyer-client privilege and not permit the auditor to examine them. Whether this would be considered a scope limitation depends on the circumstances. AU-C 501.A59 points out that if there are such questions about the applicability of the privilege, the auditor may request legal counsel's confirmation that the information is subject to that privilege and that the information was considered by the legal counsel in responding to the letter of inquiry. Unless the auditor is able to obtain such confirmation, the matter is likely to constitute a scope limitation.

As noted in AU-C 501.A60, if management imposes a scope limitation on the audit and the auditor cannot obtain sufficient appropriate audit evidence through alternative procedures, a disclaimer of opinion should be rendered or, when practical, the auditor might withdraw from the engagement.

## **Environmental Remediation Liabilities**

FASB ASC 410, *Asset Retirement and Environmental Obligations*, provides accounting and auditing guidance related to environmental remediation liabilities. In general, FASB ASC 410 requires CIRAs to accrue environmental remediation liabilities when the criteria of FASB ASC 450, *Contingencies*, are met. This area is challenging because of the number of applicable state and federal laws, and the possibility that many years may elapse between the contamination event and identification of the liability. *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* and *PPC's Guide to Preparing Financial Statements* provide more information on environmental laws and accounting for environmental remediation liabilities.

**Audit Procedures.** To identify instances of noncompliance with laws and regulations (such as environmental regulations) that may have a material effect on the financial statements, AU-C 250.14 requires auditors to (a) inquire of management and, when appropriate, those charged with governance about whether the CIRA is in compliance with such laws and regulations and (b) inspect correspondence, if any, with the appropriate licensing or regulatory authorities. The extent of other procedures performed for environmental liabilities depends on the CIRA's potential to incur such liabilities. Questions auditors may ask to evaluate a CIRA's potential for environmental remediation liabilities are included in Exhibit 2-1. If there is an increased risk that the CIRA has environmental remediation liabilities, auditing procedures generally are the same procedures applied for other contingent liabilities (that is, reading the minutes of board or administrative committee meetings, making inquiries of the CIRA's attorney, and making inquiries of the client). Some of the inquiries auditors should make of management include whether they have:

- Considered environmental matters that may materially affect the financial statements.
- Established effective policies and procedures to assess and record information on environmental matters.
- Been notified that the CIRA has been designated as a PRP or otherwise has an increased risk of exposure to environmental liabilities.

## Exhibit 2-1

### Questions for Identifying an Increased Risk of Environmental Liabilities

Is there any indication the CIRA has violated environmental laws? (While complying with the law in force at the time a toxic substance is disposed of normally does not free the CIRA from its liabilities for cleaning up the site, any penalties may be reduced.)

Does the CIRA use or generate regulated substances in its operations?

Is the CIRA required to have a permit to transport, store, treat, or dispose of hazardous wastes?

Has the CIRA ever used landfills, underground storage tanks or barrels to dispose of hazardous substances?

Are there any pending civil or criminal investigations related to environmental issues?

Have regulatory authorities or environmental consultants issued any reports on property the CIRA is associated with, such as site assessments or impact studies?

Are there any requirements for site clean-up of any property abandoned, purchased, or closed during the period? Any intentions for future removal and site restoration?

Has the CIRA retained any environmental remediation liabilities for any sites it has sold?

Is the CIRA aware of mold intrusion affecting the development or are any mold remediation projects in progress?

\* \* \*

Auditors frequently obtain information about potential environmental liabilities through the lawyer's letter. If the client has been notified that a potential liability exists for a site with which it is or has been associated, the auditor would normally probe (through additional inquiry and analysis) an assertion by the CIRA's attorney that the risk of loss is other than probable.

**Auditing the Estimated Liability.** If a CIRA has been designated a PRP or has an increased risk of exposure, the auditor needs to obtain an understanding of the method used to estimate the liability. If the client uses an attorney, engineer, or other specialist to make the estimate, the auditor should treat it as if a specialist has been used.

In addition to the general information discussed later in this lesson, auditors may also consider information such as the following when assessing the adequacy of the client's estimate:

- The CIRA's previous cleanup experience, if any.
- The cleanup experiences of other CIRAs.
- Data released by the EPA or other organizations.

**Auditing Potential Recoveries.** The CIRA may be able to file a claim for recovery of its remediation costs from insurers, nonparticipating PRPs, prior property owners, and governmental or third-party funds. Potential recoveries are evaluated separately from the related liability. To assess whether recovery of a potential claim is probable, auditors generally need to confirm recoverable amounts directly with the insurer, nonparticipating PRPs, or any specialized legal counsel that is involved. In addition, auditors will generally need to obtain evidence about the collectibility of receivables from these parties. Auditors generally will also need to make inquiries of the CIRA's legal counsel. Unless there is a legal right of offset, potential recoveries are not netted against potential liabilities.

**Mold.** Mold intrusion is a common environmental concern for CIRAs due to the significant expenses incurred by associations for mold remediation. Unfortunately for CIRAs, most insurance policies have been rewritten to exclude mold damage. Attorneys are cautioning CIRA boards of directors to be proactive in responding to mold claims. Once mold is discovered, repair, remediation, and possibly relocation of the unit owners occur as part of the remediation process.

Determining the responsible party and the extent and/or type of repairs and remediation, as well as unit owner relocation policies, varies by association and the specific circumstances encountered. The auditor needs to inquire of management as to the association's policy with regards to these matters and the expected financial impact. Often, however, the financial impact is unknown until the extent of the damage is uncovered and the extent of necessary remediation can not be determined until the mold is exposed. For mold remediation projects in process, the association needs to consider whether disclosure of the contingency in the notes to the financial statements is adequate. An illustrative disclosure example follows:

Mold has been found and remediated in one or more units of the Association during the year. Neither the extent of the mold intrusion, nor the total financial impact to the Association, can be determined at this time.

## Risks and Uncertainties

FASB ASC 275, *Risks and Uncertainties*, requires disclosures about (a) certain risks and uncertainties that could significantly affect the amounts or situations reported in the financial statements or the near term functioning of the entity and (b) certain inherent limitations in financial statements. The disclosures are grouped into the following four areas:

- Nature of operations.
- Use of estimates in the preparation of financial statements.
- Certain significant estimates.
- Current vulnerability resulting from certain concentrations.

The first two disclosures generally are required for all financial statements. The second two are required only for estimates and concentrations that meet specified criteria. FASB ASC 275 does not apply to condensed or summarized interim financial statements. The first two areas do not require significant additional audit work because the disclosures are required in all financial statements and the information needed for the disclosures is readily available. However, for the other two areas, specific procedures may be necessary to determine that all required disclosures have been identified.

**Nature of Operations.** FASB ASC 972-235-50-1 requires CIRA financial statements to disclose the entity for which the CIRA provides services, the areas it controls, and the number of units in the CIRA. In most cases, those disclosures will satisfy the requirements of FASB ASC 275 to disclose the nature of operations. If a CIRA has significant revenue from nonmembers, however, FASB ASC 275 also requires disclosure of the relative importance of that segment of the CIRA's operations.

**Use of Estimates.** FASB ASC 275 requires financial statements to disclose that the preparation of financial statements requires the use of management estimates. That boilerplate disclosure generally is included in the summary of significant accounting policies.

**Certain Significant Estimates.** Initially, an auditor's objective is to determine whether all significant estimates have been identified. The auditor may be aware of significant estimates from knowledge of the CIRA's operating characteristics and the industry in which it operates. Some estimates may be identified as a result of risk assessment procedures or further audit procedures applied to specific financial statement elements. AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, also provides guidance that is useful. As discussed later in this lesson, AU-C 540 requires the auditor to obtain an understanding, through the performance of risk assessment procedures, of how management identifies those transactions, events, and



conditions that may require accounting estimates. When doing so, the auditor is required to make inquiries of management about changes in circumstances that may result in new or changed estimates. The exhibit to AU-C 540 provides numerous examples of accounting estimates that are included in financial statements.

FASB ASC 275 requires additional disclosures for certain significant estimates. The additional disclosures are required when the estimate meets both of the following criteria:

- It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events, and
- The effect of the change would be material to the financial statements.

*Near term* means within a period of time not to exceed one year from the date of the financial statements.

The next step is determining whether it is at least reasonably possible that an estimate will change by a material amount in the near term. The term *reasonably possible* encompasses the entire range from “more than remote” to “less than likely.” It could be concluded that it is at least reasonably possible that almost any estimate could change. To conclude otherwise, auditors must conclude that there is only a *remote* chance of an estimate changing.

*Materiality* for disclosure under FASB ASC 275 does not depend on the amount reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have on the financial statements. Disclosure may be required even if an estimate resulted in the recognitions of a small financial statement amount or no amount. When evaluating the potential materiality of a change in an estimate, auditors should use the same materiality thresholds used to evaluate uncorrected misstatements at the conclusion of the audit. Using planning materiality, which is calculated in the planning stage of the audit to establish the extent of audit tests, is not necessarily appropriate.

AU-C 540 indicates that auditors are required to obtain sufficient appropriate evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with GAAP. If there are significant risks associated with an accounting estimate, auditors are also required to evaluate the adequacy of disclosure of estimation uncertainty in the financial statements. AU-C 540.A130 notes that the importance of the auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases as the range of possible outcomes of the estimate also increases in relation to materiality.

Whenever auditors conclude there is only a remote chance of an estimate changing, best practices indicate that it is good practice to document such conclusions, particularly if the decisions are difficult or contentious. Such documentation can be unstructured and can be done, for example, on the relevant workpaper or in a separate memo. AU-C 540.22 notes that the auditor is required to document the basis for conclusions pertaining to the reasonableness of accounting estimates and their disclosure when there are significant risks.

**Current Vulnerability Resulting from Certain Concentrations.** FASB ASC 275 requires disclosure of current vulnerability from concentrations that exist at the balance sheet date (a) in the volume of business with a particular customer, supplier, or lender, (b) in revenue from particular products or services, (c) in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations, and (d) in the market or geographic area in which an entity conducts its operations if the concentrations meet the following criteria:

- The concentration makes the entity vulnerable to the risk of a near-term severe impact.
- It is at least reasonably possible that the events that could cause the severe impact will occur in the near term; that is, within one year from the date of the financial statements.

Vulnerability from concentrations occurs when an entity is exposed to a greater risk of loss than would have existed if the entity had mitigated its risk through diversification. A concentration is of concern when it involves something that cannot be easily replaced, for example, if a cooperative purchases most of its heating fuel from a single

supplier that cannot easily be replaced. Concentrations may involve another entity or individual, or they may involve a group of counterparties or items that have similar economic characteristics, such as a group of homeowners that collectively expose the CIRA to a particular kind of risk.

The audit approach for concentrations is similar in many respects to the audit approach for significant estimates. That is, initially, the auditor's objective is to determine whether all concentrations have been identified. If the auditor identifies concentrations, evaluation of disclosure can be documented on the relevant workpaper, by memo, or on a relevant checklist. The auditor may be aware of concentrations from knowledge of the CIRA's operating characteristics and the industry in which it operates. Some concentrations may be identified as a result of audit procedures applied for specific financial statement elements. One significant difference between auditing disclosures of concentrations and auditing disclosures of significant estimates is that the threshold for disclosure is different. For concentrations, the threshold is *severe impact*, whereas for significant estimates, the threshold is *material*. (Severe impact refers to a significant financially disruptive effect on the normal functioning of the association. It is more than material, but less than catastrophic.) Auditors may find that fewer concentrations require disclosure. That, however, is a matter of professional judgment based on the individual circumstances of each client.

**Wording the Disclosure.** Applying the requirements of FASB ASC 275 requires significant judgment on the part of both the auditor and the client. However, FASB ASC 275 contains only disclosure requirements. It does not require amounts to be recorded in the financial statements. For that reason, an approach of "when in doubt, disclose" is recommended. In a sense, by making the disclosure, both the client and the auditor transfer some of the risk due to uncertainties in the financial statements to the users of the financial statements themselves. By not making the disclosures, however, the client and the auditor forego an opportunity to reduce the risk that a user may successfully assert in litigation that the disclosures should have been made.

CIRAs may have concerns that the disclosures required by FASB ASC 275 will include information considered by management to be confidential. That is particularly true for disclosure of certain concentrations. Other concerns may include that the disclosures are too negative. Some client resistance may be overcome by carefully wording the proposed disclosures. For example, when disclosing a concentration, phrases such as "a significant portion" or "a substantial percentage" are appropriate. The guidance does not require disclosure of names or percentages.

**Reporting Issues.** FASB ASC 275 only leads to modifying the auditors' report if either—

- The disclosures are incorrect or not adequate, in which case the report should be modified for a departure from GAAP, or
- The auditors are unable to obtain sufficient audit evidence to support management's assertion about the nature, presentation, and disclosure of an uncertainty, in which case the report should be modified for a scope limitation.

Report modification just because there is an uncertainty is not required.

## PROCEDURES FOR ACCOUNTING ESTIMATES AND FAIR VALUE

### Accounting Estimates

Preparation of financial statements normally requires making accounting estimates. AU-C 540.07 defines an *accounting estimate* as "an approximation of a monetary amount in the absence of exact measurement." The following are examples of accounting estimates that may be relevant to CIRAs:

- a. Net realizable values of assessments receivable.
- b. Valuation of common property contributed by the developer/sponsor.
- c. Valuation of securities.

Accounting estimates may be recognized in the financial statements (for example, the allowance for doubtful accounts or an impairment adjustment) or only disclosed (for example, disclosure of the fair value of financial instruments).

AU-C 540 does not prescribe specific audit procedures to substantiate specific accounting estimates; instead, it emphasizes that the auditor should follow a risk-based approach when auditing accounting estimates. An auditor should understand how management (a) identifies transactions, events, and conditions that require accounting estimates and (b) makes estimates (including understanding the methods, assumptions, relevant controls, specialists required, changes from prior periods, and how estimation uncertainty has been assessed). Through the performance of risk assessment procedures, the auditor should identify and assess risks associated with the development of accounting estimates.

The nature and reliability of information available to management when making estimates will vary. As a result, the degree of estimation uncertainty associated with estimates will vary. The degree of estimation uncertainty affects the risk of material misstatement of estimates. AU-C 540 defines *estimation uncertainty* as “the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.” In identifying and assessing risks associated with accounting estimates, the auditor is required to (a) evaluate the degree of estimation uncertainty associated with accounting estimates and (b) determine if those estimates with high estimation uncertainty represent significant risks. For identified significant risks, the auditor is required to understand the entity’s controls, including control activities.) Accounting estimates with a higher degree of estimation uncertainty also might be susceptible to management bias.

The auditor’s further audit procedures for identified accounting estimates should be responsive to the assessed risks of material misstatement that are related to those estimates. In responding to assessed risks for accounting estimates, AU-C 540 requires the auditor to do one or more of the following:

- Test the operating effectiveness of the controls over how management made the estimate, along with appropriate substantive procedures.
- Determine if subsequent events up to the date of the auditor’s report provide audit evidence about the estimate.
- Test how management made the estimate and the underlying data, including the evaluation of the appropriateness of the method, reasonableness of the assumptions, and the reliability of the underlying data.
- Develop a point estimate or range to evaluate management’s point estimate.

The approach selected by the auditor will normally depend on the nature of the estimate, the effectiveness of the procedure in providing sufficient appropriate audit evidence, and the assessed risk of material misstatement, including whether the risk is considered to be a significant risk.

Auditors also are required to perform a review of the outcome of accounting estimates that were included in the prior period. Generally, the outcome of an accounting estimate will differ from the amount that was recognized in the prior period. By identifying and understanding the reasons for such differences, the auditor may obtain information about the effectiveness of management’s prior period estimation process, audit evidence that is pertinent to re-estimation of prior period estimates in the current period, or evidence of matters requiring disclosure in the financial statements such as estimation uncertainty. In addition, AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires a retrospective review of management’s judgments or assumptions related to significant accounting estimates included in prior period financial statements to determine if there is an indication of management bias and a risk of material misstatement due to fraud. As a practical matter, both reviews can be coordinated when reviewing prior period estimates.

**Significant Risks.** When the auditor has determined that there is a significant risk associated with an accounting estimate, AU-C 540 requires auditors to evaluate:

- How management considered alternative assumptions and why they were rejected or how estimation uncertainty was addressed in making the accounting estimate (e.g., the use of a sensitivity analysis).
- Whether the significant assumptions used by management are reasonable.

- When relevant to the reasonableness of the significant assumptions used by management or the application of GAAP, management's intent and ability to carry out a specific course of action.
- Whether disclosures in the financial statements relating to estimation uncertainty are adequate. (Even though the client's disclosures might comply with GAAP, the auditor might deem them to be inadequate in light of the specific facts and circumstances.)

If the auditor deems that management has not adequately addressed the effects of estimation uncertainty, the auditor should, when necessary, develop a range to evaluate the reasonableness of the estimate. Furthermore, for accounting estimates with significant risks, the auditor is required to obtain sufficient appropriate evidence about whether management's decision to recognize, or not recognize, the estimate, as well as the measurement basis, are in accordance with GAAP.

**Evaluating the Reasonableness of Estimates and Determining Misstatements.** When evaluating the reasonableness of management's estimates, if the audit evidence supports a point estimate, a misstatement represents the difference between the auditor's point estimate and the amount recorded by management. If the auditor has developed a range and management's estimate falls outside that range, the misstatement is at least the difference between management's point estimate and the nearest point of the auditor's range.

**Disclosures.** AU-C 540 emphasizes that the auditor should obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements relating to accounting estimates are in accordance with GAAP. Checklists provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* can help the auditor determine whether disclosures relating to accounting estimates are complete and appropriately presented. The auditor would still need to determine whether enough audit evidence has been collected to support the matters presented in the disclosures. In addition, as discussed above, when an accounting estimate has significant risks, the auditor is required to evaluate the disclosures pertaining to estimation uncertainty in the financial statements.

**Indicators of Possible Management Bias.** AU-C 540.21 requires the auditor to review judgments and decisions made by management when making accounting estimates to determine if there are any indicators of possible management bias. Indications of management bias may affect the auditor's conclusions regarding risk assessment and whether there are implications for the rest of the audit. AU-C 540.A134 provides the following examples of indicators of possible management bias regarding accounting estimates:

- Changes in an estimate, or the underlying method, when management has made a subjective assessment that there has been a change in circumstances.
- The entity uses its own assumptions for fair value accounting estimates that are inconsistent with observable market assumptions.
- Selection or construction of significant assumptions that result in a favorable point estimate for management's purposes.
- Selection of a point estimate that indicates a pattern of optimism or pessimism.

AU-C 240.32 also requires the auditor to review estimates for bias and evaluate whether underlying circumstances represents a risk of material misstatement due to fraud. Similar to AU-C 540, AU-C 240 requires the auditor to evaluate whether the judgments and decisions made by management when making the estimate indicate possible bias, even if they are individually reasonable. If so, the auditor is required to reevaluate accounting estimates as a whole. The auditor might also consider whether differences between estimates best supported by the audit evidence, and the estimates included in the financial statements that are individually reasonable, indicate (in the aggregate) a possible bias on the part of management. If management, for example, always chooses estimated amounts for the valuation of assets that are at the low end of the range the auditor considers reasonable, the combined effect could result in a material misstatement of income. In that case, the auditor should consider whether other recorded estimates reflect a similar bias and perform additional procedures to address those estimates. The auditor might also consider whether management's estimates were at one end of the auditor's reasonable range in the prior year and at the other end in the current year. That could indicate the possibility that

management is using accounting estimates to manage earnings. If the auditor believes that is the case, the auditor should consider communicating the matter to those charged with governance as discussed later in this lesson.

AU-C 240.32 further requires auditors to perform a retrospective review of significant prior-year accounting estimates to determine whether the underlying judgments and assumptions indicate possible bias. The items selected for review should be those estimates based on highly sensitive assumptions or those that are significantly affected by judgments made by management. The review may provide additional information about whether the current year's estimates could be biased.

**Documentation.** AU-C 540.22 requires the following matters related to accounting estimates to be included in audit documentation:

- For accounting estimates with significant risks, the basis of conclusions about the reasonableness of the estimate and related disclosures.
- Indicators of management bias.

### **Fair Value Measurements and Disclosures**

GAAP requires some assets, liabilities, and components of equity to be measured or disclosed at fair value. Examples of a CIRA's use of fair value measurements include (a) abandoned or foreclosed units received by the CIRA for nonpayment of delinquent assessments, (b) units received by the CIRA from the developer in settlement of litigation, (c) securities classified as available for sale, and (d) common property transferred to the CIRA by the developer. The requirements of AU-C 540 apply when auditing fair value accounting estimates.

Some fair values are readily determinable because there are relevant quoted market prices (such as for marketable securities classified as available for sale). For such items, published price quotations in an active market are the best evidence of fair value. When there is no observable market price or items have characteristics requiring an estimate to be made, use of a valuation method, such as discounted cash flows, may provide the best estimate of fair value.

When a valuation method is used, the auditor considers the appropriateness of the method, including management's rationale for selecting the method. Auditors may consider whether management has evaluated the range of values resulting from different methods and investigated the reasons for the differences. Changes in circumstances may require changes in the method used to determine fair value. If there has been a change from the prior period in estimates or the methods, the auditor should determine if such changes are appropriate in the circumstances.

The following approaches may be used to obtain evidence supporting a fair value estimate determined using a valuation model:

- Test the client's valuation, including management's assumptions (or those of a specialist), the valuation model, and the underlying data.
- Develop an independent estimate and compare it to the client's valuation.
- Review subsequent events and transactions to corroborate the client's valuation. (However, the auditor should consider only those events or transactions that reflect circumstances existing at the balance sheet date.)

When testing the client's valuation or developing an independent estimate based on management's assumptions, the auditor should evaluate whether management's assumptions are reasonable and not inconsistent with market information. If management retained a specialist to develop the valuation, the auditor's responsibility to test the assumptions does not change. The auditor considers the source and reliability of evidence supporting the assumptions, pays special attention to assumptions that are highly sensitive or uncertain and those susceptible to misapplication or bias, and considers the sensitivity of the valuation to changes in assumptions and market conditions.

To be reasonable, the assumptions, individually and taken as a whole, need to be realistic and consistent with the following:

- The general economic environment, the economic environment of the specific industry, and the entity's economic circumstances.
- Existing market information.
- The plans of the entity, including what management expects will be the outcome of specific objectives and strategies.
- Assumptions made in prior periods, if appropriate.
- Past experience of, or previous conditions experienced by, the entity to the extent currently applicable.
- Other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures.

AU-C 540.A83 also provides additional matters the auditor might consider when evaluating the reasonableness of assumptions pertaining to fair value accounting estimates, including:

- When relevant, whether and how market-specific inputs have been included in the development of assumptions.
- Whether assumptions are consistent with observable market conditions and the characteristics of the asset or liability measured at fair value.
- Whether the sources of market-participant assumptions are relevant and reliable.
- When a number of different market participant assumptions exist, how management selected the assumptions to use.
- Whether and how management considered assumptions used in comparable transactions, assets, or liabilities.

When there are unobservable inputs, the auditor's evaluation of the assumptions will likely be combined with other responses to assessed risks as discussed earlier in this lesson. Also, fair value accounting estimates with unobservable inputs as a result of illiquid markets may provide challenges to management. Therefore, the auditor would consider the risks that may exist for such estimates when assessing the risks of material misstatement and developing appropriate responses.

The accuracy, completeness, and relevancy of the underlying data should also be tested, and the auditor should ensure that the resulting valuation properly reflects both the assumptions and the data. Tests may include verifying the source of the data, recomputation, and review of information for internal consistency.

The auditor who independently develops assumptions for use in evaluating the client's estimate still needs to understand management's assumptions so the auditor can assess whether any significant matters have been omitted and can evaluate any significant differences between management's and the auditor's estimates.

For certain valuations, best practices indicate that the development of an independent estimate or the use of subsequent events to corroborate the client's valuation will not be practical or may be of limited usefulness. Also, for long-term liabilities such as asset retirement obligations, the use of subsequent events would generally not apply.

During summarization and evaluation procedures, the auditor should evaluate the sufficiency of the evidence obtained and its consistency with other evidence obtained during the audit. Regardless of the audit approach used,

the auditor should ordinarily obtain management representations about the reasonableness of significant assumptions and consider certain communications with those charged with governance. Management representations and communications with those charged with governance are discussed later in this lesson.

### Identifying Financial Instruments of Nonpublic Entities

Financial instruments consist of the following:

- a. Cash.
- b. Evidence of an ownership interest in an entity.
- c. Contracts that require one entity to deliver cash or another financial instrument to another entity.
- d. Contracts that require two entities to exchange financial instruments on potentially unfavorable terms.

Contracts that are financial instruments can be grouped into five categories: unconditional receivable-payable contracts, receivable-payable contracts conditional on the occurrence of an event outside the control of either party, financial option contracts, financial guarantees or other conditional exchanges, and financial forward contracts. Since contracts are not financial instruments unless they are to be settled with cash or other financial instruments, a number of common rights and obligations are excluded, such as deferred revenue for membership assessments received in advance that will be settled by providing services. Similarly, executory contracts for future services to be provided by one of the parties (such as an operating lease) are not financial instruments.

### Disclosure Requirements

FASB ASC 825 primarily requires certain entities to disclose (a) the fair values of financial instruments for which it is practical to estimate fair values and (b) concentrations of credit risk. Disclosures about market risk of financial instruments are encouraged, but not required. This course suggests that most CIRAs are exempt from the requirement to disclose the fair value of financial instruments. Fair value disclosures are discussed in *PPC's Guide to Preparing Financial Statements*.

### Auditing Fair Value Disclosures

When auditing fair value disclosures, the following guidance applies:

- Evaluation of whether fair value disclosures are in conformity with GAAP ordinarily involves the same audit procedures used to audit fair value measurements recognized in the financial statements.
- If fair value disclosure is omitted because it is not practical to determine fair value with sufficient reliability, information that would be pertinent to such an estimate should be disclosed along with the reasons why it is not practical to estimate fair value. In that case, the adequacy of disclosures required in such circumstances is evaluated.

## ADDRESSING SUBSEQUENT EVENTS

AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, defines the types of subsequent events the auditor should evaluate and specifies the procedures that should be performed to determine the occurrence of such events. FASB ASC 855-10, *Subsequent Events*, includes accounting and disclosure standards for subsequent events.

### Dating the Auditor's Report and Subsequent Events Note in the Financial Statements

FASB ASC 855-10-50-1 requires reporting entities to disclose the date through which subsequent events have been evaluated and whether that date is the date the financial statements were issued or were available to be issued. That disclosure is required regardless of whether the reporting entity recognizes or discloses a subsequent event

in its financial statements. Generally, CIRAs will evaluate subsequent events through the date that the financial statements are available to be issued, i.e., when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained. Often, this will be the date of the auditor's final conference with the CIRA when proposed adjustments to the financial statements are agreed upon. Therefore, the remainder of this discussion addresses subsequent events in the context of the date that the financial statements are available to be issued.

FASB ASC 855-10-20 notes that subsequent events are events or transactions that occur subsequent to the balance sheet date but before financial statements are available to be issued. The period within this time is called the *subsequent events period*, and the audit procedures performed specifically to search for material events in this period are referred to as the *subsequent events review*.

The auditor's report is dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the opinion. This includes evidence about subsequent events, so the auditor's report date cannot be earlier than the date of management's subsequent events evaluation note. AU-C 560.A10 notes that, in most cases, the date of management's subsequent events evaluation note will be the same date as the auditor's report. Furthermore, AU-C 580 requires management to make specific representations relating to information concerning subsequent events, and the date of the management representation letter should be the same as the date of the auditor's report. Therefore, the subsequent evaluation note date, the management representation letter date, and the auditor's report date generally will be the same. See discussion on coordinating these dates later in this lesson.

In addition, ordinarily, the date of the auditor's report is expected to be close to the report release date. Many firms adopt a policy about when to date their auditor's report if there is a delay in releasing the report (that is, how long of a delay makes it necessary to redate the report). A decision to redate the report should result in extending the subsequent events review to the later date. Auditors should consider covering that matter in their firm's quality control policies and procedures. Dating of the auditor's report is discussed later in this lesson.

### **Subsequent Events Review Procedures**

Some subsequent events may be discovered as a result of audit procedures applied for specific financial statement components (for example, cutoff tests and assessment of valuation, such as considering the impairment of assets). AU-C 560.10 requires auditors to perform other procedures specifically to search for material subsequent events, including (a) understanding the procedures management has established to ensure that subsequent events are identified; (b) reading minutes of meetings held through the date of the auditor's report and inquiring about matters discussed at such meetings for minutes that are not yet available; (c) reading any interim financial statements or financial reports prepared in the subsequent period and investigating any unusual fluctuations; and (d) inquiring of management about the existence of significant subsequent events. Auditors' subsequent event procedures also often include evaluating whether events provide evidence about accounting estimates, scanning journals and ledgers for the subsequent period and considering whether the carrying amount of assets has become impaired subsequent to year end. Furthermore, the lawyer's response and the management representation letter may also provide evidence of, or representations about, the existence of significant subsequent events. The auditor would apply any additional audit procedures necessary to follow up on material subsequent events identified.

**Timing.** Subsequent events review procedures should cover the period from the date the financial statements are available to the date of the auditor's report, or as close to that date as practicable.

Also, as mentioned earlier in this lesson, the lawyer's letter should have an effective date that is as close as possible to the audit report date (for example, generally within about two weeks of the report date). The management representation letter should be dated as of the audit report date.

### **Subsequent Events Occurring after the Date of the Report**

Subsequent to the date of the auditor's report, the auditors may become aware of facts that existed on that date that might have caused them to believe information supplied by the association was incorrect, incomplete, or otherwise unsatisfactory had they then been aware of them. In such circumstances, the auditors should consider the



guidance in AU-C 560, *Subsequent Events and Subsequently Discovered Facts* (formerly AU 561), in determining an appropriate course of action.

The guidance in AU-C 560 can be summarized as follows:

- a. Facts discovered after the date of the auditor's report but before the report release date—
  - (1) Discuss the matter with management and when appropriate, those charged with governance.
  - (2) Determine whether the financial statements need revision.
  - (3) If management revises the financial statements, perform procedures necessary with respect to the revision, update management representations, and either (a) dual-date the auditor's report for the revision or (b) date the auditor's report as of the later date and extend subsequent events procedures to that date.
  - (4) If management does not revise the financial statements, modify the auditor's report.
- b. Facts discovered after the report release date—
  - (1) Discuss the matter with management and when appropriate, those charged with governance.
  - (2) Determine whether the financial statements need revision.
  - (3) If management revises the financial statements, perform procedures necessary with respect to the revision, update management representations, and either (a) dual-date the auditor's report for the revision or (b) date the auditor's report as of the later date and extend subsequent events procedures to that date. If the auditor's opinion on the revised financial statements differs from the previous opinion, determine that appropriate disclosures are made.
  - (4) If management does not revise the financial statements and the audited financial statements were not made available to third parties, notify management not to make the statements available to third parties until they have been revised and the auditors have issued a new report. If the audited financial statements were made available to third parties, assess whether management has taken appropriate steps to prevent reliance on the statements.
  - (5) If management does not take appropriate steps to prevent reliance on the financial statements before their revision, notify management and those charged with governance that the auditor will seek to prevent reliance on the auditor's report, and seek to prevent reliance if management and those charged with governance still do not take appropriate steps.

According to AU-C560.A18, this guidance is applicable, even if the auditor has withdrawn or been discharged.

Procedures to be performed are included in the audit procedures provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*. *PPC's Guide to Nonpublic Companies* provides a detailed listing of the objectives and requirements of AU-C 560. *PPC's Guide to Auditor's Reports* provides reporting guidance when the decision is made to issue revised financial statements and the auditor's report.

## TRANSACTIONS WITH RELATED PARTIES

Most business transactions result from bargained dealing. When the parties to a transaction are related, the objectivity expected in unrelated bargaining may be lost. Because of the loss of objectivity, knowledge of the nature and volume of transactions with related parties may be necessary for financial statement users to properly evaluate the CIRA's financial condition and results of operations. Consequently, FASB ASC 850, *Related Party Disclosures*, requires material related-party transactions to be disclosed. Under FASB ASC 850 related parties include affiliates; equity investees; pension, profit-sharing, and similar trusts managed by or under the trusteeship of management;

principal owners, management, and members of their immediate families; other parties if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the parties might be prevented from pursuing its own separate interest; or another party that can significantly influence the management or operating policies of the transacting parties or that has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from pursuing its own separate interests.

### **Auditing Standards for Related Parties**

Authoritative literature outlining the auditor's responsibilities with regard to related parties and related-party transactions is contained in AU-C 550, *Related Parties*. AU-C 550 requires the auditor to (a) perform risk assessment procedures to identify and assess the risks of material misstatement arising from related-party relationships and transactions, (b) determine whether any of those risks are significant risks, and (c) design and perform further audit procedures in response to those risks. In addition, under AU-C 550, as part of performing risk assessment procedures, the auditor should obtain an understanding of the controls surrounding related parties and related-party transactions and treat significant related-party transactions outside the normal course of business as significant risks. Furthermore, if the auditor identifies related-party transactions that have previously not been identified or disclosed by management, the auditor should perform additional procedures regarding (a) the risk that additional related-party transactions may exist, and (b) the consideration of fraud.

### **Audit Procedures**

Audit procedures for related parties are generally applied at the start of the audit, in connection with other audit procedures applied to financial statement components, and near the end of the audit as a final review. At the start of the audit, auditors perform risk assessment procedures to identify obvious or known related parties so that the auditors can develop appropriate audit procedures and can recognize transactions with those parties when applying audit procedures. Some of the procedures used are (a) inquiring of predecessor auditors; (b) reviewing prior year workpapers; (c) discussing with the engagement team the susceptibility of the financial statements to material misstatement due to error or fraud that could result from related party relationships and transactions; (d) reading minutes of board of directors' meetings; (e) reviewing documents such as income tax returns and regulatory filings; (f) inquiring of management for the names of related parties, material transactions with them, and any changes from the prior period; and (g) inquiring of management and others about controls over related-party relationships and transactions.

Most audit procedures for related parties relate to receivables and payables. Occasionally, auditors may discover that the client is settling related-party receivables or payables at year end and renewing them after year end. In those circumstances, the auditors need to consider whether the settlements are accounted for based on their economic substance and whether such transactions are adequately disclosed in the financial statements. Auditors also should remain alert when inspecting documents or records (for example, bank and legal confirmations and minutes of board of directors' meetings) for arrangements or other information that may indicate the existence of a previously undisclosed related-party relationship or transaction. AU-C 550.23 requires the auditors to perform certain procedures when they identify related parties or significant related-party transactions that management has not previously identified or disclosed. Furthermore, when significant transactions outside the association's normal course of business are identified, the auditor should inquire of management about the nature of the transactions and whether related parties could be involved (AU-C 550.17).

Generally, the purpose of final review procedures is to evaluate whether there are undisclosed transactions with related parties and to evaluate the adequacy of disclosure of identified transactions. Some audit procedures of an overall review or analytical nature that are performed near the end of the audit may disclose related-party transactions. Generally, those procedures include scanning accounting records for large, unusual, or nonrecurring transactions or balances, particularly those around the end of the period; considering the nature and extent of business with the CIRA's officers, the developer/sponsor, and major suppliers, borrowers, or lenders for undisclosed relationships; and considering whether transactions are occurring, but not being given accounting recognition, e.g., the transfer of a unit in development from the developer to the CIRA in settlement of litigation.

**Substantiating Material Related-party Transactions.** Generally, the audit procedures applied to substantiate material transactions with related parties are the normal procedures applied to other significant transactions, e.g.,

vouching, confirmation, and recomputation. However, if an auditor has identified a risk of material misstatement related to a transaction's nature or purpose or the recording of the transaction, it may be necessary to apply additional procedures. Examples of such procedures include confirmation, inspecting evidence possessed by the other party to the transaction; discussing relevant information with intermediaries, such as banks, agents, or attorneys; referring to financial publications, credit agencies, and other sources for information about unfamiliar parties to the transaction; etc. It is a good idea for the auditor to consider whether any related-party transactions are occurring that are not being recognized in the accounting records.

Other procedures may be necessary to understand the transaction or obtain evidence about it, such as consultation with persons knowledgeable about a particular specialized type of transaction, application of audit procedures at the related-party, or even an audit of the related party's financial statements. The auditor also may consider obtaining representations from senior management and directors about whether they, or any other related parties, engaged in any transactions with the CIRA during the period.

FASB ASC 850 and AU-C 550.25 indicate that representations about related-party transactions should not imply that the transactions were consummated on an arm's-length basis unless those representations can be substantiated. AU-C 550.A45 notes that generally it is difficult to substantiate management representations that a related-party transaction was consummated on an arm's-length basis. (AU-C 550.A46–.48 provide some example procedures that might be performed to substantiate such representations.) If management discloses in the financial statements that a related-party transaction was consummated on an arm's-length basis, but prefaces that representation with a phrase such as "Management believes that . . ." or "It is the Association's belief that . . ." management's responsibility to substantiate the representation is not affected. Also, the auditor needs to consider wording that is potentially ambiguous about arm's-length status in the same manner. For example, management might state that the transactions are consummated on a reasonable basis. Because there are no criteria for the reasonableness of related-party transactions, the assertion cannot be substantiated. If the representations cannot be substantiated, the auditor needs to consider the implications for the auditor's opinion on the financial statements.

Auditors also need to understand the business purpose of material related-party transactions and that proper authorization of such transactions, such as by CIRA management, board of directors, or those charged with governance, is more important than for similar transactions with unrelated parties.

**Related-party Transactions and Fraud.** AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to consider the existence of fraud risk factors when identifying and assessing risks of material misstatement due to fraud. A common thread in many frauds is the use of related parties unknown to the auditor to facilitate management intentionally misstating the financial statements (for example, selling real estate or other assets to a related party for artificial gain). Appendix A to AU-C 240 lists the risk factors that may involve transactions with related parties.

## Disclosures

FASB ASC 850 requires certain disclosures about related parties. A full list of those disclosures is beyond the scope of this course, but more information is available in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. The Westview Homeowners' Association is likely to experience significant losses on one of its long-term vendor contracts. This is an example of which of the following?
  - a. Related-party transactions.
  - b. Subsequent events.
  - c. Accounting estimates.
  - d. Commitments and contingencies.
10. FASB ASC 275 requires which of the following to be disclosed in all financial statements affected by risks or uncertainties?
  - a. The nature of operations.
  - b. The single largest significant estimate.
  - c. Future vulnerability due to specific concentrations.
  - d. Whether the entity can continue as a going concern.
11. Which of the following accounting estimates is most likely to be affected by management bias?
  - a. Estimate 1 has remained the same for the last few years.
  - b. Estimate 2 uses fair value assumptions that reflect those used by the market.
  - c. Use of Estimate 3 results in a positive point estimate for management.
  - d. Use of Estimate 4 does not indicate any type of pattern on management's part.
12. After performing a CIRA audit and releasing her report, Jane discovers facts that affect her opinion. What is the first thing she needs to do?
  - a. Seek to prevent reliance on the auditor's report.
  - b. Discuss the matter with management.
  - c. Determine whether the financial statements need to be revised.
  - d. Notify management not to make the financial statements available to third parties.
13. When performing a CIRA audit, Tom discovered a significant related-party transaction that was not disclosed by management. What should Tom do differently for this transaction than other related-party transactions?
  - a. He needs to determine if the lack of disclosure was an act of fraud.
  - b. He should perform risk assessment procedures to identify the risks of material misstatement.
  - c. He must obtain an understanding of the CIRAs controls for related-party transactions.
  - d. He needs to determine if any associated risks are significant.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. The Westview Homeowners' Association is likely to experience significant losses on one of its long-term vendor contracts. This is an example of which of the following? **(Page 44)**
- a. Related-party transactions. [This answer is incorrect. While it is possible for a vendor contract to be a related-party transaction, that is not specified in the scenario above; therefore, there is a better answer to this question.]
  - b. Subsequent events. [This answer is incorrect. Subsequent events are events or transactions that occur subsequent to the balance sheet date but before financial statements are available to be issued. While it is possible that the losses described above could occur as a subsequent event to a set of annual financial statements, that is not definite, so there is a better answer to this question.]
  - c. Accounting estimates. [This answer is incorrect. An accounting estimate is "an approximation of a monetary amount in the absence of exact measurement." An example of an accounting estimate relevant to CIRAs is net realizable values of assessments receivable. The type of losses described above would not fit under this definition.]
  - d. **Commitments and contingencies.** [This answer is correct. Commitments are contractual obligations for a future expenditure. Contingencies are existing conditions or situations that involve uncertainties about possible gain or loss to an entity that will be resolved when the future events occur (or fail to occur). Examples of commitments and contingencies of concern to a CIRA auditor include (1) pending or threatened litigation or unasserted claims, (2) commitments related to expansion or rehabilitation of facilities, (3) possible losses on long-term contracts, and (4) long-term leases with required fixed payments for several years.]
10. FASB ASC 275 requires which of the following to be disclosed in all financial statements affected by risks or uncertainties? **(Page 50)**
- a. **The nature of operations.** [This answer is correct. FASB ASC 275 requires disclosures about (1) certain risks and uncertainties that could significantly affect the amounts or situations reported in the financial statements or the near term functioning of the entity and (2) certain inherent limitations in the financial statements. Two disclosures are generally required for all financial statements: nature of operations and use of estimates in the preparation of financial statements. These disclosures do not require significant extra audit work because the disclosures are required in all financial statements and the information needed for the disclosures is readily available.]
  - b. The single largest significant estimate. [This answer is incorrect. According to FASB ASC 275, disclosure of certain significant estimates is only required for estimates that meet specific criteria. This guidance is not limited to the single largest estimate. If it is necessary, additional procedures may be needed.]
  - c. Future vulnerability due to specific concentrations. [This answer is incorrect. The disclosure for current vulnerability resulting from certain concentrations is only required by FASB ASC 275 if the concentrations meet certain criteria; however, if that is the case, additional procedures may be needed.]
  - d. Whether the entity can continue as a going concern. [This answer is incorrect. Whether or not an entity can continue as a going concern is a separate consideration; therefore, any related disclosures for this consideration would be different from those required by FASB ASC 275 for risks and uncertainties.]
11. Which of the following accounting estimates is most likely to be affected by management bias? **(Page 54)**
- a. Estimate 1 has remained the same for the last few years. [This answer is incorrect. According to AU-C 540.A134, an indication of possible management bias is when there are changes in an estimate, or the

- underlying method, when management has made a subjective assessment that there has been a change in circumstances.]
- b. Estimate 2 uses fair value assumptions that reflect those used by the market. [This answer is incorrect. One of the examples of possible management bias provided by AU-C 540.A134 is that the entity uses its own assumptions for fair value accounting estimates that are inconsistent with observable market assumptions.]
  - c. **Use of Estimate 3 results in a positive point estimate for management. [This answer is correct. AU-C 540.A134 provides certain examples of indicators of possible management bias regarding accounting estimates. One such example is selection or construction of significant assumptions that result in a favorable point estimate for management's purposes. Therefore, in an audit where this situation exists, the auditor would need to be wary of management bias.]**
  - d. Use of Estimate 4 does not indicate any type of pattern on management's part. [This answer is incorrect. According to AU-C 540.A134, management bias may exist when a point estimate is selected that indicates a pattern of pessimism or optimism.]
12. After performing a CIRA audit and releasing her report, Jane discovers facts that affect her opinion. What is the first thing she needs to do? **(Page 59)**
- a. Seek to prevent reliance on the auditor's report. [This answer is incorrect. According to AU-C 560, this is an action that may be taken in this situation; however, it is the last resort, so there are other actions that Jane should try before seeking to prevent reliance on her report.]
  - b. **Discuss the matter with management. [This answer is correct. According to AU-C 560, the first thing an auditor should do when subsequent facts are discovered after the report release date is discuss the matter with management and when appropriate, those charged with governance. Therefore, if Jane begins by contacting management, she is in compliance with the authoritative guidance.]**
  - c. Determine whether the financial statements need to be revised. [This answer is incorrect. According to AU-C 560, this does need to be done. However, it should be Jane's second step. There is another action she needs to take before making this determination.]
  - d. Notify management not to make the financial statements available to third parties. [This answer is incorrect. Though AU-C 560 does include this in its list of actions, there are other actions that Jane needs to take before she can consider making this notification to management.]
13. When performing a CIRA audit, Tom discovered a significant related-party transaction that was not disclosed by management. What should Tom do differently for this transaction than other related-party transactions? **(Page 60)**
- a. **He needs to determine if the lack of disclosure was an act of fraud. [This answer is correct. If the auditor identifies related-party transactions that have previously not been identified or disclosed by management, the auditor should perform additional procedures regarding (1) the risk that additional related-party transactions may exist and (2) the consideration of fraud. Therefore, this is one of the actions Tom needs to take under these circumstances.]**
  - b. He should perform risk assessment procedures to identify the risks of material misstatement. [This answer is incorrect. Tom would need to take this action for any related-party transaction, per AU-C 550. So, while it should be done, there are other actions Tom would need to take specifically for an undisclosed related-party transaction.]

- c. He must obtain an understanding of the CIRAs controls for related-party transactions. [This answer is incorrect. AU-C 550 requires auditors to obtain an understanding of the controls surrounding related parties and related-party transactions as part of their risk assessment procedures. Therefore, Tom should have already done this before he found the undisclosed related-party transaction.]
- d. He needs to determine if any associated risks are significant. [This answer is incorrect. Per AU-C 550, Tom does need to determine whether any associated risks are significant; however, this would be required for all related-party transactions. It is not specific to an undisclosed related-party transaction. Therefore, there is a better answer to this question.]



## ADDRESSING GOING CONCERN CONSIDERATIONS

### Introduction

FASB ASU 2014-15, *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern* (which is codified in FASB ASC 205-40), established requirements for management to (a) evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and (b) provide related disclosure requirements. ASU 2015-14 is effective for the annual period ending after December 15, 2016, and for interim periods within years beginning after December 15, 2016.

The principal provisions of FASB ASC 205-40—

- Define the term *substantial doubt*.
- Require management to evaluate whether conditions and events raise substantial doubt about the entity's ability to continue as a going concern at both interim and annual period ends.
- Require management's evaluation to be based on an assessment of the effect of known and reasonably knowable conditions and events at the date the financial statements are available to be issued and for a period one year after that date.
- Identify principles for considering whether management's plans mitigate the substantial doubt.
- Require certain disclosures when consideration of management's plans alleviates substantial doubt.
- Require an explicit statement by management that there is substantial doubt as well as other disclosures when substantial doubt is not alleviated.

FASB ASC 205-40 differs in several respects from SAS No. 126 (AU-C 570A), *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. These differences are discussed later in this lesson and in section 1807 of PPC's *Guide to Audits of Nonpublic Companies*.

In February 2017, the AICPA issued SAS No. 132 (AU-C 570), *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, which provides requirements to auditors regarding an entity's ability to continue as a going concern. The SAS, when effective, will supersede SAS No. 126. One of the key considerations in issuing the SAS was to consider the requirements contained in FASB ASC 205-40. SAS No. 132 is effective for audits of financial statements for periods ending on or after December 15, 2017.

**SAS No. 126 Objectives.** Under SAS No. 126, the objectives of the auditor when considering the entity's ability to continue as a going concern are to evaluate and conclude, using the evidence obtained during the audit, whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, evaluate the possible effects on the financial statements including the adequacy of related disclosures, and determine the implications for the auditor's report.

**Evaluating the Entity's Ability to Continue as a Going Concern.** As discussed, FASB ASC 205-40 provides guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern. Certain key differences exist between the accounting standards and the auditing standards under SAS No. 126, prior to the implementation of SAS No. 132. The discussion in this section discusses both accounting and auditing standards as appropriate.

Under AU-C 570A, the auditor has two responsibilities related to an entity's ability to continue as a going concern.

- a. To evaluate whether conditions or events identified during the audit, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, i.e., a period not to exceed one year beyond the balance sheet date. FASB ASC 205-40-50-1 is more specific as to the time period which management looks at when evaluating the entity's

ability to continue as a going concern. In connection with preparing financial statements, the entity's management should evaluate whether conditions and events, in the aggregate, raise substantial doubt, as defined by FASB ASC 205-40-20, about the entity's ability to continue as a going concern within one year after the date the financial statements are available to be issued (FASB ASC 205-40-50-1). If the auditor identifies conditions and events that cause him or her to believe there is substantial doubt about entity's ability to continue as a going concern (and management has not identified those), the audit procedures in AU-C 570A should be performed.

- b. If the auditor concludes there is substantial doubt about the entity's ability to continue as a going concern, the auditor should gather evidence and consider the effect on the financial statements, the adequacy of disclosures, and the audit report.

The evaluation discussed in item a. is required for all audits, and item b. is necessary only when the auditor has concluded there is substantial doubt.

**Assessing Results of Audit Procedures.** AU-C 570A does not mandate any specific procedures designed solely to search for conditions or events that might affect the association's ability to continue as a going concern, but it does require specific assessment of whether audit procedures that were applied identified such conditions and events. Some auditing procedures for CIRAs include applying analytical procedures; reviewing subsequent events; reviewing compliance with terms of debt and loan agreements; reading minutes; confirmation with related parties and third parties of the details of arrangements to provide or maintain financial support; inquiring of the CIRA's legal counsel about litigation, claims, and assessments; etc.

If necessary, the auditor applies procedures to obtain additional information about any conditions and events identified. If, after considering the identified conditions and events, the auditor believes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, he or she should obtain information about management's plans intended to mitigate the effect of the conditions and events and assess the likelihood that those plans can be effectively implemented. Examples of conditions or events that, when considered in the aggregate, may indicate there could be substantial doubt about the dealership's ability to continue as a going concern for a reasonable period of time include the following:

- Negative trends, such as recurring operating losses, negative cash flows from operating activities, adverse key financial ratios, significant decline in members/owners and related assessments, or significant increase in unpaid assessments.
- Other indications of possible financial difficulties, such as denial of usual trade credit from contractors and suppliers, default or restructuring of debt agreements, need to seek new sources or methods of financing, or need to dispose of substantial assets.
- Internal matters, such as physical structure of complex deteriorating or in disrepair; inadequacy or lack of reserve funding; need for special working capital assessments; uneconomic long-term commitments; use of funds for future major repairs and replacements to finance current operations; mushrooming construction costs relative to major repairs and replacements; large investment losses; severe discord among members of management, board, developer, members/owners, etc.; or need to significantly revise operations.
- External matters that have occurred, such as adverse legal proceedings, legislation, or similar matters that might jeopardize the CIRA's ability to operate; significant declines in values of real estate/increase in foreclosures; significant uninsured or underinsured catastrophe or disaster such as earthquake, tornado, or flood; significant economic downturns; lost rental income from commercial units due to a sluggish commercial real estate market; or significant ownership of units by developers and financial institutions.

**Consideration of Management Plans.** After considering the identified conditions and events, an auditor who believes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time should obtain information about management's plans intended to mitigate the effect of those conditions or events. The auditor should assess the likelihood that management's plans can be effectively implemented. Auditors also need to assess whether the plans are likely to mitigate the adverse effects of the identified conditions and

events. If necessary, the auditor should apply audit procedures to obtain evidential matter about management plans (including any available prospective financial statements). When evaluating management's plans to continue as a going concern, an appropriate level of professional skepticism is important.

**Documentation Requirements.** When conditions or events cause the auditor to believe there is substantial doubt about the CIRA's ability to continue as a going concern for a reasonable period of time, AU-C 570A.22 requires documentation of the following:

- Conditions or events causing the auditor to believe there is substantial doubt about the CIRA's ability to continue as a going concern.
- The elements of management's plans most significant to overcoming the adverse effects of the conditions or events.
- The auditing procedures performed and evidence obtained to evaluate those significant elements.
- The auditor's conclusion about whether substantial doubt remains or is alleviated and the possible effects on the financial statements and related disclosures.
- The possible effects on the auditor's report, including the auditor's conclusion about whether an emphasis-of-matter paragraph is necessary and whether to modify the auditor's report for inadequate disclosures.

Best practices suggest that auditors use a generalized audit program step or checklist to document going concern considerations. That will ensure that the assessment will be made on every audit. The checklist should summarize the consideration of management's plans and other procedures necessary when conditions and events are identified and enables auditors to meet the documentation requirements of AU-C 570A.

**Differences between AU-C 570A and Accounting Standards.** Prior to issuance of ASU 2014-15 and the resulting guidance on going concern considerations in FASB ASC 205-40, no requirements existed in GAAP for going concern, so auditors have used the auditing standards, specifically SAS No. 126 (AU-C 570), *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, to evaluate going concern uncertainties and the related disclosures. Although the accounting standards have been issued and are now effective, the SAS No. 126 requirements continue to be effective for auditors under GAAS, until the effective date of SAS No. 132. Therefore, it is important for auditors to be aware of the differences that exist between the auditing and accounting standards. In January 2015, the AICPA issued four interpretations to SAS No. 126 that address certain differences and provide guidance on what to do until the effective date of SAS No. 132.

### **Going Concern Requirements for Audits of Financial Statements for Periods Ending on or after December 15, 2017**

In February 2017, the Auditing Standards Board (ASB) issued SAS No. 132, (AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, which supersedes, when effective, the current guidance at SAS No. 126 (AU-C 570A). Conceptually, the primary difference between SAS No. 132 and the existing guidance is that the new standard explicitly recognizes management's responsibility to consider going concern issues under GAAP and premise the auditor's procedures on that responsibility. It also clarifies the applicability of the standard when the financial statements are based on a financial reporting framework other than GAAP.

While SAS No. 132 is effective for audits of financial statements for periods ending on or after December 15, 2017, since SAS No. 132 incorporates management's evaluation of whether aggregate conditions or events exist that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, it is believed that certain of the requirements would be performed prior to its effective date.

One of the primary technical differences between existing guidance in SAS No. 126 and SAS No. 132 is the lookout period, or reasonable period of time. Under SAS No. 132, reasonable period of time is defined as the period required by the applicable financial reporting framework, or, if no such period is designated, one year from the date the financial statements are available to be issued. This brings the lookout period under the auditing standards into line with the period defined by GAAP in FASB ASC 205-40.

**SAS No. 132 Objectives.** The auditor's objectives under SAS No. 132 are as follows:

- To obtain sufficient and appropriate audit evidence about and conclude on the appropriateness of management's use of the going concern basis of accounting in preparing the financial statements.
- To conclude on whether substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time exists, based on the audit evidence obtained.
- To evaluate possible effects on the financial statements, such as the adequacy of disclosure regarding an entity's ability to continue as a going concern for a reasonable period of time.
- To issue an auditor's report in accordance with the auditing standards.

**Risk Assessment Procedures and Related Activities.** SAS No. 132 was modeled by the AICPA after the IAASB's International Standard for Auditing, which includes going concern procedures early in the audit process. Likewise, SAS No. 132 includes procedures for auditors to perform in the planning and risk assessment phases of the audit. AU-C 570.12 requires that the auditor consider, when performing risk assessment procedures as discussed in AU-C 315, whether there are aggregate conditions or events that raise doubt about the entity's ability to continue as a going concern for a reasonable period of time. As part of risk assessment procedures, the auditor is required to determine if management has performed a preliminary evaluation of whether such conditions or events have been identified. If so, auditors and management would discuss management's evaluation of conditions or events that raise substantial doubt about the entity's ability to continue as a going concern, as well as plans to address any issues identified. If management has not yet made such an evaluation, the standard requires the auditor to discuss with management why management intends to use the going concern basis of accounting and inquire as to any existing conditions or events that raise substantial doubt about the entity's ability to continue as a going concern. Auditors would consider management's evaluation in the risk assessment process and remain alert throughout the audit for any evidence indicating conditions or events that raise substantial doubt regarding going concern.

Outside of the auditor's inquiry and discussion with management regarding its evaluation of aggregate conditions or events, SAS No. 132 does not specify any other specific risk assessment procedures designed to search for conditions or events that might affect the entity's ability to continue as a going concern.

AU-C 570.A7 provides examples of adverse conditions and events that can raise substantial doubt about an entity's ability to continue as a going concern. The guidance notes, similar to FASB ASC 205-40, that an entity should determine the likelihood and magnitude of the potential effects of such conditions and events, along with the consideration of the timing.

**The Auditor's Evaluation.** SAS No. 132 requires the auditor's evaluation to address management's evaluation of the entity's ability to continue as a going concern, consider the same time period as management's evaluation, and consider whether management has considered all relevant information of which the auditor is aware when making management's evaluation.

AU-C 570.A20 notes that the auditor has no responsibility to rectify any lack of analysis by management to support its evaluation. The auditor may, however, be able to conclude that substantial doubt exists even when management has not performed a detailed analysis. For example, management may have not performed a detailed analysis to support its evaluation if the entity has a history of profitable operations and readily available financial resources. In this situation, the auditor may not need to perform detailed evaluation procedures of the appropriateness of management's evaluation if the auditor's other audit procedures allow the auditor to conclude whether there is substantial doubt in the circumstances. In situations where the applicable financial reporting framework requires management to make an evaluation, such as under FASB ASC 205-40, the lack of a detailed analysis by management might be considered as an indicator of an internal control deficiency as discussed in AU-C 265.

In other situations, the auditor's evaluation of management's evaluation of whether there is substantial doubt might include a review of the process that management used, the assumptions employed, management's plans, and whether the plans are feasible in the circumstances.

**Periods beyond the Evaluation Period.** AU-C 570.15 notes that the auditor should inquire if management has any knowledge of conditions or events beyond the management evaluation period that could have an impact on the

entity's ability to continue as a going concern. Besides the inquiry, no additional procedures are required by SAS No. 132 for the identification of additional conditions or events that may raise substantial doubt about the entity's ability to continue as a going concern beyond the period evaluated by management. AU-C 570.A27 notes that conditions or events identified after the evaluation period would not affect the evaluation of whether substantial doubt exists, but may impact other disclosure requirements or a consideration of whether financial statements are fairly presented.

**Audit Procedures.** In order to obtain sufficient appropriate audit evidence about whether conditions and events identified and considered in the aggregate raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, AU-C 570.16 states that the auditor should perform the following procedures:

- Request that management perform an evaluation if they have not yet done so.
- Evaluate management's plans in relation to its going concern evaluation, considering whether it is probable that the plans can be effectively implemented, and whether the plans would mitigate the conditions or events that raise substantial doubt about the entity's ability to continue as a going concern.
- If a cash forecast relevant to management's plans has been prepared, evaluate the reliability of the underlying data generated to prepare it and determine whether there is adequate support for the underlying assumptions. This includes considering contradictory audit evidence, such as assumptions in the cash flow forecasts that are inconsistent with those used for other purposes like impairment or deferred tax asset analysis.
- Consider any facts or information that have become available since the date of management's evaluation.

**Other Relevant Procedures.** AU-C 570.A28 notes examples of procedures that might be relevant to obtaining sufficient appropriate audit evidence whether identified conditions or events raise substantial doubt about the entity's ability to continue as a going concern.

**Management's Plans.** The significance of identified conditions or events might be mitigated by certain plans of management that are probable of implementation and would be effective in overcoming the adverse effects of such conditions or events. AU-C 570.A8 provides examples of management plans that might be implemented and the information that should be considered when evaluating the plan's feasibility and probability of effective implementation within one year after the date the financial statements are available to be issued.

**Auditor's Conclusions.** SAS No. 132 requires the auditor to make the following conclusions:

- Evaluate whether sufficient appropriate audit evidence has been obtained and conclude on the appropriateness of management's use of the going concern basis of accounting, when preparing the financial statements, when relevant.
- Conclude, based on audit evidence obtained, on whether there are aggregate conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- When the auditor concludes that the use of the going concern basis of accounting is appropriate by management, but substantial doubt about the ability to continue as going concern exists, evaluate the adequacy of the disclosures as required by the applicable financial reporting framework.
- When aggregate conditions or events have been identified and, based on audit evidence obtained, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern has been alleviated, evaluate the adequacy of the disclosures as required by the applicable financial reporting framework.

When considering the adequacy of the disclosures under GAAP, the auditor will look to the requirements in FASB ASC 205-40-50.

**Documentation Requirements.** When conditions or events cause the auditor to believe there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time before the consideration of management plans, AU-C 570.32 requires documentation of the following:

- The conditions or events.
- Significant elements of management's plans to overcoming the conditions or events, per the auditor's judgment.
- Audit procedures performed in evaluating significant elements of management's plans and the evidence obtained, where applicable.
- The auditor's conclusion regarding whether substantial doubt continues to exist or is alleviated.
- When substantial doubt remains, the possible effects of the conditions or events on the financial statements and the adequacy of disclosures.
- When substantial doubt is alleviated, the auditor's conclusion about the need for and the adequacy of disclosures about the principal conditions or events that originally created substantial doubt and management's plans that alleviated it.
- The auditor's conclusion concerning the effects of the auditor's report.

Best practices suggest that auditors use a generalized audit program step or checklist to document going concern considerations. This will ensure that the assessment will be made on every audit. The checklist should summarize the consideration of management's plans and other procedures necessary when conditions and events are identified and enables auditors to meet the documentation requirements of SAS No. 126 or SAS No. 132.

## THE MANAGEMENT REPRESENTATION LETTER

AU-C 580, *Written Representations*, requires the auditor to request written representations from management with appropriate responsibilities for the financial statements. A management representation letter, among other things, confirms oral representations about specific matters given to the auditor during the audit and provides audit evidence that supports the validity of results of other audit procedures.

### Content of the Letter

**Representations about Management's Responsibilities.** In the representation letter, CIRA officials acknowledge their primary responsibility for the financial statements (even if the auditor drafts the financial statements and related notes). Among other things, AU-C 580.10–.11 requires the auditor to request management to provide specific representations that it has fulfilled the responsibilities concerning the terms of the audit engagement for—

- preparation and fair presentation of the financial statements;
- design, implementation, and maintenance of internal control relevant to preparation and presentation of financial statements that are free of material misstatements due to error or fraud;
- providing all relevant information and access; and
- recording and reflecting all transactions in the financial statements.

In addition, AU-C 580 and other auditing standards require the auditor to request other written representations from management. Furthermore, the auditor may request other written representations considered appropriate in certain situations. AU-C 580.26 indicates that when management does not provide one or more of the written representations requested, the auditor should (a) discuss the omission with management, (b) reevaluate management's integrity, (c) evaluate the implications for the reliability of management's other written or oral representations and audit evidence

generally, and (d) take appropriate actions. Appropriate actions include determining the possible impact to the auditor's report pursuant to the guidance provided by AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*. The inability to obtain written representations is a scope limitation that prevents the auditor from expressing an unmodified opinion. When those representations are either (a) not provided by management, or (b) the auditor cannot rely on the representations due to the auditor concluding that sufficient doubt exists about management's integrity, AU-C 580.25 requires the auditor to disclaim an opinion or withdraw from the engagement. According to AU-C 580.A34, depending on the reasons for the refusal or the nature of the omitted representations, the auditor may determine that a qualified opinion is appropriate.

**Audit Adjustments.** AU-C 580.14 requires an acknowledgment in the representation letter that management has considered whether the effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A summary of the uncorrected misstatements should be included in, or attached to, the representation letter. Authoritative literature does not provide specific guidance for the auditor when there are no uncorrected misstatements. In that situation (that is, when either no misstatements are noted in the audit or all noted misstatements are corrected), it is believed no representation about uncorrected misstatements is necessary in the management representation letter.

Uncorrected misstatements communicated in the representation letter include both misstatements identified by the auditor and misstatements brought to the auditor's attention by management. The summary of uncorrected misstatements also may include the current year effect of unadjusted audit differences from prior years (that is, the turnaround effect). Some auditors set an amount below which detected misstatements need not be accumulated on the summary of audit differences. Those misstatements need not be included in the summary of uncorrected misstatements communicated in the management representation letter.

The adjustments included in the summary may be aggregated. If the auditor chooses to aggregate the misstatements, they are normally aggregated by financial statement caption. If the adjustments are aggregated, they should be presented in sufficient detail to provide CIRA management and board representatives with an understanding of the nature, amount, and effect of the uncorrected misstatements.

**Unique CIRA Representations.** In addition to items specified in AU-C 580, the letter should include any other matters relevant to CIRAs or to the specific engagement. For example, CIRAs frequently use managing agents, and there is often a lack of auditor interaction with the CIRA's board of directors and officers. In those circumstances, it is particularly important to remind the CIRA's officers and, if applicable, the managing agent of their responsibility for the financial statements as well as their responsibility to provide the auditors with complete and accurate information.

In addition, it is a good idea for auditors to obtain representations from management and the board of directors about the following matters in addition to those made in audits of the financial statements of other kinds of reporting entities:

- Disclosures based on a study of future major repairs and replacements.
- The association's policy for funding future major repairs and replacements.
- The association's policy for disposing of the excess of revenues over expenses, if any.

Although representations obtained in CIRA engagements are similar to those obtained in engagements for commercial businesses, auditors should consider obtaining additional representations in certain areas, however, as discussed below.

- a. *Funds for Major Repairs and Replacements.* Auditors ordinarily obtain representations regarding the CIRA's funding for major repairs and replacements. The representations generally include the following items:

- Whether the CIRA has complied with its policy for funding future major repairs and replacements including requirements, if any, for outside studies to estimate future costs.

- If the CIRA is accumulating funds for future major repairs and replacements, whether the board of directors believes they will be adequate.
- b. *Allocation of Expenses against Membership and Nonmembership Income (or against Exempt and Nonexempt Function Income)*. Best practices suggest that auditors obtain the CIRA's representation that the CIRA's allocations conform with IRS rules, which state that such allocations be made "on a reasonable and consistently applied basis."
- c. *Excess Revenues over Expenses*. CIRAs have some options that will allow them to exempt the excess of assessments over operating expenses from federal taxation. The CIRAs may elect to—
  - apply the excess against the next year's assessments, or
  - refund the excess to members.

If certain strict criteria are met, CIRAs may elect to transfer the excess to the fund for major repairs and replacements. Auditors should usually obtain representations about the CIRA's policy for the current year.

- d. *Required Supplementary Information about Future Major Repairs and Replacements*. AU-C 730, *Required Supplementary Information*, requires auditors to obtain the following management representations:
  - Acknowledgment of its responsibility for the required supplementary information.
  - Its belief that the required supplementary information is measured and presented in accordance with prescribed guidelines.
  - Methods of measurement and presentation have not changed from those used in prior periods (or the reasons for any changes).
  - Significant assumptions or interpretations underlying the measurement or presentation of the required supplementary information.
- e. *Adequacy of Insurance*. Although not required, some auditors review management's evaluation of the adequacy of insurance. In that case, the auditors may consider obtaining representations about whether management has reviewed the adequacy of insurance and whether they believe it is adequate.
- f. *Interfund Transactions*. It is a best practice for auditors to obtain the CIRA's representation that there are no unauthorized transfers or designations of fund balance or interfund borrowings, or uncollectible interfund loans.
- g. *Responsibility for Tax Election*. It is a best practice for auditors to obtain the CIRA's representation that management is responsible for the choice of filing either Form 1120 or 1120-H, as appropriate.

If required communications are made orally (as permitted in certain circumstances under AU-C 260, *The Auditor's Communication with Those Charged with Governance*), it is desirable for management to acknowledge in the representation letter that the matters have been communicated. Also, the representation letter may include management's acknowledgment that it will let the auditor review any subsequently published document that includes the auditor's report.

**Audit Adjustments.** AU-C 580.14 requires an acknowledgment in the representation letter that management has considered whether the effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A summary of the uncorrected misstatements should be included in, or attached to, the representation letter. Authoritative literature does not provide specific guidance for the auditor when there are no uncorrected misstatements. In that situation (that is, when either no misstatements are noted in the audit or all noted misstatements are corrected), best practices indicate that no representation about uncorrected misstatements is necessary in the management representation letter.



Uncorrected misstatements communicated in the representation letter include both misstatements identified by the auditor and misstatements brought to the auditor's attention by management. The summary of uncorrected misstatements also may include the current year effect of unadjusted audit differences from prior years (that is, the turnaround effect). Some auditors set an amount below which detected misstatements need not be accumulated on the summary of audit differences. Those misstatements need not be included in the summary of uncorrected misstatements communicated in the management representation letter.

The adjustments included in the summary may be aggregated. If the auditor chooses to aggregate the misstatements, they are normally aggregated by financial statement caption. If the adjustments are aggregated, they should be presented in sufficient detail to provide CIRA management and board representatives with an understanding of the nature, amount, and effect of the uncorrected misstatements.

### **Materiality**

AU-C 580.A22 permits, but does not require, limiting representations to matters that are either individually or collectively material to the financial statements. That limitation is acceptable, however, only for representations that directly relate to amounts included in the financial statements and only if the auditor and management reach an agreement about what is material for that purpose. It would not be acceptable, for example, to limit representations about the completeness of available financial records; management's responsibility for fair presentation; or management's responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud. AU-C 580.A22 notes that materiality may be different for different representations, and it permits but does not require including an explicit discussion of materiality in the representation letter, in either qualitative or quantitative terms. A discussion that includes both qualitative and quantitative terms is also acceptable. However, a purely quantitative discussion of materiality is inappropriate because it relies solely on quantitative considerations when determining materiality.

### **Signatures on the Letter**

The representation letter is obtained from officials who are responsible for and knowledgeable about, directly or through others, the matters covered by the representations. For a CIRA, such officials include CIRA officers (such as the president), board members, and managing agent, if any. If the CIRA has a treasurer, the auditor might consider having that person also sign the letter.

### **Periods Covered by the Letter**

AU-580 requires written representations from management who have responsibility for the financial statements and knowledge of the matters concerned for all financial statements and periods covered by the auditor's report. For example, if the auditor reports on comparative financial statements, management's representation letter for the most recent audit should address all periods on which the auditor is reporting. AU-C 580.A26 explains that even when current management was not present during all periods referred to in the auditor's report, current management's responsibilities for the financial statements as a whole are not diminished, and the requirement for the auditor to request written representations from them covering the whole of the relevant periods still applies. If management or the managing agent changed during or after the period under audit, the current management may be hesitant to provide this assurance. It is a best practice for the auditor to insist on written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. The only reason for not requesting representations would be that the position the person holds is not responsible for the financial statements. That is especially true of managing agents. Auditors may point out that the letter limits the Confirmant's responses to the best of their knowledge and belief. In some cases, the managing agent may sign the representation letter, but new CIRA officials not present during the period under audit may decline because they are new to the situation. It seems likely that this is acceptable and would not result in a scope limitation. However, the auditor needs to make inquiries to determine that the reason for the new CIRA officials not signing the letter is because the officials were not responsible for the financial statements and not due to other reasons (such as a disagreement about accounting matters or knowledge of an actual or suspected material misstatement). It would also be a good idea to ask the official to sign a separate representation stating that the official has no knowledge of a material matter that was not properly treated in the financial statements.

## Dating of the Letter and Updating Letters

The auditor is concerned with matters occurring through the date of the audit report, not merely through the balance sheet date. As a result, the management representation letter should be dated as of the date of the auditor's report.

**Updating Letters.** There are circumstances that require predecessor auditors to obtain updating representation letters from management. AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, requires a predecessor auditor to obtain a representation letter from management, in addition to the previous requirement for a representation letter from the successor auditor, before reissuing a report on financial statements of a prior period. This requirement applies when the prior period financial statements are presented on a comparative basis with audited financial statements of a subsequent period. The updating management representation letter should address (a) whether management is aware of any new information that would cause them to believe that any of the previous representations should be modified and (b) whether any events occurring subsequent to the latest balance sheet date of the financial statements reported on by the predecessor require disclosure in or adjustment to such financial statements.

## Receipt of the Letter

AU-C 580.A27 indicates that the auditor does not need to possess management's representation letter on the date of the auditor's report. The requirement can be met if, on or before the date of the auditor's report, management has received the final representation letter and confirmed to the auditor that they will sign the letter without exception. The auditor will need to possess the signed letter before releasing the audit report. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unmodified opinion and may cause the auditor to disclaim an opinion on the financial statements or to withdraw.

## Reliance on Management's Representations

The management representation is part of the audit evidence the auditor obtains; however, it is not a substitute for other necessary audit procedures to corroborate information about matters for which written representations are obtained. For example, the auditor cannot simply accept management's representations as the only necessary audit evidence for significant matters. If the auditor cannot verify a representation using another form of evidence, such as management's intent to hold investment securities to maturity, the auditor needs to evaluate whether the representation is feasible considering factors such as past history with the client and the current economic conditions. In particular, if the auditor becomes concerned about management's competence, integrity, ethical values, or diligence, the auditor should determine the effect that those concerns may have on the reliability of management's representations (oral or written) and audit evidence in general. Significant concerns in that area may cause the auditor to conclude that the risk of management misrepresentation is such that an audit cannot be conducted. According to AU-C 580.A30, even when those charged with governance implement appropriate corrective measures, such measures may not be enough to enable the auditor to issue an unmodified audit opinion. In addition, if other audit evidence contradicts a representation made by management, the auditor should attempt to resolve the matter by performing audit procedures. In the case of such identified contradictions, the auditor may consider whether the risk assessment remains appropriate and, if not, may revise the risk assessment and perform appropriate procedures to respond to the assessed risks. Depending on the circumstances, the auditor may need to consider whether reliance on management's representations relating to other aspects of the financial statements and audit evidence in general is appropriate.

# CONSIDERATION OF THE ACCUMULATED RESULTS OF AUDIT PROCEDURES

## Reevaluating Risk Assessments

The auditor's assessment of the risks of material misstatement at the relevant assertion level made during planning is based on available audit evidence and naturally may change as additional evidence is obtained. For example, in performing substantive procedures, the auditor may identify misstatements that are larger or more frequent than had been anticipated. AU-C 315.32 requires the auditor to revise the risk assessment and modify further planned

audit procedures if new information is obtained or if the initial assessed risks of material misstatement at the assertion level change during the audit. Furthermore, AU-C 330.27 requires the auditor to reevaluate, before the conclusion of the audit, whether the assessment of risks of material misstatement at the relevant assertion level remains appropriate. The audit evidence may either confirm the auditor's risk assessments or result in the auditor performing additional audit procedures. Exhibit 2-2 illustrates this concept.

As indicated in Exhibit 2-2, an auditor should not assume that an identified error or instance of fraud is an isolated occurrence. Instead, the auditor needs to consider how the misstatement affects the assessed risks of material misstatement. (In addition, misstatements may indicate a significant deficiency or material weakness in internal control.) In doing so, the auditor should consider all relevant audit evidence, even if it appears to contradict relevant assertions in the financial statements.

## **Exhibit 2-2**

### **Reevaluating the Initial Assessment of the Risk of Material Misstatement at the Relevant Assertion Level**

When planning the audit of ABC CIRA, the auditor initially assessed a low level of risk that the CIRA would not record assessments in the proper period. The auditor then determined the nature, timing, and extent of substantive procedures related to the cut-off assertion based on the auditor's assessment of a relatively low risk of material misstatement. However, the CIRA's accounting personnel were confused about how to record assessments for billings that were prepared on December 31, related to the following year's assessment.

In the examination of assessments receivable, the auditor identified a misstatement of assessments receivable and revenue. Further investigation led to identifying cut-off issues as the cause of the misstatement. As a result, the auditor reevaluated the initial risk assessment relating to cut-off and increased the extent of tests of details over billing cut-off to obtain a higher level of assurance that all material misstatements relating to cut-off errors had been identified.

\*                      \*                      \*

It is natural to have some deviations in the way controls are applied. Deviations may be caused by such factors as changes in key personnel, seasonal fluctuations in activity, and human error. As a result, controls may not operate as effectively as the auditor had expected. If the auditor detects deviations when performing tests of controls, the auditor makes inquiries to understand such matters and their potential consequences and should determine whether the tests provide an appropriate basis for reliance on the controls, whether additional tests of controls are needed, or whether the potential risks of misstatement need to be addressed by substantive procedures. The auditor should also evaluate whether misstatements identified when performing substantive procedures alter the auditor's judgment about the effectiveness of the related controls.

At the end of the audit, the auditor should conclude whether sufficient appropriate audit evidence was obtained to reduce to an appropriately low level the risk of material misstatement in the financial statements and to support the opinion on the financial statements. This requires the auditor to evaluate whether the audit was performed at a level that provides the auditor with a high level of assurance that the financial statements, taken as a whole, are free of material misstatement. The sufficiency and appropriateness of audit evidence is a matter of the auditor's professional judgment.

AU-C 330.29 states that if the auditor has not obtained sufficient appropriate audit evidence with respect to a material financial statement assertion, the auditor should try to obtain additional evidence. If the auditor cannot obtain sufficient appropriate audit evidence, the auditor should either express a qualified opinion or disclaim an opinion.

### **Evaluating the Existence of Fraud**

**Fraud Risk Assessment Is an Ongoing Process.** Assessing the risks of material misstatement due to fraud is an ongoing process that should occur throughout the audit. Fraud risks may be identified during the engagement

acceptance/continuance process, during engagement planning, while obtaining an understanding of internal control, when assessing the risks of material misstatement of the financial statements due to error or fraud, when performing further audit procedures to respond to assessed risks, or when communicating with management or others. Examples of conditions the auditor may note that may change or support the assessment of risks made during planning are included in Exhibit 2-3.

### **Exhibit 2-3**

#### **Conditions That May Change or Support the Auditor's Assessment of Fraud Risks**

- Unrecorded transactions or transactions recorded improperly as to account, amount, period, or CIRA policy.
- Balances or transactions that are unsupported or unauthorized.
- Adjustments made by the CIRA at the last minute that substantially affect financial results.
- Evidence of employees' unauthorized or unnecessary access to systems or records.
- Missing documents.
- Indications of altered documents.<sup>a</sup>
- Only photocopies or electronic versions of documents being provided to auditors when originals are expected to exist.
- Significant unexplained reconciling items.
- Vague, implausible, or inconsistent responses by the client to the auditor's inquiries.
- Significant physical assets are missing.
- Denial by client personnel of auditor's access to records, facilities, certain employees, members, vendors, or others.<sup>b</sup>
- Unusual discrepancies between confirmation replies and the CIRA's records.
- Failure to retain documents or electronic files consistent with the CIRA's record retention policies or practices.
- Unusual delays by CIRA personnel in providing requested information.
- Unreasonable time pressures to resolve complex or contentious accounting issues.
- Attempts by the management or the managing agent to intimidate audit team members or control the conduct of the audit.
- Complaints or tips received by the auditor about fraud or potential fraud.
- Unwillingness to make financial statement disclosures more clear or complete.
- Management's proposal of adjustments, not previously identified or communicated to the auditor, that offset misstatements found by the auditor.
- Evidence of management bias in accounting estimates.

#### **Notes:**

- <sup>a</sup> If the auditor suspects that documents have been altered, it may be necessary to engage a specialist to determine their authenticity.

- b Denial of access to information may constitute a limitation on the scope of the audit sufficient to preclude an unmodified opinion on the financial statements.

\* \* \*

**Required Procedures.** AU-C 240.34 requires auditors to evaluate, at or near the completion of field work, whether the results of auditing procedures (including analytical procedures performed as substantive tests, or in the overall review stage of the audit) affect the assessment made earlier in the audit regarding the risks of material misstatement due to fraud or indicate a previously unidentified risk of material misstatement due to fraud. In addition, analytical procedures relating to revenue through the end of the reporting period are required to be performed. If the full year's revenue information is available during audit planning, the procedures can be performed during preliminary analytical procedures. Otherwise, the procedures performed during planning should be updated during the final analytical review stage of the audit.

Based on the evaluation, the auditor determines whether additional or different audit procedures are necessary. In addition, the auditor should perform a qualitative evaluation of misstatements identified in the financial statements and determine whether the misstatements may indicate possible fraud. Communication among the engagement team about information or conditions that indicate potential risks of material misstatement due to fraud should continue throughout the audit.

### **Evaluating Significant Unusual Transactions**

Additional substantive procedures that may be needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances. Because of the judgmental nature of the auditor's risk assessments and the inherent limitations of internal control, particularly the risk of management override, some substantive procedures have to be performed in every audit.

AU-C 240.32 requires the auditor to evaluate the business rationale for significant unusual transactions to address the risk of management override of controls by considering whether the business rationale (or lack thereof) suggests that transactions may have been entered into to perpetrate fraudulent financial reporting or conceal misappropriation of assets. In evaluating the business rationale for significant unusual transactions, factors the auditor considers include whether:

- The transaction is overly complex in relation to its stated purpose.
- Management is overly concerned that the transaction receives a particular accounting treatment.
- Previously unidentified related parties are involved in the transaction.
- The parties to the transaction lack substance.
- The transaction and the manner of accounting have been reviewed and approved at an appropriate level, such as by those charged with governance.

### **Considering the Application of Significant Accounting Principles for Bias**

According to AU-C 240.29, the auditor should evaluate whether the application of significant accounting principles indicates a bias on the part of management. In particular, the auditor should consider accounting related to subjective measurements and complex transactions. Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure is one way in which fraudulent financial reporting can be accomplished.

### **Documentation Requirements**

AU-C 230.08 requires auditors to document significant audit findings or issues, the conclusions reached about made in reaching those conclusions. Judging the significance of a finding or issue generally requires an objective analysis of the facts and circumstances.

## Evaluation of Presentation and Disclosure

AU-C 330.26 establishes the basic requirement that the auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with GAAP. AU-C 330.A72 explains that evaluating the overall presentation of the financial statements, including the related disclosures, involves the following:

- Presentation in a manner that reflects the appropriate classification and description of financial information.
- The form, arrangement, and content of the financial statements, including the related notes, with respect to the—
  - terminology used,
  - amount of detail given,
  - classification of items in the financial statements, and
  - basis of amounts set forth in the financial statements.

In forming an opinion on financial statements, according to AU-C 700.16, the auditor should evaluate several matters, including the following, related to presentation and disclosures, as to whether—

- significant accounting policies selected and applied are adequately disclosed,
- information presented is relevant, reliable, comparable, and understandable,
- disclosures enable intended users to understand the effect of material transactions and events on the entity's financial position, results of operations, and cash flows; and
- terminology used, including the title of each financial statement, is appropriate.

In this evaluation, the auditor considers the presentation, structure, and content of each of the individual financial statements presented (e.g., typically the balance sheet, statement of revenues and expenses, statement of changes in fund balances, and statement of cash flows), as well as the overall presentation of the financial statements as a whole.

**Summary of Planning and Performing Audit Procedures for Presentation and Disclosure.** An appropriate audit approach to planning and performing audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with GAAP can be summarized as follows:

- Make a preliminary determination of the disclosure information that is material, considering both quantitative and qualitative matters.
- As part of performing risk assessment procedures, including during the discussion of the engagement team, identify potential material misstatements in disclosures at the assertion level that could arise due to error or fraud.
- Plan and perform further procedures designed to detect whether material misstatements have occurred at the assertion level in material areas of disclosure that are responsive to the risks of material misstatement. As part of planning and performing procedures, consider whether—
  - particular disclosures require the involvement of an auditor's specialist or
  - particular disclosures require special audit consideration.

- Further audit procedures related to disclosures ought to include the following:
  - Procedures for testing the gathering of disclosure information as part of the financial reporting and closing process, including information from systems and processes that are not part of the general ledger system.
  - Procedures to agree or reconcile disclosure information with the underlying accounting records and systems and processes that are not part of the general ledger system.

## USING ANALYTICAL PROCEDURES

AU-C 520.06 requires the use of analytical procedures in the final review stage of the audit. The purpose of analytical procedures at this stage is to identify any unusual or unexpected financial statement relationships not previously identified and to assist the auditor in assessing the validity of the conclusions reached, including the opinion on the financial statements. The auditor assesses whether the financial statements make sense in light of the knowledge and understanding obtained during the audit. When the auditor does not have a sufficient understanding of the cause of an unusual or unexpected relationship, the auditor may need to revise the risk of material misstatement and apply additional audit procedures.

Preliminary analytical procedures are risk assessment procedures performed to obtain an understanding of the entity and its environment for the purpose of assessing the risks of material misstatement and determining what further audit procedures should be performed in response to the risk assessment. Final review analytical procedures are used to consider the adequacy of the procedures performed. Although the objective of applying the procedures may differ, the analytical procedures actually applied may be very similar or identical. At the planning stage, analytical procedures will be applied to unaudited amounts. In the final review stage, the procedures will be applied to amounts after audit adjustment. Thus, in the final review, a simple comparison to prior period amounts at the financial statement level is normally effective.

One common form of documentation is referred to as a *flux analysis*. A flux analysis is a narrative explanation by financial statement caption (line item) of the change in the amount from the prior period and of any unusual or unexpected relationships to other financial statement line items in the current period. A flux analysis does not appear to be required by AU-C 520, but it is a convenient means of documenting the thought process that is required by the standard. A flux analysis is often performed during the risk assessment process at the start of the audit. If there are relatively few adjustments made during the audit, the initial flux analysis can be updated rather than reperformed in the final review.

AU-C 240 requires the auditor to perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. Those procedures should be performed through the end of the reporting period. If the full year's revenue information is available during audit planning, the required procedures can be performed during preliminary analytical procedures and updated during the final analytical review stage of the audit.

Examples of analytical procedures and guidance on evaluating the results of analytical procedures are included in Lesson 1.

## PERFORMING THE REVIEW OF WORKPAPERS

The review of workpapers near the conclusion of the engagement generally consists of a detailed review of the audit work of staff assistants and a higher level supervisory review. The supervisory review is usually conducted after financial statements and the auditor's report have been drafted and is the final check on whether the audit work supports the overall conclusions on the financial statements. AU-C 220.18–.19 require the engagement partner to take responsibility for review of the work performed in accordance with the firm's review policies and procedures. Based on the review of audit documentation and discussion with the engagement team, on or before the date of the auditor's report, the engagement partner should be satisfied that sufficient appropriate audit evidence has been gathered to support the conclusions reached and the auditor's report to be issued. In addition, quality control standards indicate that a firm should establish policies and procedures that address supervision and

review responsibilities. AU-C 230.09 requires that the workpapers indicate who reviewed the workpapers and the date of the review.

### **Tax Department Review**

Tax considerations often are significant to CIRAs. In addition to the detailed and supervisory review by audit personnel, CPA firms with separate tax departments typically have the firm tax personnel review tax aspects of the audit workpapers and financial statements, for example, those relating to whether the CIRA elects to be taxed under IRC Section 277 or IRC Section 528. The auditor needs to discuss with tax department personnel any knowledge they may have of matters that may affect the financial statements.

### **Timing of Review of Workpapers**

AU-C 700.41 requires that the date of the auditor's report be no earlier than the date on which sufficient appropriate evidence has been obtained to support the opinion on the financial statements. Among other items, *sufficient appropriate audit evidence* includes evidence that:

- a. The audit documentation has been reviewed.
- b. The financial statements, including disclosures, have been prepared.
- c. Management has asserted that they have taken responsibility for the financial statements.

AU-C 220.19 requires that, by the date of the audit report, the engagement partner be satisfied that, through discussion with the engagement team and a review of audit documentation, sufficient appropriate evidence has been obtained to support both the audit conclusions and the audit report to be issued. It seems implicit in this requirement that detailed and supervisory reviews need to be completed before the engagement partner's review. AU-C 220.A17 observes that the engagement partner may review all audit documentation but need not do so. AU-C 230.09c requires documentation of who reviewed the audit work and the review's date and extent.

### **Review Checklists**

Most firms use some form of checklist to serve as a reminder of important engagement completion matters and to document completion of a review of the workpapers. The checklist provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* has sections for documenting the detailed review and the partner review, and it includes an optional step relating to tax department review.

### **Engagement Quality Control Review**

Quality control standards (QC standards) require firms to establish criteria to determine which (if any) engagements are subject to an engagement quality control review (EQCR). If an engagement meets the criteria established by the firm, an EQCR should be performed and completed before the report is released (AU-C 220.21 and QC 10.40). (Smaller firms may be challenged to perform engagement quality control reviews due to limited personnel resources. QC standards indicate that sole practitioners or small firms may contract with qualified external individuals or firms to perform the EQCR function.)

**Establishing Criteria for Engagement Quality Control Reviews.** In establishing criteria for performance of an EQCR, the structure and nature of the firm's practice are important. Such criteria may include considerations such as (a) the structure and nature of the firm, including the size of the firm, whether the firm is a single-office firm or part of a multi-office practice, the number of partners in the firm, the types of services the firm performs and how those services make up the total engagements of the firm; (b) the nature of the engagement, including whether it involves a matter of public interest; (c) whether unusual circumstances or risks have been identified relating to the engagement, engagement service type, or industry; and (d) whether laws or regulations require an engagement quality control review to be performed.

Firms define engagement quality control review criteria based upon the firm's unique circumstances. Since EQCR criteria is based upon each firm's unique circumstances, firms should consider whether their established EQCR



criteria need to change when firm circumstances change. The firm's quality control system should be a dynamic system that changes as the firm changes. In addition, for each type of service provided, the firm may consider a different set of EQCR criteria. In other words, the criteria established for audit engagements may differ significantly than for other types of attest engagements. Accordingly, some firms may establish criteria that result in more EQCRs being performed than other firms. Furthermore, firms may treat the same engagement differently for purposes of establishing engagement quality control review criteria. The key point is that EQCR criteria are as unique as the firm.

Any circumstance that creates an unusual or a higher level of engagement risk should be considered in establishing EQCR criteria. The following list presents some of the types of situations that can be considered when establishing EQCR criteria for a CIRA audit engagement:

- Third-party use of the report, such as a developer or the CIRA's lender for financing purposes.
- High profile clients.
- New types of service for the firm, such as attest services related to reserves for repairs and replacements.
- Clients that are new types of CIRAs (such as cooperatives or timeshares) for a firm that previously provided services only to condominium or homeowner associations, or CIRAs with ancillary operations such as a golf course or restaurant.
- CIRAs without competent or experienced accounting personnel.
- CIRAs with substantial fraud risk factors.
- CIRAs with significant related-party transactions, especially related parties such as board members or the developer who provide other services of the CIRA.
- CIRAs that have experienced material misstatements during the current or previous engagements.
- First time clients.
- Initial audits, especially audits of previously unaudited CIRAs or upon transfer of CIRA control to property owned.
- Audits with unique considerations, such as management company transition audits.
- New firm partners.

Regardless of whether a particular engagement meets the firm's stipulated EQCR criteria, it may be selected for EQCR based on current year risk during engagement performance. On the other hand, however, a firm may not choose to opt-out of performing EQCR when an engagement meets the firm's established EQCR criteria.

While firms are required to establish criteria as part of their QC policies and procedures for determining when an EQCR should be performed, if no engagements meet the criteria established by the firm for review, no EQCRs are required to be performed.

If performed, the engagement quality control review should be completed before the audit report is released. The review should be documented.

## **SUMMARIZATION AND EVALUATION AT THE END OF THE ENGAGEMENT**

One of the final steps near completion of the engagement is evaluation of the misstatements discovered in fieldwork. AU-C 240.35 requires auditors to evaluate whether identified misstatements are indicative of fraud. In addition, AU-C 450.11 requires that the individual and aggregate effects of all uncorrected misstatements be

considered to evaluate whether they are material to the financial statements as a whole. To evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers.

### Categories for Evaluation

The categories of misstatements and the format used to summarize them are matters of individual firm preference. This course uses the following classifications:

- a. *Normal Closing Entries.* These are routine entries, such as adjustments of accruals, that are made to help the client close out the books for the year. If normal closing entries are booked, they *are not misstatements* and should not be included in the summary of audit differences. Normal closing entries also ordinarily are not significant findings or issues that would be subject to the documentation requirements of AU-C 230, *Audit Documentation*. However, it is often useful to group all those entries in one place. Grouping closing entries in one place is more convenient for supervisory review and discussion with the client. The client needs to agree with booking these entries and accepting responsibility for them because the financial statements are the client's responsibility.
- b. *Audit Differences.* These are any differences noted between the accounting records and the evidence obtained during the audit. An audit difference could be any of the following:
  - (1) Passed adjustment for a specifically identified misstatement.
  - (2) Projected misstatement from a substantive audit sampling application.
  - (3) Significant unexplained difference from an analytical procedure that is treated like a misstatement.
  - (4) Difference between the client's accounting estimate and the relevant end of the auditor's acceptable range for that estimate.

### Audit Differences

In discussing summarization and evaluation, this course uses the term *audit differences* to refer to misstatements of amounts and classification. This term was adopted because, as a practical matter, the auditor can only summarize quantitative misstatements. Other misstatements, primarily those relating to presentation and disclosure assertions, are usually judged qualitatively on an individual basis.

**Types of Misstatements.** AU-C 450.A3 provides the following terminology to distinguish between the types of misstatements, which auditors may find beneficial in evaluating the effect of misstatements accumulated during the audit and communicating misstatements to management and those charged with governance:

- a. *Factual Misstatement.* This is a misstatement about which there is no doubt.
- b. *Judgmental Misstatement.* A judgmental misstatement is one that arises from judgments made by management related to accounting estimates that the auditor believes to be unreasonable. This type of misstatement may also arise due to the selection or application of accounting principles by management that the auditor considers to be inappropriate.
- c. *Projected Misstatement.* This type of misstatement is the result of the auditor's best estimate of misstatement extrapolated to entire populations arising from the use of sampling procedures.

Factual misstatements are observed directly by the auditor when performing audit procedures. For example, assessment revenue recorded in the wrong accounting period is a factual misstatement. Judgmental and projected misstatements, while not actually observed by the auditor, arise from procedures performed during the audit. For example, the auditor may determine through performance of procedures to evaluate the adequacy of the allowance for uncollectible assessments that the CIRA's bad debt expense is unreasonable given historical trends and the current economic environment, resulting in the identification of a judgmental misstatement. In addition, the auditor may determine the amount of a projected misstatement based on the results of a sampling application.

**Communication of Misstatements to Management.** AU-C 450.07 requires the auditor to communicate to management on a timely basis all misstatements accumulated during the audit, other than *clearly trivial* ones. AU-C 450.07–.09 also require the following related to the communication and correction of misstatements:

- Ask the appropriate level of management to correct accumulated misstatements.
- After the detection of a misstatement, the auditor may request management to examine the account balance, transaction class, or disclosure in which the auditor identified a misstatement and make corrections.
- When the auditor identifies a judgmental misstatement involving a difference in an estimate, the auditor may ask management to review the assumptions and methods used in developing its (management's) estimate. After management's investigation, the auditor should perform additional audit procedures to determine whether misstatements remain.
- If management decides not to correct some or all of the misstatements, the auditor should obtain an understanding of management's reasons for not correcting the misstatements and take that into account when making the qualitative considerations discussed in the "Different Levels for Different Amounts, Subtotals, or Totals" paragraph later in this lesson. The auditor should also consider the implications for the audit report. In addition, as discussed later in this lesson, uncorrected misstatements are significant audit findings under AU-C 260.13 and should be communicated to those charged with governance.

### Evaluating Audit Differences

AU-C 700.14 states that the auditor should conclude whether the financial statements as a whole are free of material misstatement. The auditor considers both the individual and aggregate effects of all uncorrected misstatements to evaluate whether the financial statements are fairly stated. In making that evaluation, the auditor should consider both quantitative and qualitative factors, as well as the effect on prior periods. The summarization and evaluation of audit differences can be complex. It is a good idea for the summarization and evaluation to include consideration of the following factors:

- *Nature.* For example, services provided but not billed, accounts payable not recorded, and assets expensed instead of capitalized.
- *Cause.* For example, arithmetic or mechanical mistake, or inappropriate application of an accounting principle because of misunderstanding, intentional use of an accounting principle that is not generally accepted, and whether misstatements are isolated or related to a common cause.
- *Amount.* The dollar amount of the difference and whether the difference is an overstatement or understatement.
- *Effect.* The financial statement components affected by the difference, (for example, the excess of revenue over expenses or total liabilities). (Also, consider the effect on compliance with loan covenants, such as maintaining certain operating ratios, or similar issues.)

As discussed above, the auditor communicates to management on a timely basis all misstatements accumulated during the audit, other than clearly trivial ones. For many small CIRAs, management will have corrected all nontrivial misstatements and remaining uncorrected misstatements will be limited. Generally, management will record factual misstatements. For judgmental misstatements, management often will challenge the auditor's assumptions about the misstatement and resolve any differences in those assumptions to determine if an adjustment should be made. For projected misstatements, management normally evaluates the population to determine the actual misstatements in the population to eliminate the projection element.

The quantitative effects of misstatements need to be combined in a way that enables the auditor to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, the misstatements materially misstate the financial statements as a whole. That simply means the auditor needs to consider not only the materiality of individual misstatements, but also their combined effect on important financial statement totals or subtotals.

The application and other explanatory material related to evaluating the effect of uncorrected misstatements included in AU-C 450 explains that before considering the combined effect of uncorrected misstatements, the auditor considers each misstatement separately to evaluate the following matters:

- Its effect in relation to the relevant individual classes of transactions, account balances, or disclosures, including whether materiality levels for that particular class of transactions, account balance, or disclosure, if any, has been exceeded.
- The effect of considering the individual misstatement on the financial statements taken as a whole, including whether it is appropriate to offset misstatements. For example, it may be appropriate to offset misstatements of items within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate. If the misstatement of an individual financial statement amount causes the financial statements as a whole to be materially misstated, auditors need to exercise caution before aggregating that misstatement with misstatements in other financial statement components. It is unlikely that the effect of an individually material misstatement can be offset against other misstatements that diminish its effect on important financial statement totals or subtotals in order to justify that, as a whole, the financial statements are not materially misstated. For example, it is not appropriate for a material misstatement of revenue to be netted against an offsetting misstatement of expenses, even though the aggregate effect on net income is not material.
- The effect of misstatements related to prior periods. In prior periods, misstatements may not have been corrected by the entity because they did not cause the financial statements for those periods to be materially misstated. Those misstatements might also affect the current period's financial statements. AU-C 450.11 states that in determining whether uncorrected misstatements are material (individually or in the aggregate), the auditor should consider the effect on the current period's financial statements of those prior period misstatements. The two main approaches used for considering the effect of prior period misstatements (that is, the rollover and iron curtain methods) are discussed later in this lesson.

**Clearly Trivial Misstatements.** Some auditors set an amount below which detected misstatements need not be accumulated on the summary of audit differences (often referred to as adjustments passed at the workpaper level). AU-C 450.05 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial. AU-C 450.A2 explains that clearly trivial does not mean the same thing as not material. Misstatements that are clearly trivial are inconsequential in amount, whether considered individually or in the aggregate and whether judged by any criteria of size, nature, or circumstance. Clearly trivial matters are a wholly different order of magnitude (smaller) than materiality determined in accordance with AU-C 320. If there is any uncertainty regarding an item meeting the classification of clearly trivial, the matter is not considered to be clearly trivial.

When determining whether the amount of a misstatement meets the clearly trivial criteria, auditors need to be careful not to net proposed adjustments at the workpaper level. For example, assume the auditor has determined that only misstatements greater than \$500 need to be accumulated on the summary of audit differences. If the auditor has a known misstatement that overstates income by \$10,000 and a misstatement that understates income by \$10,500, both misstatements need to be included on the summary of audit differences.

**Evaluating Estimates.** A discussion of accounting estimates and examples of common accounting estimates were included earlier in this lesson. The result of auditing an accounting estimate is often a range for the estimate that the auditor considers acceptable. AU-C 540 states that an accounting estimate may be evaluated by reviewing subsequent events; testing management's methods, assumptions and data; or developing a point estimate or a range. If the client's estimate is unreasonable based on the auditor's evaluation, then the difference between the client's estimate and the auditor's estimate would be considered a judgmental misstatement. (When the auditor's estimate is a range, the amount of the misstatement is the difference between the client's estimate and the closest end of the auditor's range.)

AU-C 540.21 requires the auditor to review judgments and decisions made by management when making accounting estimates to determine if there are any indicators of possible management bias. If management, for example, always chooses estimated amounts for the valuation of assets that are at the low end of the auditor's range of acceptable amounts, the combined effect could result in a material misstatement of income. In that case, the

auditor would consider whether other recorded estimates reflect a similar bias and perform additional procedures to address those estimates taken as a whole. The auditor might consider whether management's estimates were at one end of the auditor's reasonable range in the prior year and at the other end in the current year. That could indicate the possibility that management is using accounting estimates to manage the excess of revenues over expenses. If the auditor believes that is the case, the auditor should consider communicating the matter to those charged with governance as discussed later in this lesson.

AU-C 240.32 requires the auditor to review accounting estimates for biases that could result in material misstatement due to fraud. If the auditor identifies possible bias, the auditor should evaluate accounting estimates as a whole.

**Different Materiality Levels for Different Amounts, Subtotals, or Totals.** For planning purposes, a judgment is made about a single materiality amount for the financial statements as a whole, known as *planning materiality*. In addition to planning materiality, the auditor determines whether there are particular financial statement items for which a lower planning materiality amount is appropriate based on user perceptions of the particular items. Also, to achieve the objective of performing the audit to obtain reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements, the auditor establishes a performance materiality amount at the individual account balance, class of transaction, or disclosure level. Determining performance materiality is beyond the scope of this course but is discussed more fully in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*. The auditor also considers materiality when evaluating audit differences at the conclusion of the engagement. During this evaluation, the auditor considers the effect of misstatements on specific amounts, subtotals, or totals in financial statements. In this case, it is possible to use a larger amount in evaluating the effect on certain amounts, subtotals, or totals than on others. Audit differences can be accumulated by various financial statement subtotals to accommodate the auditor's consideration of the effect of misstatements noted.

However, exclusive reliance on a quantitative amount or percentage relationship for determining materiality is not appropriate. Qualitative factors also should be considered. The consideration of qualitative factors may cause the auditor to conclude that a quantitatively small misstatement is material to the financial statements. AU-C 450.A23 indicates that some misstatements surrounding circumstances (qualitative considerations) may cause the auditor to conclude that they are material, individually or when aggregated with other misstatements, even if they are lower than the amount previously designated as material to the financial statements as a whole. If, as the audit progresses or when evaluating audit findings, the auditor concludes that lower materiality levels than the amounts determined during audit planning are appropriate, the auditor should reconsider the related levels of performance materiality and the sufficiency of the further audit procedures that were performed. AU-C 450.06 indicates that the auditor should determine whether misstatements identified as the audit progresses require revision to the overall audit strategy and audit plan. In making that determination, the auditor considers whether (a) the nature of identified misstatements and the circumstances related to their occurrence indicate that other misstatements may exist, that when aggregated with misstatements already accumulated, could be material, or (b) the misstatements accumulated during the audit approaches materiality levels determined in accordance with AU-C 320 (that is, planning and/or performance materiality).

**Overall Evaluation.** Even if the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, the auditor recognizes that there is a risk that the financial statements may be materially misstated due to further undetected misstatements. If combined uncorrected misstatement is very close to the amount an auditor considers material to the financial statements as a whole, the risk of further misstatement may be considered unacceptable. For example, if an auditor considers \$20,000 material and uncorrected misstatement is \$5,000, the risk of further misstatement of \$15,000 may be considered acceptably low. If combined uncorrected misstatement is very close to \$20,000, the risk may be considered unacceptably high. In that case, the auditor needs to perform additional procedures or determine that the CIRA appropriately adjusts the financial statements.

### Evaluating the Existence of Fraud

If the auditor believes or suspects misstatement is indicative of fraud, the auditor should evaluate its implications for the audit. Those implications may be more significant if management is involved. If management is involved, questions about management's integrity may raise doubts about the auditor's ability to rely on representations made

during the audit. In that case, the auditor should reevaluate the assessment of the risks of material misstatement due to fraud and its resulting effect on the nature, timing, and extent of audit procedures to respond to the assessed risks.

If the auditor concludes that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor should evaluate the implications for the audit.

In some cases, the risk of material misstatement of the financial statements due to fraud is so significant that auditors should consider withdrawing from the engagement. If the auditors withdraw, they should communicate the reasons for their withdrawal to the appropriate level of management and those charged with governance and determine whether they have a professional or legal requirement to report the withdrawal and the reasons for it to those who engaged them or to regulatory authorities. The decision to withdraw may depend on whether the identified risks call into question the integrity of management and whether management or others with oversight are diligent and cooperative in investigating the situation and taking appropriate action. Best practices indicate that auditors considering withdrawal should consult with legal counsel.

### Documentation Requirements

To evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers. AU-C 450.12 states that the auditor should prepare documentation of the following:

- The amount by which misstatements would be regarded as clearly trivial.
- All misstatements accumulated by the auditor during the audit, and whether they have been corrected by management.
- The auditor's conclusion as to whether uncorrected misstatements, individually or in the aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion.

**Summary of Audit Differences.** An auditor needs to combine, or aggregate, the effect on the financial statements of all uncorrected misstatements to evaluate whether the financial statements as a whole are materially misstated. According to AU-C 450, misstatements need to be combined in a way that enables the auditor to consider whether the misstatements in individual amounts, subtotals, or totals in the financial statements materially misstate the financial statements as a whole. That simply means the auditor needs to consider not only the materiality of individual misstatements, but also their combined effect on important financial statement totals or subtotals.

Two methodologies have been used in practice to aggregate differences—the *rollover* method and the *iron curtain* method. Some firms use the *rollover* method; others use the *iron curtain* method. The main difference between the two methods is how the effects of prior-period misstatements are considered. The rollover method considers all misstatements (current-period misstatements as well as the impact of prior-period waived adjustments on current-period income). The iron curtain method focuses on the impact of misstatements on the audited *balance sheet* and considers the effect on current-period income of amounts needed to correct the balance sheet. For further information regarding the rollover and iron curtain methods, see *PPC's Guide to Audits of Nonpublic Companies*.

### Evaluation of Overall Materiality

The combined effect of uncorrected misstatements on various financial statement components (amounts, subtotals, or totals) should be compared to the amount that the auditor considers material to the financial statements as a whole. The auditor's judgments about materiality in audit planning may be different than materiality used in evaluating audit findings because it is not possible to anticipate everything that could ultimately influence judgments about materiality when evaluating audit findings at completion of the audit. For example, while performing the audit, the auditor may become aware of quantitative or qualitative factors that were not initially considered but could be important to users of the financial statements. Those factors should be considered in making materiality judgments about audit findings. If the auditor concludes that a lower materiality level than initially determined is appropriate, the auditor should reconsider performance materiality and appropriateness of the nature, timing, and extent of further audit procedures. If the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that could be material when aggregated with identified misstatements, the auditor should also consider whether the overall audit strategy and audit plan need to be revised.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. Which of the following CIRAs is most likely to have difficulty continuing as a going concern?
  - a. CIRA 1 had operating losses on its most recent financial statements.
  - b. CIRA 2 switches its main supplier for a new vendor.
  - c. CIRA 3 renovates the members' clubhouse.
  - d. CIRA 4's real estate has declined a great deal in value.
15. Which of the following statements best describes how an auditor deals with a going concern issue under AU-C 570A?
  - a. The auditor must perform specific procedures to determine whether the entity's ability to continue as a going concern is an issue.
  - b. If there is substantial doubt, the auditor should obtain information about management's plans to mitigate the effect of the conditions or events.
  - c. The auditor should consider management's plans to mitigate substantial doubt separately from the doubt itself.
  - d. Since management's plans are assessed, it is unnecessary for the auditor to document findings about such substantial doubt.
16. Which of the following auditors has correctly addressed an issue related to the management representation letter in a CIRA audit?
  - a. Imogen has management focus the letter on CIRA-specific issues, such as funding major repairs and replacements.
  - b. James accepts management's oral statements in lieu of a written representation letter.
  - c. Kendra has her CIRA client limit its representations to those that are material to the financial statements.
  - d. Louis expresses an unmodified opinion on the CIRA's financial statements even though management did not provide representations.
17. Which of the following CPA firms has correctly dealt with an issue related to engagement quality control reviews (EQCRs)?
  - a. Firm A establishes its own criteria for when EQCRs are necessary.
  - b. Firm B performs its EQCRs after the audit report has been released.
  - c. Firm C is small enough that it considers itself exempt from EQCR requirements.
  - d. Firm D maintains the same EQCR requirements every year for consistency.

18. What is the correct term for a misstatement in which the auditor uses sampling to estimate how a misstatement will affect an entire population of data?
- a. Audit differences.
  - b. Judgmental misstatement.
  - c. Projected misstatement.
  - d. Factual misstatement.



## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. Which of the following CIRAs is most likely to have difficulty continuing as a going concern? **(Page 68)**
  - a. CIRA 1 had operating losses on its most recent financial statements. [This answer is incorrect. One year of losses is not enough to engender doubt about an entity's ability to continue as a going concern. However, if the CIRA has a negative trend of recurring operating losses over multiple years, then doubt may legitimately be raised.]
  - b. CIRA 2 switches its main supplier for a new vendor. [This answer is incorrect. There could be many valid reasons why an entity switches suppliers. However, doubt may arise about a CIRA's ability to continue as a going concern if the usual trade credit is denied by contractors and suppliers, as this may mean the entity is having financial difficulties.]
  - c. CIRA 3 renovates the members' clubhouse. [This answer is incorrect. Renovations can be a perfectly normal part of the operating cycle of a CIRA. However, an internal matter that may indicate difficulty in continuing as a going concern would be if the CIRA's physical structure were deteriorating or in disrepair. The fact that CIRA 3 has the funds to do a renovation actually speaks well of their ability to continue as a going concern, because it should indicate they are not running into financial difficulties.]
  - d. **CIRA 4's real estate has declined a great deal in value. [This answer is correct. There are many external matters that could raise doubt about an entity's ability to continue as a going concern for a reasonable period of time. Examples include (1) legal proceedings, legislation, or similar matters that might jeopardize the CIRA's ability to operate; (2) significant declines in values of real estate/increase in foreclosures; and (3) significant uninsured or underinsured catastrophe or disaster such as earthquake, tornado, or flood. Though the decline in real estate value may not be CIRA 4's fault, it may negatively impact the CIRA's ability to continue as a going concern, as it could affect the CIRA's ability to sell units and get mortgages. Therefore, CIRA 4's auditor needs to address doubt about the ability to continue as a going concern in the audit engagement.]**
15. Which of the following statements best describes how an auditor deals with a going concern issue under AU-C 570A? **(Page 68)**
  - a. The auditor must perform specific procedures to determine whether the entity's ability to continue as a going concern is an issue. [This answer is incorrect. AU-C 570A does not mandate any specific procedures designed solely to search for conditions or events that might affect the association's ability to continue as a going concern, but it does require specific assessment of whether audit procedures that were applied identified such conditions and events.]
  - b. **If there is substantial doubt, the auditor should obtain information about management's plans to mitigate the effect of the conditions or events. [This answer is correct. If, after assessing the auditing procedures applied, the auditor believes there is substantial doubt about the CIRA's ability to continue as a going concern, AU-C 570A requires the auditor to obtain information regarding management's plans to mitigate the adverse effects of the conditions and events that indicate there is substantial doubt about the entity's ability to continue as a going concern and the likelihood of effectively implementing those plans.]**
  - c. The auditor should consider management's plans to mitigate substantial doubt separately from the doubt itself. [This answer is incorrect. Management's plans to mitigate the effect of conditions or events that give rise to substantial doubt that the CIRA can continue as going concern are integral to the auditor's consideration of the issue as a whole. The auditor's initial substantial doubt could even be alleviated by management's plans. Therefore, both sides of the issue must be considered together.]
  - d. Since management's plans are assessed, it is unnecessary for the auditor to document findings about such substantial doubt. [This answer is incorrect. When conditions or events cause the auditor to believe,

before consideration of management's plans, there is substantial doubt about the CIRA's ability to continue as a going concern for a reasonable period of time, AU-C 570A.22 requires documentation of specific items, such as the conditions or events that caused the auditor to have this substantial doubt.]

16. Which of the following auditors has correctly addressed an issue related to the management representation letter in a CIRA audit? **(Page 75)**

- a. Imogen has management focus the letter on CIRA-specific issues, such as funding major repairs and replacements. [This answer is incorrect. It is a best practice for auditors to obtain representations from management and the board of directors about CIRA-specific matters (e.g., the association's policy for funding future major repairs and replacements) *in addition* to those made in audits of the financial statements for other kinds of reporting entities. Therefore, while Imogen can have her client's management include these issues, the management representation cannot focus *solely* on these CIRA-specific items.]
- b. James accepts management's oral statements in lieu of a written representation letter. [This answer is incorrect. AU-C 580, *Written Representations*, requires the auditor to request written representations from management with appropriate responsibilities for the financial statements. A management representation letter, among other things, confirms oral representations about specific matters given to the auditor during the audit and provides audit evidence that supports the validity of the results of other audit procedures. James would not have this necessary audit evidence if his representations from management were oral instead of written.]
- c. **Kendra has her CIRA client limit its representations to those that are material to the financial statements. [This answer is correct. AU-C 580.A22 permits, but does not require, limiting representations to matters that are either individually or collectively material to the financial statements. That limitation is acceptable, however, Kendra will need to make sure that representations limited thusly directly relate to amounts in the financial statements and reach an agreement with management about what is material for this purpose.]**
- d. Louis expresses an unmodified opinion on the CIRA's financial statements even though management did not provide representations. [This answer is incorrect. AU-C 580 is clear that the inability to obtain appropriate written representations prevents an auditor from expressing an unmodified opinion and may cause an auditor to disclaim an opinion or even withdraw from the engagement. Therefore, Louis would not be able to express an unmodified opinion unless the CIRA's management provides the necessary representations.]

17. Which of the following CPA firms has correctly dealt with an issue related to engagement quality control reviews (EQCRs)? **(Page 82)**

- a. **Firm A establishes its own criteria for when EQCRs are necessary. [This answer is correct. Quality control standards (QC standards) require firms to establish criteria to determine which (if any) engagements are subject to an EQCR. Therefore, since the QC standards do not prescribe any mandatory criteria, Firm A has complied with them by setting this criteria.]**
- b. Firm B performs its EQCRs after the audit report has been released. [This answer is incorrect. According to AU-C 220.21 and QC 10.40, if an engagement is subject to an EQCR, the review should be performed and completed *before* the report is released. Therefore, Firm B needs to perform its EQCRs earlier in the audit process.]
- c. Firm C is small enough that it considers itself exempt from EQCR requirements. [This answer is incorrect. Smaller firms may be challenged to perform EQCRs due to limited personnel resources. QC standards indicate that sole practitioners or small firms may contract with qualified external individual or firms to perform the EQCR function. Therefore, Firm C is not exempt from EQCRs solely because of its size.]
- d. Firm D maintains the same EQCR requirements every year for consistency. [This answer is incorrect. The firm's quality control system should be a dynamic system that changes as the firm changes. Therefore,

Firm D should consider whether its established EQCR criteria need to change when firm circumstances change.]

18. What is the correct term for a misstatement in which the auditor uses sampling to estimate how a misstatement will affect an entire population of data? **(Page 84)**
- a. Audit differences. [This answer is incorrect. This term refers to differences noted between the accounting records and the evidence obtained during the audit.]
  - b. Judgmental misstatement. [This answer is incorrect. Per AU-C 450.A3, this term refers to a misstatement that arises from judgments made by management related to accounting estimates that the auditor believes to be unreasonable. This type of misstatement may also arise due to the selection or application of accounting principles by management that the auditor considers to be inappropriate.]
  - c. **Projected misstatement. [This answer is correct. According to AU-C 450.A3, this term refers to misstatement that is the result of the auditor's best estimate of misstatement extrapolated to entire populations arising from the use of sampling procedures.]**
  - d. Factual misstatement. [This answer is incorrect. This term refers to misstatement about which there is no doubt, according to the definitions provided in AU-C 450.A3.]

# PREPARING A DRAFT OF THE FINANCIAL STATEMENTS AND THE AUDITOR'S REPORT

## Financial Statements

*PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* presents illustrations of CIRA financial statements. In many small CIRA audit engagements, the auditor drafts or assists with drafting the financial statements. (Financial statement preparation assistance is a nonattest service subject to the requirements of ET 1.295 of the AICPA *Code of Professional Conduct*). Management needs to understand that the auditor's involvement in drafting the financial statements does not change the fact that management is responsible for the financial statements. Management is expected to acknowledge its responsibility in the management representation letter. Furthermore, for the auditor to remain independent, among other things, management should agree to accept that responsibility, and the auditor should be satisfied that management has the ability to do so. The auditor's understanding with the client regarding drafting the financial statements should be documented as discussed later in this lesson. The auditor needs to discuss the representation letter with management personnel so they understand the meaning and significance of acknowledging responsibility for the financial statements.

Management also needs to understand that the auditor's involvement in drafting the financial statements may be the result of a significant deficiency or material weakness in internal control that should be communicated, in writing, to management and those charged with governance. AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, including issues related to the auditor's involvement in financial statement preparation, is discussed in detail later in this lesson.

## Notes to the Financial Statements

The notes to the financial statements are an integral part of the financial statements. Normally, the information in the notes is tested when the related financial statement components are tested.

Even the most experienced auditors find it necessary to use an aid to remind them of the multitude of disclosures required by GAAP. One option is to use a disclosure checklist, such as the one provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

## Dating the Auditor's Report

AU-C 700.4 requires the date of the auditor's report to be no earlier than the date that sufficient appropriate audit evidence has been obtained to support the opinion on the financial statements. Among other items, *sufficient appropriate audit evidence* includes evidence that:

- a. The audit work has been reviewed.
- b. The financial statements, including disclosures, have been prepared.
- c. Management has taken responsibility for the financial statements.

Auditors need to coordinate the following dates:

- Audit report date.
- Management representation letter date.
- Subsequent events evaluation note disclosure date.

To coordinate the auditor's report date, management representation letter date, and the subsequent events evaluation note disclosure date, this course suggests that the auditor take the following steps:

- Discuss the dating requirements with management in advance of starting the audit.
- Include in the engagement letter a provision that management will not date the subsequent event note earlier than the date of their management representation letter and the date of the auditor's report.

That process will generally result in the date management discloses as the date through which they have evaluated subsequent events being the same date as the auditor's report.

### **Auditor's Reports**

AU-C 700, *Forming an Opinion and Reporting on Financial Statements*, addresses the auditor's responsibility to form an opinion on the financial statements and on the form and content of the auditor's report.

This section discusses the following aspects of audit reports that often arise in CIRA engagements:

- Note disclosure on funding future repairs and replacements.
- Reporting on comparative financial statements.
- Reporting on supplementary information accompanying the basic financial statements.
- Reporting on comparisons of budgeted and actual information.
- Required supplementary information on future major repairs and replacements.
- Reporting on information required by HUD.
- Auditor's responsibility for other information.

### **Note Disclosure on Funding Future Major Repairs and Replacements**

To keep the financial statements from being misleading, the FASB ASC 972-235-50-2 requires CIRAs to disclose the following information concerning their funding for future major repairs and replacements:

- Requirements, if any, in statutes or association documents (or mortgage or governmental bodies funding requirements, such as the FHA), to accumulate funds for future major repairs and replacements and the CIRA's compliance or lack of compliance with them
- A description of the CIRA's funding policy, if any (including a policy to fund future major repairs and replacements by special assessments or borrowings when needs occur), and compliance with that policy
- A statement that funds, if any, are being accumulated based on estimated future (or current) costs and that actual expenditures may vary from those estimates and the variations may be material
- Amounts assessed for major repairs and replacements in the current period, if any
- A statement indicating whether a study was conducted to estimate the remaining useful lives of common property components and the costs of future major repairs and replacements.

### **Comparative Financial Statements**

If CIRAs present their financial statements using fund accounting, prior-period financial statements usually are presented in a single column and show only total-all-funds information. If auditors are to express an unmodified opinion on the prior-period financial statements, the prior-year statements should include all of the detail required

by GAAP. Thus, generally auditors need to consider whether the statements include all of the disclosures required by GAAP, especially information about funds that have been designated for future major repairs and replacements and any assessments that were used for purposes other than those for which they were designated. Often any necessary disclosures may be easily made in the notes to the financial statements. If the prior-period financial statements include all of the disclosures required by GAAP, the auditors should issue a standard unmodified report in conformity with AU-C 700.

If prior period comparative financial information lacks the sufficient detail required by GAAP as described above, AU-C 700.A52 states that the auditor need not opine on the comparative information in accordance with AU-C 700. However, when comparative information is presented but not covered by the auditor's opinion on the financial statements, AU-C 700.47 requires the auditor to clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking. To comply with that requirement, auditors may add a separate section in the auditor's report following the opinion paragraph with a heading such as "Report on Summarized Comparative Information," as follows:

### **Report on Summarized Comparative Information**

We have previously audited XYZ Homeowners' Association's 20X2 financial statements, and we expressed an unmodified opinion on those financial statements in our report dated February 10, 20X3. In our opinion, the summarized comparative information presented herein as of and for the year ended December 31, 20X2, is consistent, in all material respects, with the audited financial statements from which it has been derived.

If the CIRA requests the auditor to express an opinion on the prior period as well as the current period and the information for the prior period does not include sufficient detail to constitute a fair presentation in accordance with GAAP, the CIRA would need to include additional columns or separate detail and the required disclosures for the prior period, or the auditor would need to modify the opinion on the prior period financial statements in accordance with AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*.

### **Supplementary Information**

Some CIRAs choose to present information supplementing the financial statements, such as the following:

- Schedules of revenues and expenses.
- Analysis of activity in the repair and replacement fund.
- For CIRAs involved with HUD reporting, the financial schedule required by HUD.

In addition, FASB ASC 972-235-50-3 *requires* CIRAs to disclose certain supplementary information about future major repairs and replacements outside the basic financial statements. The following auditing standards define the types of information accompanying the basic financial statements and provide guidance on the auditors' related responsibilities, including reporting responsibilities:

- AU-C 720, *Other Information in Documents Containing Audited Financial Statements*.
- AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*.
- AU-C 730, *Required Supplementary Information*.

In most circumstances, other than required supplementary information, auditors' responsibilities for supplementary information accompanying the CIRA's basic financial statements will be governed by AU-C 725. According to AU-C 725, auditors have a responsibility to report on supplementary information presented outside the basic financial statements when they (a) have audited the financial statements and (b) are engaged to report on whether the supplementary information is fairly stated in relation to the financial statements as a whole. (The auditors' responsibilities when the supplementary information is contained in a document such as a CIRA's annual report and they are not engaged to report on supplementary information are set forth in AU-C 720, *Other Information in Documents Containing Audited Financial Statements* and discussed later in this lesson. AU-C 725 requires auditors to apply the

following procedures to determine whether the supplementary information is fairly stated in relation to the basic financial statements as a whole:

- a. Determine that the supplementary information was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements.
- b. Determine that the supplementary information relates to the same period as the financial statements.
- c. Determine that the supplementary information will accompany the audited financial statements or that the audited financial statements will be made readily available by the CIRA. (Audited financial statements are considered to be "readily available" if a third party user can obtain the audited financial statements without any further action by the entity, for example, because they are available on the entity's website.)
- d. Inquire of management about the purpose of the supplementary information, the criteria used by management to prepare it, and any significant assumptions or interpretations underlying the measurement or presentation of the supplementary information.
- e. Determine that the form and content of the supplementary information complies with applicable criteria.
- f. Obtain an understanding of the methods of preparing the supplementary information and determine whether they are consistent with those used in prior years (or if preparation methods have changed from those used in prior periods, the reason for those changes).
- g. Compare and reconcile the supplementary information to the financial statements or the underlying accounting and other records.
- h. Evaluate the appropriateness and completeness of the supplementary information.

In addition, AU-C 725.06–.07 require auditors to obtain the following acknowledgments and written representations from management:

- a. Obtain the agreement of management that it acknowledges and understands its responsibility to—
  - Prepare the supplementary information in accordance with applicable criteria.
  - Provide the auditors with certain written representations. (See item b.)
  - Include the auditor's report on the supplementary information in any document that contains the supplementary information and that indicates that the auditors have reported on it.
  - Present the supplementary information with the audited financial statements or make the audited financial statements readily available to intended users of the supplementary information if the supplementary information will not be presented with the audited financial statements.
- b. Obtain the following written representations from management:
  - Acknowledgment of its responsibility for preparing the supplementary information in accordance with the applicable criteria.
  - Belief that the supplementary information, including its form and content, is fairly presented in accordance with the applicable criteria.
  - Methods of measurement or presentation used to prepare the supplementary information are consistent with those used in prior years (or if preparation methods have changed from those used in prior periods, the reason for those changes).

- Significant assumptions or interpretations underlying the measurement or presentation of the supplementary information.
- When the supplementary information is not presented with the audited financial statements, that it will make the audited financial statements readily available to the intended users of the supplementary information no later than the issuance of the supplementary information and the auditors' report.

The engagement letter can be used if the auditors choose to obtain management's acknowledgments in item a. above in writing. Representation letters can include management's representations from item b. above.

**Auditors' Reports.** An auditor's report on supplementary information may either be presented separately or included as an other-matter paragraph following the opinion paragraph of the auditor's report on the financial statements. The other-matter paragraph or separate report should include statements that—

- a. The audit was conducted for the purpose of forming an opinion on the financial statements as a whole.
- b. The supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements.
- c. The supplementary information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.
- d. The supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information to the underlying accounting and other records used to prepare the financial statements or the financial statements themselves and other additional procedures, in accordance with GAAS.
- e. In the auditor's opinion, the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

In addition, when reporting separately on the supplementary information, the auditor's report should include a reference to (a) the report on the financial statements, (b) the date of that report, (c) the nature of the opinion expressed on the financial statements, and (d) any report modifications. When the report on supplementary information is presented as an other-matter paragraph of the auditor's report on the financial statements, the other-matter paragraph should include a heading such as "Report on Supplementary Information."

As discussed above, auditors may express an opinion on supplementary information accompanying audited financial statements when (a) engaged to do so and (b) the supplementary information was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements. When supplementary information includes nonaccounting data and other information that is not directly related to the basic financial statements and, consequently, not susceptible to auditing procedures applied in the audit of the basic financial statements, auditors are not able to express an opinion on the presentation of the information in relation to the financial statements as a whole. In those circumstances, although not required by AU-C 725, it may be a good idea for auditors to disclaim an opinion on the information so that the degree of responsibility the auditors are taking with respect to the information will be clear. In addition, the information on which the auditors are disclaiming an opinion should be clearly designated as "unaudited" or include a reference to the auditor's disclaimer of opinion.

If the supplementary information is materially misstated in relation to the financial statements as a whole, the auditor should discuss the matter with management and propose appropriate revisions. If the revisions are not made:

- If the auditor is engaged to report on the supplementary information in an other-matter paragraph of the auditor's report on the financial statements, the auditor should modify the opinion on the supplementary information and describe the misstatement in the report.
- If the auditor is engaged to report on the supplementary information in a separate report, the auditor should withhold the report on the supplementary information.



## Comparisons of Budgeted and Actual Information

A CIRA's financial statements may include schedules that compare budget information with actual results for the period. Normally, budget comparisons are presented in one of two ways:

- *Expired Periods.* The current year actual compared with the budget for the current year (that is, the budget covers the same period as the historical financial statements).
- *Prospective Periods.* The current year actual compared with the budget for next year (for example, the financial statements for the year ended December 31, 20X6, include the CIRA's 20X7 budget).

The reporting responsibility for budgets differs depending on whether for an expired or prospective period.

**Budgets for Expired Periods.** If the expired budget is part of the supplementary information on which the auditors have been engaged to report, AU-C 725 applies and it may be better for the auditor to disclaim an opinion on it as explained above.

**Budgets for Prospective Periods.** If the financial statements include budget information for a period that has not expired, the unexpired budget meets the definition of prospective financial information in the AICPA professional standards. The professional standards that apply to services performed on prospective financial information are not found in the auditing standards, which relate to historical financial information. Depending on the level of assurance the CIRA wishes to obtain on the budgeted information, a CPA may be engaged to perform one of the following types of services, listed in order of the least amount of assurance to the most:

- Preparation (no assurance, CPA does not issue report)
- Compilation (no assurance, CPA issues report)
- Agreed-upon procedures (CPA reports on procedures applied to the subject matter, and findings)
- Examination (CPA obtains reasonable assurance and provides an opinion about whether the subject matter is in accordance with criteria)

The professional standards for engagements to prepare or compile prospective information are found in sections AR-C 70 and AR-C 80, respectively, of the Statements on Standards for Accounting and Review Services (SSARS). The professional standards for engagements to examine or perform agreed-upon procedures on prospective financial information are provided in Statement on Standards for Attestation Engagements (SSAE) No. 18, *Attestation Standards: Clarification and Recodification*, and codified in Sections AT-C 205, AT-C 215, and AT-C 305.

If the practitioner is not engaged to perform one of the levels of service described above on prospective financial information and is only providing audit services on the historical financial statements for the client, AU-C 720 applies to the presentation of the unexpired budget information. Adding an Other Matter paragraph to the audit report to disclaim an opinion on the prospective financial information is recommended.

Prospective financial information is beyond the scope of this course. *PPC's Guide to Forecasts and Projections* provides detailed presentation and reporting guidance on comparative presentations of actual and prospective information.

## Required Supplementary Information on Future Major Repairs and Replacements

FASB ASC 972-235-50-3 requires CIRAs to disclose the following supplementary information about future major repairs and replacements of its common property as supplementary information outside of the basic financial statements:

- Estimates of current or future costs of future major repairs and replacements of all existing components, such as roofs, including the following:
  - Estimated amounts required

- Methods used to determine the costs
- The basis for the calculations, including assumptions, if any, about interest and inflation rates
- Sources used
- Dates of studies made for that purpose, if any
- A presentation of components to be repaired and replaced that includes the following:
  - Estimates of the remaining useful lives of the components
  - Estimates of current or future replacement costs
  - Amount of funds accumulated for each component to the extent designated by the CIRA's board of directors

Exhibit 2-4 illustrates presentations of required supplementary information.

Auditors have the following alternatives when required supplementary information is presented with audited financial statements:

- Include an other-matter paragraph in their report after the opinion paragraph that refers to the information and disclaims an opinion on it in accordance with AU-C 730, *Required Supplementary Information*.
- Report on whether the information is fairly stated, in all material respects, in relation to the basic financial statements in accordance with AU-C 725, *Supplementary Information in Relation to the Financial Statements Taken as a Whole*.

Generally, because of the nature of the required supplementary information regarding future major repairs and replacements, auditors will report on it in accordance with AU-C 730. Reporting on required supplementary information is discussed later in this lesson.

**Applying Limited Procedures.** Required supplementary information differs from voluntary presentations of information outside of the basic financial statements because a designated accounting standard setter such as the FASB considers the information an essential part of the financial reporting of certain entities and because authoritative guidelines for presentation of the information have been established. Thus, AU-C 730 requires auditors to apply certain limited procedures to the required supplementary information.

The limited procedures are described in AU-C 730.05. In general, they require auditors to—

- Make inquiries of management about the method of preparing the required supplementary information, including (a) whether the required supplementary information conforms to prescribed guidelines, (b) significant assumptions underlying the information, and (c) whether the information has been prepared on a consistent basis.
- Compare the required supplementary information for consistency with management's responses to the preceding inquiries, the financial statements, and other information obtained during the audit of the financial statements.
- Obtain certain written representations from management.

Although auditing standards require auditors to apply limited procedures to presentations of required supplementary information, the objective of the procedures differs significantly from the objective of procedures applied during an audit of financial statements. Since the limited procedures do not include examining evidence or testing to corroborate management's responses to auditors' inquiries, auditors do not have a basis for expressing an opinion on the required supplementary information itself. See Lesson 2 for a discussion of the reporting options.

Exhibit 2-4 lists the required procedures contained in AU-C 730.05. The exhibit also compares those required procedures to procedures tailored to required supplementary information on future repairs and replacements that were included in Paragraph 7.101 of the now inactive AICPA guide. The guide states that auditors should consider its specific procedures in carrying out the required procedures. Although the guide is inactive, the procedures in it are not onerous, and it is best practice for auditors to apply them whenever the required supplementary information is included with audited financial statements. Auditors need to tailor their inquiries to the approach followed by the CIRA in developing the required supplementary information. For example, if the required supplementary information has been prepared by the CIRA's board of directors, auditors would address their inquiries to the particular members responsible for developing the information.

#### Exhibit 2-4

##### Limited Procedures for Required Supplementary Information

Description of Procedure	Required by AU-C 730.05	Additional Procedure in AICPA Guide
1. Inquire of the managing agent or the board of directors about the methods used by the board to develop the required supplementary information (e.g., internal study made by the board of directors, estimates obtained from licensed contractors, or a study conducted by a professional engineer).		X
2. Inquire of the managing agent or the board of directors about each of the following items:		
a. Whether the required supplementary information is measured and presented in conformity with prescribed guidelines.	X	
b. Whether the methods and bases used for estimating the amounts are reasonable.		X
c. Any significant assumptions or interpretations underlying the measurement or presentation of the information.	X	
d. Whether the methods and bases for estimating the amounts are documented.		X
e. Whether the CIRA's historical property maintenance costs were considered in determining the information to be disclosed.		X
f. Whether the age and condition of the common property components were considered in determining the information and amounts to be disclosed.		X
g. Whether the methods of measurement or presentation have been changed from those used in the prior period and the reasons for any such changes.	X	
h. Whether or not the reserve study preparer has the Reserve Specialist designation as a way of confirming that the study was completed in conformance with the National Reserve Study Standards.		X
i. When the study was performed (that is, what is the age of the study).		X

Description of Procedure	Required by AU-C 730.05	Additional Procedure in AICPA Guide
3. If the study was conducted by the board of directors, consider whether the sources of the information used to estimate useful lives (technical manuals) and current or future repair and replacement costs (bids from contractors) are reasonable.		X
4. Determine by physical inspection of the common property or review of legal documents whether the required information is disclosed for all major components.		X
5. Compare the information for consistency with the following:		
a. Management's responses to the preceding inquiries.	X	
b. Basic audited financial statements.	X	
c. Other knowledge obtained during the audit of the financial statements.	X	
6. Compare estimates of repair and replacement costs with current period expenditures and with the annual budget, if any.		X
7. Check the mathematical accuracy of amounts disclosed.		X
8. Obtain written representations from management that it acknowledges its responsibility for the required supplementary information and about (a) whether the required supplementary information is measured and presented in accordance with prescribed guidelines, (b) whether the methods of measurement or presentation have changed from those used in the prior period and, if so, the reasons for such changes, and (c) any significant assumptions or interpretations underlying the measurement or presentation of the required supplementary information.	X	
* * *		

In applying the limited procedures discussed above, auditors need to consider whether the procedures underlying the reserve study itself are sufficient to ensure accuracy and completeness. In making the required inquiries of management about the methods of preparing the required supplementary information, auditors generally question their CIRA clients as to whether *they* believe the CIRA has an adequate reserve study. Some CIRA clients may believe their reserve study is not adequate because, for example, the study lacks all required components, it has incorrect pricing or measurements, or the replacement dates used in the study do not match the CIRA's maintenance program. In other cases, CIRA management may not devote time to reviewing the CIRA's reserve study, only having one prepared because it is required by state law. CIRA management often know the physical complex better than anyone else and are a valuable source of information about the reliability of the reserve study.

Smaller CIRAs or those that do not employ a managing agent may request auditors to assist their board of directors in preparing the required supplementary information. If the auditors provide much more than assembly-type assistance with an audit client's reserve study, it is a best practice for them to consider whether they are providing a nonattest service that threatens independence (as defined by ET 1.295) by performing such work.

**Auditors' Reports.** In most cases, auditors will disclaim an opinion on the required supplementary information in accordance with AU-C 730, *Required Supplementary Information*. The AICPA guide at Paragraph 7.129 states that auditors may subject the supplementary information to certain auditing procedures in conjunction with the audit of the financial statements, and AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, notes that auditors may be engaged to report on whether required supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. However, it seems likely that the required supplementary information on future major repairs and replacements is not ordinarily susceptible to the auditing procedures applied in the audit of the basic financial statements, and the limited procedures required by AU-C 730.05 are not sufficient to enable the auditor to express an opinion on the required supplementary information in relation to the basic financial statements.

When some or all of the required supplementary information accompanies the CIRA's audited financial statements and the auditors apply the limited procedures listed above to the information, AU-C 730.07–.08 require auditors to add an other-matter paragraph following the opinion paragraph to their report on the financial statements that includes the following statements:

- That GAAP requires the information about future major repairs and replacements to be presented to supplement the financial statements.
- That such information, although not a part of the basic financial statements, is required by the FASB, which considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context.
- That the auditor has applied certain limited procedures to the required supplementary information in accordance with GAAS, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to the auditor's inquiries, the basic financial statements, and other knowledge the auditor obtained during the audit of the basic financial statements.
- That the auditor does not express an opinion or provide any assurance on the information because the limited procedures do not provide sufficient evidence to express an opinion or provide any assurance on the information.

The other-matter paragraph should be modified in the following circumstances:

- The supplementary information that the FASB requires to be presented is omitted. However, auditors need not present the required supplementary information if the CIRA omits it.
- The auditors have concluded that the required supplementary information departs materially from prescribed guidelines.
- The auditors are unable to complete the prescribed procedures. Although auditors are unable to complete the procedures, if they conclude that the information has not been measured or presented in conformity with the guidelines in the AICPA guide, the auditor could suggest appropriate revision; if the CIRA refuses to revise it, the auditors can describe the nature of any material departures in their report. (Auditors also need to consider whether the circumstances should be communicated to those charged with governance as required by AU-C 260, *The Auditor's Communication With Those Charged With Governance*. See the discussion later in this lesson.)
- The auditors are unable to remove substantial doubts about whether the required supplementary information conforms to prescribed guidelines.

Since required supplementary information is not part of the basic financial statements and is not necessary for the financial statements to be presented in conformity with generally accepted accounting principles, none of the preceding circumstances preclude auditors from expressing an unmodified opinion on the basic financial statements.

**Required Supplementary Information Presented in a Note to the Financial Statements.** CIRAs should disclose the required supplementary information about future major repairs and replacements outside of the basic financial statements. Nevertheless, some state statutes currently require some of that information to be presented in the notes to the financial statements. For example, certain state statutes require changes in replacement fund balances allocated to each common property component to be disclosed in the notes to the financial statements. Thus, some CIRAs may present the preceding information in the notes to the financial statements and the estimated remaining useful lives and estimated replacement cost of each common property component in a supplementary schedule outside of the basic financial statements. AU-C 730 does not address how to report when the required supplementary information is presented in the notes to the financial statements. This course suggests that the authoritative literature does not prohibit that practice. However, it is likely that reporting in accordance with AU-C 730 would be cumbersome in those cases, since the notes would include both unaudited required supplementary information and audited disclosures, and some required supplementary information would be in a schedule outside of the basic financial statements. Thus, it would be difficult for the auditors' disclaimer to clearly identify the required supplementary information by descriptive title or page number of the document. Accordingly, whenever possible, it may be preferable to present all of the required supplementary information either in a note to the financial statements or in a separate schedule outside of the basic financial statements.

### **CIRAs Involved with HUD Reporting**

If the CIRA is involved in a not-for-profit or a for-profit multifamily housing program and is receiving financial assistance from HUD, the HUD reporting and audit requirements for such programs mandate that a hardcopy of the financial data schedule (this is a template used to submit financial information electronically to HUD's financial assessment subsystem) be included with the basic financial statements and reported on by the auditor. Since the financial data schedule is outside the basic financial statements, auditors should report on this information in relation to the financial statements taken as a whole.

### **Other Information**

**Other Information in Documents Containing Audited Financial Statements.** AU-C 720, *Other Information in Documents Containing Audited Financial Statements*, applies to "other information" in "documents containing audited financial statements" and the auditors' report, when auditors are not engaged to report on whether the information is fairly stated, in all material respects, in relation to the financial statements as a whole as those terms are defined in AU-C 720. For purposes of AU-C 720:

- *Other information* is defined as "financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information" (AU-C 720.05). Examples of other information include (a) a report by management or those charged with governance, (b) financial summaries or highlights, (c) employment data, (d) planned capital expenditures, (e) financial ratios, (f) names of officers and directors, and (g) selected quarterly data.
- Documents containing audited financial statements refer to annual reports (or similar documents) that are issued to owners (or similar stakeholders) and annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the auditors' report thereon.

AU-C 720 does not apply when the auditor is engaged to report on whether the information accompanying the financial statements is fairly stated, in all material respects, in relation to the financial statements as a whole. (In that case, AU-C 725 applies. See the discussion earlier in this lesson.)

Because auditors are not engaged to report on the other information, they have no responsibility to determine whether the information is properly stated, but they should read the other information and consider the manner in which it is presented to identify material inconsistencies between the other information and the financial statements or material misstatements of fact, if any. Furthermore, the auditors are not required to report on the other information. (However, the auditors may add an other-matter paragraph to their report to disclaim an opinion on the other information.)

Some larger CIRAs may issue annual report documents that contain the audited financial statements and the auditor's report, and best practices indicate that AU-C 720 would apply in those cases. However, best practices indicate that AU-C 720 will not apply in most circumstances that auditors encounter with their CIRA clients because their clients do not issue *documents containing audited financial statements* as that term is defined in AU-C 720. *PPC's Guide to Auditor's Reports* discusses AU-C 720 in detail, including auditors' responsibilities to communicate to those charged with governance when the other information in documents containing audited financial statements is materially inconsistent with the audited financial statements or contains a material misstatement of fact and management refuses to revise the other information.

**Other Information in Electronic Sites Containing Audited Financial Statements.** When a CIRA makes its audited financial statements (including the auditors' report) available on its website, electronic bulletin boards, or similar venues, auditors may question their responsibility with respect to other information in those electronic sites. AU-C 720.A4 clarifies that, for purposes of GAAS, information contained on an entity's website is not considered to be "other information" and, accordingly, is not subject to the requirements of AU-C 720. Thus, auditors are not required to read information contained in the sites or consider the consistency of the other information in the sites with the original documents.

Auditors may be requested by their clients to provide other services with respect to information in electronic sites. Best practices indicate that, in that situation, the guidance for applying agreed-upon procedures would generally apply. *PPC's Guide to Nontraditional Engagements* discusses the requirements for performing agreed-upon procedures engagements.

## AUDITING GROUP FINANCIAL STATEMENTS

### Determining Whether AU-C 600 Applies

AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, addresses the auditing considerations that apply to audits of group financial statements, particularly those that involve component auditors. Auditors need to understand the following two terms when determining whether AU-C 600 applies to an audit:

- *Group Financial Statements*—financial statements that include the financial information of more than one component.
- *Component*—an entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements.

In many cases, determining whether financial statements include more than one component, and thus, whether AU-C 600 applies, is relatively straight-forward. For example, a subsidiary, branch, division, equity-method investee, special purpose entity, variable interest entity, or business activity that produces separate financial information that requires consolidation in the group financial statements often may be readily identified as a component. However, professional judgment is necessary when determining whether a business activity such as ancillary operations of a CIRA (as opposed to a separate legal entity) represents a component. In some circumstances, if the financial reporting system organizes financial information by function, product or service, or geographical location for external reporting, those activities may be identified as components. Furthermore, if the operations, management, and financial reporting of a business activity are separate from those of the group, it generally is more likely to be considered a component. On the other hand, Paragraph .93 of the AICPA Audit Risk Alert, *Understanding the Responsibilities of Auditors for Audits of Group Financial Statements*, notes that "when financial information about a function, product or service, or geographical location is first part of the group's financial reporting system and then disaggregated by group management for operating purposes, the group engagement team may consider such financial information in whole or part as a class of transactions rather than components." That is, the auditor may be able to perform procedures directly on the aggregated data.

This course suggests that CIRA ancillary operations generally are not components because information from ancillary operations is typically recorded in centrally maintained accounting records, either by CIRA management

or the managing agent. If the financial statements that the auditor has been engaged to audit do not include components (as defined in AU-C 600), the audit is not an audit of group financial statements and the requirements of AU-C 600 do not apply.

### Applying AU-C 600

If AU-C 600 applies in an audit, certain of its requirements apply anytime the auditor is auditing group financial statements, that is, when there is more than one component included in the financial statements. Other additional requirements apply when there are one or more component auditors. AU-C 600 defines a *component auditor* as “an auditor who performs work on the financial information of a component that will be used as audit evidence for the group audit.” A component auditor may be part of the group engagement partner’s own firm, a network firm of the group auditor, or another auditing firm. Auditors who are not members of the group engagement team are considered to be component auditors. Even auditors from the same firm who perform audit work on a component are considered component auditors and subject to the relevant requirements of AU-C 600, such as obtaining an understanding of the component auditor and determining the type of work to be performed on the financial information of the component. As a practical matter, those requirements would not normally be difficult to meet, but may require additional documentation.

AU-C 600 applies to all audits of group financial statements, whether or not there are auditors involved who are not members of the group engagement team. AICPA Technical Question and Answer at Q&A 8800.24, *Applicability of AU-C Section 600 When Only One Engagement Team Is Involved*, explains that while certain considerations related to component auditors are not relevant, other considerations, such as understanding components, identifying significant components, and identifying component materiality, are relevant to all group audits.

AU-C 600 establishes comprehensive requirements for the conduct of a group audit, including developing an overall audit strategy and audit plan, as well as reporting responsibilities, including the decision of whether to make reference to a component auditor in the auditor’s report on the group financial statements. *PPC’s Guide to Audits of Nonpublic Companies* provides extensive discussion of planning and performing a group audit and how to obtain sufficient appropriate evidence regarding the financial information of components. *PPC’s Guide to Auditor’s Reports* provides extensive discussion and examples of auditor’s reports, including reports in which reference is made to component auditors.

## COMMUNICATIONS WITH THE CLIENT

### Communicating Internal Control Related Matters

AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, as amended by AU-C 940, establishes requirements for auditors to communicate certain control deficiencies, including control deficiencies, in a management agent’s internal control, that they have identified during the audit. Control deficiencies that, in the auditor’s judgment, are *significant deficiencies* or *material weaknesses* should be communicated in writing to management and those charged with governance. According to AU-C 265—

- The auditor should evaluate identified control deficiencies and determine whether, individually or in combination, they are significant deficiencies or material weaknesses.
- The auditor should communicate, in writing, to management and those charged with governance all significant deficiencies or material weaknesses identified during the audit, including those that were remediated during the audit and those communicated in prior audits if they have not been corrected.
- The auditor should communicate, in writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor’s professional judgment, are of sufficient importance to merit management’s attention.

To determine which control deficiencies to report, the auditor first *identifies* control deficiencies, and then *evaluates* them to determine whether the deficiencies, individually or in combination, are significant deficiencies, material weaknesses, or other deficiencies.



**Identifying Control Deficiencies.** AU-C 265 indicates “a deficiency in internal control over financial reporting 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, misstatements on a timely basis.” A control deficiency may be either a deficiency in design or a deficiency in operation. Deficiency in design and deficiency in operation are discussed further later in this lesson.

In a GAAS audit, an auditor is not required to perform procedures to identify deficiencies in internal control. However, an auditor may become aware of control deficiencies while performing audit procedures such as obtaining an understanding of internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing further audit procedures to respond to assessed risks, and communicating with management or others. Accordingly, an auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed.

**Evaluating Control Deficiencies.** Although there is no requirement to search for control deficiencies to communicate, the auditor should evaluate identified control deficiencies to determine, on the basis of the audit work performed, whether they constitute significant deficiencies or material weaknesses. Auditors should evaluate control deficiencies individually and in combination with other deficiencies affecting the same significant class(es) of transactions, significant account balance(s) or disclosure(s), relevant assertion, or component of internal control. This is because multiple control deficiencies that affect the same financial statement class(es) of transactions, account balance(s) or disclosure(s), relevant assertion, or component of internal control increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness even though they are individually insignificant.

**Significant Deficiency.** According to AU-C 265.07, a *significant deficiency* is “a deficiency, or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance.”

**Material Weakness.** A *material weakness* is defined by AU-C 265.07 as a “deficiency, or combination of deficiencies, in internal control over financial reporting, 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. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable as defined as follows:

- *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
- *Probable.* The future event or events are likely to occur.”

AU-C 265 requires auditors to separately identify significant deficiencies and material weaknesses. The difference between a significant deficiency and a material weakness is the severity of the control deficiency when evaluated individually or in combination with other deficiencies. The severity of an identified control deficiency depends on (a) the magnitude of the potential misstatement resulting from the deficiency or deficiencies and (b) whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, a misstatement of an account balance or disclosure.

When evaluating the severity of an identified control deficiency under AU-C 265, it seems logical that most auditors will begin by considering whether an identified control deficiency should be considered a material weakness. If not, they will consider its severity to determine whether it should be communicated to management as a significant deficiency. Unlike judgments about materiality, which can affect whether a client's financial statements are fairly presented (and, thus, the auditor's report), the auditor's judgment about the severity of an identified control deficiency affects only whether the auditor communicates the significant deficiency or material weakness to the client. Therefore, when in doubt, best practices suggest communicating it to the client.

**Examples of Deficiencies.** As discussed above, a control deficiency may be either a deficiency in design or a deficiency in operation. A *deficiency in design* exists when a control necessary to meet the control objectives is missing or an existing control is not properly designed so that, even if it operates as designed, the control objective would not be met. A *deficiency in operation* exists when a properly designed control does not operate as designed

or when the person performing the control lacks the necessary authority or qualifications to perform the control effectively. Exhibit 2-5 lists examples from AU-C 265 for both deficiencies in design and deficiencies in operation. While AU-C 265 distinguishes between the two types of control deficiencies, there is no requirement to indicate in the communication to management and those charged with governance which are deficiencies in design and which are deficiencies in operation. The examples in the exhibit may be control deficiencies, significant deficiencies, or material weaknesses.

### **Exhibit 2-5**

#### **Examples of Circumstances That May Be Control Deficiencies, Significant Deficiencies, or Material Weaknesses**

##### ***Deficiencies in the Design of Controls***

- Inadequate design of internal controls over the preparation of financial statements.
- Inadequate design of internal control over a significant account or process.
- Inadequate documentation of the internal control components.
- Insufficient control consciousness within the association, e.g., the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (if those controls would be necessary for effective internal control over financial reporting).
- Inadequate design of information technology (IT) general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management lack the qualifications and training to fulfill their assigned functions. For example, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording transactions or preparing the financial statements.
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of internal control over time.
- The absence of an internal process to report deficiencies in internal control to management on a timely basis.
- An indication that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance or other evidence that certain aspects of the control environment are ineffective.
- Failure of management to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified or other evidence that the entity's risk assessment process is ineffective.
- Absence of controls over a significant identified risk or other evidence of an ineffective response to significant risks that have been identified.
- Absence of a risk assessment process when such a process would ordinarily be expected to have been established.

##### ***Failures in the Operation of Internal Control***

- Failure in the operation of effectively designed controls over a significant account or process, for example, the failure of a control requiring dual authorization for significant disbursements.

- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy.
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. [This circumstance may need careful consideration when it is evaluated as a significant deficiency or material weakness. Material weaknesses relating to controls over the safeguarding of assets only exist if controls to prevent, or detect and correct, a material misstatement of the financial statements are ineffective.]
- Failure to reconcile significant accounts.
- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, expenses are consistently understated at the direction of management.
- Misrepresentation by client personnel to the auditor.
- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.
- An observed deviation rate that exceeds the number of deviations expected by the auditor in the test of the operating effectiveness of a control.

\* \* \*

**Factors to Consider When Evaluating Control Deficiencies.** The auditor considers not only whether a misstatement has actually occurred but also (a) whether there is a reasonable possibility of misstatement and (b) the magnitude of a potential misstatement. A reasonable possibility of misstatement exists when the likelihood of an event occurring is either reasonably possible or probable. AU-C 265.A8 lists a number of risk factors that may affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, in internal control will result in a misstatement of an account balance or disclosure. Those factors include, but are not limited to, the following:

- The nature of the classes of transactions, account balances, disclosures, and assertions involved; e.g., suspense accounts or transactions with related parties may present more risk.
- The cause and frequency of the exceptions detected as a result of the deficiency or deficiencies in internal control.
- Susceptibility of the related assets or liabilities to loss or fraud.
- The complexity, subjectivity, or extent of judgment needed to determine the amount involved.
- The relationship or interaction of the control with other controls.
- Interaction of the control deficiency with other control deficiencies.
- Possible future consequences of the deficiency.
- The importance of controls to the financial reporting process.

When AU-C 265 discusses evaluating the magnitude of a potential misstatement, it is really dealing with whether an identified deficiency could result in a misstatement that is material to the financial statements. According to AU-C 265.A6, factors that affect the magnitude of a misstatement that might result from a deficiency, or deficiencies, in internal control, include, but are not limited to, the following:

- The financial statement amounts or transaction totals exposed to the deficiency. Generally, the most an account balance or transaction total could be overstated is the recorded amount. Potential understatement, however, is not limited to the recorded amount.

- The volume of activity (in the current period or expected in future periods) in the account or class of transactions exposed to the deficiency.

AU-C 320, *Materiality in Planning and Performing an Audit*, elaborates on that guidance in AU-C 320.A12, which provides the following examples of circumstances that might cause a misstatement to be material, even when the amount falls below the materiality threshold:

- Whether laws or regulations affect users' expectations about how certain information should be measured or disclosed (for example, related-party transactions and the remuneration of management and those charged with governance).
- The key disclosures with regard to the industry in which the entity operates (for example, funding for future major repairs and replacements of common property for a CIRA).
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, turnover of control from a developer or sponsor to the CIRA).

In addition to those circumstances, best practices indicate that auditors also could consider circumstances such as the following when evaluating the magnitude of a potential misstatement caused by an identified control deficiency, including whether the deficiency:

- Is immaterial to the entity's excess of revenues over expenses for the current period, but material to the overall trend of excess of revenues over expenses (for example, a misstatement that changes a deficiency of revenues over expenses to an excess of revenues over expenses).
- Results in events or circumstances that could materially affect the financial statements. For example, an illegal payment of an otherwise immaterial amount might be material if it could lead to a material contingent liability or a material loss of revenue. In addition, some misstatements, although not individually significant, may be pervasive to the financial statements (that is, misstatements that affect numerous financial statement amounts, subtotals, or totals).
- Masks a change in excess of revenues over expenses or other trends, especially in the context of general economic conditions.
- Has an affect on the entity's compliance with loan covenants, other contractual agreements, or regulatory provisions (for example, a misstatement that would reveal a default under a debt covenant).
- Is the result of fraud or suspected fraud. (In this case, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, as described in AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, even if the effect of the misstatement is not material to the financial statements.)
- Affects professional fees, if the auditor is concerned that there is an inadequate understanding of the client's litigation exposure and the identity of all attorneys engaged during the period.
- Affects material disclosures related to a small account balance (for example, impairment of common property assets that are not capitalized on the financial statements),

Indicators of Material Weaknesses. According to AU-C 265.A11, the following conditions are indicators of material weaknesses:

- Identification of fraud, whether or not material, on the part of senior management.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.
- Identification by the auditor of a material misstatement of the financial statements in circumstances indicating that the misstatement would not have been detected by the entity's internal control.

- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

While AU-C 265 identifies the factors described in the preceding paragraph only as indicators of material weaknesses, best practices indicate that auditors generally would consider such deficiencies material weaknesses. For that reason, many auditors begin the evaluation process by determining whether any of the deficiencies identified during the audit are indicators of a material weakness.

**PPC's Process for Evaluating the Severity of Deficiencies.** In summary, when evaluating the severity of an identified control deficiency under AU-C 265, best practices indicate that most auditors will begin by considering whether an identified deficiency is considered a material weakness. If not, they will consider its severity to determine whether to communicate it to management and others as a significant deficiency. Specifically, best practices indicate that the process will be as follows:

- For an identified deficiency, determine whether it is a material weakness by considering whether (a) the magnitude of the potential misstatement could result in a material misstatement to the financial statements and (b) there is a reasonable possibility that the misstatement would not be prevented, or detected and corrected, on a timely basis by the entity's internal controls.
- For an identified deficiency not considered a material weakness, consider whether the deficiency is important enough to merit attention by management and those charged with governance as a significant deficiency. When making this evaluation, consider whether a prudent official with knowledge of the same facts and circumstances would likely reach the same conclusion.
- Combine individual deficiencies affecting the same account balance or disclosure, relevant assertion, or component of internal control and evaluate whether they are considered either a significant deficiency or a material weakness.

Finally, for other deficiencies in internal control not communicated as either material weaknesses or significant deficiencies, the auditor should consider whether to communicate them to management in accordance with the requirement in AU-C 265.12(b).

**Auditor Identifies Misstatements in the Financial Statements.** During the course of an audit, an auditor might identify (and propose adjustments to correct) any number of errors, some of which may be material to the CIRA's financial statements. As noted above, AU-C 265 indicates that the auditor's identification of a material misstatement of the financial statements in circumstances that indicate that it would not have been identified by the entity's internal control is an indicator of a material weakness. Therefore, whenever the auditor identifies a material misstatement in the financial statements, the auditor should evaluate whether the control deficiency that allowed the misstatement to occur represents a material weakness or a significant deficiency.

If an auditor identifies a misstatement that is less than material, the auditor can also evaluate whether the control deficiency that allowed the misstatement to occur represents a control deficiency, a significant deficiency, or a material weakness. If the auditor determines the control deficiency is, individually or when aggregated with other deficiencies, a significant deficiency or a material weakness, AU-C 265 requires the auditor to communicate the deficiencies to the appropriate parties.

**Combining Deficiencies.** AU-C 265 requires auditors to evaluate control deficiencies both individually and when combined with other deficiencies affecting the same class of transactions, account balance or disclosure, relevant assertion, or component of internal control to determine whether they represent a significant deficiency or material weakness on a combined basis. An auditor may consider several control deficiencies in and of themselves insignificant and, thus, only a control deficiency. However, if those control deficiencies are all related (for example, they all relate to the same account balance or same component), the requirement in AU-C 265 to combine control deficiencies might cause the auditor to consider them a significant deficiency or a material weakness when aggregated.

**Prudent Official Test.** AU-C 265 requires auditors to consider whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's conclusion. In other words, would a prudent official,

knowing what the auditor knows about the facts and circumstances, other controls tested, and the likelihood and magnitude of potential misstatement, agree with the auditor's conclusion that a deficiency is not a material weakness? AU-C 265 does not define the term *prudent official*. Instead, the intent is for the auditor to take a final, objective look at the severity of the deficiency similar to what a regulator or someone in an agency oversight role would do. This objective consideration is used only to gauge whether the auditor's final judgment about the severity of a control deficiency is greater than, but never lower than, the auditor's preliminary judgment.

**Do CIRAs Automatically Have a Control Deficiency If the Auditor Prepares the Financial Statements?** The auditor's preparation of the financial statements does not automatically indicate that there is a material weakness, significant deficiency, or other control deficiency. Many smaller CIRAs request auditors to prepare, or assist with preparing, the financial statements and related disclosures. Those services can range from preparing the complete set of financial statements (including the notes) to preparing only one statement (such as the statement of cash flows), to preparing only the notes to the financial statements. The auditor's preparation of the financial statements does not cause a control deficiency. However, it may be the result of a control deficiency. A system of internal control over financial reporting includes controls over financial statement preparation, including note disclosures. A control deficiency exists when the client does not have controls over preparation of the financial statements that would prevent, or detect and correct, misstatements in the financial statements.

In addition to auditors' responsibilities under AU-C 265 to determine whether material weaknesses or significant deficiencies exist that should be communicated to the client, auditors also need to consider whether they are independent under the AICPA's *Code of Professional Conduct*. The determination of auditor independence is a separate evaluation from determining whether control deficiencies exist. The preparation of financial statements is a nonattest service. That means that, before auditors prepare financial statements for their clients, they should determine whether the requirements of ET 1.295 have been met. In addition, the auditor also needs to consider the cumulative effect of performing multiple nonattest services on the threats to independence.

The requirements of ET 1.295 for nonattest services include obtaining management's agreement to oversee the financial statement preparation service by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, or experience. Under ET 1.295, the individual designated by management should possess the technical skills, knowledge, and experience sufficient to (a) understand the financial statement preparation service enough to be able to provide general direction for the service; (b) understand the key issues the auditor identifies; (c) make any required management decisions; and (d) evaluate the adequacy of, and accept responsibility for, the results of the auditor's work. The auditor considers whether the designated individual fulfills this competency requirement based on factors such as the individual's understanding of the service, knowledge of the client's business and industry, general business knowledge and education, and position within the client. When assessing competency, the relative importance of those factors is considered in relation to the financial statement preparation service being performed.

Furthermore, the auditor's preparation of the financial statements and the related notes does not relieve the client of the responsibility for the financial statements and for the establishment of controls over the financial reporting process.

Determining whether a control deficiency exists and whether it is a significant deficiency or a material weakness is subjective and often may be a difficult judgment call. There are many gray areas requiring professional judgment. Best practices indicate that auditors cannot draw a hard line on what constitutes a significant deficiency or a material weakness. Instead, auditors need to evaluate the facts and circumstances specific to each situation.

**Communication Requirements.** The auditor should communicate significant deficiencies and material weaknesses identified during the audit, including significant deficiencies and material weaknesses in a managing agent's internal control, in writing to those charged with governance. AU-C 260, *The Auditor's Communication With Those Charged With Governance*, defines *those charged with governance* as the persons responsible for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting process. In a CIRA, those charged with governance may include the CIRA's board of directors, audit committee (if any), and the management company.

In addition, AU-C 265.12 states that the auditor also should communicate the following to management:

- In writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.
- In writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

The communication is best made by the report release date but, in any case, should be made within 60 days of that date. The report release date is defined in AU-C 230, *Audit Documentation*, as the date that the auditor grants the entity permission to use the auditor's report in connection with the financial statements. The communication of significant deficiencies should include the following elements:

- a. The definition of a material weakness and, when relevant, of a significant deficiency.
- b. A description of each significant deficiency and material weakness identified along with an explanation of their potential effects.
- c. Sufficient information to allow those charged with governance and management to understand the context of the communication. In particular, the auditor's communication should include elements to explain that:
  - (1) The purpose of the audit was for the auditor to express an opinion on the financial statements.
  - (2) The audit included consideration of internal control over financial reporting in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of internal control.
  - (3) The auditor is not expressing an opinion on the effectiveness of internal control.
  - (4) The auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.
- d. A paragraph restricting the use of the communication to management, those charged with governance, others within the organization, and any governmental authority to which the auditor is required to report, in accordance with AU-C 905, *Restricting the Use of an Auditor's Report*.

When explaining the potential effects of the significant deficiencies and material weaknesses, it is not necessary for the auditor to quantify those effects. In fact, the potential effects may be described in terms of (a) the control objectives that might not be achieved; (b) the types of errors the control was designed to prevent, or detect and correct; or (c) the risk(s) of misstatement that the control was designed to address. In some cases, the potential effects may be evident from the description of the significant deficiencies or material weaknesses, and therefore no further explanation would be necessary.

When preparing the written communication, the auditor may decide to group significant deficiencies or material weaknesses together. The auditor also may include in the written communication suggestions for remedial action on the deficiencies, management's actual or proposed responses, and a statement about whether the auditor has undertaken any steps to verify whether management's responses have been implemented. The auditor also may decide to include in the communication the following information as additional context:

- The general inherent limitations of internal control, including the possibility of management override of controls.
- The specific nature and extent of the auditor's consideration of internal control during the audit.

AU-C 265.11 notes that the auditor should communicate in writing significant deficiencies and material weaknesses identified and remediated during the audit. Furthermore, AU-C 265.A20 indicates that significant deficiencies and material weaknesses reported in prior years that still exist need to be reported again. In those circumstances, it is also a good idea to include an indication that the same comments were made in prior communications. For convenience, such comments may be presented separately from new comments under a heading such as "Significant Deficiencies Communicated in Prior Years." Prior-year comments typically are presented after new comments. The communication may merely refer to the previously-issued communication and its date.

The auditor may orally communicate significant deficiencies and material weaknesses during the audit. These communications need not be in writing at the interim date. However, communications of significant deficiencies or material weaknesses ultimately should be communicated in writing to management and those charged with governance.

**Reporting When There Are No Significant Deficiencies.** To prevent potential misunderstandings, AU-C 265.16 prohibits the auditor from issuing a written communication stating that no significant deficiencies were noted during the audit. Even though there may be no significant deficiencies, less serious control deficiencies may still exist. AU-C 265.12 requires auditors to communicate to management, in writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's judgment, are of sufficient importance to merit management's attention. If the communication is in writing, the form of communication is not subject to the requirements of AU-C 265. Accordingly, auditors may want to include the deficiencies in a separate communication such as a management letter. If other deficiencies in internal control are communicated to management orally, the auditor should document the communication.

**Reporting When There Are No Material Weaknesses.** The auditors' communication of significant deficiencies may indicate that no material weaknesses were noted. Thus, auditors may discuss the absence of *material weaknesses* but not the absence of *significant deficiencies*. If the auditor agrees to issue a written communication indicating no material weaknesses were identified during the audit, AU-C 265.15 states that the written communication should include the matters required by AU-C 265.14(a), (c) and (d).

**Other Internal Control Deficiencies and Management Letter Comments.** As discussed above, AU-C 265.12 requires auditors to communicate to management, in writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management and that, in the auditor's judgment, are of sufficient importance to merit management's attention. (If the auditor decides to communicate such matters orally, AU-C 265 requires the communication to be documented.) From a practical standpoint, many auditors already communicate such other deficiencies in a separate section of their significant deficiency and material weakness letters. In addition, auditors also often include in a management letter matters such as other suggestions on how to improve administrative or other functions (for example, legal requirements, operational efficiencies, and tax strategies) may be identified, and as a matter of client service, most auditors take time to educate and inform the client by communicating them in a formal "management letter."

## Communication with Those Charged with Governance

AU-C 260, *The Auditor's Communication With Those Charged With Governance*, requires auditors to communicate with those charged with governance certain matters related to the financial statement audit that are relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. The communication requirements of AU-C 260 apply to all entities, regardless of their governance structure or size. However, the standard does provide specific considerations for situations in which all of those charged with governance are also involved in managing the entity. AU-C 260 does not establish requirements for communication with management or owners unless they are also charged with a governance role.

The term *those charged with governance* includes all "person(s) . . . with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process" (AU-C 260.06). In most CIRAs, governance is the collective responsibility of a board of directors, the audit committee (if any), the management company, or others. In some smaller CIRAs, however, one person may be charged with governance, such as the president or chairman of the board. In a small CIRA, management and those charged with governance may be the same people.



In some small CIRAs, the appropriate person(s) with whom to communicate may not be clearly identifiable. In this situation, the auditor and the engaging party need to discuss and agree on who are the appropriate person(s) within the governance structure. Also, if all those charged with governance are involved in managing the CIRA, the auditor should consider whether communication with the person(s) with financial reporting responsibilities adequately informs all of those with whom the auditor would otherwise have to communicate because of their governance role. Many governing bodies have subgroups, such as audit committees or similar groups. The auditor should evaluate whether communication with a subgroup of those charged with governance (or with an individual) adequately meets the auditor's responsibility to communicate with those charged with governance.

The auditor should communicate the following broad categories or matters to those charged with governance:

- a. The auditor's responsibilities under generally accepted auditing standards regarding the financial statement audit.
- b. An overview of the planned scope and timing of the audit.
- c. Significant findings or issues from the audit.
- d. Information regarding uncorrected misstatements.

**Auditor's Responsibilities under GAAS.** The auditor should communicate the following matters:

- a. The auditor is responsible for forming and expressing an opinion about whether the financial statements are presented fairly, in all material respects, in conformity with GAAP.
- b. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

The auditor may communicate these matters through the engagement letter or similar means as long as that communication is provided to those charged with governance. The auditor may simultaneously communicate other matters, such as the degree of responsibility assumed for errors or fraud, internal control, independence, and similar matters.

**Planned Scope and Timing of Audit.** The objective of this aspect of the communication is to provide an overview of key aspects of scope and timing without compromising audit effectiveness. For example, the auditor might describe the use of the concept of materiality in planning and performing the audit, but not specific testing thresholds or amounts.

**Significant Audit Findings.** The auditor should communicate the following matters:

- a. *Qualitative Aspects of the Entity's Significant Accounting Practices.* The appropriateness of the accounting policies to the particular circumstances of the CIRA, management's process for identifying and making significant estimates, and the neutrality, consistency, and clarity of disclosures. If the auditor considers a significant accounting practice to be inappropriate, the auditor should explain why and request changes.
- b. *Significant Difficulties Encountered During the Audit.* Explicit and implicit restrictions imposed by management, including significant delays in providing required information, unavailability of evidence, an unnecessarily brief time to complete the audit, or unexpected effort to obtain audit evidence.
- c. *Uncorrected Misstatements.* The effect that uncorrected misstatements (other than those considered to be trivial), individually or in the aggregate, from the current and prior period may have on the opinion. The auditor should request that the misstatements be corrected and discuss the implications of failing to correct known and likely misstatements, considering qualitative as well as quantitative factors.
- d. *Disagreements with Management.* Whether or not satisfactorily resolved, differences with management about application of accounting principles, audit scope, or reporting disclosures, and similar matters that individually or in the aggregate could be significant to the CIRA's financial statements or the auditor's report.

- e. *Independence.* Circumstances or relationships that in the auditor's professional judgment may reasonably be thought to bear on independence, and to which the auditor gave significant consideration in reaching the conclusion that independence has not been impaired. (AU-C 260 does not mandate this communication, but AU-C 260.A15 states the auditor "may determine" it is appropriate.)

The auditor should also communicate any other audit findings that, in the auditor's judgment, would be significant and relevant to oversight of financial reporting.

In addition to the matters listed above, unless all those charged with governance are involved in managing the entity, the auditor also should communicate the following:

- a. *Material Corrected Misstatements.* Misstatements brought to the attention of management as a result of auditing procedures.
- b. *Representations Requested from Management.* This may be done by providing a copy of the written representations obtained from management.
- c. *Management's Consultations with Other Accountants.* The auditor's views about significant accounting or auditing matters that were the subject of consultation.
- d. *Significant Issues Discussed or Subject to Correspondence with Management.* Issues such as application of accounting principles and auditing standards; and business conditions, plans or strategies that may affect the risks of material misstatement.

The significant audit findings should be communicated in writing when the auditor believes that oral communication would not be adequate. When the communication is in writing, the auditor should indicate that it is intended solely for the information and use of those charged with governance and, if appropriate, management, and is not intended to be and should not be used by anyone other than these specified parties. The communication should be on a sufficiently timely basis to permit appropriate action. The auditor should evaluate whether the two-way communication process with those charged with governance is adequate for purposes of the audit and, if it is not, consider the effects on the auditor's risk assessment process and the ability to obtain sufficient and appropriate audit evidence supporting the auditor's opinion.

AU-C 260 does not change the additional communication requirements of other auditing standards. These additional communications are generally required only under the specific circumstance, and thus, are not included in every communication. These other possible required communications with those charged with governance are found in the following AU-C sections—

- AU-C 210, *Terms of Engagement.*
- AU-C 240, *Consideration of Fraud in a Financial Statement Audit.*
- AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements.*
- AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit.*
- AU-C 550, *Related Parties.*
- AU-C 560, *Subsequent Events and Subsequently Discovered Facts.*
- AU-C 570 and AU-C 570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.*
- AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors).*
- AU-C 610, *Using the Work of Internal Auditors.*

- AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*.
- AU-C 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*.
- AU-C 720, *Other Information in Documents Containing Audited Financial Statements*.
- AU-C 730, *Required Supplementary Information*.
- AU-C 930, *Interim Financial Information*.
- AU-C 935, *Compliance Audits*.

**Documentation of Communications.** AU-C 260.20 requires the auditor to document matters that have been communicated orally (including when and with whom they were communicated). This documentation may include a copy of minutes prepared by the entity. When matters have been communicated in writing, the auditor should retain a copy of the communication. The engagement letter may be used to communicate planning matters, including the auditor's responsibilities under GAAS and the planned scope and timing of the audit, as long as the letter is provided to those charged with governance. Alternatively, a letter can be used to communicate those matters with those charged with governance during the planning phase of the audit.

### **Fraud and Noncompliance with Laws and Regulations**

AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, imposes detection and communication responsibilities for violations of laws and regulations (previously referred to as *illegal acts*) that have a direct and material effect on the determination of financial statement amounts. (Federal income tax status governing CIRAs, for example, include laws and regulations that have a direct effect on the determination of material amounts and disclosures in the financial statements.) AU-C 250 imposes lesser responsibilities for *detection* of violations of laws or regulations having *material but indirect* effects on the determination of financial statement amounts (primarily inquiry and inspection of any relevant correspondence) and establishes communication responsibilities for those violations. The auditor's responsibility to evaluate the results of audit procedures and consider whether they lead the auditor to believe that an error or fraud may have occurred was discussed earlier in this lesson. More information about the auditor's detection and communication responsibilities under AU-C 240 related to misstatements caused by fraud is provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*. This discussion addresses auditors' responsibilities when evidence indicates that noncompliance with laws and regulations or fraud may have occurred.

When the auditor is confronted with information indicating potential noncompliance with laws and regulations (such as noncompliance cited in regulatory examination reports or the payment of fines and penalties) or a circumstance that indicates the possibility of fraud (such as a discrepancy between the accounting records and other audit evidence, including transactions with no supporting documentation, no apparent authorization or that have not been recorded), the auditor should consider how and why they might have occurred and investigate further. If the investigation indicates there may have been a violation of laws and regulations or fraud, the auditor should:

- a. Obtain an understanding of the matter and sufficient other information to evaluate the possible effects on the financial statements and the auditor's report, including the need for adjustments and for disclosure of a violation of laws or regulations and any related contingencies, or the need for a report modification if necessary financial statement adjustments or disclosures are not made or because of a scope limitation.
- b. Consider the implications for other aspects of the audit, for example, risk assessment and reliance on management's representations.
- c. Discuss the matter and the need for any further investigation with an appropriate level of management at least one level above those involved.
- d. If appropriate, consult with the CIRA's legal counsel (or suggest that the CIRA consult with legal counsel) on any questions of law and on the course of action the client should take.

- e. Document a description of the identified or suspected violation of laws and regulations or fraud and the results of any conversations with management, those charged with governance, and others, if applicable.

In the rare event that management is not willing to follow sound legal advice about fraud or violations of laws or regulations, the auditor should consider seeking the recommendation of legal counsel about possible courses of action, including possible withdrawal from the engagement. The auditor would, of course, carefully document all communications related to the matter and its disposition.

**Fair Housing Amendments Act of 1988 (Public Law 100-430).** The Act prohibits discrimination in housing on the basis of handicap or familial status. [There are certain exemptions for housing of older persons, which were amended by the Housing for Older Persons Act of 1995 (Public Law 104-76).] Under the law, unlawful discrimination is subject to fines. Because the Fair Housing Act does not directly affect the determination of financial statement amounts, however, a CIRA's noncompliance with the Act usually is regarded as having a material but indirect effect on the determination of the amounts and disclosures in its financial statements. However, AU-C 250 requires auditors to (a) inquire of management and, when appropriate, those charged with governance, about whether the CIRA is in compliance with the Act and (b) inspect correspondence, if any, with relevant regulatory authorities. Auditors also may become aware of noncompliance by performing other audit procedures, such as reading minutes of board of directors' meetings. If the auditors identify or suspect noncompliance, they should obtain an understanding of the nature of the noncompliance and the circumstances in which it has occurred and further information to evaluate the possible effects on the financial statements. Nonetheless, because of the inherent limitations of an audit, auditors may not detect material misstatements of the financial statements, including disclosures, resulting from noncompliance with laws and regulations.

Notwithstanding auditors' lesser responsibility for detection of noncompliance with laws and regulations that have an indirect effect on the determination of the amounts and disclosures in the financial statements, some accountants choose to determine (through inquiry or inspection of the governing documents) whether the CIRA qualifies for exemption from the Act.

**Communication about Possible Violations of Laws and Regulations or Possible Fraud.** AU-C 250.21 requires the auditor to ensure that the audit committee or others charged with governance are adequately informed about violations of laws or regulations, unless clearly inconsequential, that come to the auditor's attention. If the auditor determines there is evidence that fraud may exist (even if the matter is inconsequential), AU-C 240.39 requires the auditor to report it to the appropriate level of management. If the fraud or potential fraud involves senior management or causes the financial statements to be materially misstated, it should be reported directly to those charged with governance. AU-C 240.A69 indicates that auditors *may consider it appropriate* to communicate with those charged with governance about misappropriations committed by lower-level employees that do not result in a material misstatement. Auditors also normally reach an understanding with those charged with governance regarding communication about those misappropriations committed by lower-level employees. In the absence of such an agreement, it is a good idea for the auditor to report all instances of fraud to both the appropriate level of management and to those charged with governance. It is a best practice for communications about possible fraud to be made in writing; if made orally, the nature of the communication should be documented in the workpapers.

Both AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, and AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, state that the auditors should determine whether they have a responsibility to report noncompliance with laws and regulations or fraud to a party outside the entity. For example, state laws may require communication of noncompliance with certain laws and regulations. Best practices suggest that auditors seek legal advice in those situations.

## THE ENGAGEMENT SUMMARY MEMORANDUM

AU-C 230.08 requires the auditor to document the significant findings or issues that arose during the audit, including related conclusions and significant professional judgments. AU-C 230.A13 suggests that the preparation of a summary or completion memorandum that includes a description of significant findings or issues and how the audit addressed them can be helpful in meeting that documentations requirement. Thus, although not required, some CPA firms, especially those that are larger, have found it helpful to prepare a memorandum summarizing the significant accounting and auditing issues that arose and how they were resolved. Those who

favor the memorandum believe it forces auditors to reconsider whether they performed enough procedures and it facilitates the internal review of the working papers. However, for smaller audits, the time required to prepare the memorandum often is not justified, especially since the information included in an engagement summary memorandum can be found elsewhere in the workpapers.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. The Clearwater Association asks Sam to draft its financial statements. Sam is also scheduled to perform the CIRA's annual audit. How will this affect the audit engagement?
  - a. Drafting the financial statements will cost Sam his independence, so he then cannot perform the CIRA's annual audit.
  - b. Clearwater will need to indicate that Sam is now fully responsible for the association's financial statements.
  - c. Clearwater will need to provide a management representation letter, and Sam should discuss it with management personnel.
20. Xavier is engaged to audit a CIRA. The CIRA includes supplementary information with its financial statements, which the CIRA engages Xavier to report on. Xavier addresses the supplementary information in an other-matter paragraph in his auditor's report. Which of the following should that paragraph include?
  - a. A reference to the date of the auditor's report.
  - b. A statement that the supplementary information was required.
  - c. A statement that he will not express an opinion on the supplementary information.
  - d. A statement that the supplementary information was subject to audit procedures.
21. Financial summaries and employment data are examples of which of the following?
  - a. Required supplementary information.
  - b. Other information.
  - c. A HUD requirement.
  - d. Comparative financial statements.
22. Which of the following terms is used for a situation in which an auditor finds one or more deficiencies in an entity's internal control over financial reporting that give rise to the reasonable possibility that a material misstatement of the financial statements will not be either prevented or detected and corrected on a timely basis?
  - a. Material weakness.
  - b. Significant deficiency.
  - c. A deficiency in operation.
  - d. A deficiency in design.

23. Which of the following should an auditor communicate in writing to those charged with governance?
- a. Identified significant deficiencies and material weaknesses.
  - b. Deficiencies in internal control not deemed significant.
  - c. A list of what the auditor intends to communicate to those charged with governance.
  - d. A statement that no significant deficiencies were found.
24. While performing a CIRA audit, Jeffery uncovers information that leads him to believe the CIRA has violated an applicable law. Which of the following should Jeffery do?
- a. Discuss the violation and need for more investigation with the CIRA employees who were involved.
  - b. Withdraw from the engagement immediately.
  - c. Consult with the CPA firm's legal counsel about actions that the CIRA can take.
  - d. Obtain an understanding of the violation and related information.



## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. The Clearwater Association asks Sam to draft its financial statements. Sam is also scheduled to perform the CIRA's annual audit. How will this affect the audit engagement? **(Page 94)**
  - a. Drafting the financial statements will cost Sam his independence, so he then cannot perform the CIRA's annual audit. [This answer is incorrect. If certain steps are taken, Sam can draft the CIRA's financial statements and retain his independence. Therefore, if he is still independent from Clearwater, Sam will be able to also perform the audit engagement.]
  - b. Clearwater will need to indicate that Sam is now fully responsible for the association's financial statements. [This answer is incorrect. If Sam is going to perform the audit engagement, management needs to understand that his involvement in drafting the financial statements does not change the fact that management is responsible for them. Therefore, if Clearwater wants Sam to perform its annual audit, its management must accept this responsibility.]
  - c. **Clearwater will need to provide a management representation letter, and Sam should discuss it with management personnel. [This answer is correct. Management is expected to acknowledge its responsibility for the financial statements in the management representation letter. Furthermore, for the auditor to remain independent, among other things, management should agree to accept that responsibility, and the auditor should be satisfied that management has the ability to do so. The auditor needs to discuss the representation letter with management personnel so they understand the meaning and significance of acknowledging responsibility for the financial statements. If all qualifications are met, including the management representation letter, Sam should be able to retain his independence and still perform the audit engagement.]**
20. Xavier is engaged to audit a CIRA. The CIRA includes supplementary information with its financial statements, which the CIRA engages Xavier to report on. Xavier addresses the supplementary information in an other-matter paragraph in his auditor's report. Which of the following should that paragraph include? **(Page 98)**
  - a. A reference to the date of the auditor's report. [This answer is incorrect. Xavier has a choice between reporting on supplementary information in an other-matter paragraph or in a separate report. When using a separate report, references to the report on the financial statements and the date of that report are necessary. Since Xavier is reporting on the supplementary information in a paragraph within the auditor's report on the financial statements, such references are unnecessary.]
  - b. A statement that the supplementary information was required. [This answer is incorrect. The other-matter paragraph should include a statement that the supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements.]
  - c. A statement that he will not express an opinion on the supplementary information. [This answer is incorrect. Because the CIRA engaged Xavier to report on the supplementary information, if the evidence warrants, the other-matter paragraph should include a statement that, in the auditor's opinion, the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.]
  - d. **A statement that the supplementary information was subject to audit procedures. [This answer is correct. One of the items that an other-matter paragraph on supplementary information should include is a statement that the supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures. This information will allow Xavier to present complete information in his other-matter paragraph.]**
21. Financial summaries and employment data are examples of which of the following? **(Page 104)**
  - a. Required supplementary information. [This answer is incorrect. Required supplementary information differs from voluntary presentations of information outside of the basic financial statements because a

designated accounting standard setter such as the FASB considers the information an essential part of the financial reporting of certain entities and because authoritative guidelines for presentation of the information have been established. That is not the case for the examples listed above. An example of required supplementary information for a CIRA might be information about future major repairs and replacements.]

- b. **Other information.** [This answer is correct. *Other information* is defined by AU-C 720.05 as “financial and nonfinancial information (other than the financial statements and the auditor’s report thereon) that is included in a document containing audited financial statements and the auditor’s report thereon, excluding required supplementary information.” Examples of other information include (1) a report by management or those charged with governance, (2) financial summaries or highlights, (3) employment data, (4) planned capital expenditures, (5) financial ratios, (6) names of officers or directors, and (7) selected quarterly data.]
  - c. A HUD requirement. [This answer is incorrect. If the CIRA is involved in a not-for-profit or a for-profit multifamily housing program and is receiving financial assistance from HUD, the HUD reporting and audit requirements for such programs mandate that a hardcopy of the financial data schedule be included with the basic financial statements and reported on by the auditor. The items listed above are not related to this hardcopy, nor are they required by HUD.]
  - d. Comparative financial statements. [This answer is incorrect. This is when the current-period and prior-period financial statements are presented together. This is a different type of information than the examples provided.]
22. Which of the following terms is used for a situation in which an auditor finds one or more deficiencies in an entity’s internal control over financial reporting that give rise to the reasonable possibility that a material misstatement of the financial statements will not be either prevented or detected and corrected on a timely basis? **(Page 107)**
- a. **Material weakness.** [This answer is correct. According to AU-C 265.07, this is the definition of a *material weakness*.]
  - b. Significant deficiency. [This answer is incorrect. According to AU-C 265-07, a *significant deficiency* is “a deficiency, or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance. Therefore, though a significant deficiency can be part of the deficiencies described above, this is not the term for that specific situation.]
  - c. A deficiency in operation. [This answer is incorrect. This exists when a properly designed control does not operate as designed or when the person performing the control lacks the necessary authority or qualifications to perform the control effectively. A deficiency in operations can lead to the situation described above, but a different term applies to that situation.]
  - d. A deficiency in design. [This answer is incorrect. This exists when a control necessary to meet the control objectives is missing or an existing control is not properly designed so that, even if it operates as designed, the control objective would not be met. Though a deficiency in design can contribute to the situation described above, a different term will apply.]
23. Which of the following should an auditor communicate in writing to those charged with governance? **(Page 112)**
- a. **Identified significant deficiencies and material weaknesses.** [This answer is correct. The auditor should communicate significant deficiencies and material weakness identified during the audit, including significant deficiencies and material weaknesses in a managing agent’s internal control, in writing to those charged with governance.]
  - b. Deficiencies in internal control not deemed significant. [This answer is incorrect. AU-C 265.12 states that other deficiencies in internal control identified during the audit that have not been communicated to

management or by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention should be communicated to management either orally or in writing.]

- c. A list of what the auditor intends to communicate to those charged with governance. [This answer is incorrect. Communicating a list of intended communications to those charged with governance before making the actual communication would be unnecessary extra work. However, AU-C 265.12 does require the auditor to communicate in writing significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance to *management*, unless it would be inappropriate to communicate directly to management in the circumstances.]
  - d. A statement that no significant deficiencies were found. [This answer is incorrect. To prevent potential misunderstandings, AU-C 265.16 prohibits the auditor from issuing a written communication stating that no significant deficiencies were noted during the audit.]
24. While performing a CIRA audit, Jeffery uncovers information that leads him to believe the CIRA has violated an applicable law. Which of the following should Jeffery do? **(Page 117)**
- a. Discuss the violation and need for more investigation with the CIRA employees who were involved. [This answer is incorrect. Jeffery needs to discuss the matter and the need for any further investigation with an appropriate level of management, not with lower level employees. The appropriate level of management is at least one level above those involved in the law violation.]
  - b. Withdraw from the engagement immediately. [This answer is incorrect. In the rare event that management is not willing to follow sound legal advice about fraud or violations of laws or regulations, the auditor should consider seeing the recommendation of legal counsel about possible courses of action, including possible withdrawal from the engagement. However, such a drastic step would be taken later in the process. When Jeffery uncovers the information about the violation, he still has other recourses to take before having to withdraw.]
  - c. Consult with the CPA firm's legal counsel about actions that the CIRA can take. [This answer is incorrect. If appropriate, Jeffery can consult with the *CIRA's* legal counsel (or suggest that the CIRA consult with legal counsel) on any questions of law and on the course of action that the client should take. Jeffery should reserve consulting with the firm's legal counsel for other issues, such as withdrawing from the engagement.]
  - d. **Obtain an understanding of the violation and related information.** [This answer is correct. If investigation indicates that there may have been a violation of laws and regulations or fraud, the auditor should do several things, such as obtaining an understanding of the matter and sufficient other information to evaluate the possible effects on the financial statements and the auditor's report, including the need for adjustments and for disclosure of a violation of laws or regulations and any related contingencies, or the need for a report modification if necessary financial statement adjustments or disclosures are not made or because of a scope limitation. Therefore, in this situation, Jeffery needs to obtain an understanding of his CIRA client's violation to know how to proceed.]



## EXAMINATION FOR CPE CREDIT

### Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 1—Performing Substantive Procedures and Concluding the Audit (HOATG171)

#### Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

**ONLINE GRADING.** Log onto our Online Grading Center at [cl.thomsonreuters.com/ogs](http://cl.thomsonreuters.com/ogs) to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of \$89 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

**PRINT GRADING.** If you prefer, you may email, mail, or fax your completed answer sheet, as described below (\$89 for email or fax; \$99 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation**, and payment via one of the following methods:

- Email to: [CPLGrading@thomsonreuters.com](mailto:CPLGrading@thomsonreuters.com)
- Fax to: **(888) 286-9070**
- Mail to:

**Thomson Reuters**  
**Tax & Accounting—Checkpoint Learning**  
**HOATG171 Self-study CPE**  
**36786 Treasury Center**  
**Chicago, IL 60694-6700**

**Note:** The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
3. Each answer sheet sent for print grading must be accompanied by the appropriate payment (\$89 for answer sheets sent by email or fax; \$99 for answer sheets sent by regular mail). Discounts apply for three or more

courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is \$254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The \$10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **September 30, 2018**. CPE credit will be given for examination scores of 70% or higher.
5. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS**. Be sure to keep a completed copy for your records.
6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

**EXAMINATION FOR CPE CREDIT****Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 1—Performing Substantive Procedures and Concluding the Audit (HOATG171)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. Which of the following pieces of audit evidence would be considered the most reliable?
  - a. Item 1 was obtained from sources inside the entity.
  - b. Item 2 was obtained by inquiry.
  - c. Item 3 was obtained using a photocopied document.
  - d. Item 4 was obtained from information in documentary form.
2. Which of the following is typically of less use in a CIRA audit?
  - a. Trend analysis.
  - b. Ratio analysis.
  - c. Reasonableness tests.
  - d. Tests of details.
3. Kara plans to use analytical procedures when performing a CIRA audit. Which of the following should she do first?
  - a. Document the analytical procedure used.
  - b. Evaluate the likelihood that the balance is materially misstated.
  - c. Develop an expectation of what an account balance is supposed to be.
  - d. Investigate the cause of any significant differences that were not expected.
4. Mike is engaged to audit the Meadowlark Villas Homeowners' Association. Which of the following will he likely need to pay more attention to in this audit than he would when auditing a commercial business?
  - a. Cash.
  - b. Investments.
  - c. Derivatives.
  - d. Prepaids.
5. Which of the following makes up a CIRA's main source of revenue?
  - a. Tax assessments.
  - b. Member assessments.
  - c. Investments.
  - d. Rental income.

6. The following auditors are all engaged in CIRA audits. Who correctly addressed an issue related to the performance of substantive audit procedures?
- a. Alan accepts the fair values provided for derivatives by third parties without question.
  - b. Betty spends the majority of her audit time assessing the adequacy of insurance coverage.
  - c. Cal tests cash collections instead of confirming assessments receivable from members and documents his reasoning for omitting confirmations.
  - d. Donna tests subsequent cash collections for every receivable balance to make sure that assessments are substantiated.
7. In which of the following situations would it be appropriate for an auditor to skip confirming accounts payable?
- a. CIRA 1 accounts for expenses on a cash basis during the year.
  - b. CIRA 2 has extended payment terms with several of its vendors.
  - c. CIRA 3 has accounts payable balances that include significant debit memos.
  - d. CIRA 4 is likely to have incomplete accounts payable.
8. The Oceanview Cliffs Association requires members to pay security deposits for keys to the recreation center and when using the clubhouse for a personal event. The security deposits are refundable if members return the association's property in good condition. How should these deposits be categorized?
- a. As revenue.
  - b. As liabilities.
  - c. As debt.
  - d. As prepaids.
9. Which of the following alternative income sources would be considered unusual for a CIRA?
- a. Fees for pool management.
  - b. Revenues from garage operations.
  - c. Oil and gas royalties.
  - d. Restaurant revenue.
10. Sean is engaged to audit a CIRA. As part of this engagement, he makes the rebuttable presumption that the risk of improper revenue recognition may have resulted in the financial statements being misstated. What is the best way for Sean to identify situations in which the revenue recognition requires more detailed audit testing?
- a. Performing appropriate analytical procedures.
  - b. Performing tests of transactions.
  - c. Measuring the appropriateness of audit evidence.
  - d. Considering the effectiveness of internal control.



11. Which of the following statements most accurately describes a subsidy agreement?
- a. Reserve subsidies are the least complex and most desirable form of this type of agreement.
  - b. Subsidy agreements must take one of certain specific forms prescribed by the applicable legislation.
  - c. Understanding the CIRA's subsidy agreement helps the auditor determine if payables and receivables are accurate.
  - d. Subsidy agreements generally affect a maximum of two line items in a CIRA's financial statements.
12. Julia is engaged to audit a CIRA that had to accumulate funds for major repairs after a tree fell into the roof of the clubhouse. Which procedure should Julia perform to specifically address this repair and the associated funds?
- a. Coordinate audit testing of expenditures with testing of the repair fund.
  - b. Perform enough audit procedures to ensure the complete accuracy of the required supplementary information.
  - c. Test the CIRA's internal control to make sure all the related operations and additional staff are taken into consideration.
  - d. Perform additional substantive procedures to test any operating expenses that would be considered significant and unusual transactions.
13. Which of the following may take the form of an agreed-upon procedures engagement under the attestation standards?
- a. An initial CIRA audit when control is transferred to property owners.
  - b. An initial CIRA audit which includes contacting a predecessor auditor.
  - c. An audit in which the CIRA is subject to subsidy agreements.
  - d. A management company transition audit.
14. Which of the following occurs when an auditor reviews a CIRA's interim financial information?
- a. The auditor has sufficient evidence to express an opinion on the CIRA's financial statements.
  - b. The auditor must perform the interim review steps separately from steps that will be performed for the annual review.
  - c. The auditor will perform steps such as obtaining a management representation letter and issuing a review report.
  - d. The auditor is required to perform more procedures than in an annual audit to compensate for the lack of financial information.

15. Which of the following auditors has correctly addressed an issue related to their CIRA audit clients' legal representation letter?
- a. Evelyn contacts each of the CIRA's lawyers, including one only involved with collections and one who performed no services.
  - b. Frank requests that the legal representation letter be dated as of the beginning of the year covered by the audit.
  - c. Greta makes sure that the letter provided by her client's lawyer reflects the specified materiality amount.
  - d. Hal requests the CIRA's lawyer to provide a summary letter that aggregates the effects of all potential legal claims.
16. Which of the following procedures will help an auditor determine whether a CIRA is at risk for environmental remediation liabilities due to noncompliance with related laws and regulations?
- a. Making inquiries of those charged with governance or the CIRA's management.
  - b. Initiating correspondence with the associated licensing or regulatory authorities.
  - c. Helping the CIRA establish policies and procedures related to environmental matters.
  - d. Making inquiries of association members and those who live in the development.
17. When will an entity suffer vulnerability from concentrations?
- a. When the entity uses multiple vendors and suppliers.
  - b. When the concentration opens them to a higher risk of loss.
  - c. When use of concentrations is combined with use of significant estimates.
  - d. When the entity could get the same product from another source.
18. John is engaged to audit a CIRA. During the course of his audit, John discovers that the CIRA uses accounting estimates to determine the value of common property contributed by the developer. John determines that this is a significant risk. Which of the following does AU-C 540 require John to do, since this is now a significant estimate?
- a. Evaluate the alternative estimates that were considered and rejected by management.
  - b. Determine whether related financial statement disclosures comply with GAAP.
  - c. Document the precise level of estimation uncertainty that affects the estimate.
  - d. Test whether associated controls are operating efficiently.
19. The Panther City Association receives custody of a foreclosed unit and must determine its value for the financial statements. Which of the following fair value measurements would be the most reliable?
- a. The selling price of a similar unit in the development.
  - b. The amount the former owner owed on the mortgage.
  - c. A value calculated using the discounted cash flows method.
  - d. The amount that the unit was worth three years ago when it was new.

20. Which of the following is considered a financial instrument?
- a. Marginal ownership interest in an entity.
  - b. An IOU received in lieu of cash.
  - c. An executory contract for future services.
  - d. An unconditional receivable-payable contract.
21. Lucy is engaged to perform a CIRA audit. The balance sheet date is June 30. Lucy's auditor's report will be dated August 30. When should the CIRA management date its subsequent events evaluation note?
- a. June 30.
  - b. July 30.
  - c. August 30.
  - d. December 31.
22. At what point does an auditor usually apply audit procedures for related parties?
- a. Prior to engagement acceptance.
  - b. At the beginning of the audit.
  - c. Intermittently throughout the audit, as needed.
  - d. At the beginning and end of the audit.
23. Sam is engaged to audit a CIRA that has related-party transactions. He deems one of these transactions as material, and it also gives rise to significant risk of material misstatement of the CIRA's financial statements. Which of the following is an additional procedure that Sam may need to apply to the transaction under these circumstances?
- a. Vouching the transaction.
  - b. Inspection of evidence from the other party.
  - c. Documentation of the transaction.
  - d. Recomputation of the transaction.
24. The Silver Lake Association has undergone recent financial difficulty, but it does have a large amount of cash reserves. When performing the association's annual audit, Lisa must consider its ability to continue as a going concern for a reasonable amount of time. According to AU-C 570A, what is the minimum amount of time Lisa must believe the association can stay in business to avoid substantial doubt about its ability to continue as a going concern?
- a. At least six months.
  - b. At least one year.
  - c. At least 18 months.
  - d. More than two years.

25. If Lisa decides that there is substantial doubt about the Silver Lake Association's ability to continue as a going concern, how does she need to address this issue according to the guidance in AU-C 570A?
- a. She must ask the CIRA to add a note on the issue to the financial statements.
  - b. She must consider the adequacy of disclosures.
  - c. She must either disclaim an opinion on the statements or give an adverse opinion.
  - d. She must withdraw from the engagement before issuing a report.
26. A CIRA's management representation letter could be signed by which of the following personnel? (Select all that apply.)
- i. The president or other CIRA officers.
  - ii. Members of the CIRA's board.
  - iii. Members of the CIRA (e.g., homeowners).
  - iv. The CIRA's managing agent.
  - v. The independent auditor.
- a. v.
  - b. i. and iv.
  - c. i., ii., and iv.
  - d. i., ii., iii., and iv.
27. A CIRA's management representation letter should be dated as of which of the following?
- a. The date of the auditor's report.
  - b. The balance sheet date.
  - c. Ninety days after the balance sheet date.
  - d. One year beyond the date the financial statements were audited.
28. The following auditors are all performing CIRA engagements. Which auditor has correctly addressed an issue related to consideration of the accumulated results of the audit procedures that were performed?
- a. Ian identifies an error during the audit but, based on management explanation, assumes it is an isolated occurrence.
  - b. Jolene limits her assessment of fraud to the acceptance/continuance and planning portions of the audit engagement.
  - c. Kris uses professional judgment to determine that no substantive procedures are needed for this engagement.
  - d. Lainey performs required revenue procedures when she performs preliminary analytical procedures and updates them during final review.

29. What is the purpose of performing analytical procedures in the final review stage of an audit?
- a. To obtain an understanding of the entity and its environment.
  - b. To determine which additional audit procedures are needed for risk assessment.
  - c. To consider the adequacy of the procedures already performed.
  - d. To help the auditor prepare the required flux analysis.
30. The following CPA firms are all performing CIRA audits. Which one has correctly addressed an issue related to the review of workpapers at the end of the engagement?
- a. Firm 1 limits its review of the workpapers to a high-level supervisory review performed by an audit partner.
  - b. Firm 2 has one of its tax partners review the workpapers of every CIRA audit the firm performs.
  - c. Firm 3 performs all workpaper reviews after the audit is complete and the report has been released.
  - d. Firm 4 performs both workpaper review and engagement quality control reviews (EQCRs) on all audit engagements.
31. The rollover and iron curtain methods are used to do which of the following?
- a. Aggregate audit differences.
  - b. Document misstatements.
  - c. Evaluate overall materiality.
  - d. Evaluate the existence of fraud.
32. Which of the following dates need to be coordinated? (Select all that apply.)
- i. The balance sheet date.
  - ii. The audit report date.
  - iii. The engagement letter date.
  - iv. The date of the management representation letter.
  - v. The date of the note disclosure about the subsequent events evaluation.
- a. i. and iii.
  - b. i., ii., and iv.
  - c. ii., iv., and v.
  - d. ii., iv., iii., and v.

33. Harold is engaged to audit the Mistletoe Valley Homeowners' Association. The association includes schedules of revenues and expenses with its financial statements. How will this supplementary information affect Harold's audit?
- a. He must get a representation from management that the information was derived from the financial statements.
  - b. He must determine that the supplementary information relates to either the same period as the financial statements or one period prior.
  - c. He must request a reconciliation of the supplementary information and the financial statements from management.
  - d. He must obtain an understanding of the methods the association used to prepare the supplementary information.
34. Charlotte is engaged to audit the Redwood Homeowners' Association. The CIRA's financial statements include a schedule comparing the current year's budget with next year's budget. How will this affect Charlotte's audit?
- a. She must apply the requirements of AU-C 725 and disclaim an opinion on the budget.
  - b. She should add an Other Matter paragraph to the audit report to disclaim an opinion on the prospective budgetary information.
  - c. She is required to perform agreed-upon procedures to the prospective budgetary information and report on the findings.
  - d. She is required to examine the prospective budgetary information and provide an opinion.
35. Which of the following occurs when a CIRA is required to present supplementary information with its financial statements?
- a. The auditor must express a qualified opinion on the required supplementary information.
  - b. The auditor must apply specific limited procedures on the supplementary information.
  - c. The auditor must present information about the supplementary information in an emphasis-of-matter paragraph.
  - d. The auditor must prepare a flux analysis to accompany his or her auditor's report.
36. Under which of the following circumstances would AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, apply to a CIRA audit?
- a. The CIRA has an ancillary operation recorded in accounting records that are centrally maintained.
  - b. The CIRA has an ancillary business activity with separate financial reporting from the rest of the association.
  - c. The CIRA maintains a single set of financial statements on an annual basis instead of group financial statements.
  - d. The CIRA does not have any component units to include in its annual financial statements.

37. Under which of the following circumstances would a material weakness in internal control most likely exist?
- a. The auditor discovered minor fraud on the part of senior management.
  - b. Financial statements were reissued to correct a clerical error.
  - c. The entity's internal control found and prevented a misstatement.
  - d. Those charged with governance provide effective oversight.
38. Logan releases his report on a CIRA audit on April 30. During the audit, he found a material weakness that must be communicated to those charged with governance. How long does Logan have to make this communication?
- a. The communication must be made on April 30.
  - b. The communication must be made before June 29.
  - c. The communication must be made before July 29.
  - d. The communication must be made by the CIRA's year-end.
39. Which of the following must an auditor communicate to the appropriate level of management, whether or not it is inconsequential?
- a. Fraud.
  - b. Violations of laws and regulations.
  - c. Misappropriations by lower level employees.
  - d. Areas where fraud could occur in the future.
40. Which of the following might an auditor use for an overview of audit data, including significant accounting and auditing issues that came up during the engagement and how they were resolved?
- a. The management representation letter.
  - b. The legal representation letter.
  - c. The written communication to those charged with governance.
  - d. An engagement summary memorandum.





## GLOSSARY

**Accounting estimate:** An approximation of a monetary amount in the absence of exact measurement.

**Analytical procedures:** Evaluations of financial information made by a study and comparison of plausible relationships among both financial and nonfinancial data.

**Appropriateness:** The measure of the quality of audit evidence, that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

**Audit differences:** Differences noted between the accounting records and the evidence obtained during the audit.

**Component:** An entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements.

**Component auditor:** An auditor who performs work on the financial information of a component that will be used as audit evidence for the group audit.

**Deficiency in design:** When a control necessary to meet the control objectives is missing or an existing control is not properly designed so that, even if it operates as designed, the control objective would not be met.

**Deficiency in internal control:** 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, misstatements on a timely basis.

**Deficiency in operation:** When a properly designed control does not operate as designed or when the person performing the control lacks the necessary authority or qualifications to perform the control effectively.

**Engagement quality control review (EQCR):** A process designed to provide an objective evaluation, by an individual or individuals who are not members of the engagement team, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

**Estimation uncertainty:** The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

**Factual misstatement:** A misstatement about which there is no doubt.

**Financial instruments:** Cash, evidence of an ownership interest in an entity, contracts that require one entity to deliver cash or another financial instrument to another entity, and contracts that require two entities to exchange financial instruments on potentially unfavorable terms.

**Flux analysis:** A narrative explanation by financial statement caption (line item) of the change in the amount from the prior period and of any unusual or unexpected relationships to other financial statement line items in the current period.

**General procedures:** Procedures an auditor is required to perform that are not related to particular account balance.

**Group financial statements:** Financial statements that include the financial information of more than one component.

**Interim financial information:** Financial information or statements covering a period less than a full year or for a 12-month period ending on a date other than the entity's fiscal year end.

**Judgmental misstatement:** A misstatement that arises from judgments made by management related to accounting estimates that the auditor believes to be unreasonable or due to the selection or application of accounting principles by management that the auditor considers to be inappropriate.

**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.

**Normal closing entries:** Routine entries made to help clients close out the books for the year.

**Planning materiality:** A judgment about a single materiality amount for the financial statements as a whole.

**Precision:** The degree of accuracy of the expectation developed by the auditor to the actual amount when performing analytical procedures.

**Projected misstatement:** A misstatement that is the result of the auditor's best estimate of misstatement extrapolated to entire populations arising from the use of sampling procedures.

**Ratio analysis:** The study of the relationship between two financial statement amounts or between financial and relevant nonfinancial amounts.

**Reasonableness tests:** Tests that estimate a financial statement amount or the change in an amount from the prior year.

**Related parties:** Affiliates; equity investees; pension, profit-sharing, and similar trusts managed by or under the trusteeship of management; principal owners, management, and members of their immediate families; other parties if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the parties might be prevented from pursuing its own separate interest; another party that can significantly influence the management or operating policies of the transacting parties or that has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from pursuing its own separate interests.

**Senior management:** The principle executive, financial officers, and any other members of senior management who have a significant role in the entity's financial management.

**Severe impact:** A significantly financially disruptive effect on the normal functioning of the association.

**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.

**Subsequent events:** Events or transactions that occur subsequent to the balance sheet date but before the financial statements are available to be issued.

**Subsequent events review:** Audit procedures performed specifically to search for material events that occur during the period between the balance sheet date and the date the financial statements are available to be issued.

**Substantive procedures:** Further audit procedures performed for the purposes of detecting material misstatement at the relevant assertion level.

**Sufficient appropriate audit evidence:** Evidence that the audit documentation has been reviewed; the financial statements, including disclosures, have been prepared; and management has asserted that they have taken responsibility for the financial statements.

**Sufficiency:** The measure of the quantity of audit evidence.

**Tests of balances:** Tests applied directly to the details of balances in the accounting records.

**Tests of details:** Tests performed by auditors that can be applied to either transactions or balances.

**Tests of transactions:** Tests of the processing of individual transactions by inspection of the documents and accounting records involved in processing.

**Those charged with governance:** The persons responsible for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting process.

**Trend analysis:** Comparing the absolute dollar amount or percentage change in accounts over time.



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# COMPANION TO PPC'S GUIDE TO HOMEOWNERS' ASSOCIATIONS AND OTHER COMMON INTEREST REALTY ASSOCIATIONS

## COURSE 2

### COMMON INTEREST REALTY ASSOCIATIONS AND APPLICABLE ACCOUNTING PRINCIPLES AND PRACTICES (HOATG172)

#### OVERVIEW

**COURSE DESCRIPTION:** This interactive self-study course provides an introduction to common interest realty associations (CIRAs) and the applicable accounting principles and practices that affect those entities. Lesson 1 defines a CIRA, explains the different types of CIRAs, and discusses the regulatory environment and authoritative literature associated with a CIRA audit. Lesson 2 provides an in-depth look into the applicable accounting principles and practices that a CIRA will employ.

**PUBLICATION/REVISION DATE:** September 2017

**RECOMMENDED FOR:** Users of *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*

**PREREQUISITE/ADVANCE PREPARATION:** Basic knowledge of accounting

**CPE CREDIT:** 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at [www.nasbaregistry.org](http://www.nasbaregistry.org) for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

**FIELD OF STUDY:** Accounting

**EXPIRATION DATE:** Postmark by **September 30, 2018**

**KNOWLEDGE LEVEL:** Basic

#### Learning Objectives:

#### Lesson 1—Common Interest Realty Associations

Completion of this lesson will enable you to:

- Recognize what defines a common interest realty association (CIRA), the common characteristics and types, and how CIRAs are established.
- Identify the regulatory environments for the CIRA industry, the accountant's involvement with CIRAs, and the authoritative literature for CIRA audits.

#### Lesson 2—Accounting Principles and Practices for CIRAs

Completion of this lesson will enable you to:

- Recognize the authoritative guidance that affects CIRAs.
- Identify how CIRAs account for cash and cash equivalents and the disclosures and which type of marketable securities CIRAs can invest in and how to account for them.

- Determine the measurement of the amounts owed, the valuation of receivables, the appropriate classification on the financial statements for member assessments, reporting of other income and receivables, and accounting guidance for CIRAs related to common property and other real property.
- Identify the accounting treatment for prepaid expenses and other assets for CIRAs and the management of capital improvement funds.
- Recognize a CIRA's management of debt and other liabilities, including the financing options open to a CIRA, interfund transfers and security deposits and how a CIRA would report on members' equity and income taxes.

**TO COMPLETE THIS LEARNING PROCESS:**

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**ADMINISTRATIVE POLICIES:**

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

# Lesson 1: Common Interest Realty Associations

## INTRODUCTION

Lesson 1 discusses the basics of common interest realty associations (CIRAs). This lesson begins by defining CIRAs and comparing their common characteristics and types. It then discusses how CIRAs are established. It continues by explaining the regulatory environment for CIRAs including federal and state regulations. It then covers industry trends and the accountants' involvement with CIRAs. The lesson concludes with a discussion of the applicable authoritative literature for conducting CIRA audits.

### Learning Objectives:

Completion of this lesson will enable you to:

- Recognize what defines a common interest realty association (CIRA), the common characteristics and types, and how CIRAs are established.
- Identify the regulatory environments for the CIRA industry, the accountant's involvement with CIRAs, and the authoritative literature for CIRA audits.

## WHAT ARE COMMON INTEREST REALTY ASSOCIATIONS?

Condominium associations, homeowners' associations, and cooperative housing corporations are the main types of common interest realty associations. They are similar, in some respects, to the neighborhood associations often found in real estate developments of single-family residences. The neighborhood associations typically are concerned about matters such as neighborhood security, development, zoning, traffic, and beautification. Some associations also enforce architectural or other deed restrictions, such as requiring homes to be constructed of brick or fences of a certain design.

The sole purpose of both types of associations is to serve the collective needs of the neighboring property owners. As the term implies, however, "common interest realty associations" or "CIRAs" refer to organizations of property owners who—

- own or have the exclusive right to use their individual living quarters and
- share the exclusive use of certain property with all of the other property owners in the development.

*Common interest realty association* is the term used in FASB ASC 972, *Real Estate—Common Interest Realty Association*. *Community association* and *common interest development (CID)* are frequently used in the industry, as well. For simplicity, the FASB's terminology is used in this course.

### Common Characteristics of CIRAs

The specific characteristics of CIRAs vary depending on the type of real estate that is owned by the association and by the individual property owners that are members of the association. Even so, all CIRAs have three primary functions—to serve as a business, as a governance structure, and as a community. In addition, the principal activities of all CIRAs are essentially the same: (a) to manage, maintain, repair and replace the common property used by all of the property owners, (b) to provide other services for their members, such as security and trash removal, (c) to enforce compliance with governing documents and state and local statutes and regulations relating to the operations of the CIRA, (d) to enforce rules for the mutual benefit of their members, (e) to equitably assess and collect funds from their members to finance the expenses of operating the CIRA, and (f) to design programs to foster a sense of community. The following characteristics are common to all CIRAs:

- CIRAs are separate legal entities established under state laws and composed of the property owners within a specific real estate development.
- Property owners in the specific real estate developments may own lots and improvements, defined interior spaces, or shares of stock or membership certificates.

- Membership in the CIRA is automatic and cannot be separated from ownership of the underlying real estate.
- Funding of the CIRA's operations by periodic assessment of all members.
- Association members share the use of common area property within the real estate development (that is, property such as landscaped areas, parking lots, building elevators, and recreational facilities that is not owned and used exclusively by individual members).
- Association members are bound by restrictive covenants.
- The associations provide a means for self-government of their members through boards of directors that enforce the CIRAs' governing documents and carry out their operations.

## Types of CIRAs

It is generally impossible to distinguish CIRAs by the physical appearance of the real estate development. Instead, CIRAs are primarily distinguished by the property that is owned by the CIRA's members and by the CIRA. The principal types of CIRAs are as follows:

- *Condominium Associations.* All unit owners in condominiums own their individual living quarters. They also have an undivided percentage interest in the common property that is inseparable from ownership of the unit itself. Condominium associations generally do not have title to any real property within the development.
- *Homeowners' Associations (HOAs).* Members of homeowners' associations own their own dwelling and the land on which the dwelling sits. The HOAs, rather than the residents, have title to all of the common property within the development.
- *Cooperative Housing Corporations.* Residents of cooperatives own shares of stock (or membership certificates) in the cooperative corporation, which gives them the right to occupy a specific unit in the cooperative. The cooperative housing corporations, rather than the tenant-shareholders, have title to all real estate within the development, both the common property and the individual units.
- *Timeshare Developments.* The user of a timeshare development is entitled to (a) the right to use a certain accommodation or class of accommodations, generally in weekly increments that occur annually or on some other repeating basis or (b) a fee simple ownership interest in an accommodation, coupled with specified use rights. A resort condominium is an example of a timeshare development.

Accountants also may encounter the following types of common interest ownership developments:

- *Townhomes.* Townhomes are a form of property ownership in which the property owners own their individual unit and share a common wall and may also share ownership of other common property. If the development does not include other common property, the ownership is typically recorded as conventional real estate with a common wall agreement, and a CIRA is not established. If the development includes other common property, it is typically owned by the CIRA, and accounting would be similar to that for homeowners' associations. "Townhome" may also be used to refer to the style of home rather than the type of association. They may be found in homeowners' associations or condominium associations.
- *Condominium Trusts.* In some states, condominium developments establish nonprofit trusts rather than associations of property owners to manage the common property. If the trusts own all of the property, accounting is similar to that of a cooperative housing corporation.
- *Master Associations.* Developers may establish "master associations" (also referred to as "umbrella associations") when two or more common interest housing developments share recreational facilities or other common property or receive services as part of a contract covering more than one development. They are responsible for administering the shared common property or providing the shared services and

assessing residents of the participating developments for their portion of the related expenses. Alternatively, the master association may assess each participating association for its expenses and the participating association would in turn assess its residents.

- *Cohousing Communities.* Those communities are less common in the United States and are based on a shared space concept from Denmark. The residents own their individual homes and share in the ownership of common areas, such as dining halls, parking lots, and community gardens. They also contribute a designated number of hours per week to community services, such as gardening, cooking meals, or cleaning up after meals.
- *Commercial Associations.* Those associations provide nonresidential facilities. Examples are industrial parks, shopping centers, professional buildings, parking facilities, marinas, and docks.
- *Condo-hotel Developments.* Condo-hotels are unique in that the legal structure of the development is that of a typical full ownership condominium association, but the operations mimic those of a timeshare association, or a hotel operation. That is, buyers own a unit in the condo-hotel development for a designated number of weeks. The remainder of the year, the condo-hotel unit is rented out as a hotel room. They are generally developed at the high-end, luxury portion of the market and currently are most common in the states of Florida, Nevada, California, and Hawaii.

Although timeshare developments and commercial associations are similar in some respects to residential associations, they may be subject to unique regulatory, accounting, and tax requirements. A discussion of the legal environments of timeshare developments and commercial associations is beyond the scope of this course, but further information is provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

Residents of some common interest housing developments also may participate in voluntary membership associations that provide security or other services to their members. Voluntary membership associations such as those are not CIRAs; they are not governed by FASB ASC 972. (Some states regulate voluntary homeowners' associations under the states' not for profit corporation statutes.)

**Condominium Associations.** The condominium form of ownership is a fee simple ownership of defined space, usually within a multi-unit building. (*Fee simple ownership* is an unrestricted ownership of rights to property, including the right to use and dispose of the property.) The physical boundaries of the units are described in the declaration of condominium. Generally, a unit consists of the interior surfaces of the unit's perimeter walls, floor, and ceiling. This is often referred to as the "interior shell" or "box of air" method of defining unit ownership. Informally, it may be referred to as "paint in, ceiling down, and slab up." Accordingly, most often, the building's structure—its foundation; exterior and common walls; roof, plumbing, and electrical components; and hallways—as well as the land under the building, are part of the common areas, as are amenities such as landscaped areas, parking lots, courtyards, swimming pools, and clubhouses. (However, in some condominiums, the unit boundaries include the exterior elements of structures and also structural slabs.) Exclusive use common areas include balconies and patios. However, the physical boundaries of some condominium units include only the interior airspace and the airspace above the building while the real property belongs to the condominium association.

Unlike homeowners' associations and cooperatives, condominium associations (sometimes referred to as unit owners' associations) generally do not have title to the common property within the condominium development. Rather, each unit owner has an undivided percentage interest in the common property that is inseparable from ownership of the unit itself; it is said to be *appurtenant* to the unit. Condominium ownership gives each unit owner the right to share the use of the common areas with other unit owners and an obligation for a pro rata share of the expenses to manage, maintain, and repair them.

Although unit owners in a condominium development own only space and an undivided interest in common elements, condominium ownership is a form of real property ownership. Thus, in certain respects, condominium ownership is similar to single-family residence ownership in that (a) individual financing of unit purchases is possible, (b) property taxes are assessed directly to unit owners, and (c) unit owners retain the right to sell their units. Courts generally have struck down the associations' right to approve the sales of individual units but have

upheld their right to screen prospective purchasers and their right of first refusal. (On the other hand, leasing restrictions of various kinds are common and also have been widely upheld in court.)

Because condominium owners are often told that they own only space, they can be surprised to learn that they may own and be responsible for interior features such as wallpaper, flooring, painted surfaces, bathroom and electrical fixtures, built-in appliances, cabinets, etc. The condominium declaration describes in detail the boundaries of the individual units, as well as the items within the unit boundaries that are part of the units.

**Homeowners' Associations.** Homeowners' associations or "HOAs" generally are established by developers of "planned unit developments" or "PUDs." PUDs (sometimes also referred to as planned residential developments or PRDs) are land developments that typically cluster (a) residential units, often of varying design, (b) open space, and (c) recreational and other amenities for optimal use of the property. PUDs are a fee simple type of residential real estate ownership in which the owners not only have title to their individual dwelling but also to the land on which the dwelling sits. Unlike the condominium form of ownership, the HOA, rather than the residents, has title to all of the common property within the development. The common property may be as minimal as the space between homes or include property such as roads and utilities within the development, parklands, and recreational facilities. Property ownership automatically conveys a membership interest in the homeowners' association to the residents who are responsible for paying assessments to the HOA to cover the cost of maintaining the common areas and providing necessary services. In turn, their property deeds allow them access to the common elements.

Like condominium owners, property owners in HOA communities also share many similarities with owners of single-family residences. They may separately mortgage their homes and are directly liable for the related property taxes. There are usually no restrictions on selling the property.

**Cooperative Housing Corporations.** Cooperatives (sometimes also referred to as cooperative apartment developments) are a form of residential housing in which the tenants are stockholders in a corporation that owns the land, building, and any improvements. Residents of cooperatives do not own their individual living quarters. Rather, as stockholders of the cooperative housing corporation, the tenants enter into proprietary leases that give them (a) the right to occupy defined living areas and (b) the right of access to the common property owned by the cooperative (that is, the property not included in the individual units, such as the public portion of the building—lobby, elevators, and hallways—and access roads, sidewalks, and parks). Stock or membership certificates issued by the cooperative to the purchaser of the membership interest are evidence of ownership in cooperatives.

Cooperatives are financed by mortgages of the entire property. Because the corporation owns the real estate, it is directly liable for the debt rather than the individual tenant-shareholders. Similarly, municipalities assess property taxes to the corporation based on the total value of the cooperative, rather than to the individual tenants for their units. The tenant-shareholders, on the other hand, are responsible for monthly assessments (sometimes referred to as maintenance fees or carrying charges) according to the terms of their proprietary leases. The assessments represent tenants' proportionate share of the costs of operating and maintaining the building, which includes mortgage payments, real estate taxes, insurance, and personnel costs. Although the tenant-shareholders are not personally liable to creditors, it is in their best interests to ensure that the cooperative's obligations are satisfied. For example, mortgage lenders are able to foreclose on the entire building if a cooperative defaults on its debt. Likewise, local governments have authority to file a tax lien on the entire building if property taxes are unpaid. In both cases, the interests of all tenant-shareholders are jeopardized. Thus, if residents default on their assessments, the remaining tenant-shareholders usually are assessed additional amounts to make up the deficiency.

Because of the financial interdependence of all of the tenant-shareholders, they generally are unable to transfer their interests in the cooperative without approval of the cooperative's board of directors.

**Comparison of Certain Common Interest Realty Associations.** Exhibit 1-1 compares the primary characteristics of condominium associations, homeowners' associations, and cooperatives.

**Exhibit 1-1****Comparison of Certain Common Interest Realty Associations**

<b>Characteristic</b>	<b>Condominium Association</b>	<b>Homeowners' Association</b>	<b>Cooperative</b>
Type of real estate development that creates the CIRA	Condominium	Planned unit development	Cooperative housing corporation
Architectural design of development	Generally one or more multiunit buildings composed of numerous apartments	Single-family detached homes or townhouses and open areas	Generally one or more multiunit buildings composed of numerous apartments
Type of property owned by the CIRA's members	Generally interior airspace and proportionate interest in the common property (real property ownership)	Home and the land on which it sits (real property ownership)	Membership interest in the cooperative corporation represented by shares of stock or membership certificates (personal property ownership)
Property owned by the CIRA	Generally only common personal property purchased with CIRA funds (However, in certain circumstances, the CIRA owns the real property.)	All common property (both personal and real property)	All real and personal property (both common property and property occupied by the individual units)
Who owns the common property	Unit owners	CIRA	CIRA
Transferability of unit owners' interests	No restrictions, but CIRA may have right of first refusal	No restrictions, but CIRA may have right of first refusal	Generally only with approval of the cooperative's board of directors
Legal form of association	Corporation or unincorporated association based on state laws	Corporation or unincorporated association based on state laws	Corporation
Legal authority for association	State nonprofit laws and condominium statutes	State nonprofit laws and, if enacted, specific state statutes	State business or nonprofit corporation laws
Income tax status	Allowed to file Forms 1120 or 1120-H	Allowed to file Forms 1120, 1120-H, or 990	Required to file Form 1120-C
Basic legal documents of association	Condominium Declaration (or Master Deed); CIRA bylaws; articles of incorporation; rules and regulations (or house rules)	Declaration of Covenants, Conditions, and Restrictions; CIRA bylaws; articles of incorporation; rules and regulations (or house rules)	Membership agreements; proprietary leases; articles of incorporation; rules and regulations (or house rules)

Characteristic	Condominium Association	Homeowners' Association	Cooperative
Liability for mortgage and property taxes	Unit owners	Unit owners	CIRA (Owners' monthly maintenance fees cover their proportionate share.)
Form of financial statements	May use fund accounting or entity accounting	May use fund accounting or entity accounting	Many use fund accounting or entity accounting
	*	*      *	

### Mixed-use Associations

A growing trend within the industry is the formation of mixed-use associations related to the development of mixed-use property. These associations can be generally broken down into two configurations: the *layered* association and the *combined* association. In either configuration, a mixed-use association may include a combination of residential, timeshare, and commercial (retail, manufacturing, or office) condominium units within the same association or groups of associations.

**Layered Associations.** The layered association configuration generally consists of a master association for the development and one or more special use associations that are members of the master association. A common example of this is a high-rise building in a downtown area that contains commercial or retail units on street or lower levels, with residential units on upper floors. In some cases, the commercial or retail units are formed as an association. In other cases, they are simply rental units that pay rent on the units owned by the master association. The residential units are generally formed as a separate association.

A general benefit of a layered association is that the residential association will usually qualify as a residential condominium association for tax purposes. It also means that the maintenance activities of the residential association are usually confined to interior common areas, as the master association normally assumes responsibility for exterior common areas. The master association may or may not qualify as residential for tax purposes, depending upon the portion of square footage devoted to residential use.

If the commercial or retail units are formed as a separate commercial association, the commercial condominium units are individually owned. The owner of the unit generally pays assessments both to the commercial association and to the master association. Often, for convenience, the owner pays a single assessment to the commercial association, and the commercial association pays an assessment on behalf of all owners to the master association. This simplifies operations and assures the master association that it will collect all assessments promptly, as the collection risk is passed to the commercial association.

If the commercial or retail units are not formed as a separate association, then the units are generally owned by the master association and rented to users. In this case, the tenant will pay rent to the master association. This generally means that the master association will not qualify as a homeowners' association under IRC Sec. 528 for tax purposes since it may have difficulty meeting the residential test, the 60% exempt function income test, and the 90% exempt function expenditures test.

**Combined Associations.** The combined association consists of a single association with one or more special use activities. The physical property development of a combined association can be identical to that of the physical property development of a layered association (for example, either type of property development can consist of a high-rise building in a downtown area that contains commercial or retail units on street or lower levels, with residential units on upper floors). However, because of the structure of a combined association, the combined nature of the activities generally provides for more complex operations.

The assessment structure for a combined association will necessarily require allocations between residential and nonresidential activities. In addition, because of the combined activities, the association often will not qualify as a homeowners' association under IRC Sec. 528 for tax purposes, as it may have difficulty meeting the residential test, the 60% exempt function income test, and the 90% exempt function expenditures test.



## How CIRAs Are Established

In today's fast-paced and busy environment, although many people want to own their own home, they have no desire to spend the time and money associated with maintaining a single-family home. Also, as leisure time becomes increasingly important to most people, they want easy access to recreational amenities and open space at an affordable price. Others simply cannot afford a single-family home. Those factors, plus the premium on land in some parts of the country and the potential for cost economies in developing multi-family housing, often convince real estate developers that it is more profitable to build condominiums or planned communities rather than the traditional single-family detached home. In some cases, existing rental properties have been converted to condominium ownership.

State and local laws may require developers to establish a CIRA or may effectively prohibit them from transferring property to a local governmental unit. For example, as stated later in this lesson, all 50 states have enacted laws regulating condominium development and management, and they require CIRAs to be formed to manage and maintain the common areas in condominium projects. Similarly, local jurisdictions are beginning to require developers of planned communities to establish CIRAs before they will approve their site plans because they do not want the responsibility for maintaining the common property after the development is completed. In other cases, developers turn to CIRAs for the following reasons:

- They perceive that prospective purchasers will prefer that alternative. Using any vehicle other than a CIRA to manage common property ultimately means that it can no longer be restricted for the exclusive use of the property owners in the development but must be open to others. Because restricted use of the common property is viewed by most prospective purchasers as one of the primary advantages of living in planned communities, many developers view CIRAs as the only viable alternative.
- Prospective purchasers may decide not to buy in a particular development if they are uncertain whether voluntary membership organizations will be able to generate enough revenue to maintain and repair recreational amenities in the future.
- Federal lending and lending-related organizations such as the Federal National Mortgage Association (FNMA or Fannie Mae), the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), the Department of Veterans Affairs (VA), and the Federal Housing Administration (FHA) have requirements with which developers must comply before the organizations will become involved in the financing process for condominium or similar real estate projects either through loan guarantees, mortgage insurance, or providing a market for mortgages in the secondary market.

Whatever the developers' decision, it generally is made early in the development process since it ultimately affects how the development will be designed, financed, and marketed.

**Selecting a Method for Managing the Common Property.** When developers choose to build a project that involves the shared use of common property, they must provide a vehicle for managing and maintaining that common property after construction is completed. The nature of the cooperative form of ownership automatically means that the common property will be managed by the tenant-shareholders. For condominiums and HOA communities, however, developers may consider several alternatives. For example, they may:

- transfer the responsibility of the common property to a CIRA;
- dedicate the common areas to a governmental unit, such as the city where the development is located;
- convey the property to a voluntary membership organization, such as a social club;
- dedicate some common property, such as roads and utilities, to a governmental unit and convey the recreational amenities, such as the swimming pool and tennis courts, to a voluntary membership organization; or
- sell or lease operating amenities that are revenue-producing, such as golf courses or restaurants, to a separate company to operate.

**Preparing the Necessary Legal Documents.** The unique nature of the property ownership in common interest ownership developments generally requires developers to file certain legal documents in the property records of the local government where the development is located to create the project. Since the creation of a condominium is prescribed by state law, each state details the specific documents that must be filed and the manner of recording them. At a minimum, however, the documents (a) define the space for the development and divide it into numerous individual parcels and common areas, (b) create the CIRA to manage the common areas and explain how it will operate, and (c) describe the owners' rights and restrictions on the use of the common property and their obligation to fund future maintenance and repairs for it. As stated earlier, CIRAs are separate legal entities, and some states require them to be incorporated. Thus, in addition to the documents relating to the real estate itself, developers often must file a charter or articles of incorporation establishing the condominium association with the state.

HOAs are created by covenants rather than being required by state law, and the individual property deeds in HOA communities are subject to those covenants. Some states do regulate the operation of HOA communities; but typically, the legal requirements are less detailed and less stringent than those for condominiums. Depending on state laws, the documents creating HOA communities may be similar to those for condominiums and address essentially the same matters listed in the paragraph above or may more closely resemble the documents for real estate transactions involving the construction and sale of single-family detached homes. Like condominium associations, many HOAs are incorporated. If so, developers also must file incorporation papers with the state.

A few states have adopted statutes to regulate the operation and management of cooperatives, but generally there is no statutory authority for them. In most cases, cooperatives derive their authority from their articles of incorporation, bylaws, and the proprietary leases between the cooperative corporation and its tenant-shareholders. Other than recordings associated with the cooperative's articles of incorporation, their governing documents, unlike those of condominium associations and HOAs, generally are not recorded.

**Transferring Control of the CIRA to the Property Owners.** As explained in earlier, CIRAs typically are formed when the appropriate legal documents—the declaration or covenants—are filed. Because developers create CIRAs before the property is sold or even constructed, they control them during the initial period by appointing individuals to serve on the CIRAs' boards of directors. State law or the CIRAs' legal documents, however, detail how control is to be transferred to the property owners and establish the timetable for the transfer. The process of transferring control, referred to as the transition period, is a gradual process. For example, it may begin when the first unit is sold or after the sale of a specified percentage of units. To illustrate, some states may prescribe that 25% of the CIRA's board of directors be elected by the unit owners after 25% of the units are sold, one-third of the CIRA's board be elected by unit owners after 50% of the units are sold, and all of the CIRA's board be elected by unit owners after 75% of the units are sold. Often, the transfer of control is required to be completed within a specified period, such as within two years after the sale of the first unit.

Since the developers' interests are not necessarily consistent with those of the property owners, the CIRAs' governing documents sometimes limit the authority of developer-controlled boards of directors. For example, they may be precluded from amending the CIRAs' bylaws or increasing its operating budget. Some states also mandate that CIRAs be audited when control is transferred from the developer to the property owners.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following is a common characteristic to all CIRAs?
  - a. CIRAs cannot be legal entities under state law.
  - b. Members share the use of common area property within the real estate development.
  - c. Property owners cannot own shares of stock in the development.
  - d. The board of directors provides the funding of the CIRA operations.
2. Which of the following accurately describes the type of CIRA known as a homeowners' association?
  - a. Members own their own dwellings and the land on which the dwelling sits.
  - b. Owners of the units own their individual living quarters but generally do not own real property in the development.
  - c. Residents own shares of stock or membership certificates but do not hold real estate titles.
  - d. The user is entitled to the right to use an accommodation in increments that occur on a repeating basis.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following is a common characteristic to all CIRAs? **(Page 149)**
  - a. CIRAs cannot be legal entities under state law. [This answer is incorrect. One of the common characteristics common to all CIRAs is that they are separate legal entities established under state laws and composed of the property owners within a specific real estate development.]
  - b. Members share the use of common area property within the real estate development. [This answer is correct. CIRAs share several common characteristics. One of these characteristics is that association members share the use of common area property within the real estate development. Some examples of common areas are parking lots, building elevators, and recreational facilities that are not owned and used exclusively by individual members.]**
  - c. Property owners cannot own shares of stock in the development. [This answer is incorrect. Property owners in the specific real estate developments may own lots and improvements, defined interior spaces, or shares of stock or membership certificates. This is a characteristic all CIRAs have in common.]
  - d. The board of directors provides the funding of the CIRA operations. [This answer is incorrect. Funding of the CIRA's operations is by periodic assessment of all members, not just the board of directors. This funding structure is a common characteristic to all CIRAs.]
2. Which of the following accurately describes the type of CIRA known as a homeowners' association? **(Page 150)**
  - a. Members own their own dwellings and the land on which the dwelling sits. [This answer is correct. Is it generally impossible to distinguish CIRAs by the physical appearance of the real estate development. Therefore they are primarily distinguished by the property owned by the CIRA members and by the CIRA. Homeowners' Associations (HOAs) are one of the principle types. Members of HOAs own their own dwellings and the land on which it sits. The HOAs, rather than the residents, have title to any real property within the development.]**
  - b. Owners of the units own their individual living quarters but generally do not own real property in the development. [This answer is incorrect. This type of CIRA is known as a condominium association. All unit owners in condominiums own their living quarters. They also have undivided percentage interests in the common property that is inseparable from ownership of the unit itself. Condominium owners usually do not have title to any real property within the development.]
  - c. Residents own shares of stock or membership certificates but do not hold real estate titles. [This answer is incorrect. This CIRA type is referred to as a Cooperative Housing Corporation. Residents of cooperatives own shares of stock or membership certificates in the corporation, which gives them the right to occupy a specific unit in the cooperative. The cooperative housing corporations, rather than the tenant-shareholders, have title to all real estate within the development, both in the common property and the individual units.]
  - d. The user is entitled to the right to use an accommodation in increments that occur on a repeating basis. [This answer is incorrect. This type of CIRA is called a timeshare development. The user is entitled to either a right to use the accommodation on a repeating basis, or fee simple ownership interest in an accommodation, coupled with specific rights. An example of a timeshare development is a resort condominium.]

## REGULATORY ENVIRONMENT

### Federal Regulations

The CIRA industry is not specifically regulated at the federal government level. Currently no federal laws have been enacted that regulate the creation of CIRAs or prescribe rules for performing their functions of maintaining common property and providing services for their members. Federal laws do regulate certain aspects of selling units in real estate developments, however, including condominiums and HOA communities. For example, the Interstate Land Sales Full Disclosure Act requires developers to register with the Office of Interstate Land Sales Registration before commencing any interstate sales. The Securities Act of 1933 applies if units are sold with emphasis on the economic benefits to the purchaser, such as when they are offered with a mandatory rental pool arrangement, if, according to the SEC's criteria, the sale is considered to be the offering of a security in the form of an investment contract. Real estate developments subject to the Securities Act of 1933 are not discussed in this course.

Some federal laws, such as those designed to ensure fair housing practices, focus on broad public policy issues and aim to protect consumers who purchase units in condominiums, HOA communities, or cooperatives. For example—

- The Fair Housing Amendments Act of 1988 prohibits discrimination in housing on the basis of handicap or familial status. It applies to almost all residential real estate sales and leases, including those in condominiums, homeowners' associations, and cooperatives. Under the law, unlawful discrimination based on familial status is subject to fines. There are exemptions to the Act, however, that apply to housing of older persons.
- The Condominium and Cooperative Conversion Protection and Abuse Relief Act offers, among other things, limited protection to unit owners from developer abuses that occur (a) during conversion of rental units to condominium or cooperatives and (b) before control of the CIRA is transferred to unit owners. For example, under the Act, the CIRA may be able to terminate long-term contracts or leases with the developer that were entered into before transition.

The Americans with Disabilities Act of 1990 gives civil rights protections to individuals with disabilities. The two sections of the Act that affect CIRAs—the “employment” and “public accommodation” provisions—are briefly summarized below:

- Under the Act's employment provisions, employers may not use qualification standards, employment tests, or other selection criteria that screen out individuals with disabilities unless the standards or other criteria are shown to be job related and necessary for the position. The Act also requires that employers make reasonable accommodations to enable disabled workers to perform their jobs. That may include making office facilities readily accessible to disabled workers as well as modifying work schedules and revising personnel policies and training manuals. The Act's employment provisions do not apply to employers with less than 15 employees.
- The Act's public accommodation provisions provide that disabled persons must be provided with opportunities to “full and equal enjoyment of the goods, services, facilities, privileges, advantages, or accommodations” enjoyed by other members of society. The public accommodation provisions apply only to CIRAs with facilities that may be used by nonmembers (for example, commercial condominiums, mixed-use residential and commercial CIRAs, or CIRAs that open certain of their facilities to nonmembers, such as recreational facilities). In other words, CIRAs are only exempt from the provisions of the Act if the use of their facilities is limited to members and their guests. In addition, it seems likely that the accommodation provisions also probably apply to any sales office maintained by the CIRA. The Act requires removal of barriers to disabled persons in places of public accommodation when it is “readily achievable” to do so, that is, when removal can be accomplished without much difficulty or expense. Examples of the types of modifications that would be readily achievable in most cases are adding wheelchair ramps and installing grab bars in toilets. When barrier removal is not readily achievable, an entity must provide access through alternative means. For example, assume a CIRA's club house, normally unused during the day, is rented to a day-care center that is open to both members and nonmembers. In

lieu of adding a wheelchair ramp, the day-care center might have an employee accompany the children of disabled parents out to the driveway at the end of the day and remain with the children at curbside until the parent arrives to pick them up.

**Lending and Lending-related Agencies.** Federal and quasi-federal agencies may be involved with common interest ownership developments in three primary ways:

- They may make mortgage loans to individuals purchasing units in the developments [for example, the Department of Veterans Affairs (VA)].
- They may provide mortgage insurance to lending institutions that make loans to individual purchasers [for example, the Federal Housing Administration (FHA)].
- They may provide a market for mortgages in the secondary market [for example, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)].

Each agency has established requirements that developments must meet before the agency will become involved in the financing process. Generally the requirements relate to the project's physical construction or occupancy rate or mandate that the CIRA's governing documents include certain minimum provisions regarding the authority of both the property owners and the CIRA to operate and maintain the property. Thus, the requirements generally do not directly affect the CIRA's financial statements.

Federal agencies place different levels of importance on insurance coverage and reserve funds. FHA requires certain reserve fund levels when providing blanket mortgage insurance to a cooperative association. Fannie Mae and Freddie Mac require reserve funds to be kept separate from operating funds. Freddie Mac also requires CIRAs to set aside funds for insurance deductibles within the CIRA's reserve funds. Freddie Mac requires condominium associations in high-risk areas of California either to have earthquake insurance before it buys mortgages for those units or pay an interest rate override to compensate the lender for the added risk assumed. Some lenders may penalize those CIRAs that do not have reserves through higher underwriting charges. Accountants for CIRAs with federal agency financing should consult the most recent information available from that federal agency.

**HUD Assisted Projects.** HUD has enacted numerous programs that provide direct loans, rent and interest subsidies, or mortgage insurance to condominiums and cooperatives. The objective of the newer HUD programs is to encourage the construction and maintenance of housing for a targeted segment of the population, such as low and moderate income families or the elderly. Many of the older HUD assistance programs, however, were not tied to financial ability but provided a method of financing cooperatives and condominiums before conventional financing from private institutional lenders was available.

The principal HUD programs covering cooperatives and condominiums are as follows:

### **Cooperative Programs**

- *Section 213 Cooperative Housing* insures mortgages made by private lending institutions for new construction and substantial rehabilitation of cooperative housing projects. While this program is authorized, few new projects are insured under this program. Most cooperatives now receive assistance under the Section 221(d)(3) insured loan programs.
- *Section 221(d)(3) Mortgage Insurance for Single Room Occupancy Projects* also provides mortgage insurance for new construction and substantial rehabilitation of cooperative housing projects. It serves a similar purpose as the Section 213 program described above but differs in terms of maximum allowable funding, down payment requirements for cooperative shares, and how insurance claim benefits will be paid to HUD approved lenders. The principal difference between the Section 221(d)(3) and 221(d)(4) programs is the loan-to-value ratios available to project owners. HUD insures up to 100% of replacement cost under Section 221(d)(3) projects owned by nonprofit or cooperative owners. Profit-motivated owners of Section 221(d)(3) projects and all Section 221(d)(4) projects can finance only up to 90% of replacement cost. Beginning in fiscal year 2013, HUD suspended the Section 221(d)(3) program unless the project to be financed also receives Low Income Housing Tax Credits (LIHTC).

- *Section 223(f) Mortgage Insurance for Purchase or Refinancing of Existing Projects* insures loans to purchase or refinance existing rental property not in need of substantial rehabilitation. Under the program, mortgage insurance is available (a) to refinance existing cooperative housing projects or (b) for the purchase and conversion of existing rental projects to cooperative housing.
- *Section 202 Supportive Housing for the Elderly* provides capital advances for the construction, rehabilitation, or acquisition with or without rehabilitation of structures that will serve as supportive housing for very low-income elderly persons, including the frail elderly. It provides rent subsidies for the projects to help make them affordable. Occupancy in Section 202 housing is open to any very low-income household comprised of at least one person who is at least 62 years old at the time of initial occupancy.
- *Section 811 Supportive Housing for Disabled Persons* provides capital advances for the construction or rehabilitation of housing occupied by disabled persons between the ages of 18 and 62. The advance does not have to be repaid as long as the housing remains available for very low-income persons with disabilities for at least 40 years.

### Condominium Programs

- *Section 234(d) Condominium Mortgage Insurance* insures loans to finance the construction or rehabilitation of housing projects that owners intend to sell as condominiums. No loans have been insured under this program for several years.

All cooperatives and condominiums receiving financial assistance are subject to specific HUD program requirements, which often include the following:

- Complying with criteria for resident eligibility and allowable financial assistance for low and moderate income housing.
- Obtaining approval for expenditures for construction, repairs and replacements, and operations.
- Accumulating funds for contingencies (referred to as “general operating reserves” or “GOR”) and for future major repairs and replacements.
- Maintaining accounting records in accordance with HUD guidelines.
- Periodic compliance and financial reporting including submission of annual financial statements.

Specific considerations for accountants providing services to HUD assisted cooperatives and condominiums and reporting on their financial statements are discussed later in this lesson.

### State Regulations

**Uniform Laws.** The CIRA industry is regulated primarily at the state level. Most recent state legislation is based on the following group of uniform state laws drafted by the National Conference of Commissioners on Uniform State Laws:

- Condominium Act.
- Planned Community Act.
- Common Interest Ownership Acts (applies to all types of common interest ownership developments; versions enacted in 1992, 1994, and 2008).

The uniform laws were drafted to encourage consistency among state statutes and also attempted to equitably address the conflicting interests of developers, purchasers, lenders, and other parties involved in common interest housing developments. Only a minority of states has adopted the uniform laws as their own. Many states, however, have used them as models for enacting their own legislation.

**Specific State Condominium Statutes.** All 50 states have enacted statutes to regulate condominium developments and condominium associations. States generally refer to the statute as a state condominium act, a state horizontal property act, or a state unit ownership act. Although the laws differ among the states, most include the key provisions of the Uniform Condominium Act. They are similar in their treatment of many aspects of creating and managing condominiums, generally covering the following matters:

- How to create the condominium.
  - Contents of legal documents to be filed.
  - Where the documents should be recorded.
- Unit owners' rights and obligations
  - Contents of unit deeds.
  - Description of the property owned by each unit owner including allocation of common property.
  - Provision for access to common property.
  - Restriction against conveying units and common property separately.
  - Responsibility for maintenance of common property and allocation of common expenses.
- Transition.
  - How control will be transferred from the developer to the individual property owners.
  - Developers' responsibilities for assessments on unsold units and other costs.
- Operating the condominium.
  - Organization and authority of CIRA.
  - Board of directors and officers.
  - Meeting requirements.
  - Allocation of voting interests and voting majority.
  - Lien rights of the CIRA and rights of secured lenders.
- Financial management.
  - Responsibility to maintain financial records.
  - Unit owners' right of access to financial records.
  - Requirement for accountants' report on annual financial statements.
- Modifying the covenants that govern the condominium.
  - Amending the condominium declaration.
  - Terminating the condominium.

Not surprisingly, states with concentrations of condominium developments, most notably California and Florida, have developed more extensive regulations, and they generally prescribe more specific operational procedures.



For example, some state laws require CIRAs to incorporate or address matters such as obtaining insurance for the condominium, method of handling casualty losses, and explicit duties and functions of the CIRA's boards of directors.

**HOA and Cooperative State Statutes.** As a general rule, states do not regulate HOA communities or cooperatives as strictly as condominiums. Only a few states have adopted statutes specifically governing their operation and management. Absent detailed laws, the states rely primarily on their general property laws, in the case of HOA communities, and on their business or nonprofit corporation laws, in the case of cooperatives. In many respects, cooperatives are treated as any other landlord, and laws governing tenant/landlord relationships may apply.

### Privacy Regulations

Protection of personal and financial information has become an increasingly important issue over the last decade as the incidence of failure to adequately protect personal information has become common. Congress has already enacted certain privacy laws to specifically regulate some industries, such as financial institutions and health care providers. A discussion of prominent federal regulations addressing privacy that may affect CIRAs follows.

**The Fair and Accurate Credit Transactions Act.** The Fair and Accurate Credit Transactions Act (FACTA), enacted in December 2003, was passed in part to protect consumers against identity theft. All entities within the United States that regularly use consumer credit information or report information to national consumer reporting agencies are subject to the provisions of FACTA.

One important provision of FACTA requires appropriate measures to dispose of information derived from consumer reports. Any entity that maintains or possesses consumer report information for a business purpose (in electronic or paper form) must take reasonable measures to protect against unauthorized access or use of such information in connection with its disposal. While FACTA provides disposal guidelines, the standard for disposal is intentionally flexible so that individual entities can determine what measures are reasonable based on the sensitivity of the information, the costs and benefits of different disposal methods, and relevant changes in technology over time. FACTA directed various agencies, including the FTC, the Federal Reserve Board, the FDIC, the SEC, and others, to adopt comparable and consistent rules regarding the disposal of sensitive consumer report information. The FTC's website has information to educate businesses about these requirements at [www.consumer.ftc.gov](http://www.consumer.ftc.gov) Associations (and their accountants) should consider whether the association's operational practices require compliance with these regulations. Noncompliance can include civil liability damages, class-action lawsuits, and both federal and state fines.

**Privacy Considerations.** As a result of continuing significant confidentiality issues, including millions of instances of identity theft, privacy regulations continue to develop. Future editions of this course will provide updates on new privacy protection legislation affecting CIRAs.

### Significance to Accountants

Accountants should be familiar with laws and regulations governing CIRAs because they may affect the CIRA's operations or the manner of reporting transactions in their financial statements. For example, common provisions of state laws require the CIRA's financial statements—

- to be audited, reviewed, or compiled by independent accountants, depending on the amount of the CIRA's annual revenues;
- to disclose certain information not required by GAAP, such as specific categories of revenues and expenses;
- to be delivered to all unit owners within a specified period of time after the CIRA's year-end.

Often, laws govern levying and collecting assessments, assessing late charges for delinquent payments, or establishing separate bank accounts for funds for major repairs and replacements of common property. Other laws require CIRAs or their members to engage in some form of alternative dispute resolution (ADR) before filing a lawsuit. Some state laws, such as those prohibiting CIRAs from levying fines for covenant violations, may directly affect the amounts reported in the financial statements.

## INDUSTRY TRENDS

### Some Statistics

Owning residences in communities managed by CIRAs is a principal form of home ownership in the U.S. In 2016, the Community Associations Institute (CAI) estimated that 342,000 community associations exist, consisting of 26.3 million housing units. Consider the following additional statistics:

- Approximately 69 million Americans live in community associations.
- In 2016, community associations have collected approximately \$88 billion in annual assessments.
- Assessments collected for the repair, replacement and enhancement of common property totaled approximately \$25 billion in 2016.

Community associations have demonstrated the ability to satisfy a full range of housing needs, from starter homes to retirement communities, primary residences to vacation homes, and low-income housing to the most expensive housing available.

Approximately 42%–45% of the community association housing units in the U.S. are condominiums and 51–55% are HOAs. Cooperatives, which represent 3%–4% of community association housing units, are prevalent primarily on the east coast and were used extensively to provide individual ownership of large real estate projects before the existence of state legislation enabling the condominium form of ownership. Most new developments in urban areas today, however, are condominiums.

### Advantages of CIRA Developments

**Economic Pressures.** Today, with local governments fighting budget restrictions, real estate developers are often forced to provide certain infrastructure traditionally provided by government, such as streets and water and sewer facilities. Land costs also have increased dramatically. In the face of that pressure, some developers turn to CIRA developments to reduce housing costs by constructing higher density projects, such as condominiums and planned communities, with associations of property owners that will be responsible for the ongoing maintenance of that infrastructure. Many homeowners themselves face similar economic pressures. Comparable single-family homes may be more expensive, and mortgage costs and home operating and maintenance expenses continue to escalate.

**Community Considerations.** Some associations now serve homeowners who choose to live in an “exclusive” community. Certain homeowners’ associations cater to upper-income individuals who select community associations based on lifestyle and community considerations rather than economic considerations. Many “gated” communities are being created to provide an increased level of security for association residents and a wide range of high-end amenities to enrich resident lifestyle. Other associations cater to active adult, senior citizen, and young family lifestyles. In addition, some specialized homeowners’ associations may cater to boaters, while others are “fly-in” associations with their own private airports.

**Demographic Factors and Life-style Changes.** An aging population, a growing number of working couples and single women, and an increased desire for leisure time also create a demand for the low maintenance property ownership and recreational amenities that CIRA developments offer. Previous living patterns that emphasized the desirability of suburban living are frequently being replaced by preferences toward residing nearer to urban centers to take advantage of the proximity to job markets, cultural attractions, and social activities.

**Scarcity of Natural Resources.** The basic law of supply and demand also is influencing the move toward CIRA developments. The scarcity of land in many metropolitan areas, land use restrictions enacted by city and county governments, energy shortages, lack of water and sewer capabilities in outlying areas, and environmental concerns all support the trend toward CIRA developments.

### The Future

The trend toward common interest housing communities does not mean that the conventional single-family residence is a thing of the past, but it does indicate that CIRA developments remain an increasingly important factor

in the housing future of this country. CAI predicts that some of the trends for the future of community associations include the following:

- Living in a community association will continue to be a popular housing choice.
- There will be more emphasis placed on community harmony.
- Community associations will continue to reflect the racial and cultural diversity of the U.S.
- Associations will continue to adapt to address social issues such as the need for residential day care and aging facilities for members.
- Community associations will provide inclusionary housing to low-income and moderate-income homebuyers.
- "Smart communities" will incorporate new technologies to improve connectivity with schools, hospitals, municipal government, and businesses.

A significant future trend that will impact CIRA developments as profoundly as it will affect all segments of American society is the aging population. The *older* population [defined by the U.S. Department of Health and Human Services (HHS) as persons 65 or older] totaled 47.8 million persons in 2015. In 2015, almost one in every seven persons (or 14.9% of the U.S. population) was an older American. However, this aging trend is just beginning as the *Baby Boom* generation approaches retirement age. The United States Census Bureau projects 88 million persons will be at least age 65 by the year 2050. The social, economic, and physical health of the *older* population will naturally impact CIRA developments.

In addition to future changes in community associations, the common interest ownership concept also includes properties other than residential housing, such as the following:

- Commercial and industrial condominiums, such as industrial parks, shopping centers, and professional buildings.
- Mixed-use condominiums that include facilities such as a shopping mall, a hotel, offices, and residential units. (See discussion earlier in this lesson.)
- Resort condominiums, such as timeshare and condo-hotel developments.
- Land condominiums, such as parking facilities, marinas, docks, and recreational vehicles.

### **What Does It Mean for Accountants?**

Obviously, any changing industry offers practice development opportunities, and the potential for reaching new clients and expanding services is not limited to just CIRAs themselves. Marketing efforts can be directed toward all parties involved in each aspect of the industry, such as architects, developers, contractors, financiers, management companies, and unit owners. Accountants' involvement with CIRAs is discussed later in this lesson.

## CIRA Membership Organizations

The following membership organizations can provide more information about CIRAs:

- *Community Associations Institute* (CAI) is a nonprofit educational organization serving the CIRA industry. It provides educational seminars and publishes a wide variety of newsletters and books on various aspects of CIRAs. Information about membership, publications, and seminars may be obtained online at **[www.caionline.org](http://www.caionline.org)**.
- *National Association of Housing Cooperatives* (NAHC), a nonprofit organization promoting the interests of cooperative housing communities, publishes newsletters and other information on various aspects of cooperatives. It is the only national cooperative housing organization. Information about membership, publications, and conferences may be obtained online at **[www.coophousing.org](http://www.coophousing.org)**.
- *American Resort Development Association* (ARDA) is a trade association representing the vacation ownership and resort development industries. ARDA's membership includes companies with interests in vacation ownership resorts, community development, fractional ownership, camp resorts, land development, lot sales, second homes, and resort communities. Members range from small, privately held firms to publicly traded companies and international corporations. Information about membership, publications, and seminars may be obtained online at **[www.arda.org](http://www.arda.org)**.
- *Community Association Managers International Certification Board* (CAMICB) (formerly the National Board of Certification for Community Association Managers or NBC-CAM) is an independent certification organization incorporated by CAI. Its sole purpose is to provide a certification program for community association managers resulting in a nationally recognized credential. Information about manager certification can be obtained online at **[www.camicb.org](http://www.camicb.org)**.
- *Institute of Real Estate Management* (IREM) is a nonprofit organization serving the needs of real estate professionals. Unlike the other organizations listed previously, IREM is not designed to provide services solely to the CIRA industry. IREM focuses on commercial real estate and residential management, which includes CIRA management. Information on membership and services provided can be obtained online at **[www.irem.org](http://www.irem.org)**.

## Management Designations within the CIRA Industry

The following is a list of nationally recognized management or other community association professional credentials or designations, presented by issuing organization:

- Community Associations Institute (CAI)
  - AMS—Association Management Specialist
  - PCAM—Professional Community Association Manager
  - AAMC—Accredited Association Management Company
  - LSM—Large-Scale Manager
  - RS—Reserve Specialist
  - CIRMS—Community Insurance and Risk Management Specialist
- Community Association Managers International Certification Board (CAMICB)
  - CMCA—Certified Manager of Community Associations
- American Resort Development Association (ARDA)
  - RRP—Registered Resort Professional

- ARP—Associate Resort Professional
- Institute of Real Estate Management (IREM)
  - CPM—Certified Property Manager
  - ARM—Accredited Residential Manager
  - AMO—Accredited Management Organization
- National Association of Housing Cooperatives (NAHC)
  - RCM—Registered Cooperative Manager

## ACCOUNTANTS' INVOLVEMENT WITH CIRAS

### Reporting on Financial Statements

Virtually all CIRAs are subject to annual financial reporting requirements imposed by either state statute or their own governing documents. Thus, accountants primarily are involved with CIRAs because they are engaged to audit, review, or compile and report on the CIRA's annual financial statements. The level of service that accountants provide depends on several factors, the more important of which are the following:

- Level of service specified by state statutes or the CIRA's governing bodies.
- Needs of the users of the financial statements.
- Cost of the engagement relative to other alternatives.
- Auditor independence.

Accountants may also be requested to provide financial statement services for an entity closely affiliated with, but separate from, the CIRA. A common example would be a social or recreation club that is administered by the CIRA and consists of certain, but not all, of the members of the CIRA. Since membership in the organization is not mandatory and is not an inseparable part of the common property, the club is not a part of the CIRA. (Lesson 2 includes a discussion of other types of cash funds CIRAs may hold and the related financial statement treatment.)

As noted previously, cooperatives and condominiums receiving HUD financial assistance are required to submit annual financial statements to HUD. The financial statements are not required to be audited unless the CIRA's HUD assistance meets certain thresholds established by HUD. If an audit is required by HUD, it should be performed in accordance with generally accepted auditing standards (GAAS), generally accepted governmental auditing standards (GAGAS), and the *Consolidated Audit Guide for Audits of HUD Programs*, which exceed GAAS requirements in certain respects.

Providing services to HUD-assisted CIRAs is not specifically discussed in this course. However, GAGAS (as established by *Government Auditing Standards*), the *Consolidated Audit Guide for Audits of HUD Programs*, and numerous HUD Handbooks provide detailed guidance on accountant qualifications, specific program compliance, financial statement format and disclosures, and reporting. *PPC's Guide to HUD Audits* focuses on HUD-assisted multifamily housing projects owned by business entities (for-profit entities) and nonprofit entities and can be ordered online at [tax.thomsonreuters.com](http://tax.thomsonreuters.com).

**Independence.** A CPA who is not independent with respect to a CIRA may not issue an audit or review report on the CIRA's financial statements. (An accountant who is not independent may issue a compilation report on the financial statements of the CIRA if the lack of independence is disclosed.) The CPA's independence may therefore have a significant impact on the level of service provided for a CIRA.

The AICPA *Code of Professional Conduct* (see the discussion later in this lesson) requires independence in the performance of attest services, such as audit or review. AICPA members are required to apply the risk-based

approach of the *Conceptual Framework for Independence and Ethical Conflicts* when making independence-related decisions unless the related circumstances are explicitly addressed by the Code. Under that risk-based approach, a member's relationship with a client is evaluated to determine whether it presents an unacceptable risk to independence. The evaluation gives consideration to threats to independence and related safeguards. If a relationship would compromise the member's professional judgment when rendering an attest service, the risk is unacceptable. The risk is also unacceptable if an informed third party having knowledge of all relevant information would perceive the relationship to be compromising.

## Tax Services

Due to the complexity of income tax rules, CIRAs usually depend on the expertise of outside accountants for tax services. Most CIRAs are taxed on nonexempt function income, nonmember income, or nonpatronage income. They generally are taxed as corporations. Condominium associations, HOAs, and timeshare associations may elect to file their federal income tax returns either on Form 1120 or on a special corporate tax return for homeowners' associations, Form 1120-H. All subchapter T cooperatives are required to file special Form 1120-C for cooperative associations. In rare cases, HOAs are exempt from taxation but still must file an information return on Form 990.

In a cooperative, the corporation, rather than its individual tenant-shareholders, is directly liable for mortgage interest and property taxes for the entire building. If the cooperative meets certain conditions, however, IRS rules permit the tenant-shareholders to deduct their proportionate share of the mortgage interest and real estate taxes paid by the cooperative on their personal income tax returns. Thus, in addition to preparing income tax returns for the CIRA itself, cooperatives usually engage accountants to provide annual information to their tenant-shareholders about their allowable deductions for mortgage interest and real estate taxes.

## Replacement Fund Studies

As explained previously, one of the CIRA's primary responsibilities is to maintain the project's common property. To carry out that responsibility, some CIRAs either elect or are required to assess their members to provide funds for future major repairs and replacements of the property. Often the amount to be assessed is determined after the following studies of the property:

### A "component" study

- Inventories the common property
- Assesses its current condition
- Estimates its remaining life
- Estimates its replacement cost

### A "funding" study

- Determines required funding levels
- Provides alternative funding models

Although replacement fund studies (often called "reserve studies") generally are performed by professional engineers or licensed contractors, accountants sometimes also accept engagements to perform them. Accountants' responsibilities for those engagements depend on the nature of the engagement. For example, a CIRA's board of directors may conduct a study to estimate future expenditures for major repairs and replacements and engage accountants to report on the reliability of that study. In most situations, that type of engagement is governed by the professional requirements in the AICPA's *Statements on Standards for Attestation Engagements* (SSAEs), because the accountants are expressing an opinion, conclusion, or findings about the reliability of subject matter or an assertion that is measured against suitable and available criteria. On the other hand, accountants may be asked to develop assumptions about the future costs of maintaining the CIRA's common property, often with the assistance of specialists. In that case, best practices indicate that the engagement is a consulting engagement rather than an attestation engagement because the accountants, not the CIRA, are assuming responsibility for the assumptions. In conducting and reporting on consulting engagements, accountants should look to the AICPA's *Statement on Standards for Consulting Services* for guidance. Accountants should not accept any engagement involving reserve studies, however, unless they have adequate knowledge of the subject matter and the requisite expertise to evaluate the assumptions inherent in the presentation.

Accountants who perform the CIRA's audit may also be asked to develop or assist in the development of the CIRA's replacement fund study. (The replacement fund study generally provides the basis for the supplementary information

required to be disclosed in conjunction with CIRA financial statements.) Developing or assisting in the development of the CIRA's replacement fund study is subject to the *Conceptual Framework for Independence* and *Ethical Conflicts* within the AICPA *Code of Professional Conduct* and the independence interpretations at ET 1.295 of the Code concerning nonattest services. Although auditors are not explicitly prohibited from performing or assisting in the performance of the CIRA's replacement fund study, auditors need to exercise caution when evaluating the facts and circumstances of their particular situation with the CIRA client to ensure that independence is not impaired by participating in such an engagement. This course also strongly cautions auditors against accepting reserve study consulting services without first carefully considering the *Conceptual Framework* and ET 1.295 to determine whether independence may be impaired.

### Nonattest Services

CIRAs often engage outside accountants to provide nonattest services such as preparing the CIRA tax return or providing other accounting and bookkeeping assistance. Whether the CIRA engages outside accountants to provide accounting and bookkeeping assistance often depends on whether their financial records are maintained internally or by a managing agent. If the CIRA hires a managing agent, its services generally include preparing the CIRA's annual operating budget; billing, collecting, and maintaining accountability for assessments from residents; preparing payroll tax returns; maintaining financial records; and preparing periodic financial reports for the CIRA's board of directors. On the other hand, self-managed CIRAs may engage outside accountants to assist in those areas.

Maintaining independence is a critical concern for accountants who perform CIRA audit services and also provide additional client assistance.

## AUTHORITATIVE LITERATURE

### Generally Accepted Auditing Standards

Auditors of CIRAs should conduct their audits in accordance with GAAS as established by the American Institute of Certified Public Accountants (AICPA). The AICPA *Code of Professional Conduct* requires members to comply with SASs. This course is updated for changes in professional literature and includes guidance about how those changes might affect audits of CIRAs. However, auditors are responsible for awareness and timely implementation of new pronouncements. This course recommends that firms have a system in place to ensure staff members are informed about current authoritative literature.

**Defining Professional Responsibility.** The auditor's degree of responsibility in complying with professional requirements is identified through two categories as follows (AU-C 200.25):

- *Unconditional Requirements.* Unconditional requirements are those that an auditor must follow in all cases if the circumstances apply to the requirement. Auditing standards use the word *must* to indicate an unconditional requirement.
- *Presumptively Mandatory Requirements.* An auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances when the auditor determines it necessary to depart from a relevant requirement. In that case, the auditor should perform alternative procedures to achieve the intent of the requirement (see AU-C 200.26). Auditing standards use the word *should* to indicate a presumptively mandatory requirement.

The auditor must document the justification for any necessary departure from a presumptively mandatory requirement of GAAS, along with how alternative procedures performed sufficiently achieve the intent of the requirement.

**Use of the Terms *Must* and *Should*.** Throughout this course, the terms *must* and *should* are used in accordance with AU-C 200.25. The term *is required* is used interchangeably with *should*.

**Form and Structure of the Auditing Standards.** Each auditing standard is divided into the following topics:

- *Introduction.* Includes matters such as the purpose and scope of the guidance, subject matter, effective date, and other introductory material.

- **Objectives.** Establishes objectives that allow the auditor to understand what to achieve under the standards. The auditor uses the objectives to determine whether additional procedures are necessary for their achievement and to evaluate whether sufficient appropriate audit evidence has been obtained.
- **Definitions.** Where relevant, provides key definitions that are relevant to the standard.
- **Requirements.** States the requirements that the auditor is to follow to achieve the objectives unless the standard is not relevant or the requirement is conditional and the condition does not exist.
- **Application and Other Explanatory Material.** Provides further guidance to the auditor in applying or understanding the requirements. While this material does not in itself impose a requirement, auditors should understand this guidance. How it is applied will depend on professional judgment in the circumstances considering the objectives of the standard. The requirements section references the applicable application and explanatory material. Also, when appropriate, considerations relating to smaller and less complex entities are also included in this section.

A standard may also contain exhibits or appendices. Appendices to a standard are part of the application and other explanatory material. The purpose and intended use of an appendix is explained in the standard or in the title and introduction of the appendix. Exhibits to standards are interpretive publications. Interpretive publications are not auditing standards and do not contain requirements. Rather, they are recommendations on applying the standards in particular circumstances that are issued under the authority of the Auditing Standards Board. Auditors are required to consider applicable interpretive publications when planning and performing the audit.

Within the AICPA *Professional Standards*, the auditing standards use "AU-C" section numbers. The organization of the AU-C sections (which aligns with the organization of the ISAs) is as follows:

- Preface.
- Glossary.
- AU-C Section 200–299: General Principles and Responsibilities.
- AU-C Section 300–499: Risk Assessment and Response to Assessed Risks.
- AU-C Section 500–599: Audit Evidence.
- AU-C Section 600–699: Using the Work of Others.
- AU-C Section 700–799: Audit Conclusions and Reporting.
- AU-C Section 800–899: Special Considerations.
- AU-C Section 900–999: Special Considerations in the United States.
- Appendixes.

AU-C Preface—*Principles Underlying an Audit Conducted in Accordance With Generally Accepted Auditing Standards*, contains the principles underlying an audit conducted in accordance with generally accepted auditing standards (the principles). These principles are not requirements and are not authoritative. They provide a framework that is helpful in understanding and explaining an audit and are organized to provide a structure for the codification of SASs. The structure addresses the purpose of an audit, responsibilities of the auditor, performance of the audit, and reporting.

**Overall Objectives and Requirements.** AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, contains the auditor's overall responsibilities in accordance with GAAS. The overall objectives of the auditor in conducting an audit of financial statements are as follows:

- Obtain reasonable assurance about whether the financial statements are free from material misstatement.



- In accordance with the auditor's findings, (a) report on the financial statements, and (b) make the communications required by GAAS.

The auditor must be independent of the entity when performing an engagement in accordance with GAAS unless (a) GAAS provides otherwise, or (b) law or regulation requires accepting the engagement and reporting on the financial statements. *PPC's Guide to Audits of Nonpublic Companies* discusses the overall objectives and related requirements to achieve the objectives in detail.

### **AICPA Code of Professional Conduct**

The AICPA *Code of Professional Conduct* provides guidance and rules that auditors need to comply with in connection with audit engagements. AU-C 220.A4 indicates that it sets forth the fundamental principles of professional ethics, including objectivity and independence. Auditors are required to be independent in the audit of the financial statements. AU-C 200.16 also requires auditors to follow ethical requirements that are relevant to the engagement.

The Code also establishes two broad based conceptual frameworks, one for members in public practice and one for members in business, that set forth requirements for situations in which a member has identified a threat to compliance with the rules in the Code and the relationship or circumstances creating the threat is not covered within the Code.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

3. Which of the following is **not** a primary way that federal or quasi-federal agencies may be involved with common interest ownership developments?
  - a. Making mortgage loans to individuals purchasing property in the developments.
  - b. Providing mortgage insurance to lending institutions.
  - c. Providing markets for mortgages in secondary markets.
  - d. Prohibiting discrimination in housing on the basis of handicap or familial status.
4. Which of the following statistics is accurate for CIRAs?
  - a. Annual assessments for community associations are over \$60 billion.
  - b. Owning a residence managed by a CIRA is a minor form of home ownership.
  - c. Community associations are not found in low-income housing developments.
  - d. Cooperatives represent a majority of community association housing units.
5. Clint is engaged to audit and report on a CIRA's financial statements. The CIRA receives HUD financial assistance and is required to submit audited financial statements to HUD. Which of the following is true concerning Clint's engagement?
  - a. Because Clint is auditing a CIRA, he can disregard state imposed financial reporting requirements.
  - b. Clint must perform the audit in accordance with GAAS, GAGAS, and the *Consolidated Audit Guide for Audits of HUD Programs*.
  - c. Clint must combine the closely affiliated recreation club into the CIRA audit.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

3. Which of the following is **not** a primary way that federal or quasi-federal agencies may be involved with common interest ownership developments? **(Page 160 )**
  - a. Making mortgage loans to individuals purchasing property in the developments. [This answer is incorrect. Federal and quasi-federal agencies are involved with common interest ownership developments in three primary ways. One of these is by making mortgage loans to individuals purchasing units in the developments such as the Department of Veterans Affairs (VA) loans.]
  - b. Providing mortgage insurance to lending institutions. [This answer is incorrect. One of the three primary ways that federal and quasi-federal agencies are involved with common interest ownership developments is by providing mortgage insurance to lending institutions that make loans to individual purchasers. An example of this is the Federal Housing Administration (FHA).]
  - c. Providing markets for mortgages in secondary markets. [This answer is incorrect. Both federal and quasi-federal agencies are involved with common interest ownership developments by providing a market for mortgages in the secondary market. For example, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).]
  - d. **Prohibiting discrimination in housing on the basis of handicap or familial status. [This answer is correct. Prohibiting this type of discrimination in housing is the purpose of The Fair Housing Amendments Act of 1988. Although it does apply to condominiums, homeowners' associations, and cooperatives it is not one of the three primary ways that federal or quasi-federal agencies are involved with common interest ownership developments.]**
4. Which of the following statistics is accurate for CIRAs? **(Page 164)**
  - a. **Annual assessments for community associations are over \$60 billion. [This answer is correct. In 2016, community associations had collected approximately \$88 billion in annual assessments. Assessments collected for repair, replacement and enhancement of common property totaled approximately \$25 billion in 2016.]**
  - b. Owning a residence managed by a CIRA is a minor form of home ownership. [This answer is incorrect. Owning residences in communities managed by CIRAs is a principal form of home ownership in the United States. In 2016, the CAI estimated that 342,000 community associations existed, consisting of 26.3 million housing units.]
  - c. Community associations are not found in low-income housing developments. [This answer is incorrect. Community associations have shown the ability to satisfy a full range of housing needs from starter homes to retirement communities, including vacation homes and low-income housing. They are not restricted to only expensive developments.]
  - d. Cooperatives represent a majority of community association housing units. [This answer is incorrect. Cooperatives only represent only 3% to 4% of community housing units and are prevalent primarily on the east coast.]
5. Clint is engaged to audit and report on a CIRA's financial statements. The CIRA receives HUD financial assistance and is required to submit audited financial statements to HUD. Which of the following is true concerning Clint's engagement? **(Page 167)**
  - a. Because Clint is auditing a CIRA, he can disregard state imposed financial reporting requirements. [This answer is incorrect. Virtually all CIRAs are subject to annual financial reporting requirements imposed by either state statute or their own governing documents. Therefore Clint cannot disregard state reporting requirements.]

- b. Clint must perform the audit in accordance with GAAS, GAGAS, and the *Consolidated Audit Guide for Audits of HUD Programs*. [This answer is correct. CIRA's receiving HUD financial assistance are required to submit annual financial statements to HUD. These statements are required to be audited if the assistance meets certain thresholds. Since the CIRA's audited statements are required by HUD, Clint should perform the audit in accordance with GAAS, GAGAS, and the *Consolidated Audit Guide for Audits of HUD Programs*, which exceed GAAS requirements in certain respects.]**
- c. Clint must combine the closely affiliated recreation club into the CIRA audit. [This answer is incorrect. Entities closely affiliated with, but separate from the CIRA, do not have to be combined with the CIRA. Since membership in the organization is not mandatory and is not an inseparable part of the common property, the club is not a part of the CIRA and Clint is not required to combine them.]



# Lesson 2: Accounting Principles and Practices for CIRAs

## INTRODUCTION

### AICPA Audit and Accounting Guide

Until 1991, the authoritative accounting literature did not specifically address accounting for CIRAs. Thus, not surprisingly, industry accounting practices were diverse because they often were based on a combination of GAAP for commercial businesses, regulatory requirements, and income tax rules. In response to increasing requests from accountants for guidance in auditing and accounting for CIRAs, the AICPA issued an audit and accounting guide titled *Common Interest Realty Associations* in September 1991. The guide's objectives included increasing the comparability of CIRAs' financial statements, which made them more useful and informative to financial statement users, and provided necessary guidance to accountants on the accounting principles that apply to CIRAs and on providing services to them. The principal focus of the guide was the accounting issues that were unique to CIRAs, which included the following:

- Accounting recognition and measurement of common property and facilities
- Accounting and financial statement disclosures of funds for future major repairs and replacements of common property
- Financial statement presentation for CIRAs

The requirements in that guide applied to *all* types of residential and nonresidential common interest realty associations, including condominium associations, homeowners' associations, cooperative housing corporations, and time-share associations.

### Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the authoritative guidance that affects CIRAs.
- Identify how CIRAs account for cash and cash equivalents and the disclosures and which type of marketable securities CIRAs can invest in and how to account for them.
- Determine the measurement of the amounts owed, the valuation of receivables, the appropriate classification on the financial statements for member assessments, reporting of other income and receivables, and accounting guidance for CIRAs related to common property and other real property.
- Identify the accounting treatment for prepaid expenses and other assets for CIRAs and the management of capital improvement funds.
- Recognize a CIRA's management of debt and other liabilities, including the financing options open to a CIRA, interfund transfers and security deposits and how a CIRA would report on members' equity and income taxes.

### GAAP for CIRAs

Prior to June 2009, the only accounting guidance that specifically applied to CIRAs was the AICPA Audit and Accounting Guide, *Common Interest Realty Associations*. Because the guide primarily dealt with transactions and events unique to CIRAs, accountants would have also needed to consider other accounting pronouncements in determining generally accepted accounting principles for CIRAs.

In June 2009, the FASB authorized the *FASB Accounting Standards Codification*™ as the single source of authoritative U.S. accounting and reporting standards for nongovernmental entities. Accordingly, there are now only two levels of GAAP—authoritative and nonauthoritative. The *FASB Accounting Standards Codification*™ includes all previously existing GAAP issued by standard-setters from more than 20 sources, including Accounting Principles Board Opinions, Accounting Research Bulletins, FASB Statements, FASB Staff Positions, FASB Interpretations,

AICPA Interpretations, AICPA Statements of Positions, EITF Abstracts, AICPA Practice Bulletins, and AICPA Audit and Accounting Guides. Thus, the FASB Codification superseded all existing GAAP guidance, including the accounting and financial reporting guidance presented in other publications such as the AICPA Audit and Accounting Guides, which are presented and maintained in the Codification. The accounting guidance previously included in the AICPA Guide, *Common Interest Realty Associations*, has been codified at FASB ASC 972. The framework for determining the appropriate accounting for CIRAs in areas for which specific GAAP does not exist is discussed below.

### **Framework for Determining Appropriate Accounting Principles for CIRAs**

FASB ASC 972 prescribes the appropriate accounting treatment for many transactions and events encountered by CIRAs, but since it is not comprehensive, accountants would need to also look to other GAAP in the FASB Codification in deciding how to account for transactions and events that are not addressed in FASB ASC 972.

**Are CIRAs Nonprofit Organizations?** When using the FASB Codification, it is first necessary to consider whether CIRAs are classified as nonprofit entities. FASB literature broadly classifies entities as *business enterprises* or *not-for-profit organizations*. The nonauthoritative SFAC No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, Paragraph 6, distinguishes not-for-profit organizations from business enterprises because they have the following characteristics:

- a. Receipts of significant amounts of resources from resource providers who do not expect to receive either repayment or economic benefits proportionate to resources provided.
- b. Operating purposes that are other than to provide goods or services at a profit or profit equivalent.
- c. Absence of defined ownership interests that can be sold, transferred, or redeemed, or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the organization.

SFAC No. 4 notes that the line between not-for-profit organizations and business enterprises is not always sharp since the incidence and relative importance of the preceding characteristics in any organization are different. CIRAs, for example, possess the second characteristic but generally are not considered to possess the first or last. Are CIRAs then outside of the definition of not-for-profit organizations? Paragraph 7 of SFAC No. 4 states:

Examples of organizations that clearly fall outside the focus of this Statement include all investor-owned enterprises and other types of organizations, such as mutual insurance companies and other mutual cooperative entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants. The objectives of financial reporting set forth in Concepts Statement 1 [*Objectives of Financial Reporting by Business Enterprises*] are appropriate for those types of organizations.

The characteristics and examples in Paragraphs 6 and 7 of SFAC No. 4 are repeated in the definition of not-for-profit organizations in FASB ASC 958-20. Thus, although SFAC No. 4 and the two FASB statements do not specifically exclude condominium associations, homeowners' associations, housing cooperatives, and time-share associations, such associations seem more likely to fall in the excluded category of entities that operate for the direct economic benefit of members or shareholders. Consequently, they would not consider them to be nonprofit organizations for purposes of applying GAAP and would look to GAAP for commercial businesses for accounting guidance if it addresses transactions that are analogous to those encountered by CIRAs. Although CIRAs are not considered to be nonprofit organizations, they may be tax-exempt. The tax-exempt designation is used for purposes of applying tax law, not accounting principles.

**Using the FASB Codification to Determine GAAP for CIRAs.** FASB ASC 972 establishes accounting principles specifically applicable to CIRAs. In addition, when accounting for a transaction or event is not specified within a source of authoritative GAAP for that entity, CIRAs should look to accounting principles for similar transactions or events within other authoritative GAAP in the FASB Codification. Thus, as a general rule, if CIRA financial statements reflect transactions or events that are the same as or similar to those in GAAP financial statements of commercial businesses, similar accounting treatment is appropriate. For example, a CIRA's significant accounting policies



should be disclosed in conformity with FASB ASC 235-10-50 and any contingencies should be recorded and disclosed in the financial statements in conformity with FASB ASC 450-10-50. Other GAAP included in the FASB Codification might also be relevant to CIRAs in certain circumstances, such as accounting for leasing transactions (FASB ASC 840) and classifying obligations when a violation of debt covenants is waived by creditors (FASB ASC 470-10). If the accounting treatment for a transaction or event is not specified within authoritative GAAP, CIRAs then consider nonauthoritative guidance from other sources. Nonauthoritative sources of GAAP are discussed below.

**Grandfathered Guidance.** According to FASB ASC 105-10-70-1, some of the guidance specified by industry practices is considered as “grandfathered.” What this means for CIRAs is that if a CIRA followed and continues to follow an accounting treatment that conformed to industry practice as of March 15, 1992, it need not change to follow the guidance in the FASB Codification. (However, it is a best practice for all CIRAs to follow the provisions of the FASB Codification because it is believed to be the best thinking of the profession on accounting for CIRAs.) Furthermore, all CIRAs must conform with the guidance in the FASB Codification if the underlying pronouncement became effective after March 15, 1992.

**Nonauthoritative Guidance—Industry Accounting Practices.** With the effective date of the FASB Codification, accounting practices that are prevalent and widely accepted in a particular industry but are not included in the Codification have the status of nonauthoritative accounting guidance. (Previously, industry accounting practices that were prevalent and widely accepted were included in category d. of the GAAP hierarchy and could be considered as a source of GAAP in the absence of accounting guidance in a higher category of accounting guidance.) However, FASB ASC 105-10-05-2 indicates that entities may consider prevalent industry accounting practices when the accounting treatment for a transaction or event (or a similar transaction or event) is not specified in authoritative GAAP. In the CIRA industry, however, it may be difficult to determine whether industry accounting practices not included in the Codification are accepted practice because industry practice has historically been so diverse. Accounting principles for CIRAs also tend to be heavily influenced by state regulations and income tax requirements, and even though reliance on regulatory and tax accounting practices is prevalent in the industry, it cannot necessarily be characterized as GAAP. Nevertheless, certain accounting practices, such as presenting unclassified balance sheets, have widespread acceptance in the industry and are considered accepted practice.

**Other Nonauthoritative Guidance.** With the effective date of the FASB Codification, there are two levels of GAAP—the accounting principles included in the Codification, which are authoritative, and all other accounting guidance, which is nonauthoritative. Nonauthoritative guidance includes the following:

- Practices that are widely recognized and prevalent either generally or in the industry.
- Accounting guidance in the AICPA Guide but not incorporated into the FASB Codification.
- FASB Concepts Statements.
- AICPA Issues Papers.
- Technical Information Service Inquiries and Replies included in AICPA Technical Questions and Answers.
- International Accounting Standards of the International Accounting Standards Board.
- Pronouncements of other professional associations or regulatory agencies.
- Accounting textbooks, handbooks, and articles.

Accountants may consider nonauthoritative guidance when the accounting for a transaction or event (or a similar transaction or event) is not addressed in the FASB Codification. In that case, the appropriateness of the nonauthoritative guidance depends on (a) its relevance to the circumstances, (b) the specificity of the guidance, (c) the general recognition of the issuer or author as an authority, and (d) the extent of use in practice. For example, FASB Concepts Statements normally would be more influential than other sources.

## Using Present Value Information in Accounting Measurements

The nonauthoritative SFAC No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, provides a framework for using future cash flows as the basis for measuring assets and liabilities. According to SFAC No. 7:

- *The Present Value of Future Cash Flows Should Be Used to Value an Asset or Liability Only When Observable Marketplace Transactions for Similar Items Are Not Available.*
- *Estimated Cash Flows Should Reflect the Range of Possible Outcomes Rather Than a Single Amount.* Even though present value measurements traditionally have used a single “most-likely” cash flow amount, SFAC No. 7 states that using *all* estimates of possible cash flows rather than the single “most-likely” estimate may be a more effective method for measuring cash flows in many circumstances.
- *Estimated Interest Rates Should Reflect the Range of Possible Outcomes Rather Than a Single Rate.* Even though present value measurements traditionally have used a single interest rate that reflects the risk associated with the future cash flows, SFAC No. 7 states that such a rate cannot reflect uncertainties in timing. However, the “expected” cash flow method can be used to measure present value when the timing of cash flows is uncertain.
- *Financial Statement Preparers May Consider Cost-benefit Constraints When Deciding Whether to Use the “Expected” Cash Flow Method.*
- *The Measurement of a Liability Always Should Consider the Credit Standing of the Debtor.* The effect of a debtor’s credit standing on a liability’s fair value depends on the debtor’s ability to pay as well as provisions that protect debt holders. SFAC No. 7 states that the effect of a debtor’s credit standing generally is considered by adjusting the interest rate in the liability’s present value measurement.
- *A “Catch-up” Approach Is the Preferable Technique for Reporting Changes in Estimated Cash Flows.* A “catch-up” approach adjusts the carrying amount of an asset or liability to the present value of the revised estimated cash flows, discounted at the original effective interest rate.

Although FASB Concepts Statements do not change generally accepted accounting principles, they establish the objectives and concepts that the FASB uses in developing standards of financial accounting and reporting. Additional information about SFAC No. 7 and FASB Concept Statements in general can be found in *PPC’s Guide to Preparing Financial Statements*.

## Difference in Treatment of Specific Transactions for Financial Reporting and Tax Purposes

Some transactions may be treated differently for financial reporting and tax purposes. For example, initial contributions required by new members upon purchase of their units to provide the CIRA with additional working capital are treated as contributed capital for financial reporting purposes but as revenue for tax purposes.

## Determining the Reporting Entity—Subsidiaries, Committees, and Clubs

In most instances, the association is, by itself, the sole entity for financial reporting purposes. However, there are instances where other entities may be required to be included in financial reporting under GAAP. The financial results of a related entity need to be included in the financial statements of the reporting entity in either of the following situations:

- a. The reporting entity has an equity interest in another entity *and* has the ability to exercise significant influence over that entity.
- b. The reporting entity controls another entity.

Within the homeowners' association industry, this usually takes the form of one of the following types of organization:

- Subsidiaries.
- Committees.
- Clubs.

Some associations, primarily larger associations with extensive activities, may form a separate wholly-owned corporation to conduct activities that are separate from, but are directly related to or supportive of activities desired by members of the association. Legal liability issues related to the activities are often a driving force in creation of the separate corporations. Subsidiaries can be formed for activities such as the following:

- Commercial rentals of property.
- Equestrian operations.
- Golf operations.
- Water utility operations.
- Food and beverage operations.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. Which of the following is true regarding accounting guidance for CIRAs?
  - a. FASB ASC 972 provides comprehensive guidance to CIRAs.
  - b. CIRAs should apply guidance used for transactions or events similar to those in GAAP financial statements of commercial businesses.
  - c. CIRAs can find all the guidance needed in the ACIPA Audit and Accounting Guide, *Common Interest Realty Associations*.
  - d. CIRAs are classified as not-for-profit organizations for accounting treatment.
7. The accountant for the Bakersfield HOA is trying to determine the accounting method for future cash flows for measuring the assets and liabilities in the financial statements. Which of the following should the accountant follow?
  - a. Estimated cash flows should be based on a single amount within the financial statements.
  - b. The future value of cash flows should be used to value assets and liabilities in the financial statements.
  - c. Estimated cash flows should be reported on a discounted basis, adjusting the carrying amount of the assets and liabilities.
  - d. The accountant can consider the cost-benefit of using the "expected" cash flow method.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. Which of the following is true regarding accounting guidance for CIRAs? **(Page 178)**
- a. FASB ASC 972 provides comprehensive guidance to CIRAs. [This answer is incorrect. FASB ASC 972 prescribes the appropriate accounting treatment for many transactions and events encountered by CIRAs, but it is not comprehensive. Accountants would need to also look to other GAAP in the FASB Codification in deciding how to account for transactions and events that are not addressed in FASB ASC 972.]
  - b. CIRAs should apply guidance used for transactions or events similar to those in GAAP financial statements of commercial businesses. [This answer is correct. As a general rule, if CIRA financial statements reflect transactions or events that are the same as or similar to those in GAAP financial statements of commercial businesses, similar accounting treatment is appropriate.]**
  - c. CIRAs can find all the guidance needed in the AICPA Audit and Accounting Guide, *Common Interest Realty Associations*. [This answer is incorrect. Prior to June 2009, the only accounting guidance that specifically applied to CIRAs was the AICPA Audit and Accounting Guide, *Common Interest Realty Associations*. Because the guide primarily dealt with transactions and events unique to CIRAs, accountants would have also needed to consider other accounting pronouncements in determining generally accepted accounting principles for CIRAs.]
  - d. CIRAs are classified as not-for-profit organizations for accounting treatment. [This answer is incorrect. Although SFAC No. 4 and two FASB statements do not specifically exclude condominium associations, homeowners' associations, housing cooperatives, and time-share associations, it is believed such associations fall in the excluded category of entities that operate for the direct economic benefit of members or shareholders. Consequently, they would not consider them to be nonprofit organizations for purposes of applying GAAP.]
7. The accountant for the Bakersfield HOA is trying to determine the accounting method for future cash flows for measuring the assets and liabilities in the financial statements. Which of the following should the accountant follow? **(Page 180)**
- a. Estimated cash flows should be based on a single amount within the financial statements. [This answer is incorrect. SFAC No. 7 states that using all estimates of possible cash flows rather than the single "most-likely" estimate may be a more effective method for measuring cash flows in many circumstances.]
  - b. The future value of cash flows should be used to value assets and liabilities in the financial statements. [This answer is incorrect. The present value of future cash flows should be used to value an asset or liability only when observable marketplace transactions for similar items are not available per SFAC No. 7.]
  - c. Estimated cash flows should be reported on a discounted basis, adjusting the carrying amount of the assets and liabilities. [This answer is incorrect. A "catch-up" approach adjusts the carrying amount of an asset or liability to the present value of the revised estimated cash flows, discounted at the original effective interest rate as stated in SFAC No. 7.]
  - d. The accountant can consider the cost-benefit of using the "expected" cash flow method. [This answer is correct. According to SFAC No. 7, financial statement preparers may consider the cost-benefit constraints when deciding whether to use the "expected" cash flow method.]**

## CASH AND CASH EQUIVALENTS

### Overview of Accounting Standards

Cash and cash equivalents include demand deposits with banks and other financial institutions, cash on hand (for example, change funds and undeposited receipts), certificates of deposit, money market funds, and certain short-term investments such as Treasury bills. Accounting for cash and cash equivalents of common interest realty associations is virtually the same as accounting for similar assets in commercial businesses. However, since many CIRAs accumulate funds for future major repairs and replacements, cash is often more material to CIRAs' financial statements than to the financial statements of commercial businesses. The amounts recorded in the financial statements represent the amounts available to the CIRA at the balance sheet date, including any accrued interest (i.e., interest income should be recognized in the period it is earned). Other important accounting considerations relate to disclosures regarding cash and cash equivalents such as the following:

- *Restrictions.* Significant amounts of cash and cash equivalents that are not readily available for normal disbursements because of withdrawal restrictions should not be classified as cash and cash equivalents. For example, long-term certificates of deposit that are subject to a substantial penalty on withdrawal prior to maturity should be classified as investments rather than as cash and cash equivalents and the restrictions, if material, should be disclosed in the notes to the financial statements. On the other hand, certificates of deposit often are not subject to withdrawal limitations although withdrawal before maturity may result in a loss of a portion of the interest earned. In those circumstances, seems likely that the CDs may be included with "Cash." The CDs need not be separately disclosed in that case; however, disclosure is not prohibited.
- *Overdrafts.* CIRAs frequently have cash accounts with more than one financial institution. Generally, for each financial institution, all cash account balances should be totaled to determine whether the CIRA has a net positive or negative balance. If a net negative balance with a financial institution is immaterial, the account may be offset against positive balances in other financial institutions. However, if it is material, the accounts (a) should be included with liabilities, either presented separately or included with accounts payable, and (b) if the CIRA presents a classified balance sheet, should be included with current liabilities.
- *Held Checks.* "Held checks" dated at or before the balance sheet date (and reflected as outstanding checks on the bank reconciliation) that were not released until after the balance sheet date should be reclassified as accounts payable, if material.

Cash designated for special purposes should be segregated from cash available for general operations and normally, if it is legally restricted, should be excluded from current assets if the CIRA presents a classified balance sheet.

### Distinguishing between Cash, Cash Equivalents, and Investments

A statement of cash flows prepared in conformity with FASB ASC 230-10 is one of the basic financial statements that CIRAs are required to present. It is necessary to distinguish between cash, cash equivalents, and investments when preparing financial statements because FASB ASC 230-10 requires (a) the total amount of cash and cash equivalents shown in the statement of cash flows to be the same as similarly titled line items or subtotals in the balance sheet and (b) financial statement disclosures about the policy for determining which items are treated as cash equivalents. (In addition, FASB ASC 323-10 establishes accounting principles for debt securities the CIRA intends to hold to maturity that differ from those for debt securities classified as cash equivalents.) Thus, if there are several cash accounts in the balance sheet (for example, cash on hand, demand deposits, and money market accounts) that should be combined to agree with the statement of cash flows, the balance sheet either should combine or subtotal those amounts or additional disclosure should be presented either on the face of the cash flow statement or in the notes to the financial statements. Similarly, short-term investments that are not cash equivalents should not be combined in the balance sheet with cash and cash equivalents. Instead, the balance sheet should present those investments as a separate item and either show a single amount for cash and cash equivalents, with additional disclosures provided in the notes, if considered necessary, or subtotal cash and cash equivalents in the balance sheet. If a CIRA presents its financial statements using fund accounting, the balance sheet should (a) subtotal cash and cash equivalents and (b) segregate cash equivalents and investments for each fund.

**How Cash Is Defined.** FASB ASC 230-10-20 defines cash and cash equivalents as follows:

### CASH

#### *Definition (FASB ASC 230-10-20)*

. . . cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also may effectively withdraw funds at any time without prior notice or penalty . . .

#### *Examples:*

Certificates of deposit, money market accounts, and repurchase agreements that have the characteristics described above.

### CASH EQUIVALENTS

#### *Definition (FASB ASC 230-10-20)*

. . . short-term, highly liquid investments that (a) are readily convertible into known amounts of cash and (b) are so near to their maturity that they present insignificant risk of changes in value because of changes in interest rates.

#### *Examples:*

Treasury bills, commercial paper, money market accounts that are not classified as cash, and other short-term investments whose original maturity is three months or less. (Note that equity securities never meet the definition of cash equivalents.)

If penalties associated with certificates of deposit or money market accounts are material or if stated terms effectively restrict withdrawal of funds, the funds should not be classified as cash; rather, they should be classified as cash equivalents or as investments, depending on their maturity. Generally those accounts will be classified as investments rather than cash equivalents, however, since their original maturity will not be three months or less. Thus, most CIRAs will not have accounts that are classified as cash equivalents unless they have purchased Treasury bills or other short-term investments with an original maturity date of three months or less. Usually, a CIRA's cash-type accounts will meet the FASB ASC 230-10-20 definition of cash, or they will be classified as investments because they will not meet the three-month original maturity criterion.

While the classification of cash-type accounts as either cash or investments has little effect on the CIRA's balance sheet, how those amounts are classified does affect the CIRA's statement of cash flows. According to FASB ASC 230-10, cash receipts and payments from transactions affecting cash and from purchasing and selling cash equivalents should be reported as operating activities and may be presented net. However, cash receipts and payments from purchasing and selling investments should be reported as investing activities and are required to be reported at their gross amounts in the statement of cash flows. Some accountants impose a higher materiality threshold to evaluate whether certificates of deposit are subject to material withdrawal restrictions or penalties and, thus, should not be classified as cash.

**Accounting Policy for Determining Cash Equivalents.** Not all short-term investments that qualify as cash equivalents are required to be treated as such. A CIRA may elect to treat some qualifying investments as cash equivalents and other qualifying investments as short-term investments. However, if an entity has cash equivalents, FASB ASC 230-10-50-1 requires financial statements to disclose the policy for determining which items are treated as cash equivalents. It is a best practice to disclose that information in the accounting policies note to the financial statements.

**Financial Statement Presentation.** It is a best practice to present all cash accounts as a single line item in the balance sheet. (If the amounts include cash equivalents, a caption such as "Cash and cash equivalents" is appropriate.) If additional detail is considered necessary, (such as for combining the individual accounts that comprise the amount that agrees to the statement of cash flows), components may be disclosed in the notes to the financial statements or as supplementary information.

### Cash Designated for Specific Purposes

A CIRA's bylaws frequently stipulate that a portion of the annual assessments to unit owners will be set aside for future major repairs and replacements of the common property or other specific purposes rather than be used for



current operations. Funds designated in a CIRA's governing documents or by the unit owners for specific purposes are not legally restricted because a majority of the unit owners (as specified in the CIRA's governing documents) may subsequently decide to use the funds for other purposes. However, the funds seem to be similar to legally restricted funds since the CIRA's board of directors does not have the authority to reverse the decisions of the unit owners. Thus, such funds would be segregated from cash available for current operations in the CIRA's financial statements. Generally, CIRAs comply with that requirement by reporting the funds for future major repairs and replacements in a separate replacement fund. If the CIRA prepares its financial statements using a nonfund approach, FASB ASC 972-205-45-5 requires the fund for major repairs and replacements to be presented as an appropriation of retained earnings in the financial statements, such as the following:

Members' equity	
Designated by unit owners for future major repairs and replacements	\$ 83,000
Undesignated	6,500
	<hr/> 89,500

Designated funds are similar to restricted funds, but since they are not legally restricted, the term *restricted* should not be used in conjunction with them. (However, the term *restricted* would be appropriate if state regulations require that cash for the replacement of common property elements be maintained in an account that is separate from cash for operations.)

Additional disclosures about funds required to be segregated or the nature of funds designated by unit owners should be made in the notes to the financial statements regardless of whether the CIRA presents its financial statements using a fund or nonfund approach. GAAP also requires a CIRA's financial statements to disclose assessments that were used for purposes other than those for which they were designated.

**Interest Allocated between Operating and Replacement Funds.** When cash is invested in interest bearing savings accounts, certificates of deposit, or other short-term investments, any interest earned takes on the same character as the related investment (that is, either designated or undesignated) unless the CIRA has a specific policy to treat it otherwise. For example, a CIRA's governing documents or its board of directors may stipulate that interest earned on cash for operations or a portion of that interest be allocated to replacement funds. Since such an allocation is part of the current operating revenues, it should be reported as revenue in the statement of revenues and expenses rather than as an interfund transfer. When a CIRA's governing documents do not stipulate how interest earned is to be allocated between funds, the practitioner may look to the CIRA's operating budget and/or reserve study for an indication of how such funds are to be allocated.

**Legally Restricted Cash.** Cash that is legally restricted (for example, cash that lenders require CIRAs to maintain in a separate bank account as a condition of obtaining a loan or cash in certain HUD-assisted CIRAs) should be segregated from cash for normal operations. In addition, if CIRAs present classified balance sheets, *legally restricted cash* should be excluded from current assets and presented with other assets unless it is considered to offset debt that is classified as a current liability. For example, classifying restricted cash as a current asset would be appropriate when the cash is restricted to repay specific debt. The amount classified as a current asset should not exceed the amount of the related liability that is classified as current.

## Required Disclosures

In addition to the required financial statement disclosures related to cash equivalents and restricted cash as discussed in the preceding paragraphs, FASB ASC 825-10-50 requires all types of entities to disclose certain information about financial instruments that have concentrations of credit risk. Material amounts of cash invested in certificates of deposit or money market and other accounts that are not covered by insurance or are in excess of amounts insured represent concentrations of credit risk and should be disclosed.

## Other Cash Funds

Some CIRAs collect and hold funds as an accommodation to their members and, accordingly, they should not be recorded in the CIRA's financial statements. Distinguishing those cash funds from funds that CIRAs should record

in their financial statements, however, often requires judgment. For example, CIRAs may collect funds from the following sources:

- Members may be required to pay a deposit when they purchase units and receive their keys. The deposits are refunded to unit owners on the return of their keys when they sell their units.
- Members may purchase annual passes allowing them access to recreational facilities, such as a swimming pool or tennis court. Only members who purchase the passes may use the recreational facilities, but purchasing passes is voluntary.
- Unit owners may decide to organize picnics, Christmas parties, or other social events that members may voluntarily attend upon payment of a fee that is estimated to cover their proportionate share of the cost. As an accommodation to the unit owners, the CIRA collects the fee from unit owners who decide to participate.

It is a good idea to base decisions about whether miscellaneous collections should be recorded in the CIRA's financial statements on whether they result from activities associated with the CIRA's responsibilities of managing and maintaining the development's common property. Amounts that are budgeted as part of the CIRA's annual revenues or are included as part of members' annual assessments usually are considered to relate to the CIRA's primary responsibilities and, thus, be recorded in the CIRA's financial statements. Following that criterion, CIRAs should record amounts collected under the first two scenarios in the preceding paragraph in their financial statements, but not the last scenario. Amounts that CIRAs do not budget or collections from activities that CIRAs undertake as an accommodation to their members generally are not recorded in their financial statements, even if the CIRA authorizes the events, they include all of its members, or the CIRA bills and collects fees that are charged for the event.

While it may be preferable for the association not to get involved in accommodations to the unit owners, many associations do offer that service to their members when requested. When the CIRA collects fees from unit owners for these non-budgeted activities as an accommodation to the unit owners, the collected funds may be deposited into the CIRA's bank accounts rather than separate bank accounts (often because these social events operate on such an informal basis). If material, it is a best practice to segregate those collections into a separate trust fund if the CIRA uses fund accounting and if fund accounting is not used, disclosed on the face of the balance sheet or in the notes to the financial statements. Additionally, the amount of the cash balances at the balance sheet date, as well as the estimated extent of the total collections and the nature of the CIRA's responsibility under the arrangement should be disclosed in the financial statements. While the association may deposit money and write checks for these non-budgeted social events, the funds do not belong to the association. Accordingly, a liability should be recorded on the financial statements of the association rather than income or expense.

CIRAs sometimes receive contributions of personal property that has been purchased with social funds or other cash funds established by the CIRA's members. If the funds are not recorded in the CIRA's financial statements because they do not meet the criteria listed above for inclusion, the property should be capitalized in the operating fund (or separate property and equipment fund, if applicable) with an offsetting credit to contributed capital for the fair value of the donated property.

### **Segregation of Cash for Tax Purposes**

In addition to accounting for and financial statement presentation of cash accounts, IRS requirements for segregation of cash for tax purposes must be considered. The IRS has strict requirements regarding segregation of cash when Form 1120 is filed. While those requirements are not as stringent for filers of Form 1120-H, it is a best practice for cash to be segregated in the accounting records according to IRS guidelines to allow the CIRA the flexibility to elect either tax form in any given year.

## MARKETABLE SECURITIES

### Overview of Accounting Standards

Marketable securities consist of equity securities and debt securities. Equity securities generally represent an ownership interest in an entity, while debt securities represent a creditor relationship with an entity. Examples of debt and equity securities are as follows:

<u>Debt Securities</u>	<u>Equity Securities</u>
U.S. Treasury securities	Common stock
U.S. government agency securities	Stock rights and warrants
Municipal securities	

Although a CIRA's governing documents may restrict the type of investments that CIRAs may make, some CIRAs leave that decision to the board of directors. In most cases, CIRAs will invest primarily in debt securities, generally U.S. Treasury bills and notes.

CIRAs should account for investments in marketable securities in conformity with FASB ASC 320-10, *Investments—Debt and Equity Securities*. The following paragraphs summarize accounting principles for marketable securities. [Marketable securities that meet the definition of a derivative instrument should be accounted for in conformity with FASB ASC 815, *Derivatives and Hedging*, rather than FASB ASC 320-10.]

**Categorization of Securities.** Accounting for investments under FASB ASC 320-10 depends on (a) the type of security—either debt or equity—and (b) the entity's intent and ability to hold it to maturity. At acquisition, investments should be classified into one of the following categories:

- **Held to Maturity**—debt securities for which the entity has both the positive intent and ability to hold to maturity. Securities for which an entity has an intent to hold for an indefinite time or a lack of an intent to sell should not be classified in this category. If an entity's intent is uncertain, this category is not appropriate. A security cannot be classified as held to maturity if it can contractually be prepaid or otherwise settled in such a way that its holder would not recover substantially all of the recorded investment. A debt security with those characteristics should be evaluated in accordance with FASB ASC 815 to determine whether it contains an embedded derivative that must be accounted for separately.
- **Trading**—debt securities that do not meet the "intent to hold" criterion and equity securities that have readily determinable fair values, both of which are bought and held *principally* for the purpose of selling them in the near term (e.g., the entity's normal operating cycle) and thus *generally* are held for only a short period of time.
- **Available for Sale**—debt securities that do not meet the criterion to be classified as held to maturity or trading.

CIRAs generally will classify their securities into one of two categories—either held to maturity or available for sale. Accordingly, the provisions of FASB ASC 320-10 as they apply to trading securities are not discussed in detail in this course.

Exhibit 2-1 presents the accounting for investments required by FASB ASC 320-10. Debt and equity securities classified as available for sale should be recorded at fair value, and realized gains and losses are recorded in the statement of revenues and expenses in the period that they are earned. FASB ASC 220-10, *Comprehensive Income*, requires that unrealized gains and losses on available for sale securities be shown in a separate component of equity categorized as "other comprehensive income." (However, declines in value of individual securities below amortized cost that are other than temporary should be included in the excess of revenue over expenses. When this situation occurs, the lower-than-amortized-cost fair value becomes the new cost basis of the security. The new cost basis should not be changed for subsequent recoveries in fair value.) Debt securities classified as held to maturity are carried in the balance sheet at amortized cost (unless there is a decline in the value of individual securities that is not due to temporary declines), and realized gains and losses are recorded in the statement of revenues and expenses in the period that they are earned.

**Exhibit 2-1****FASB ASC 320-10 Requirements  
for Accounting for Investments<sup>a</sup>**

<b><u>Category</u></b>	<b><u>Type of Investment</u></b>	<b><u>Basis</u></b>	<b><u>Reporting Unrealized Gains and Losses</u></b>
Held to maturity	Debt—entity has positive intent and ability to hold to maturity, and the security cannot be contractually pre-paid or otherwise settled such that the security holder would not recover substantially all of its recorded investment	Amortized cost, reduced for non-temporary declines	Report nontemporary losses in the statement of revenues and expenses; do not recognize other unrealized gains and losses
Trading	Debt and equity—held principally for sale in the near term	Fair value	Report in the statement of revenues and expenses
Available for sale	Debt and equity other than above	Fair value	Report unrealized gains and losses as a separate component of other comprehensive income (as discussed in section ); report realized gains and losses and nontemporary losses in the statement of revenues and expenses

**Note:**

- <sup>a</sup> FASB ASC 320-10 does not apply to investments in equity securities for which either the equity method or consolidation is required. It applies to other investments in equity securities only if the fair value is readily determinable.

\* \* \*

**Applying GAAP for Marketable Securities to CIRAs**

Most CIRAs invest primarily in debt securities. Under FASB ASC 320-10, only debt securities classified as held to maturity are recognized at amortized cost; other debt securities are required to be accounted for at fair value. An explanation of why it seems likely that debt securities held by CIRAs may not meet the “held to maturity” criterion even though the CIRA may intend to hold the securities for a long term or an indefinite period appears below. Thus, at least a portion of the CIRA’s investments in debt securities often would be classified as “available for sale” under FASB ASC 320-10 and, accordingly, be accounted for at fair value. Under FASB ASC 320-10, realized gains and losses on debt securities classified as available for sale should be recognized in the period that they are earned. Unrealized gains and losses (except those that are other than temporary) should be recognized as a separate component of fund balance (or members’ equity) categorized as “other comprehensive income.”

If CIRAs have marketable equity securities, they generally classify them as available for sale. Accordingly, they are accounted for at fair value. Unrealized holding gains and losses are recognized as a separate component of fund balance (members’ equity) categorized as “other comprehensive income.”

**Determining Whether to Classify Debt Securities as Held to Maturity**

Categorizing securities may be challenging. The most difficult decisions are likely to surround whether debt securities meet the criteria to classify them as held to maturity. The held to maturity classification is deliberately

restrictive. Debt securities may be classified as held to maturity only if an entity has both (a) a positive intent to hold debt securities to maturity as well as (b) the ability to hold them to maturity. The positive intent and ability to hold criteria are more rigorous than "the mere absence of an intent to sell." In evaluating whether an entity meets those criteria, the held to maturity classification is not appropriate in the following circumstances:

- An entity's intent is uncertain (FASB ASC 320-10-25-3).
- An entity has the intent to hold the securities for only an indefinite period (FASB ASC 320-10-25-4).
- The security would be sold in response to changes in any of the following (FASB ASC 320-10-25-4):
  - a. Market interest rates and prepayment risk.
  - b. Liquidity demands.
  - c. Availability or yield of alternative investments.
  - d. Funding sources and terms.
  - e. Foreign currency risk.

To illustrate, assume that a CIRA invests cash held by its replacement fund in excess of current needs in Treasury bills. When purchased, the CIRA intends to hold the T bills to maturity and, historically, the CIRA has, in fact, held similar securities to maturity in many cases. Can the Treasury bills be classified as held to maturity? The answer depends on the circumstances.

As debt securities should not be classified as held to maturity if they would be available to be sold prior to maturity in response to the CIRA's need for liquidity (among other reasons). Thus, in determining whether the held to maturity classification is appropriate, consideration needs to be given to how the CIRA would respond to liquidity demands. For example, how would the CIRA respond if unanticipated repairs were necessary? Does the replacement fund have certificates of deposit or available for sale securities that could be sold to cover the cost of repairs? Would the CIRA be able to borrow the necessary funds from the operating fund? Would it levy special assessments? Would it borrow from a financial institution? To record the T bills as held to maturity, the likelihood of alternative funds must be realistic, and the CIRA must have the ability and intent to follow through with using alternative funds if liquidity needs arise. Accordingly, an assertion that the CIRA has the positive intent and ability to hold the T bills to maturity and would satisfy any liquidity needs that arose during the holding period by borrowing from a financial institution could not be supported if it were unlikely that the CIRA would be able to borrow the necessary funds. Similarly, an assertion that the CIRA would satisfy liquidity needs by borrowing from the operating fund could not be supported if the CIRA's financial position did not show sufficient liquidity. Likewise, an assertion that liquidity needs would be satisfied by levying special assessments could not be supported if it were unlikely the CIRA's members would agree to special assessments when the CIRA had the necessary funds invested in T bills. Similar evaluations should be made with respect to the other criteria listed previously.

FASB ASC 320-10-25-3 states that in establishing management's intention to hold securities to maturity, an entity's historical experience should be considered.

FASB ASC 320-10-25-6 provides only six changes in circumstances that may cause an entity to change its intent to hold securities to maturity *without calling into question its intent to hold other debt securities to maturity in the future* (emphasis added). The following are three of those exceptions that might, in rare cases, apply to CIRAs:

- Evidence of a significant deterioration in the issuer's creditworthiness.
- A change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not a change in tax law that revises the marginal tax rates applicable to interest income).
- A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, thereby causing an enterprise to dispose of a held to maturity security.

FASB ASC 320-10-25-7 states that it is not appropriate to apply the preceding exceptions to situations that are similar but not the same. Furthermore, the sale or transfer of a held to maturity security is permitted in response to events that are "isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated" without necessarily calling into question its intent to hold other securities to maturity. FASB ASC 320-10-25-10 explains that other than extremely remote disaster scenarios, such as a run on a bank or an insurance company, very few events would meet each aspect of that criteria.

**Consequence of Selling Held to Maturity Securities before Maturity.** Unless the sale or transfer before maturity meets the exceptions summarized previously, the sale or transfer calls into question an entity's intent to hold other debt securities to maturity in the future. Even if a held to maturity security is "accidentally" sold, it seems likely that the sale will taint the entity's intent to hold other debt securities to maturity, since an entity's controls and procedures should be adequate to prevent sales of held to maturity securities that do not meet the entity's accounting policies and the criteria of FASB ASC 320-10-25. In those circumstances, FASB ASC 320-10-35-9 states that *all securities that remain in the held to maturity category* should be reclassified as available for sale in the period in which the sale or transfer occurs (in other words, not only held to maturity securities of the same type). Furthermore, with respect to classifying debt securities as held to maturity in the future, FASB ASC 320-10-35-7 states that "judgment is required in determining when circumstances have changed such that management can assert with a greater degree of credibility that it now has the intent to hold debt securities to maturity." Since FASB ASC 320-10-25-3 requires an entity's historical experience to be considered in evaluating the appropriateness of the held to maturity category, an entity must demonstrate its ability to hold debt securities to maturity for some future period of time before the held to maturity classification would be appropriate again.

In summary, it seems that the held to maturity classification may not always be appropriate for a CIRA's debt securities. They recommend that CIRAs consider designating at least a reasonable portion of their debt securities portfolio as available for sale. As explained in the preceding paragraph, the consequences of selling or transferring debt securities classified as held to maturity before maturity are severe (i.e., reclassifying all remaining held to maturity securities as available for sale and not classifying any debt securities as held to maturity for some future period). Accordingly, exercising caution is recommended when classifying debt securities.

### Transferring Securities between Categories

An entity should reconsider whether a marketable security is properly categorized at each reporting date. Changes in circumstances, such as an entity no longer having the ability to hold a debt security to maturity, may cause a security to be re-categorized. Security transfers between categories of investments are accounted for in the new portfolio at fair value. The security's unrealized holding gain or loss at the date of the transfer is accounted for as follows:

- a. For securities transferred from the trading category, the unrealized holding gain or loss at the date of transfer has already been recognized in the excess of revenues over expenses and is not reversed.
- b. For securities transferred to the trading category, immediately recognize in the excess of revenues over expenses the portion of the unrealized holding gain or loss at the transfer date that has not been previously recognized.
- c. For debt securities transferred to the available for sale category from the held to maturity category, recognize the unrealized holding gain or loss in other comprehensive income at the transfer date.
- d. For debt securities transferred to the held to maturity category from the available for sale category, the unrealized holding gain or loss is treated as follows:
  - (1) The difference between the face value of the securities and their fair value at the date of the transfer is treated as a premium or discount and amortized over future years as a yield adjustment. Therefore, when the securities mature, their financial basis will be their face value. For example, if a debt security purchased for its \$50,000 face value has a \$70,000 fair value at the date of transfer, the \$20,000 excess of fair value over face value is amortized over the remaining life of the security through reductions in interest income recognized on the security. During the period between the transfer and maturity, the financial basis will therefore decline from \$70,000 to \$50,000, which is the amount due.

- (2) The unrealized appreciation or depreciation in the securities' fair value through the date of transfer continues to be reported as accumulated other comprehensive income, but is amortized over future years as a yield adjustment. For example, the \$20,000 excess of fair value over cost included in accumulated other comprehensive income in the preceding example is amortized over the remaining life of the security through increases in interest income. When the security matures, there will be no accumulated other comprehensive income related to it.

Amortization of the unrealized gain or loss reported in accumulated other comprehensive income offsets the effect of amortization of the premium or discount on interest income or expense. In other words, amortization of the difference between the securities' face value and fair value is offset by amortization of the related accumulated other comprehensive income. In financial statements after the transfer, the unrealized appreciation or depreciation disclosed in financial statements is the difference between the securities' fair value and fair value at the date of transfer, adjusted for unamortized premium or discount.

Available for sale securities should not be automatically transferred to the trading category merely because the entity decides to sell the security or because the passage of time has caused the security's maturity date to be within one year.

### Accounting for Treasury Securities

**Types of Treasury Securities.** Most CIRAs will invest primarily in debt securities, and often in U.S. Treasury securities. The types of Treasury securities are bills, notes, and bonds.

- Treasury bills, or T bills, are short-term obligations of the U.S. government with a term of one year or less. They require a minimum investment of \$10,000 and, when initially issued, are scheduled to mature in 3 months (13 weeks or 91 days), 6 months (26 weeks or 181 days), or 12 months. (T bills with different remaining maturities can also be purchased in secondary markets after they are initially issued.) T bills do not pay coupon interest; instead, they trade at a discount from their par value of \$10,000 and mature at par value. The discount, however, is based on the quoted yield, which is similar to an interest rate (and is the basis for determining interest rates in some agreements). The difference between the purchase price and the par value of the T bill is called "accrued interest," which is paid when the T bill matures. Physical certificates are not issued for T bill purchases; they are issued in book form only.
- Treasury notes are intermediate-term obligations of the U.S. government with terms of 2 to 10 years. They are initially issued at par value and can be purchased in \$1,000 denominations (although, depending on how they are purchased, a five note minimum may be required). Treasury notes pay semi-annual coupon interest, and they repay par value at maturity. Most Treasury notes are issued in book form only.
- Treasury bonds are similar to Treasury notes except that they have maturities over 10 years. They are initially issued at par value, pay semiannual coupon interest, and repay par value at maturity. The U.S. Treasury suspended issuance of Treasury bonds in October 2001. Most Treasury bonds are issued in book form only.

**Accounting for Treasury Bills.** When purchased, T bills should be recorded at cost, which will be a discount from their \$10,000 par value. For example, a CIRA would make the following entry to record the purchase of a 91-day T bill on September 14, 20X1, at 97:

Short-term investments	\$	9,700	
Cash			\$ 9,700
To record the purchase of T bill.			

Even though T bills do not pay coupon interest, the discount represents interest at the yield quoted at the date of acquisition. Accordingly, a question arises about whether the discount should be accreted during the period the T bill is held.

Specific guidance is provided for the *tax accounting* of T bills. According to IRC Section 454(b)(2), the discount is not accreted. If a T bill is held to maturity, all of the discount is reported as interest income. However, if it is sold prior to maturity, Section 1271(a)(3)(A) requires the following:

- Recognizing interest income in the amount of the discount that would have been accreted through the sale date.
- Treating the remainder of the difference between the sales proceeds and the acquisition cost as a short-term capital gain or loss.

Since tax rules view the discount as interest income and capital gain or loss is recognized only for value changes other than discount accretion, IRC Section 454's approach of not accreting seems to stem from the view that accretion normally is not material.

For *financial reporting*, the only guidance that addresses accounting for T bills is found in accounting textbooks and similar publications, and they differ in their conclusions about whether to accrete the discount. If the effect would be material to the financial statements, it is a best practice to accrete the discount because that is consistent with the general accounting for other discounts. As a practical matter, however, since T bills normally have low yields and mature over short periods, the effect of discount accretion seems unlikely to be material to the financial statements.

To illustrate the accounting considerations, if the discount on the T bill in the previous example were accreted and the CIRA's fiscal year ends in October, interest income of \$155 would be recognized for the year calculated as follows:

• Number of days since September 14 (date T bill was purchased)	47
• Number of days T bill is outstanding	91
• Discount (\$10,000 par value less \$9,700 acquisition cost)	\$300
• Discount accreted at the end of October ( $\$300 \times 47/91$ )	\$155

The following entry would record the accretion:

Short-term investments	\$	155	
Interest income			\$ 155
To accrete interest income on T bill.			

After that entry, the balance of the T bill would be \$9,855 (\$9,700 + \$155).

If the T bill were classified as a held to maturity security, it would be recorded in the CIRA's financial statements at \$9,855 if the discount were accreted and at \$9,700 if it were not. (Even though the financial statements would only report a net amount, separate general ledger accounts may be maintained for the par value and the discount.) If the T bill were classified as available for sale, FASB ASC 320-10 (formerly SFAS No. 115) requires it to be recorded at fair value. Accordingly, the CIRA would make an entry debiting or crediting the carrying amount of the T bill with a corresponding debit or credit to other comprehensive income.

**Determining Fair Value.** Quoted market prices are the most reliable evidence of fair value. T bills are quoted in terms of bid and asked prices. Instead of specifying a price for T bills, however, they are quoted at a discount from par value. For example, financial publications, such as the *Wall Street Journal*, often show market prices of T bills as follows:

<u>Maturity</u>	<u>Days to Maturity</u>	<u>Bid</u>	<u>Asked</u>	<u>Chg.</u>	<u>Yield</u>
Oct 10 'X6	97	5.18	5.16	+0.05	5.31

The first two columns indicate the date on which the T bills mature and the number of days remaining to maturity. As explained above, the bid and asked prices are quoted at discounts from par. In this example, the bid price



means an entity could sell a T bill from its portfolio maturing on October 10, 20X6, at a discount of 5.18% below par; it could purchase that T bill at a discount of 5.16% below par.

GAAP does not specify whether the bid price, the asked price, or some combination of the two represents the quoted price (i.e., fair value). It is a best practice to use the last bid price on the balance sheet date to estimate the fair value. Using the quotations in the preceding paragraph, fair value of a \$10,000 T bill would be determined as follows:

$$\text{Fair Value} = \$10,000 - \frac{(\$10,000 \times .0518 \times 97)}{360} = \$9,860.43$$

As illustrated below, applying the yield to the fair value over the period until the T bill matures will accrete it to \$10,000:

Quoted yield	\$ 5.31
Fair value	9,860.43
Interest income that would be earned if the investment were held for a year at the quoted yield = $\$9,860.43 \times .0531$	523.59
Number of days until maturity	97
Number of days in the denominator—while 360 days are used to calculate the price of a T bill, 365 days are used to calculate its yield	365
Interest that would be earned by holding the T bill until maturity = $\$523.59 \times \frac{97}{365}$	139.15
Accreted value at maturity = $\$9,860.43 + \$139.15$ (plus a rounding difference of \$.42)	10,000.00

If the T bill were classified as available for sale, an entry debiting investments and crediting other comprehensive income would be made to adjust the carrying amount of the T bill from cost to fair value. Since a T bill's fair value is a function of the quoted yield and the number of days to maturity, if the yield stays constant during the holding period, the fair value would change only by the amount of accreted interest. The short length of time to maturity makes significant changes in value due to economic conditions unlikely. Most of the change in value ordinarily would be from earned interest, and, therefore, if discount is accreted, the required fair value adjustment normally will be small. Thus, the effects are as follows:

- If discount is accreted, most of the change in value from the acquisition date is recorded as interest income. The effect of changes in quoted yield is recorded in other comprehensive income.
- If discount is not accreted, the required fair value adjustment consists primarily of accreted interest.
- The value of the T bill reported in the financial statements is the same whether or not discount is accreted.

As a practical matter, if the discount is accreted, the additional adjustment to record the T bill at fair value generally will not be material to the financial statements. If the discount is not accreted, there is a greater likelihood that the fair value adjustment would be material, but it may not be material in all cases.

**Accounting for Treasury Notes and Bonds.** Treasury notes and bonds may be purchased either at par (\$1,000) or above or below par, depending on market conditions. Like investments in corporate or municipal bonds, Treasury notes and bonds should be recorded at cost, and any discount or premium amortized to income using the interest method over the life of the securities. The interest method arrives at periodic interest, including amortization, that represents a level effective rate on the sum of the face amount of the investment plus or minus the unamortized premium or discount. For convenience, an investment account is typically debited for the par value of the bond or note, and related discount or premium is recorded in a separate account. For financial reporting, however, the investment account should be shown as a net amount.

To illustrate, a CIRA would make the following entry to record the purchase of 10 five-year Treasury notes at 129:

Investment in Treasury notes	\$ 10,000	
Premium on Treasury notes	2,900	
Cash		\$ 12,900
To record the purchase of Treasury notes.		

The yield implicit in the purchase price is 3.245% calculated on a semiannual basis (which is 6.49% interest). That is the rate that will discount 10 semiannual payments of \$668.75 and a single payment of \$10,000 due 10 semiannual periods from the purchase date to \$12,900. To find the premium amortization for the first six months, subtract interest calculated using the yield from the coupon interest. (A spreadsheet for calculating amortization of premium or accretion of discount is illustrated in Exhibit 2-2.)

Coupon interest	\$ 668.75
Interest using the yield ( $\$12,900 \times 3.245\%$ )	<u>418.60</u>
Premium amortization	<u>\$ 250.15</u>

### Exhibit 2-2

#### Calculating Premium Amortization or Discount Accretion

Premium amortization or discount accretion is the difference between the interest at the coupon rate and interest at the yield quoted when the Treasury obligation was bought. It can be calculated using a simple spreadsheet such as the following, which assumes 10 five-year notes totaling \$10,000 are purchased at 129 and bear coupon interest at 13.375% annually.

Par value	\$ 10,000.00
Purchase price	\$ 12,900.00
Period to maturity	
Number of years	5
Number of semiannual periods	10
Coupon rate	
Annual	13.3750 %
Semiannual	6.6875 %
Semiannual interest payments	\$ 668.75
Quoted yield at the date of purchase	
Annual	6.4900 %
Semiannual	3.2450 %

		<b>Investment Balance</b>	<b>Interest Income Using Yield</b>	<b>Premium Amortization</b>	<b>Principal Received</b>
Purchase		\$ 12,900.00			
Payment	1	12,649.85	\$ 418.60	\$ 250.15	
	2	12,391.59	410.49	258.26	
	3	12,124.95	402.11	266.64	
	4	11,849.65	393.45	275.30	
	5	11,565.42	384.52	284.23	
	6	11,271.97	375.30	293.45	
	7	10,969.00	365.78	302.97	
	8	10,656.19	355.94	312.81	
	9	10,333.23	345.79	322.96	
	10	0.00	<u>335.52</u>	<u>333.23</u>	\$ 10,000.00
			<u>\$ 3,787.50</u>	<u>\$ 2,900.00</u>	

**Notes:**

1. The premium amortization is computed by subtracting the interest income calculated using the yield from the coupon interest.
2. The investment balance is calculated by subtracting the premium amortization and principal received.
3. The method used in this illustration normally will result in a small balance at maturity, which can be charged or credited to interest income for the year of maturity. In this illustration, that adjustment increases interest income of the final period by \$ .21.
4. As an alternative, the investment balance could be calculated using present values, with premium amortization generally computed as the change in the investment balance. That requires present value calculations of the number of remaining interest payments and the single payment of par value at maturity.
5. The following illustrates the accounting entries:

Investment in Treasury notes	\$ 10,000.00	
Premium on Treasury notes	2,900.00	
Cash		\$ 12,900.00
To record acquisition of the Treasury notes.		
Cash	\$ 668.75	
Premium on Treasury notes		\$ 250.15
Interest income		418.60
To record receipt of the first interest payment.		
Cash	\$ 10,668.75	
Investment in Treasury notes		\$ 10,000.00
Premium on Treasury notes		333.23
Interest income		335.52
To record receipt of the final interest payment and the par value.		

6. Over the period the notes are held, the following would be recorded:

Cash received from 10 interest payments of \$668.75	\$ 6,687.50
Excess of \$12,900.00 cash paid for the notes over the \$10,000.00 received for their par value	(2,900.00)
Interest income recognized	<u>\$ 3,787.50</u>

\* \* \*

Every six months, the CIRA would record interest on the note and amortization of premium or discount. If the note had a coupon rate of  $13\frac{3}{8}$ , semiannual interest and premium amortization for the first six months would be recorded as follows:

Cash	\$ 668.75	
Premium on Treasury notes		\$ 250.15
Interest income		418.60
To record semiannual income on Treasury note (\$10,000 $\times$ $0.13375/2$ ) and premium amortization.		

The entry would result in the following amounts at the end of the first six months:

- Unamortized premium (\$2,900.00 initial amount less \$250.15) \$ 2,649.85
  - Investment (\$10,000 initial balance plus \$2,649.85 unamortized premium) \$ 12,649.85
- (The \$12,649.85 investment balance is the present value of nine semiannual interest payments of \$668.75 and a single payment of \$10,000 due nine semiannual periods from now, calculated using a semiannual yield of 3.245%.)
- Interest income (\$668.75 coupon less \$250.15 using yield) \$ 418.60

The yield quoted by the *Wall Street Journal* is based on the asked price. Nevertheless, the spread between the bid and asked prices normally is small enough that the yield for each price does not differ enough to materially affect the financial statements. Therefore, the quoted yield normally can be used to amortize the premium or accrete the discount.

Because Treasury notes and bonds pay coupon interest, it should be accrued and the premium or discount should be amortized as of the balance sheet. In addition, if notes or bonds are purchased between interest dates, the purchase of accrued interest also should be recorded. Similar to Treasury bills, when Treasury notes or bonds mature, an entry debiting cash and crediting investments should be made. If notes or bonds are sold before maturity, any related premium or discount would be eliminated, and accrued interest should be recorded if the sale occurs between interest dates.

If Treasury notes or bonds are classified as held to maturity securities at the balance sheet date, they should be recorded at amortized cost (that is, cost less amortization of premium or discount). If, on the other hand, they are classified as available for sale, GAAP requires them to be recorded at fair value. In that circumstance, the CIRA would record the fair value adjustment by debiting or crediting the carrying amount of the Treasury note or bond with a corresponding entry to other comprehensive income.

**Determining Fair Value.** The fair value of Treasury bonds or notes at the financial statement date is usually determined by reference to the last quoted bid price at that date. Financial publications, such as the *Wall Street Journal*, might report information such as the following:

<u>Rate</u>	<u>Maturity Mo/Yr</u>	<u>Bid</u>	<u>Asked</u>	<u>Chg.</u>	<u>Ask Yield</u>
6 <sup>7</sup> / <sub>8</sub>	July X9n	101:05	101:07	–7	6.43

The first column indicates the coupon rate—in this case, 6<sup>7</sup>/<sub>8</sub>%. The second column indicates that maturity of the Treasury note is July 20X9. (The “n” annotation indicates that this is a Treasury note rather than a bond.) The bid and asked quotes are not stated in percentages, as they are in the case of Treasury bills. Instead, numbers to the right of the colon represent 32nds of one point. In this case, the bid quote (the price at which an entity could sell) translates to 101<sup>5</sup>/<sub>32</sub> or \$1,011.56, and the asked quote (the price at which an entity could purchase) translates to 101<sup>7</sup>/<sub>32</sub> or \$1,012.19. The “ask yield” represents the yield to maturity on the note. Accordingly, the fair value of five notes maturing July 20X9 would be \$5,057.80 (\$1,011.56 × 5). If the Treasury note were classified as available for sale, the fair value adjustment would be recorded by debiting or crediting the carrying amount of the investments (cost plus or minus any related premium or discount) with a corresponding entry to other comprehensive income for the unrealized gain or loss.

**Presenting Unrealized Gains and Losses in Equity.** CIRAs should debit or credit the carrying amount of investments in available for sale marketable securities with a corresponding entry to other comprehensive income to record unrealized gains and losses on the securities and report them at fair value in the financial statements. FASB ASC 320-10-50-1 also requires the notes to the financial statements to disclose the following, by major security type, for available for sale securities: (a) amortized cost basis, (b) aggregate fair value, (c) total other-than-temporary impairment recognized in accumulated other comprehensive income, (d) total gains for securities with net gains recorded in accumulated other comprehensive income, and (e) total losses for securities with net losses recorded in accumulated other comprehensive income. For securities classified as held to maturity, the following disclosures, by major security type, are required: (a) amortized cost basis, (b) the aggregate fair value, (c) gross unrecognized holding gains, (d) gross unrecognized holding losses, (e) the net carrying amount, (f) total other-than-temporary impairment recognized in accumulated other comprehensive income, and (g) the gross gains and losses recorded in accumulated other comprehensive income for any derivatives that hedged the forecasted acquisition of the held to maturity securities. To keep track of that information, some CIRAs may prefer to use more than one account for available for sale securities, for example, initially recording all securities at cost and recording the offset to unrealized gains and losses in a separate valuation allowance account. While that practice is acceptable, the financial statements should present available for sale securities at a net amount—fair value—not cost plus or minus a valuation allowance.

FASB ASC 220-10-45-13 requires that unrealized gains and losses on available for sale securities be reported in other comprehensive income. A detailed discussion of unrealized gains and losses, comprehensive income, and illustrative financial statements are included in section .

## Derivative Instruments

FASB ASC 815, *Derivatives and Hedging*, establishes accounting and reporting standards for derivative instruments and hedging activities. FASB ASC 815 requires all entities to measure derivative instruments at fair value and recognize them as either assets or liabilities in the balance sheet. (In addition, it allows special accounting for hedging a foreign currency forecasted transaction with a derivative.) As with all accounting pronouncements, the provisions of FASB ASC 815 need not be applied to immaterial items. For example, a CIRA is not required to comply with FASB ASC 815 if its only derivative instrument is an immaterial speculative investment in a derivative.

AU-C 501 provides guidance on auditing financial statement assertions about derivatives accounted for following the requirements of FASB ASC 815. In addition, the AICPA audit guide, *Special Considerations in Auditing Financial Instruments*, also provides guidance. Although designed as audit guidance, the guidance in AU-C 501 and the audit guide is often helpful in other engagements as the audit guide has a variety of case studies that include illustrative accounting considerations. It is believed that CIRAs do not commonly use derivatives to manage risk. Accordingly, only general overview information about derivatives is provided in this discussion. For detailed

guidance on this topic, *PPC's Guide to Preparing Financial Statements* includes a full chapter about derivative instruments and applying FASB ASC 815. That guide can be ordered by calling (800) 431-9025, or online at [tax.thomsonreuters.com](http://tax.thomsonreuters.com).

**What Is a Derivative?** FASB ASC 815 defines a *derivative* as a financial instrument or other contract with all three of the following characteristics:

- a. It has at least one underlying and at least one notional amount or payment provision or both.
- b. It requires no initial net investment or an initial net investment less than required for other types of contracts expected to respond similarly to changes in market factors.
- c. Its terms require or allow net settlement; it can readily be settled net by a method outside the contract; or it provides for delivery of an asset that puts the recipient in a position similar to net settlement.

An *underlying* is a specified interest rate, security price, commodity price, foreign exchange rate, price or rate index, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). A *notional amount* is a specified number of currency units, shares, bushels, pounds, or other units. A *payment provision* specifies a fixed or determinable settlement to be made if the underlying performs in a specified manner. An underlying, along with either a notional amount or a payment provision, determines the settlement of a derivative. Therefore, a derivative instrument must have at least one underlying and at least one notional amount or payment provision (or both).

**Contracts Not Subject to FASB ASC 815.** FASB ASC 815 excludes some common types of contracts from its scope that, depending on the facts and circumstances, otherwise might be considered derivatives. Those contracts include normal purchases and sales, "regular-way" security trades, certain insurance contracts, financial guarantee contracts with certain characteristics, certain contracts not traded on an exchange, derivatives that prevent sales accounting, investments in life insurance, certain investment contracts, and certain loan commitments. In addition, derivative instruments do not include contracts that are (a) issued or held by the reporting entity, (b) indexed to its own stock, and (c) classified in statement of changes in fund balance in its balance sheet; issued by the entity in connection with stock-based compensation arrangements addressed in FASB ASC 718 or issued as contingent consideration in a business combination.

**Common Uses of Derivatives.** Derivatives offer a way for small and medium-sized entities to manage their exposure to risks and to speculate on changes in market conditions. Common derivatives, often referred to as "plain vanilla" derivatives, are available through banks and other sources. Examples of such derivatives include interest rate swaps, options to establish a range of interest rates, forward contracts to buy foreign currency, and options to buy foreign currency. CIRAs do not commonly use derivatives to manage risk.

**General Measurement Considerations.** FASB ASC 815 requires derivative instruments to be measured at fair value and reported in the balance sheet as assets or liabilities. Accounting for gains and losses (i.e., changes in fair value) depends on the intended use of the derivative. Gains and losses on derivative instruments not designated as hedging instruments should be recognized in the statement of revenues and expenses in the period of the change in fair value. Accounting for gains and losses on hedging instruments depends on the type of hedge.

One of the difficulties with accounting for derivatives is determining its fair value and the more complex the derivative, the more difficult it is to determine its fair value. The fair values of derivatives that are exchange-traded are available from independent pricing sources, such as financial publications. The fair values of other derivatives may be available through broker-dealers not affiliated with the entity. However, determining fair value can be particularly difficult if a derivative transaction has been customized to meet individual entity needs.

**General Disclosure Considerations.** Among other things, FASB ASC 815-10-50 requires disclosure of the objectives for holding hedging instruments, the risk management policy for each type of hedge, and the purpose of derivative instruments not designated as hedging instruments. It also requires disclosing information about changes in a derivative's fair value that relate to its ineffectiveness as a hedge and that are excluded from the assessment of hedge ineffectiveness.

## Accounting for Investments in Annuities

Some CIRAs invest in annuities. An annuity is an insurance contract that provides fixed or variable periodic payments made from a stated or contingent date and continuing for a specified period, such as for a number of years or for life. Typically, CIRAs invest in variable annuities, which specify the payments to be made in units rather than in dollars. When payment is due, the amount is determined based on the value of the investments in the annuity fund.

Annuities should be recorded at cost in the financial statements. Because they are not securities, they are not within the scope of FASB ASC 320-10. But annuities are financial instruments and, accordingly, the fair value of annuity contracts at the date of the financial statements should be disclosed in accordance with FASB ASC 825-10. FASB ASC 825-10 excludes insurance contracts *other than guarantees and investment contracts* from its scope; thus, the fair value disclosure requirements apply to annuities.

## Declines in Value That Are Other Than Temporary

When the fair value of an available for sale or held to maturity security declines below its amortized cost, the security is considered impaired. The CIRA needs to determine whether that impairment is other than temporary to properly account for, report, and disclose the security. The considerations for recognizing and measuring an other-than-temporary impairment loss are discussed in the following paragraphs.

FASB ASC 320-10-35-10 through 35-35A provide guidance regarding the meaning of other-than-temporary impairment and its application to debt and equity securities within the scope of FASB ASC 320-10. The ASC provides guidance for (a) determining when an investment is impaired; (b) determining whether the impairment is other than temporary; and (c) measuring, recognizing, presenting, and disclosing an impairment loss if the impairment is deemed other than temporary.

**Determining When an Investment Is Impaired.** An investment is deemed impaired if its fair value is less than its cost. For this purpose, cost includes adjustments made to an investment's cost of acquisition for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized in revenues and expenses (less any cumulative-effect adjustments), foreign exchange, and hedging. Generally, an investment should be assessed for impairment each reporting period, including interim periods if interim financial statements are issued. If an investment is deemed impaired, the impairment would be analyzed to determine if the impairment is other than temporary.

**Determining Whether the Impairment Is Other Than Temporary.** If an investment is deemed impaired, the next step is to determine whether the impairment is temporary or other than temporary. FASB ASC 320-10-35-30 states that other than temporary does not mean permanent, but it does not provide specific guidance on determining whether the decline in fair value below cost is temporary or other than temporary. Instead, it says to follow the appropriate guidance in either FASB ASC 320-10-35 and FASB ASC 325-40-35.

**Recognizing and Measuring an Impairment Loss.** An impairment loss should be recognized in earnings if the impairment is deemed to be other than temporary. The recognition and measurement of the loss depends on whether the investment is an equity security or a debt security. For an equity security, the loss is calculated as the difference between the cost and the fair value of the investment at the balance sheet date of the period for which the assessment is conducted. After recognizing the impairment loss, the fair value of the investment becomes its new cost basis, and the new basis is not adjusted for subsequent recoveries in fair value.

For debt securities, the amount of the other-than-temporary impairment recognized in earnings depends on whether the CIRA intends to sell the security (or whether it is more likely than not the CIRA will be required to sell the security) before recovery of the amortized cost basis less any current-period credit loss (that is, excess of the amortized cost over the present value of cash flows). If the CIRA plans to sell the security (or more likely than not it will be required to sell the security) before recovery, the other-than-temporary impairment should be recognized in earnings for the entire difference between the amortized cost basis and fair value at the balance sheet date. If there is no intention to sell the security and it is not more likely than not that the CIRA will be required to sell before recovery, the other-than-temporary impairment should be separated into amounts pertaining to (a) the credit loss and (b) all other factors. The amount related to the credit loss should be recognized in earnings, while the

remaining amount should be recognized in other comprehensive income (net of taxes). The prior amortized cost basis less the other-than-temporary impairment loss recognized in earnings becomes the new amortized cost basis of the security. That amount should not be adjusted for subsequent recoveries in fair value, but should be adjusted for accretion and amortization.

To illustrate the accounting for impairment of equity securities, assume that at the end of the prior year, an available for sale equity security costing \$50,000 was adjusted to its \$80,000 fair value through a \$30,000 increase in other comprehensive income. By the end of the current year, fair value declined to \$30,000, and the decline is determined to be other than temporary. At the end of the current year:

- a. The financial basis of the security should be decreased by \$50,000 from its \$80,000 fair value at the end of the prior year to its \$30,000 current fair value.
- b. A \$30,000 decrease in other comprehensive income should be recognized for the decrease in value from the security's \$80,000 fair value at the end of the prior year to its \$50,000 cost.
- c. A \$20,000 decrease in excess of revenues over expenses should be recognized for the decrease in value from the security's \$50,000 cost to its \$30,000 current fair value.

As a result, the security is reported at its \$30,000 fair value at the end of the current year, and there is no accumulated other comprehensive income for changes in its value. The new \$30,000 cost basis would be used to measure other comprehensive income for future changes in fair value. For example, if at the end of the next year, fair value increases to \$40,000, an increase of \$10,000 would be recognized in other comprehensive income. Subsequent recoveries in value are not recognized in excess of revenues over expenses until they are realized.

GAAP requires total other-than-temporary impairment losses to be presented separately on the face of the operations statement with an offset for the amount recognized in other comprehensive income. Amounts related to held-to-maturity and available-for-sale debt securities for which a portion of an other-than-temporary impairment has been recognized in earnings also must be presented separately in the financial statement where the components of accumulated other comprehensive income are reported. Finally, numerous disclosures are required related to impairments.

### **Income Tax Considerations**

Income tax rules do not allow deductions for unrealized investment losses. Thus, reductions of marketable securities for unrealized valuation declines, whether charged to current earnings or to other comprehensive income, create a temporary difference because the tax basis of the securities will exceed their basis for financial reporting. Similarly, unrealized gains are temporary differences. If the differences between financial and tax reporting are material, deferred taxes should be recorded.

In addition, interest on Treasury bills may be recorded in different periods for financial and tax purposes. If so, a temporary difference exists, and deferred taxes should be recorded.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. Which of the following is true regarding cash and cash equivalents for CIRAs?
  - a. Held checks dated before the balance sheet date that are material should be classified as accounts payable.
  - b. If a cash account at a financial institution is negative, it can be netted against all the other accounts that the CIRA has.
  - c. Cash is normally an immaterial part of a CIRA's financial statements.
  - d. All cash and cash equivalents, regardless of any restrictions placed on them, should be classified as cash and cash equivalents for CIRAs.
9. The River Bend Townhomes have a fund that was set up five years ago to save for a play park to be built in the facility for the homeowners' children. A portion of the yearly dues were designated for this purpose and placed in an interest bearing savings account. The accountant for River Bend Townhomes is creating the yearly financials. Which of the following guidance should the accountant follow for the designated fund?
  - a. A disclosure note about the play park funds should only be made in the financials if the accountant uses the fund approach.
  - b. The accountant should list that the funds are restricted for the purpose of the play park.
  - c. Interest earned on the designated funds should be included in the cash available on the CIRA's financial statements.
  - d. The accountant for River Bend Townhomes should segregate the cash allocated for the play park from other cash available.
10. The HOA of Town's Landing has invested excess funds in T bills. Which of the following is the appropriate way to provide for the tax accounting of the T bills that are held to maturity?
  - a. The discount related to the T bill should be reported as interest income.
  - b. The difference between the sales proceeds and acquisition cost should be recorded as a short term gain/loss.
  - c. The HOA should accrete the discount.
11. Which of the following is a characteristic of a derivative?
  - a. It has a fixed or determinable settlement to be made if the underlying performs in a specified manner.
  - b. It contains a specified interest rate, security price, commodity price, foreign exchange rate, price or rate index, or other variable.
  - c. It requires no initial net investment and the terms require or allow net settlement.
  - d. It holds a specified number of currency units, shares, bushels, pounds, or other units.

12. A CIRA holds an available-for-sale or held-to-maturity security; needs to determine whether an impairment is other than temporary; and properly account for, report, and disclose the security. Which of the following is correct regarding impairments?
- a. An impairment loss that is permanent should be recognized in the investment account on the balance sheet and written off in investment expense.
  - b. If an investment is impaired, the next step should be to determine if it is temporary or not.
  - c. A debt security's impairment amount should be recognized as a loss calculated as the difference between the cost and the fair value of the investment at the balance sheet date.
  - d. An investment should only be assessed for impairments at a CIRA's year end.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. Which of the following is true regarding cash and cash equivalents for CIRAs? **(Page 185)**
  - a. **Held checks dated before the balance sheet date that are material should be classified as accounts payable. [This answer is correct. For CIRAs, "held checks" dated at or before the balance sheet date (and reflected as outstanding checks on the bank reconciliation) that were not released until after the balance sheet date should be reclassified as accounts payable, if material.]**
  - b. If a cash account at a financial institution is negative, it can be netted against all the other accounts that the CIRA has. [This answer is incorrect. If a net negative balance with a financial institution is immaterial, the account may be offset against positive balances in other financial institutions. If it is material, the account (a) should be included with liabilities, either presented separately or included with accounts payable, and (b) if the CIRA presents a classified balance sheet, should be included with current liabilities.]
  - c. Cash is normally an immaterial part of a CIRA's financial statements. [This answer is incorrect. Since many CIRAs accumulate funds for future major repairs and replacements, cash is often more material to CIRAs' financial statements than to the financial statements of commercial businesses.]
  - d. All cash and cash equivalents, regardless of any restrictions placed on them, should be classified as cash and cash equivalents for CIRAs. [This answer is incorrect. Significant amounts of cash and cash equivalents that are not readily available for normal disbursements because of withdrawal restrictions should be classified as cash and cash equivalents for CIRAs.]
9. The River Bend Townhomes have a fund that was set up five years ago to save for a play park to be built in the facility for the homeowners' children. A portion of the yearly dues were designated for this purpose and placed in an interest bearing savings account. The accountant for River Bend Townhomes is creating the yearly financials. Which of the following guidance should the accountant follow for the designated fund? **(Page 186)**
  - a. A disclosure note about the play park funds should only be made in the financials if the accountant uses the fund approach. [This answer is incorrect. Additional disclosures about funds required to be segregated or the nature of the funds designated by unit owners should be made in the notes to the financial statements regardless of whether the CIRA presents its financial statements using a fund or nonfund approach.]
  - b. The accountant should list that the funds are restricted for the purpose of the play park. [This answer is incorrect. Funds designated in a CIRA's governing documents or by the unit owners for a specific purpose are not legally restricted because a majority of unit owners (as specified in the CIRA's governing documents) may subsequently decide to use to the funds for other purposes.]
  - c. Interest earned on the designated funds should be included in the cash available on the CIRA's financial statements. [This answer is incorrect. When cash is invested in interest bearing savings accounts, certificates of deposit, or other short-term investments, any interest takes on the same character as the related investment (that is, either designated or undesignated) unless the CIRA has a specific policy to treat it otherwise.]
  - d. **The accountant for River Bend Townhomes should segregate the cash allocated for the play park from other cash available. [This answer is correct. Funds that are designated are similar to legally restricted funds since the CIRA's board of directors does not have the authority to reverse the decision of the unit owners. Thus, such funds would be segregated from cash available for current operations in the CIRA's financial statements.]**

10. The HOA of Town's Landing has invested excess funds in T bills. Which of the following is the appropriate way to provide for the tax accounting of the T bills that are held to maturity? **(Page 194)**
- a. **The discount related to the T bill should be reported as interest income. [This answer is correct. If a T bill is held to maturity, all of the discount is reported as interest income.]**
  - b. The difference between the sales proceeds and acquisition cost should be recorded as a short term gain/loss. [This answer is incorrect. This is only true if the T bill is sold prior to maturity according to Section 1271(a)(3)(A).]
  - c. The HOA should accrete the discount. [This answer is incorrect. According to IRC Section 454(b)(2), the discount of a T bill should not be accreted for the tax accounting.]
11. Which of the following is a characteristic of a derivative? **(Page 200)**
- a. It has a fixed or determinable settlement to be made if the underlying performs in a specified manner. [This answer is incorrect. A payment provision specifies a fixed or determinable settlement to be made if the underlying performs in a specified manner.]
  - b. It contains a specified interest rate, security price, commodity price, foreign exchange rate, price or rate index, or other variable. [This answer is incorrect. An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, price or rate index, or other variable.]
  - c. **It requires no initial net investment and the terms require or allow net settlement. [This answer is correct. FASB ASC 815 defines a derivative as a financial instrument or other contract that has the following three characteristics: (1) it has at least one underlying and at least one notional amount or payment provision or both; (2) it requires no initial net investment or an initial net investment less than required for other types of contracts expected to respond similarly to changes in market factors; and (3) its terms require or allow net settlement.]**
  - d. It holds a specified number of currency units, shares, bushels, pounds, or other units. [This answer is incorrect. A notional amount is a specified number of currency units, shares, bushels, pounds, or other units.]
12. A CIRA holds an available-for-sale or held-to-maturity security; needs to determine whether an impairment is other than temporary; and properly account for, report, and disclose the security. Which of the following is correct regarding impairments? **(Page 201)**
- a. An impairment loss that is permanent should be recognized in the investment account on the balance sheet and written off in investment expense. [This answer is incorrect. An impairment loss should be recognized in earnings if the impairment is deemed to be other than temporary.]
  - b. **If an investment is impaired, the next step should be to determine if it is temporary or not. [This answer is correct. If an investment is deemed impaired, the next step is to determine where the impairment is temporary or other than temporary. FASB ASC 320-10-35-30 states that other than temporary does not mean permanent, but it does not provide specific guidance on determining whether the decline in fair value below cost is temporary or other than temporary.]**
  - c. A debt security's impairment amount should be recognized as a loss calculated as the difference between the cost and the fair value of the investment at the balance sheet date. [This answer is incorrect. For debt securities, the amount of the other-than-temporary impairment recognized in earnings depends on whether the CIRA intends to sell the security (or whether it is more likely than not the CIRA will be required to sell the security) before recovery of the amortized cost basis less any current-period credit loss (that is, excess of the amortized cost over the present value of cash flows). If the CIRA plans to sell the security (or more likely than not it will be required to sell the security) before recovery, the other-than-temporary

impairment should be recognized in earnings for the entire difference between the amortized cost basis and fair value at the balance sheet date.]

- d. An investment should only be assessed for impairments at a CIRA's year end. [This answer is incorrect. Generally, an investment should be assessed for impairment each reporting period, including interim periods if interim financial statements are issued.]

## MEMBER ASSESSMENTS, OTHER INCOME, AND RECEIVABLES

### Overview of Accounting Standards

Accounting standards for receivables relate primarily to the measurement of the amounts owed, the valuation of receivables, and their appropriate classification in the financial statements. Accordingly, they relate to determining (a) the amount of the receivable that is due to the CIRA, (b) when the receivable should be recognized as an asset, and (c) whether the receivable should be adjusted to reflect the possibility that it may not be collected. In addition, GAAP requires certain disclosures to be made about amounts due from related parties, amounts that may be uncollectible, amounts representing concentrations of credit risk, and the fair value of certain receivables.

### Member Assessments

The CIRA's annual budget is the basis for establishing the annual assessment required from each unit owner to cover the CIRA's operating expenses, plus a potential allocation to the replacement fund. The assessments (sometimes referred to as "maintenance fees," "carrying charges," or, in the case of cooperatives, "rent") typically are payable monthly, usually on the first of the month (but may also be billed quarterly or annually), and should be reported in the CIRA's financial statements in the period that they are assessed as either revenue or deferred revenue. (However, time-share developments typically bill their dues on a quarterly or annual basis.) Depending on the CIRA's governing documents, assessments may be equally assessed to each unit owner or may be based on another allocation method, such as the size of the units. In addition, assessments may include the allocation of certain other expenses to owners, for example, utilities that are submetered, expenses related to limited common areas, and common area expenses that benefit fewer than all of the units. (Some CIRAs present additional assessments such as those separate from regular assessments.) In certain circumstances, when the CIRA files its federal income tax return on Form 1120, if assessments at the end of the year exceed actual expenses, the excess is not taxable if the association members elect to either (a) refund the excess to the members or (b) apply the excess against the following year's assessments. For financial reporting, however, the excess assessments should be recorded as revenue. Recommendations for reporting the members' tax election in the CIRA's financial statements are as follows:

- If the members elect to refund the excess assessments, it is a best practice to show the refund as a reduction of equity in the statement of changes in fund balance (or statement of changes in members' equity if the CIRA presents its financial statements using a nonfund approach) in the period in which the refund is authorized. In other words, equity would be debited, and cash or a payable account would be credited.
- If the members elect to apply the excess against the following year's assessments, no entry would be made in the CIRA's financial statements, and the excess of revenue over expenses for financial reporting in the current year will exceed amounts reported in the CIRA's tax return. (The difference between assessments for financial and tax purposes would be shown as a Schedule M-1 or M-3 adjustment if the CIRA files Form 1120.)

Many unit owners pay their assessments on a timely basis since unpaid assessments constitute a lien on the units. Thus, at the balance sheet date, assessments receivable may not be material and may only represent billings for the most recent month. A significant balance in assessments receivable at the balance sheet date generally signals delinquent accounts.

**Delinquent Assessments.** A CIRA's governing documents normally specify penalties for delinquent assessments, such as late fees, service charges, or interest. Fees for delinquent payments generally are recorded in a separate income account, such as "Late fees" or "Interest on delinquent assessments" (although such amounts receivable from unit owners generally are included in the amount due from unit owners and, thus, included in the "Assessments Receivable" balance sheet account rather than reported in a separate receivable account). If they are not material, however, fees for delinquent assessments may be included in revenue from member assessments. It is a best practice for the CIRA's accounting records to segregate revenues from late fees and interest on delinquent accounts from other interest not received from members, such as interest on investments, because separate types of income are subject to different tax treatment. For financial statement presentation, however, late fees and interest

on delinquent accounts may be combined with other interest and presented as one line item, such as "Interest and late fees." In some cases, the CIRA's governing documents may provide that default in payment of assessments accelerates the remaining assessments for the year, and the entire balance is due and payable.

FASB ASC 310-10-35-9 through 35-11 require losses from uncollectible receivables to be accrued if a loss is probable and the amount of the loss can be reasonably estimated. The accrual must be made even though the particular receivables that are uncollectible may not be identifiable. Losses from uncollectible assessments are required to be accrued even though state laws or a CIRA's governing documents provide various other remedies for delinquent assessments, including the filing of liens, foreclosing on the unit owner, and obtaining judgment on other assets of the unit owner. However, those remedies do not ensure the collectibility of the receivables. Since liens filed by the CIRA for unpaid assessments may be subordinate to tax liens and unpaid amounts on first mortgages, an allowance for uncollectible accounts may be necessary if it is doubtful that sufficient equity in a unit exists to support the collectibility of past due amounts.

Critically evaluating collectibility is especially significant if the CIRAs are geographically located in areas of the country that have suffered economic downturns. When such economic downturns occur, delinquencies of member assessments have occasionally been so severe that some CIRAs faced going concern problems. Delinquent assessments also are common in the time-share industry due to the large number of owners in a development. Even in a good economy, significant construction defects can diminish the value of a development by causing very high expense in the form of repairs and litigation costs, which could potentially motivate members to stop paying their assessments due to the drop in value of their units.

Generally accepted accounting principles require uncollectible accounts to be accounted for using the allowance method. The specific write-off method, which is generally required for tax purposes, is a departure from GAAP. Thus, in GAAP financial statements, the specific write-off method is appropriate only if estimated uncollectible assessments at the balance sheet date are not material.

FASB ASC 210-10-45-13 states that valuation allowances for losses on receivables should be deducted from the related receivables (rather than reporting them as liabilities), and FASB ASC 310-10-50-14 requires the allowances to be disclosed. The disclosure usually is made by expanding the caption for receivables in the balance sheet. For example:

Assessments receivable, less allowance for uncollectible assessments of \$5,800	\$ 22,300
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FASB ASC 310-10-50-2 through 50-4 require disclosure of the basis of accounting for receivables, including the policy for accounting for uncollectible accounts.

**Assessments Received in Advance.** Some unit owners may pay their assessments in advance. Timeshare developments typically bill their dues on a quarterly or annual basis. (Other CIRAs may also bill their assessments less frequently than monthly.) Often, the annual dues billing is made 60 days before the budget year actually begins. If members make payments before the end of the year, the prepaid amounts at the balance sheet date should be classified as a liability—deferred revenue. A financial statement caption such as "Prepaid Assessments" or "Assessments Received in Advance" typically is used. (If a classified balance sheet is presented, it generally would be appropriate to classify assessments received in advance as a current liability.)

**Allocating Assessments to Replacement Funds.** If CIRAs assess their members for future repair and replacement of the common property, their budgets generally will specify the portion of the assessments to be allocated for that purpose. (Sometimes, however, they will levy special assessments for repairs and replacements.) FASB ASC 972-205-45-2 requires amounts assessed for normal operations to be accounted for separately from amounts assessed for future major repairs and replacements. Thus, as assessments are billed, assessment revenue, which is based upon budgets, should be allocated between operations and the replacement fund as budgeted (regardless of the amount transferred to the replacement fund). If the CIRA prepares its financial statements on a fund basis, the portion of assessments allocated for repairs and replacements should be reported as revenue of that fund. If a nonfund approach is used, assessment revenue should be allocated to separate accounts in the statement of revenues and expenses, such as "Member assessments—operations" and "Member assessments—future major repairs and replacements."

Assessment revenue is allocated between operations and repairs and replacements, but assessments receivable, assessments received in advance, and late charges and interest for delinquent assessments are typically considered to relate solely to operations. Thus, for example, financial statements of the replacement fund would record cash (or a combination of cash and a receivable if the budgeted allocations had not already been transferred) from the operating fund equal to the amount of assessments for repairs and replacements actually assessed as authorized in the budget.

**Financial Statement Disclosure.** FASB ASC 972-605-50-1 requires disclosure of assessments that were used for purposes other than those for which they were designated.

### Special Assessments

CIRAs generally have the authority to levy special or supplemental assessments, subject to unit owner approval in some circumstances, as specified in their governing documents or state statutes. Common reasons for levying special assessments include the following:

- To fund operating or replacement fund shortfalls.
- To fund projects or pay unexpected expenses that are not budgeted.
- To accumulate monies for specific future expenses.
- To repay loans.
- To accumulate monies for unanticipated expenses (sometimes referred to as contingency reserves).

The special assessment revenue should be reported separately from assessments for normal operations, if material.

If the CIRA prepares its financial statements using fund accounting, the special assessment activity is recorded in the fund for which the activity is most associated. Assessments for future major repairs and replacements and for litigation costs of developer suits for warranty claims often are recorded in the replacement fund. Alternatively, a separate fund may be established to account for special assessments. (A separate fund is especially common when special assessments are levied to repay debt.) Using a separate fund for special assessments may also make it easier to account for the special assessment activity, especially if it extends over more than one accounting period. Regardless of whether or not a separate special assessment fund is used, a separate bank account is generally established to account for special assessment revenues and expenditures. Establishing a separate bank account helps to ensure that special assessment funds are not commingled with other association monies and that they are only spent for the purpose for which they were intended.

Generally, special assessments are assessed to unit owners in the same percentage as regular assessments and have the same lien rights. However, the details of levying special assessments vary considerably depending on the provisions of state statutes and association governing documents. For example, in some circumstances, it is a board decision; in other cases, membership approval is required for special assessments in excess of a specified amount; in still other cases, the maximum term of the assessments is specified in state statutes. Because special assessments often raise potentially complex legal issues, it is important for association management to be knowledgeable about the intricacies of special assessments for their CIRA, and to involve their legal counsel regarding the association's authority to levy special assessments and the procedures to be followed.



**Revenue Recognition.** GAAP requires revenue from special assessments to be reported in the period they are assessed unless the revenue is deferred because the liabilities and expenses have not yet been incurred. The applicable requirements and this course's application guidance are as follows:

Requirement in FASB Codification	Application Guidance
FASB ASC 972-605-25-1—Special assessments shall be reported as revenue, unless they are deferred in accordance with the guidance in section 972-430-25-1.	Special assessments are considered levied when they become an obligation of the unit owners; generally, that is the date that the board or the members adopt the resolution imposing the assessments. Thus, when special assessments extend over more than one period, revenue from special assessments is recognized in the financial statements in a different period (earlier) than the period in which unit owners are billed (if they are permitted to pay their special assessments over time) or than the period in which debt is repaid (if the special assessments are levied to repay debt).
FASB ASC 972-430-25-1—Deferred revenue may include items such as special assessments designated for specific costs that have not yet been incurred. Such amounts shall be reported as revenue when the corresponding liabilities and expenses are reported.	The rationale for the requirement to defer special assessments in the circumstances specified above is that, unlike regular assessments and assessments for future repairs and replacements, until the CIRA incurs costs that were contemplated by the special assessments, it generally is obligated to return the monies to its members. Accordingly, the monies are not revenue to the CIRA until it incurs liabilities for costs related to the purpose of the special assessments.

Special assessments should be recorded as revenue in the period they are levied except in the limited circumstances when the CIRA has identified the need for specific future expenses, but they have not yet been incurred. For example, if the CIRA levies special assessments at the time a particular major repair or replacement of the common property is needed, such as roof repair, the special assessment revenue generally should be reported as deferred revenue until the corresponding liabilities for the repair are incurred.

Since most associations are not attuned to the accounting treatment of special assessments, the language creating the special assessments often does not provide adequate information for the practitioner to determine when revenue should be recorded for special assessments that are not tied to specific projects and contain extended payment options. One valuable piece of information in understanding the special assessment comes from repayment requirements. Often, some members will pay the assessment immediately, and others will opt for extended payment terms. This means that the association must carefully track assessed payments and receivables by member to know the exact amount due at any point in time.

Generally, expenses for which special assessments are levied are expected to be incurred within a relatively short period after the assessments are levied, such as a year. (An exception can occur when debt financing, which is secured by special assessments, is incurred by the CIRA.) However, the length of the period between levying the special assessment and incurring the related expenses is not necessarily a determining factor for recording the assessments either as revenue or as deferred revenue. For example, a CIRA involved in a lawsuit may levy special assessments to cover the expected costs of litigation. The special assessment revenue would be deferred in that case and recognized as revenue as the related litigation costs are incurred, even though settlement is not expected until several years in the future.

Applying the preceding criteria obviously involves judgment, and gray areas exist. However, it is a best practice for special assessments levied for the following purposes to be recognized as revenue in the period they are assessed:

- Special assessments to cover operating deficits or to raise additional working capital.
- Special assessments for unanticipated expenses (that is, for “contingency reserves”).
- Special assessments to fund a program for major repairs and replacements of the common property (rather than for specifically identified repairs).
- Special assessments to cover any expenses that have already been incurred.

**New Authoritative Guidance for Revenue Recognition.** In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The standard clarifies the principles for recognizing revenue and results in a common revenue standard for both U.S. GAAP and International Financial Reporting Standards (IFRS). ASU 2014-09 applies to revenue recognition for all industries. It eliminates inconsistencies in current revenue recognition standards and practices and removes most existing industry-specific revenue recognition requirements. In August 2015, the original effective dates of ASU 2014-09 were deferred by one year by the issuance of ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*. For nonpublic entities, the standard (as revised) is effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019 (that is, a nonpublic entity would not be required to apply the new revenue standard in interim periods within the year of adoption). The standard provides several options for early adoption; however, nonpublic entities would be able to elect to apply the standard no earlier than annual periods beginning after December 15, 2016, and interim periods within that year. In addition to ASU No. 2015-14, narrow scope amendments and exposure drafts have also been issued. The status of the project can be monitored at the FASB's website at [www.fasb.org](http://www.fasb.org). Because of the delayed effective date, this *Guide* has not been updated for the requirements of ASU 2014-09. As the effective date nears, a future edition of this *Guide* will incorporate any necessary revisions relating to the ASU.

The guidance in ASU 2014-09 is based on the principle that revenue from contracts with customers should be recognized when an entity transfers goods or services to the customer at the amount the entity expects to be entitled to receive from the customer. Under the guidance, an entity would identify performance obligations in a contract and recognize revenue as the performance obligations are satisfied. ASU 2014-09 does not seem to affect the reporting of regular monthly assessments from members for operations and repairs and replacements because, at each month end, the CIRA would have satisfied its monthly obligation for providing the services to its members. However, under the new standard, it seems logical for special assessments to be recognized as revenue as the CIRA performs its obligations (for example, as the CIRA incurs liabilities for repairs).

The main provision of the new revenue recognition rule is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance states that the following five steps should be applied by entities in order to recognize revenue:

- a. *Identify the Contract(s) with a Customer.* Define the contract agreement within specific criteria regarding identification of contract approval and commitment, the rights of the parties, payment terms, commercial substance and the probability of collection of the consideration by the entitled entity in exchange for the goods or services provided to a customer.
- b. *Identify the Performance Obligations in the Contract.* The *performance obligation* is defined as a promise in a contract with a customer to transfer a good or service to the customer. This step includes identification of the performance obligations in a contract based upon certain criteria regarding the distinction of goods or services.
- c. *Determine the Transaction Price.* The *transaction price* is defined as the amount of consideration (payment) to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The entity considers factors in order to determine the transaction price.

- d. *Allocate the Transaction Price to Each Performance Obligation in the Contract.* If the contract has more than one performance obligation, the transaction price should be allocated to each separate performance obligation based on the relative standalone selling price of that good or service.
- e. *Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation.* Determine when an entity should recognize revenue as it satisfies a performance obligation by transferring a promised good or service to a customer. The transfer of the performance obligation may be either over a period of time or at a specific point in time. The guidance provides certain criteria of when the entity should recognize revenue from satisfaction of performance obligations over time as opposed to a specific point in time.

Other provisions include guidance on accounting for some costs to obtain or fulfill a contract and financial statement footnote disclosures of information arising from contracts with customers. While ASU 2014-09 applies across all industries, the guidance does not apply to lease contracts (including operating, capital, and sale-lease-back contracts), insurance contracts provided by insurance entities, certain financial instruments, guarantees, and nonmonetary exchanges between entities in the same line of business in order to facilitate sales to customers.

ASU 2014-09 applies to CIRAs and supersedes FASB ASC 972-430, *Deferred Revenue*, and FASB ASC 972-605, *Revenue Recognition*. To aid practitioners in understanding the guidance, the AICPA has created sixteen industry revenue recognition task forces, including the timeshare entities revenue recognition task force, charged with developing revenue recognition implementation guidance that will provide helpful hints and illustrative examples in the new AICPA Guide, *Revenue Recognition*, to aid practitioners in applying ASU 2014-09. The timeshare entities revenue recognition task force identified the following potential revenue recognition implementation issues:

- Collectability.
- Identifying the performance obligations.
- Application of the percentage of completion.
- Ground lease/term products.
- Gross versus net reporting.
- Management fee agreements.
- Allocation of transaction price.
- Satisfaction of performance obligations.
- Accounting for owner associations.
- Contract costs.

More information on the task forces and the potential implementation issues can be found at [www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/RevenueRecognition/Pages/default.aspx](http://www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/RevenueRecognition/Pages/default.aspx).

**Repayment of Special Assessments.** It is usually within the board's authority to decide whether members must pay special assessments in a lump sum or are allowed to pay over time and whether interest will be charged (unless the CIRA's governing documents provide otherwise); however, all unit owners need to be given the same option. Repayment terms can vary considerably among CIRAs. However, the following payments options are typical of those commonly extended to the unit owners:

- Owners may pay off their portions at once. Some CIRAs offer their owners a discount to pay the entire special assessment immediately.
- Owners may pay principal (and interest, if charged by the association) monthly or over some other period, such as quarterly or annually, for longer-term special assessments.

Whenever members are to be charged interest or will be permitted to pay a lesser amount if they pay early, this course recommends that CIRAs consult with their attorney to ensure that they are in compliance with usury and truth-in-lending laws. While it is often desirable or necessary as a practical matter for the CIRA to offer payment options to unit owners, the practice creates an additional administrative burden for the CIRA because it requires an amortization schedule for each unit that pays the special assessment over time. Thus, it is a best practice for the payment plans to be kept as simple as reasonably possible.

When associations levy special assessments to repay loans, it is more commonplace for members to be charged interest if they pay over time because the association's intent is to pass along the financing costs to unit owners. Thus, the special assessment for each unit usually includes an interest allocation based on the interest rate of the loan. Generally, however, the interest component of unit owners' special assessments only approximates their proportionate share of actual loan costs because, for example, (a) the amount of special assessments may differ from the amount of the loan or (b) there may be timing issues (for example, special assessments may be levied before or after the commencement of CIRA's loan or the loan may begin as an interest-only construction loan and later convert to a standard amortizing loan, etc.).

**Financial Statement Disclosures.** If a CIRA establishes a separate fund to account for special assessments, its purpose is disclosed in the CIRA's summary of significant accounting policies. FASB ASC 972-605-50-1 requires disclosure of the proposed use for funds collected from special assessments. In addition, disclosure is also required for assessments that were used for purposes other than those for which they were designated. If special assessment revenue is deferred, it is a best practice to disclose an estimate of when the related expenses are expected to be incurred.

In addition, GAAP requires various disclosures when entities finance receivables.

**Refunds of Special Assessments.** Sometimes special assessments may exceed the specific expenses for which they were levied or they may be rescinded. Depending on the circumstances, the CIRA may elect to or be required to refund all or a portion of the special assessments. (Generally, state statutes or the CIRA's governing documents address the procedures for rescinding or refunding special assessments. In some cases, a membership vote is required to approve rescinding or refunding.) If special assessments are refunded, it is a best practice to report the refund only in the statement of changes in fund balance (or the statement of changes in members' equity, if the CIRA uses a nonfund reporting approach) as a return of capital in the period in which the refund is authorized.

**Income Tax Considerations.** For income tax purposes, special assessments are generally membership (exempt function) income; however, some may be treated as contributions of capital provided certain criteria are met. In those circumstances, a permanent difference between financial and tax reporting is created since the special assessments will never be reported as income in the CIRA's tax return, and deferred income taxes are not required.

## Developer Receivables

**Assessments.** Prior to the initial sale of each unit, developers are the legal owners of any unsold units. Thus, they generally are responsible for their proportionate share of the assessments relating to those units. The precise nature of their responsibilities varies and is detailed in state laws and the CIRA's governing documents. For example, the calculation of assessments due from the developer may vary with the phases of the development project, or the developer may enter into an agreement to subsidize certain association expenses. Accordingly, accountants need to look to those governing documents and the current development status of the CIRA when determining whether developer receivables have been appropriately recognized in the CIRA's financial statements. Similar to member assessments, developer assessments should be recognized in the financial statements in the period they are assessed. Some developers may pay assessments in advance as part of the original sale of a unit as an incentive to the proposed unit owner to purchase the unit. In those cases, the prepaid amounts should be classified as a liability (deferred revenue), similar to member assessments received in advance.

FASB ASC 850-10-50 requires amounts due from or to related parties to be disclosed. CIRAs' financial statements generally make that disclosure by using a balance sheet caption such as "Assessments receivable—developer." Other disclosures are also required about related party transactions, which are usually provided in the notes to the financial statements. For example, if the developer or any other individual party provides 10% or more of a CIRA's

total revenue (e.g., assessments revenue from the developer on unsold lots), that fact and the amount of revenue from each such source should be disclosed.

**Legal Settlements.** CIRAs may file suit on behalf of the unit owners against the developer for damages arising from defective construction or from payment of inadequate assessments relating to units held by the developer before their initial sale. Accounting for gain contingencies is governed by FASB ASC 450-10. Contingencies that might result in gains should not be accrued and reported in the financial statements until the gain is realized. Accordingly, if the CIRA is awarded a settlement, it should not be reported as revenue in the financial statements until the developer has consented to the judgment and is not appealing the verdict. Legal settlements for warranty claims and related litigation costs generally are reported in the replacement fund if the CIRA's financial statements are presented using fund accounting. Alternatively, activity related to material legal settlements could be recorded in a separate fund.) Gain contingencies are required to be disclosed, but the disclosure should not lead to overly optimistic estimates of the likelihood of realizing a gain. Accordingly, it is a best practice for the financial statements not to disclose gain contingencies when the possibility of realizing a gain is remote.

For income tax purposes, developer settlements may be treated as a form of recovery of capital provided certain criteria are met. In those circumstances, a permanent difference between financial and tax reporting is created since the settlement will never be reported as income in the CIRA's tax return, and deferred income taxes are not required.

### Disclosing Concentrations of Credit Risk

FASB ASC 825-10 primarily requires certain entities to disclose (a) fair values of financial instruments for which it is practical to estimate fair values and (b) concentrations of credit risk. Disclosure about market risk of financial instruments is encouraged, but not required by GAAP.

**What Are Financial Instruments?** A *financial instrument* represents cash, evidence of an ownership interest in an entity, or a contractual obligation that requires the exchange of cash or other financial instrument (including exchange of a financial instrument on potentially unfavorable terms) to another entity. Common types of financial instruments include the following:

- Cash
- Time deposits
- Accounts and notes receivable or payable
- Investments in common stock
- Loans
- Accrued expenses receivable or payable
- Loan commitments
- Financial guarantees

Contractual obligations that will be settled for consideration other than cash or financial instruments are not financial instruments. For example:

- A deferred revenue for membership assessments received in advance is settled by providing services for the period covered by the payment. Since settlement is not for cash, the deferral is not a financial instrument. But assessments receivable recognized by the CIRA for expired periods are financial instruments.
- Prepaid expense recognized for an advance payment of an insurance premium is settled by receiving coverage for the period covered by the premiums and, therefore, is not a financial instrument. But a billing for a rate adjustment for an expired period is a financial instrument for both the insurer and the insured.

Similarly, obligations that ultimately will be settled in cash are only considered to be financial instruments if one party has a contractual right to receive cash and the other party has a contractual obligation to pay cash at the balance sheet date. Thus, an accrued liability for compensation is a financial instrument because the employer has an obligation and the employee has a right at the balance sheet date that will ultimately be settled in cash. On the other hand, an accrued liability for a probable loss from a lawsuit is not a financial instrument. Although the defendant has an obligation at the balance sheet date, the plaintiff does not have a right. The liability for a settled lawsuit in which the settlement amount has been accepted is a financial instrument, however.

**Definition of Credit Risk and Market Risk.** FASB ASC 825-10-50-20 through 50-22 require certain disclosures related to credit risk and encourages other disclosures related to market risk. Credit risk is the possibility that a loss may occur from the failure of another party to perform according to the terms of the contract. Market risk is the possibility that future changes in market prices may make a financial instrument less valuable or more onerous.

**Unique Disclosure Considerations for CIRAs.** The financial instruments of most CIRAs will be recorded in their financial statements; only infrequently will they have financial instruments with off-balance-sheet risk, such as financial guarantees. Accordingly, in most cases, market risk associated with financial instruments need not be disclosed. Required disclosures generally will be limited to concentrations of credit risk associated with the following financial instruments:

- Member assessments receivable
- Developer receivables
- Cash invested in certificates of deposits or money market accounts that is not insured or that is in excess of amounts insured
- Investments in bonds

The most common disclosure that CIRAs will be required to make relates to the concentrations of credit risk associated with member assessments receivable if that amount is material at the balance sheet date. The concentrations of credit risk occur since the receivables are from individuals located within the same geographic area, and thus the collectibility of the receivables would be adversely affected by similar economic conditions. Although disclosure is required, it is not onerous. For example, the CIRA's financial statements might include the following disclosure in its summary of significant accounting policies:

#### NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

##### Assessments Receivable

Association members are subject to monthly assessments to provide funds for the Association's operating expenses, future capital acquisitions, and major repairs and replacements. Assessments receivable at the balance sheet date are stated at the amounts expected to be collected from outstanding assessments from unit owners. The Association's policy is to retain legal counsel and place liens on the properties of unit owners whose assessments are thirty days or more delinquent.

Material developer receivables also represent concentrations of credit risk requiring disclosure under FASB ASC 825-10-50. The disclosures required by FASB ASC 850-10-50 seem to provide all of the information required by FASB ASC 825-10-50.

**Disclosing Concentrations of Credit Risk for Cash Deposits.** Cash deposits with banks, broker-dealers, and other financial entities are financial instruments with credit risk. Significant concentrations of credit risk can result when cash is deposited in a single financial entity or in two or more financial entities that are based in the same geographic region. (Maintaining deposits in two or more financial entities based in the same geographic region concentrates credit risk because the financial entities are similarly affected by changes in economic conditions.) Significant concentrations of credit risk are required to be disclosed at each date for which a balance sheet is presented. Credit risk that exists between balance sheet dates, such as the risk associated with a large settlement

check that is deposited in one account and left there for a period of time before it is disbursed, does not have to be disclosed if the risk no longer exists at the date of the financial statements. In considering the nature of the disclosure, there are three principal issues:

- What constitutes a *significant* concentration?
- Should the amount of credit risk be based on the balance reported by the financial institution or the financial statement balance?
- Is the amount of credit risk reduced by FDIC or similar insurance?

GAAP does not define *significant concentrations of credit risk*. It seems logical to evaluate whether concentrations of credit risk are significant in the context of the maximum loss that could result. Thus, best practices indicate that disclosure is required if the concentration is significant, regardless of the likelihood of loss. Normal guidelines for evaluating financial statement materiality can be used in evaluating the significance of the maximum loss that could result from the concentration of credit risk.

Disclosures about concentrations of credit risk for cash deposits should provide information about the credit risk caused by maintaining cash deposits in financial institutions. That risk is the amount for which the financial institution has performance responsibility. The bank generally has no performance responsibility for deposits in transit. Similarly, the substance of outstanding checks is the same as accounts payable, and, in the event of loss, the bank may fail to honor outstanding checks. Thus, it is logical that the credit risk for cash deposits is for the balance reported by the financial institution.

Some deposits with banks are insured by the Federal Deposit Insurance Corporation (FDIC). GAAP does not address whether the credit risk for cash deposits can be reduced by insurance; it does imply that general insurance contracts acting as financial guarantees do not reduce the credit risk of loans receivable. However, there seems to be a significant difference between guarantees provided by federal and private insurance. Federal insurance will fail only in the event of a national financial catastrophe, and best practices indicate that such a negligible risk generally is ignored for purposes of disclosing concentrations of credit risk. Furthermore, in a nonauthoritative AICPA Technical Question and Answer (Q&A 2110.06), the AICPA stated that *bank statement* balances in excess of FDIC-insured amounts represent a credit risk, and that *uninsured* cash balances should be disclosed if they represent a significant concentration of credit risk. The TPA further states that while a material uninsured cash balance with a single bank should generally be disclosed, numerous immaterial uninsured cash balances on deposit with several banks may not require disclosure. Judgment is necessary to determine whether to disclose the aggregate materiality of numerous immaterial uninsured cash balances on deposit with several banks. Accordingly, credit risk for cash deposits should be reduced by related FDIC insurance, and the excess of cash deposits over insured amounts should be disclosed when material.

The Securities Investor Protection Corporation (SIPC) provides insurance for deposits with broker-dealers that is similar to that provided by the FDIC for bank deposits. Although the SIPC was created by federal law, it is not a federal agency; instead, it is a not-for-profit corporation funded by its broker-dealer members. It is permitted to borrow up to \$1 billion from the U.S. Treasury through the Securities and Exchange Commission if its funds are insufficient. Nevertheless, insurance provided by the SIPC seems more analogous to FDIC insurance than to private insurance, and, thus, they believe that SIPC insurance, like FDIC insurance, reduces credit risk for cash deposits. However, such arrangements should be disclosed in the notes to the financial statements to describe the SIPC insurance covering the association's brokerage accounts.

Some banks are now offering other private insurance to cover deposit amounts above the FDIC limit as an inducement to get associations to keep larger balances deposited with their banks. Generally, these banks will purchase blanket insurance coverage to protect the balances of their association customers that exceed the FDIC limit. This insurance is purchased by the bank at a "bank" level, as opposed to a "customer" level. (That is, the bank may purchase \$100,000,000 of private deposit insurance intended to cover all of its association customers.) In such a situation it would be a best practice for the practitioner to obtain written confirmation from the bank whether the total additional insurance coverage exceeds the bank's aggregate privately insured deposits in excess of the FDIC limitation. Additionally, the concentration of credit risk disclosure would be modified to describe the private

insurance and to disclose the amount of the association's deposits above the FDIC limit subject to such private insurance.

**Credit Risk Associated with Other Financial Instruments.** If a CIRA has material amounts invested in bonds, the related concentration of credit risk should be disclosed. Disclosures do not seem to be required for amounts invested in Treasury bills. In their opinion, since the face amount of the Treasury bill is guaranteed, the investment is similar to insured cash deposits. There is no credit risk associated with investments in marketable equity securities, only market risk, because the issuer has no performance obligation under the equity instrument. Since the maximum loss on the marketable equity securities is limited to the amounts recorded in the financial statements, disclosure about credit risk is not required. However, certain disclosures are required by FASB ASC 320-10-50.

### Ancillary Operations

Similar to commercial businesses, ancillary operations income is accounted for on the accrual basis. GAAP permits revenue and related receivables from other sources to be combined if they are not individually material (for example, "Miscellaneous income" and "Accounts receivable—other"). Even if other categories of income are immaterial in the aggregate, however, many CIRAs present them separately in the financial statements to allow the CIRA to compare budgeted amounts with actual revenue. For some CIRAs, other income can be significant. Those CIRAs need to ensure that their accounting systems are adequate to track the income and expenses related to the ancillary operations.

**General Considerations.** When the concept of community associations first began to seriously develop in the 1960s, the primary purpose of associations was to provide a form of more affordable collective housing. This was accomplished by creating "common areas" that were maintained on a communal, rather than individual, basis. It did not take long, however, for developers to realize that home buyers did not want to only save money on communal maintenance to escape individual maintenance responsibility; they also wanted to buy into a *lifestyle*. As a result, developers began to build communities centered around recreational amenities that provided a specific lifestyle.

The term *ancillary operations* describe any association activities other than the ordinary maintenance, security, governance, and administrative activities common to most associations. The scope of ancillary operations is limited only by the imaginations of the developers. Examples of ancillary operations commonly encountered include:

- Golf courses
- Facility rental, for example, a day-care center that rents space in the association clubhouse or a retail store that rents storefront space from a condominium
- Food and beverage operations, such as restaurants and bars
- Marina and boating operations
- Tennis and other recreational activities
- Equestrian operations
- Newsletter advertising

A key factor to consider is the marked difference between accounting rules and tax rules of CIRA ancillary operations. An important example of this difference occurs with the capitalization and depreciation rules. In general, however, FASB ASC 972 requires the capitalization of property and equipment owned by the CIRA that generate significant income. For tax purposes, most CIRAs do not have any tax basis in the common area assets that are associated with ancillary operations. This disparity between the accounting and tax rules results in an automatic book-to-tax depreciation difference for most CIRA ancillary activities.



For many associations, the primary motivation in establishing ancillary operations is not to generate profit but to provide services to the members. On the other hand, many associations develop ancillary operations with the thought of added commercial value to the association and/or the ability to differentiate its development from “competing” developments. Regardless of whether a profit motive exists, it is important that the revenues are adequate to fully subsidize the costs of the activities so that ancillary operations do not result in a significant drain on the association’s general operating budget (unless it is the association’s intent to subsidize the operations). It is not uncommon for ancillary operations to create political factions within associations—those who support certain activities and those who oppose the activities.

**Revenue Recognition.** Accounting treatment for ancillary operations depends in part on how the activities are conducted. For instance, an association may not charge any user fees for golf activities, but simply cover the golf course expenses through the association’s general operating assessment. Alternatively, the association may charge user fees only to members (and possibly guests and the public using a different rate schedule) that make use of the facility. However the user fees and other revenue considerations are managed, the mere existence of ancillary operations greatly increases the complexity of the accounting process.

If user fees are charged in connection with ancillary activities, the association needs to develop adequate accounting systems (and related internal controls) to account for such revenues. This places a much greater burden on the association’s accounting system, that often cannot be accommodated within an association’s general accounting system. It is not uncommon to discover that an association uses an industry specific accounting software system for its specific *association* needs and a separate *country club* accounting software system to account for golf or food and beverage operations (as an example). A *country club* accounting system often entails the use of point-of-sale (POS) software. The use of two distinct systems requires that information be accurately transferred from one system to the other to adequately account for revenues (and expenses).

If the association allows nonmember use of facilities in connection with ancillary activities, the accounting system must also provide separate accounting for revenues between members and nonmembers for each activity. In addition, it will be necessary to track the incidence of activities between members and nonmembers. For example, the association’s accounting system needs to be able to provide not only the total number of rounds of golf played, but also the number of rounds played by members and nonmembers. There also are additional internal control considerations if the ancillary operations have material amounts of cash collections.

Depending upon the ancillary activity conducted by the association, revenue recognition may become even more complicated. For example, in the case of rental operations where the association conducts a *rental pool* on behalf of its members, questions may arise as to the amount to be recorded as revenue by the association—the entire amount of rents received or simply the commission earned by the association for conducting the activity. GAAP requires that gross amounts be reported. However, in the case of rental pool operations, the commission is the income amount to be recorded by the association. (The actual rental income is the property of the separate owners.) The association is merely acting as an agent on behalf of the owners in conducting this type of activity. Another example is a pro shop with golf pro activities handled on a contract basis, where the golf pro is an independent contractor that receives all or a portion of the revenues from those activities.

**Expense Allocation.** When ancillary costs are significant or the association is otherwise concerned about the accurate tracking of the ancillary operation’s costs, the association may establish departmental accounting to capture those costs. If the association has limited ancillary operations, the benefit of establishing a separate accounting system outside of the main association accounting system to track those costs may not be cost effective. Accordingly, the association may absorb insignificant ancillary operations costs in the general operating budget.

If the association decides to track ancillary operations costs, operating ancillary activities generally results in both direct and indirect costs. Costs that are incurred directly and solely as a result of operating the ancillary activity are direct costs and would be accounted for as costs related to the ancillary operation. The association needs to also consider if it should allocate indirect costs to the ancillary activities. It is virtually impossible for such activities to exist based on their direct costs alone. Providing ancillary activities will require some portion of on-site staff and/or the management company’s time (indirect costs) to enable these activities to occur. Accordingly, the association needs to determine whether and how it should allocate such indirect costs.

**Capitalization and Depreciation.** Capitalization of common real property is unique in the CIRA industry as explained below. Excluding cooperatives, CIRAs capitalize common real property only if—

- a. The CIRA has title or other evidence of ownership of the property, and
- b. either of the following conditions are met:
  - (1) The CIRA can dispose of the property, at the discretion of its board of directors, for cash or claims to cash, with the CIRA retaining the proceeds.
  - (2) The property is used by the CIRA to generate significant cash flows from members on the basis of usage or from nonmembers.

As a result of those unique accounting capitalization rules, the importance of how ancillary operations are conducted and how revenues are generated has a significant impact on the capitalization of assets. The following example provides a literal interpretation of current GAAP, based upon prevalent industry practice as outlined in FASB ASC 972 and explained later in the lesson.

- Association A is a planned development with a golf course valued at \$15,000,000. The Association has title to the golf course land and charges green fees to its members and their guests. Those green fees approximate \$1,000,000 annually. Association A's golf course meets the criteria for capitalization explained above, as the Association has title to the property and generates significant cash flows from the property. *Accordingly, Association A capitalizes a \$15,000,000 asset.*
- Association B is also a planned development with a golf course valued at \$15,000,000. The Association has title to the golf course property, but does not charge green fees to its members. While green fees are charged to guests, the revenue received is not significant to the association. The cost of maintaining the golf course is absorbed into the assessment structure of the Association. This golf course does not meet the criteria for capitalization explained above. Although the association has title to the property, the golf course does not produce significant revenues, nor is it severable and saleable at the board's discretion because it is common area property of the Association. *Accordingly, Association B does not capitalize this \$15,000,000 asset.*

While the ancillary golf activity conducted by these two associations is identical in every other way, the fact that one generates significant revenue causes a marked difference in capitalization of assets.

Depreciation should be recorded for all capitalized ancillary assets based upon estimated useful lives of the underlying assets. Tax methods of depreciation are not acceptable for financial statement purposes unless the tax method approximates GAAP and the differences are immaterial.

**Reserve Considerations.** Associations generally assess unit owners for the future major repair and replacement of all association maintained assets (whether capitalized or not), including income-producing assets. It is the responsibility of the board of directors to assess an adequate amount to cover operating and replacement fund budgets. However, the estimation and forecast of revenues from ancillary operations plays a significant role in determining the annual budget. The association bears the responsibility to accumulate funds for maintenance and replacement of income-producing assets, irrespective of revenues generated by the underlying ancillary activity.

Normally, funds for future repair and replacement of assets used in ancillary activities are accounted for as part of that activity (for example, in the separate fund that accounts for the ancillary operations). Alternatively, some associations account for them in the replacement fund.

### Other Income

Other income reported in the CIRA's financial statements varies depending on the nature of the CIRA's operations. Similar to income from ancillary operations, other income should be reported on an accrual basis. Examples of other income include—

- Program income from special events and other programs sponsored by the CIRA.

- Services for residents, such as valet parking and maid services.
- Vending machine income.
- Utility pass-throughs.
- Nonrefundable fees, such as key fees.
- Transfer fees.
- Lease income for cell towers, cable television, or billboards.

**Utility Pass-throughs.** Utility companies often install master meters for water, gas, and electric service rather than individual meters for each unit. Cable and satellite television companies frequently enter into agreements under which the associations are billed for the total cost of the service at a reduced rate. The association then has to allocate those pass-through costs to the members since they are not billed separately by the utility companies.

Associations may install submeters to determine the costs to be billed or, in the case of cable and satellite television, divide the monthly bill by the number of units to determine the cost to be billed each unit. Approaches to recovering those costs from the members include the following:

- a. Basic monthly assessments may be increased to cover the allocated costs.
- b. The allocated costs may be billed to the members separately from the monthly assessments. Many associations choose that option so that monthly assessments will not be increased.
- c. Estimated allocated costs may be billed to the members annually to avoid possible unfavorable tax treatment for those associations that file Form 1120-H. All members have to use the utility, such as cable service, under that scenario.

Those costs may be inflated by a handling or administrative fee or to cover anticipated losses on unpaid bills.

Accounting for pass-through utility costs using the approach in item a. listed above is the same as accounting for member assessments discussed previously under "Member Assessments." In practice, accounting for separately billed utility costs such as those in items b. and c. listed above may be handled in items one of the following ways:

- Some accountants report the gross revenue and gross expense separately in the statement of revenues and expenses.
- Others offset the expense against the revenue (or vice versa), with any net difference reported in the statement of revenues and expenses.

The guidance in FASB ASC 605-45, *Revenue Recognition, Principal Agent Considerations*, applies to accounting for utility pass-throughs. Generally, principals recognize as revenue the amount charged to the customer (in other words, recognize gross revenues and gross expenses), and agents recognize as revenue the portion of the amount charged to the customer that they retain (that is, report the net difference). FASB ASC 605-45-45-1 through 45-18 say that whether the entity should recognize revenue as a principal or an agent depends on the facts and circumstances, and it provides a variety of indicators that the entity needs to evaluate in reaching a decision.

In the case of utility pass-throughs, the individual members are not party to the contract for utility services; rather, the CIRA is primarily responsible to the members for providing utility access, which FASB ASC 605-45 indicates is a strong indicator of gross reporting. Several other factors in FASB ASC 605-45 also seem to indicate that the CIRA should recognize revenue as a principal, including (a) the CIRA is involved in the determination of service specifications, (b) the CIRA has discretion in the supplier selection (when more than one supplier exists for the service), and (c) the CIRA has credit risk for the amount billed to the customer. Accordingly, it is a best practice for CIRAs to recognize gross revenue, including administrative fees, if any, and gross expenses in the statement of revenues and expenses.

If the utility pass-throughs are material, it is a best practice to disclose the accounting policy in the notes to the financial statements.

**Private Transfer Fees.** Private transfer fees are fees required by a deed or covenant restriction to be paid at the time of sale or transfer of a unit. They are typically provided for in a CIRA's governing documents to help defray costs associated with the sale of units, such as credit checks. Often, the ability to assess transfer fees, as well as the amounts, is regulated by state common interest ownership acts and is limited to fees necessary for the purpose for which they are levied (in other words, they can only be for actual costs) or to a maximum amount, such as \$100. Sometimes, especially with respect to cooperative housing corporations, transfer fees are based on a percentage of the sales price or a multiple of maintenance fees. While transfer fees generally are paid by the buyer of a unit, the proprietary leases of cooperative housing corporations often provide for a fee to be paid by the seller when a unit is sold.

Federal housing agencies (Fannie Mae, Freddie Mac, Federal Home Loan Bank) will purchase mortgage loans for units in CIRA developments only if private deed-based transfer fees are used for the exclusive benefit of the association. Because the federal agencies are such an important factor in financing home sales, including those in CIRAs, most associations comply with the requirement. Under the rule, private transfer fees can be used for maintenance and improvements to the property; administration costs; acquisitions; and cultural, educational, charitable, recreational, environmental, conservation, and similar purposes that benefit the CIRA.

Private transfer fees are generally recognized as a separate element of revenue in a CIRA's statement of revenues and expenses or included with other fees assessed by the CIRA.

## COMMON PROPERTY AND OTHER REAL PROPERTY

Accounting guidance for CIRAs (FASB ASC 972-360) does not establish requirements or provide recommendations for accounting for common *real* property. Rather, it describes "prevalent industry practice" in that regard. This section describes industry practice for accounting for common real property and explains the rationale for differing viewpoints so that accountants may be in a better position to decide on the appropriate accounting treatment in particular circumstances.

### What Is Common Property?

Common property is all real or personal property within a common interest ownership development except property that is owned exclusively by the individuals living in the development. Common property includes:

- Real property owned by individual members in common
- Real property owned by the CIRA
- Personal property owned by the CIRA and used on common real property

The governing documents of all CIRAs provide that members share the use of the common property within the development, either exclusively among the members or with others (for example, ancillary or commercial operations that are within or are part of the CIRA or that permit nonmember use and greenbelts with shared-cost agreements). Exhibit 2-3 lists examples of common property that usually exist in condominiums, HOA communities, and cooperatives.

**Exhibit 2-3****Examples of Common Property****Common Property for Condominiums, Homeowners' Associations, and Cooperatives:**

Land, such as front entrance walkways, landscaped areas, parking lots, and roads

Buildings (other than individual units) on common property and other real property improvements and landscape (including patios, terraces, courtyards)

Recreational facilities, such as clubhouses, tennis courts, and swimming pools

Hallways, lobbies, and public areas

Personal property used on common property, such as pool furnishings, clubhouse furnishings, and landscaping equipment

**Additional Common Property for Condominiums and Cooperatives:**

Land under the buildings

Exterior and common walls (including entry doors and garage doors)

Roofs

Plumbing and electrical components that service the common areas (possibly including condominium individual living units.)

Underground utilities<sup>a</sup>

**Note:**

<sup>a</sup> May also apply to homeowners' associations in certain limited circumstances.

\*                      \*                      \*

The types of common property in condominiums, HOA communities, and cooperatives may be distinguished by who has title to the property—the members in common or the CIRA. For example, in a condominium development, the individual members generally have an undivided interest in the development's common real property. (In rare cases, the CIRA owns some portion or all of the common real property.) In contrast, the CIRAs have title to common real property in HOA communities. The members do not have an undivided interest in it but only have a right to share its use. The types of common property are summarized as follows:

	<u>Condominium</u>	<u>HOA</u>	<u>Cooperative</u>
Common real property owned by members	Generally	No	No
Common real property owned by CIRA	Rarely	Yes	Yes
Common personal property owned by CIRA	Yes	Yes	Yes

The question of who owns the common property—the members or the CIRA—is significant since, as explained in the following paragraphs, it is one of the principal criteria for deciding whether CIRAs capitalize common property as assets in their financial statements.

**Capitalizing Common Real Property**

**Categories of Common Real Property.** FASB ASC 972-360-25 classifies common real property into the following broad categories:

- a. *Property That Is Directly Associated with the Unit.* (That is, common property without which the units could not be occupied and exterior property that is normally part of a freestanding unit). Examples include exterior

walls, roofs, public hallways, underlying land, sidewalks, driveways, roads, some parking spaces, and greenbelts.

- b. *Property That Is Not Directly Associated with the Unit.* (That is, community resource property that is not necessary for the primary use of the unit, although individual unit owners may benefit from its use). Examples include recreational facilities, such as swimming pools or clubhouses, managers' apartments, and properties that are primarily used for commercial operations directed at nonunit owners or at unit owners for which they pay a fee based on usage.

**Prevalent Industry Practice for Capitalizing Common Real Property.** According to FASB ASC 972-360-25-1, cooperatives recognize all common real property as assets. Condominium and homeowners' associations, on the other hand, generally do not capitalize common real property directly associated with the units (item a. in the preceding paragraph). Furthermore, FASB ASC 972-360-25-3 states that most condominium and homeowners' associations capitalize common real property not directly associated with the units (item b. in the preceding paragraph) only in the following circumstances:

- a. The CIRA has title or other evidence of ownership of the property and
- b. Either of the following conditions are met:
  - (1) The CIRA can dispose of the property, at the discretion of its board of directors, for cash or claims to cash, with the CIRA retaining the proceeds.
  - (2) The property is used by the CIRA to generate significant cash flows from members on the basis of usage or from nonmembers.

Exhibit 2-4 summarizes prevalent industry practice for capitalizing common real property.

The rationale underlying prevalent practice as described in the preceding paragraph is that the CIRA must have title to the common property before the property meets the definition of an asset. But having title is not sufficient. Those holding that view believe that if restrictive covenants severely limit and diminish the ability of the CIRA or the unit owners to dispose of or change the use of the property, the property provides no future economic benefits to the CIRA. Instead, the common real property is considered to increase the value of the property owned by the unit owners and, thus, benefit the unit owners. On the other hand, if the property can be sold at the CIRA's discretion or if it uses the property to generate significant cash flows, future economic benefits accrue to the CIRA, and the property should be capitalized.

FASB ASC 972-360-25-4 notes, however, that some CIRAs capitalize all common real property not directly associated with the units (item b. in the "Categories of Common Real Property" discussion) if they hold title to the property or have other evidence of ownership, regardless of whether they can dispose of the property and retain the proceeds or use the property to generate significant cash flows. That view is consistent with the FASB's belief that CIRAs should recognize assets in their GAAP financial statements using the same criteria as other reporting entities. Guidelines for entities to follow in determining whether to recognize assets are set forth in Statement of Financial Accounting Concepts (SFAC) No. 6, *Elements of Financial Statements*. Paragraph 26 of SFAC No. 6 states that to qualify as an asset, an item must possess the following three characteristics:

- It embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows.
- A particular entity can obtain the benefit and control others' access to it.
- The transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

According to the FASB, when CIRAs have title to common property, that common property will have all of the characteristics of an asset described in the preceding paragraph and should, therefore, be capitalized. Exhibit 2-5 explains how the preceding characteristics apply to a CIRA's common property.

**Exhibit 2-4****Prevalent Industry Practice for Capitalizing Common Property**

<b>Type of Common Property</b>	<b><u>Condominium</u></b>	<b><u>HOA Community</u></b>	<b><u>Cooperative</u></b>
<i>Real property directly associated with the unit</i>			
Examples:			
Exterior wall			
Roofs			
Public hallways			
Underlying land	Generally do not capital-	Generally do not capital-	
Sidewalks	ize	ize	Capitalize
Driveways			
Roads			
Parking spaces			
Greenbelts			
<i>Real property not directly associated with the unit</i>			
Examples:			
Recreational facilities	Capitalize if CIRA has title	Capitalize if CIRA has title	
Managers' apartments	and (1) can sell and	and (1) can sell and	
Property used for commercial operations directed at nonunit owners or at unit owners for which they pay a fee	retain proceeds or (2) can use the property to generate significant cash flows from members on the basis of usage or from nonmembers <sup>a</sup>	retain proceeds or (2) can use the property to generate significant cash flows from members on the basis of usage or from nonmembers	Capitalize
However, some CIRAs capitalize all common real property not directly associated with the units if they hold title to the property or have other evidence of ownership, regardless of whether they can dispose of the property and retain the proceeds or use the property to generate significant cash flows.			
<i>Personal property</i>			
Examples:			
Furnishings			
Recreational equipment	Capitalize	Capitalize	Capitalize
Maintenance equipment			
Work vehicles			

**Note:**

<sup>a</sup> As noted previously, condominiums rarely have title to common real property.

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Exhibit 2-5

Applying the FASB Definition of an Asset to Common Property

Characteristics of an Asset (SFAC No. 6, Paragraph 26)	How the Characteristics Apply to Common Property
Assets embody a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows.	The ability to realize the benefits of an asset through conversion to cash is not the only evidence that a probable future benefit exists. Paragraph 173 of SFAC No. 6 states that “anything that is commonly used to produce goods or services, whether tangible or intangible and whether or not it has a market price or is otherwise exchangeable, also has future economic benefit.” The key to the notion of probable future benefit in the case of common property is its use to provide services to the members.
A particular entity can obtain the benefit and control others’ access to assets.	Paragraph 184 of SFAC No. 6 states that “the entity having an asset is the one that can exchange it, use it to produce goods or services, exact a price for others’ use of it, use it to settle liabilities, hold it, or perhaps distribute it to owners.” All CIRAs exercise control over common property regardless of whether they hold title to it. For example, CIRAs may control access to property they hold by restricting use to members only, by charging nonmembers for use, or by restricting use by members to only certain hours or certain months of the year. They also may use it to provide services and could elect to distribute common property titled to the CIRA to members.
The transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred.	The past transactions or events are the developer’s formation of the CIRA on behalf of future property owners and the transfer of title from the developer to the CIRA. If the developer transfers title to common property to unit owners, as in the condominium form of ownership, no transaction affecting the CIRA has occurred, and no asset would be recognized. On the other hand, if the developer transfers title to the CIRA, such as a homeowners’ association, an event affecting the CIRA has occurred that should be given accounting recognition.
* * *	

Since the threshold criterion for capitalizing common real property is whether the CIRA has title to the property or other evidence of ownership, the issue of whether to capitalize common real property is primarily important to homeowners’ associations. Condominium associations usually do not capitalize common real property because the unit owners, rather than the CIRA, generally hold title to the property. Existing practice for cooperatives is to recognize all common property as assets. Some time-share associations treat the interior furnishings of the units as real property directly associated with the units. Homeowners’ associations, on the other hand, generally have title to common real property and must decide, in specific circumstances, whether it is appropriate to capitalize specific assets.



Most CIRAs other than cooperatives do not capitalize common real property that is directly associated with the units. Although nothing precludes CIRAs from capitalizing any common real property to which CIRAs hold title, it seems likely that CIRAs will not need to capitalize common real property directly associated with the units that was either (a) transferred by the developer or (b) purchased prior to the effective date of the AICPA guide since the cost and effort involved in determining the amounts to assign to the property in those circumstances generally is not justified by the benefit derived by financial statement users.

It is a best practice for CIRAs to conform to the prevalent industry practice with respect to capitalizing common real property that is not directly associated with the units. Thus, if the CIRA has title to the property and either (a) its board of directors can dispose of the property at its discretion and retain the proceeds or (b) the property generates significant cash flows, it seems logical for the CIRA to capitalize it. Best practices indicate that most CIRAs will not meet the first criterion regarding the authority of the CIRA's board of directors to dispose of common property and retain the proceeds. Generally, it will be either physically impossible to sever the common real property from the housing development (such as a swimming pool) or the CIRA's board of directors cannot sell the property at its discretion because a percentage of unit owners and first lien holders must consent to the sale.

In many cases, however, the common property will meet the second criterion—that of generating cash flows. Some common examples are managers' units from which the CIRA receives rental revenue, facilities that the CIRA uses to provide health or child care for a fee, and parking areas or recreational facilities that are made available to either members or nonmembers for a fee. Common real property would not be considered to meet the second criterion if it were reserved for the exclusive use of members and all of the members were assessed a fee unrelated to their use of the property.

Once a decision is made to capitalize common real property because it meets the criteria in the preceding paragraph, it would continue to be recognized as an asset in the CIRA's financial statements so long as the CIRA has title to it despite any change in the use of the asset or the board of directors' authority. For example, if the CIRA capitalizes a parking facility because a substantial portion of it is leased during the day to nonmembers, the parking facility would remain capitalized even though the CIRA subsequently changes its policy and no longer leases the facility. Similarly, assets that were capitalized because the CIRA's board of directors had authority to dispose of the asset at its discretion and retain the proceeds would continue to be recognized as assets even if the CIRA's governing documents are subsequently amended to take away that authority.

Another example situation of capitalizing common real property that generates significant cash flows occurs in some large associations that own and maintain their own roadways and charge an access fee to nonmember, and particularly commercial, users of those roadways. For some associations, those access fees can amount to a substantial revenue source. Since those types of associations typically hold title to the common areas, which includes the roads, and the roads produce significant revenue, the roads would be capitalized because they conform to prevalent industry practice for capitalizing common real property. Capitalization and depreciation of those assets also considers ongoing major repairs, replacements, and improvements. If an association starts assessing an access fee but has never previously capitalized the roads, it is a best practice for the CIRA to start capitalizing the roads as soon as it determines that the roads meet the criteria for capitalization.

**Income Tax Considerations.** Capital assets and improvements acquired with replacement funds generally do not have a tax basis when the expenditure is incurred. However, to the extent that an association recognizes taxable income from an activity, it gains tax basis in the underlying assets. Thus, there is generally a difference between the book and tax basis of capital assets acquired with replacement funds.

It is also a good idea for CIRAs to capitalize any common real property to which they have title that is purchased by the CIRA after the effective date of the AICPA guide. However, if a CIRA has *incorrectly* capitalized common property that *never* met the criteria discussed previously, the CIRA would record a prior period adjustment by restating the prior period financial statements for the correction of an error in accordance with FASB ASC 250-10, if the correction would be material to the financial statements.

### Capitalizing Common Personal Property

Certain types of CIRAs may have material common personal property. For example, time-share associations may own the interior furnishings in the units, and large-scale commercial condominium projects usually own considerable

maintenance equipment and lobby furniture. FASB ASC 972-360-25-5 requires CIRAs to capitalize common personal property, such as furnishings, recreational and maintenance equipment, and work vehicles. CIRAs generally hold title to personal property and the CIRA's board of directors usually is able to sell personal property at its discretion and retain the proceeds. Thus, the property qualifies for asset recognition under the criteria stated previously.

Failure to capitalize personal property to which the CIRA has title, whether acquired by purchase or through transfer from the developer, is a departure from GAAP.

### **Need for a Specific Capitalization Policy**

CIRAs should establish a written policy (a) stating a minimum useful life and a minimum dollar amount that is required to be spent before an expenditure is capitalized and (b) addressing the treatment of common real property that is both directly associated with the unit and not directly associated with the unit. The policy adopted should not cause a material distortion of the financial statements. In many cases, the common real property will be material to the financial statements and should be appropriately capitalized. However, in some cases, common real property be capitalized, even though the amounts involved are not material, so that complete records are kept for purposes of accountability.

### **Valuing Common and Other Real Property**

**Purchased Common Property.** Similar to other businesses, purchased common property should be reported at cost. If acquisition costs are no longer available, another reasonable basis should be used; for example, cost-based appraisals, insurance appraisals, replacement costs, or property tax appraisals adjusted for market. However, an alternative basis should be used only if historical cost information is unavailable and only to establish a value at the date of initial capitalization. Future purchased additions should be recorded at cost.

**Common Property Transferred to the CIRA by the Developer.** FASB ASC 972-360-30-1 states that if a CIRA acquires common property "in a nonmonetary transaction, such as by a nonreciprocal transfer from the developer, and if the property is recognized as an asset of the CIRA, the CIRA should recognize the property using fair values at the date of its acquisition." Fair value is determined in conformity with FASB ASC 820-10. FASB ASC 972-360-30-1 suggests that it may be helpful to consider the developer's cost, if known, in determining fair value.

FASB ASC 820-10, *Fair Value Measurement*, defines *fair value*, provides a framework for measuring fair value within GAAP, and modifies disclosures about fair value required by other pronouncements. The guidance applies whenever other accounting standards require or permit assets or liabilities to be measured at fair value, but it does not expand the use of fair value to any new circumstances. *Fair value* refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. Fair values are required to be based on the assumptions that market participants would use when pricing the asset or liability, and it establishes a fair value hierarchy of information used to develop those assumptions. Under that hierarchy, quoted prices in active markets have the highest priority and unobservable data, for example, the reporting entity's own data, has the lowest priority. *PPC's Guide to Preparing Financial Statements* discusses fair value measurements in detail, including valuation techniques.

**Other Real Property Transferred to the CIRA.** Other real property may be transferred to the CIRA in the following circumstances:

- A unit may be transferred from the developer to a condominium association in settlement of litigation arising from defective construction or from payment of inadequate assessments relating to units held by the developer before their initial sale. The unit should be recorded at fair value on the date of transfer plus actual closing costs.
- Condominiums and homeowners' associations may receive abandoned units for nonpayment of delinquent assessments. Transactions in which condominium and homeowners' associations receive units for nonpayment of delinquent assessments seem to be, in essence, in-substance foreclosures as defined by FASB ASC 310-40-40-6 in that the associations take physical possession of the property without foreclosure proceedings. In those circumstances, the asset received is accounted for as a foreclosed asset and recorded at the fair value of the unit (less estimated costs to sell if the unit is to be sold) at the date of

foreclosure or transfer, and a gain or loss is recognized on the difference between that value and the value of the delinquent assessments and any debt assumed.

- Units transferred from the developer to the association at transition, such as guest suites, manager units, or storage units. In those cases, the units would be recorded in an asset account such as "Investment in Real Estate" or "Rental Units."

Some accountants believe it is inappropriate to recognize a gain on transfer of a unit to the CIRA. Best practices indicate that a gain on the transfer of a unit would be rare because normally the owner of a unit finds a way to satisfy delinquent assessments if the value of the unit exceeds the assessments. However, if the value of the unit exceeds the delinquent assessments and any related debt assumed, it still seems likely that the unit would be recorded at fair value (less selling costs, if applicable) because the foreclosure is a separate transaction, and the fair value of the underlying unit is the most appropriate amount at which to record the transaction.

**Foreclosed Units.** A CIRA's governing documents provide the CIRA's legal authority to place an assessment lien on units that are delinquent in their assessments. The specific provision of both the CIRA's governing documents and state statutes, determine the CIRA's rights and those of the existing or future owner of the unit when there are delinquent assessments. Generally, the assessment lien creates a legal claim on a unit that makes it collateral against the delinquent assessments owed to the association, and in some cases, related attorney's fees, interest, collection costs, and late fees. The lien effectively precludes the owner from transferring title to the unit without first paying the amounts owed to the association. Furthermore, as governed by state statutes, the association is able to foreclose its assessment lien (in the same manner as a mortgage is foreclosed) to recover the amounts owed, including, if necessary, through sale of a member's unit.

In many states, assessment liens have the status of "super priority liens" with respect to delinquent assessments to the extent of a specified monetary amount, such as the most recent six or 12 months of delinquent assessments, a percentage of the original mortgage debt, or a dollar amount. In those cases, the lien position of the remainder of the assessment lien is subordinate to the first mortgage lien rights.

Disclosure in the financial statements of a CIRA's accounting policy for uncollectible assessments typically describes the CIRA's ability to place a lien on units for delinquent assessments. Neither the number of units subject to assessment liens nor the dollar amount of the delinquent assessments related to those liens needs to be disclosed. However, auditors consider those matters in evaluating the adequacy of the CIRA's allowance for uncollectible assessments.

An association's lien process may be viewed as a continuum, beginning with giving notice to the unit owner; recording the lien; enforcing the lien, including judicial foreclosure, if permitted; and ending with, in some cases, acquiring title to the unit at a foreclosure auction or sale, subject to a lender's mortgage lien (if any). There are pros and cons to a CIRA's decision to pursue foreclosure of its assessment lien in advance of a lender's foreclosure. Accordingly, those decisions are best made by the CIRA in consultation with its legal counsel. Because the foreclosure process can be not only time-consuming but also costly, some CIRAs decide to merely record the lien and wait for the lien to be paid when the mortgagee forecloses on the unit or the unit is sold. However, in the current economic environment, banks often take longer to foreclose on units when homeowners are delinquent in paying their mortgages, and even when they do foreclose, finding buyers for foreclosed units can be a lengthy process. Accordingly, some CIRAs pursue lien foreclosure in advance of a lender's foreclosure in an attempt to recover delinquent assessments, primarily through renting the unit. Other CIRAs decide to foreclose their assessment lien and take title to the unit, even if they, too, might find it difficult to rent or sell the unit, with the objective of putting pressure on the lender to foreclose or enabling them to have a voice in the decision of finding a new unit owner.

When a CIRA takes title to a foreclosed unit, it should record the unit in its financial statements at fair value (FASB ASC 310-40-40-3). FASB ASC 820-10-20 defines *fair value* as "the price that would be received to sell an asset . . . in an orderly transaction between market participants at the measurement date." In most cases, whether the CIRA decides to bid on a unit in foreclosure (in anticipation of taking title) is based on the CIRA's assessment of the unit's fair value. That assessment considers factors such as the following:

- Other liens attached to the unit, such as a mortgage.

- The physical condition of the property, for example whether costs need to be incurred to bring the unit to a rentable or saleable condition.
- Whether the CIRA is able to rent the unit and, if so, the economics of the rental market.

It is rare for an association to bid more on a unit in foreclosure than the amount of unpaid assessments due to the CIRA. Thus, the amount for which the CIRA acquires the unit in foreclosure (i.e., at a foreclosure sale or auction) is not, in and of itself, determinative of the unit's fair value and often is the minimum estimated fair value.

Typically, when there are significant delinquent assessments related to a unit, the mortgage balance exceeds the equity in the unit; otherwise, a unit owner generally would be motivated to pay the delinquent assessments to keep the unit. Accordingly, in many cases, the unit's mortgage liability is in excess of what the CIRA believes it could receive through sale of the unit. In those circumstances, fair value of the unit often derives from the CIRA's expectation of renting the unit for a period of time until the mortgage holder forecloses.

Other considerations for financial reporting include the following:

- The CIRA's estimate of fair value should take into account the unit's estimated future cash flows, for example, from renting the unit or through its eventual sale. That amount is recorded as an asset in the CIRA's financial statements, and the difference, if any, between the unit's estimated fair value and the consideration given to acquire the unit is recorded with an offsetting credit to a revenue account, such as "Gain on Acquisition of Foreclosed Unit." The recorded amount becomes the new cost basis of the unit and is depreciated over the period the CIRA expects to hold the unit. The unit should be evaluated for impairment at each subsequent financial reporting date.
- Whether the mortgage liability is recorded in the CIRA's financial statements or only disclosed seems to depend on whether the CIRA intends to sell the property and pay off the related mortgage or merely hold the unit until the mortgagee forecloses.
  - If the CIRA intends to hold or rent the property until the mortgagee forecloses, it is a best practice for the liability for the mortgage to be disclosed but not be recorded in the CIRA's financial statements. (The amount of the mortgage liability need not be disclosed.)
  - However, consistent with accounting for similar real estate transactions, if the CIRA intends to sell the unit, the fair value of the unit should be recorded as an asset and the mortgage should be recorded as a liability in the CIRA's financial statements. The mortgage liability should not be netted against the foreclosed unit. (The rationale for the accounting treatment is that, even though the CIRA has no legal obligation on the mortgage, because the property is acquired subject to the mortgage lien, the CIRA would need to satisfy the mortgage to sell the property.)
- Costs to acquire the foreclosed unit should be included in the estimate of its fair value.
- If the CIRA expects to sell the unit, estimated costs to sell reduce the unit's fair value. (Selling costs include only direct costs of selling the unit, such as sales commissions, legal and transfer fees, and other closing costs. Costs not directly related to the sale, such as insurance incurred before the unit is sold, should not be considered. Rather, such holding costs should be expensed as incurred.)
- The costs of repairs or physical improvements to a foreclosed unit should be capitalized if they significantly increase the fair value of the asset. Otherwise, they should be expensed as incurred.
- The CIRA should continue to evaluate the collectibility of delinquent assessments related to the unit. Factors to consider in determining an allowance for uncollectible assessments include, among other things, whether the CIRA is able to pursue delinquent assessments from either the previous unit owner, the mortgagee, or the eventual third-party purchaser. If the CIRA believes that the delinquent assessments are uncollectible, they should be written off by debiting the allowance for uncollectible receivables and crediting the receivable account.

- Foreclosed units should be presented as a separate balance sheet amount or included with other assets. If included with other assets, they should be disclosed in the notes to the financial statements. (FASB ASC 310-10-45-3)
- Rental income and related expenses are nonmember activities and, thus, would be taxable to the association. Accordingly, CIRAs generally account for rental income from the unit and related costs separately from member activities. If rental income is material, it should be presented separately in the CIRA's statement of revenues and expenses.
- For the period of time that the CIRA owns the unit, it should record assessment revenue from the unit so long as it has an expectation of realizing that revenue. If the CIRA no longer has a realistic expectation of collecting assessment revenue related to the unit, it should adjust receivables to the amount estimated to be collectible and no longer recognize assessment revenue (that is, if the CIRA does not have a realistic expectation of realizing assessment revenue, recording assessment revenue with an offsetting bad debt expense would not be appropriate).

**Common Property Leased by the CIRA.** Real or personal property that is leased by the CIRA should be reported following the guidance in FASB ASC 840 and related pronouncements on leasing transactions. Such guidance includes how to allocate rental costs over the lease term, and addresses capitalizing rental costs associated with ground and building operating leases that are incurred during a construction period.

**Capitalized Interest.** If a CIRA constructs assets for its own use, interest costs should be capitalized as a part of the cost of the asset in conformity with FASB ASC 835-20.

**Impaired Assets.** FASB ASC 360-10 and 205-20 provide guidance on identifying and valuing an impaired asset (i.e., an asset whose carrying amount exceeds what the CIRA will eventually recover from continuing to use it or from selling or otherwise disposing of it). Assets of a CIRA are generally intended to be held and used, rather than be disposed of. Impaired assets that will continue to be used are generally reported at the lower of carrying amount or fair value. CIRAs are required to assess long-lived assets (such as cooperative apartment buildings or homeowners' associations' clubhouses) whenever conditions or events indicate that they may not recover their carrying amounts. The carrying amount of a CIRA's long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. That recoverability determination is based on the carrying amount of the asset at the date it is tested. The amount by which the carrying amount of a long-lived asset exceeds its fair value equates to the impairment loss.

Additional requirements about the recognition, measurement, and disclosure of an impairment loss are set forth in FASB ASC 360-10. FASB ASC 310-40-40-10 clarifies that any valuation allowance for a loan collateralized by a long-lived asset should not be carried over as a separate element of the cost basis for purposes of accounting for the long-lived asset under FASB ASC 360-10 subsequent to foreclosure.

**Asset Retirement Obligations.** FASB ASC 410 and FASB ASC 410-20-25 provide accounting requirements for obligations associated with the retirement of tangible long-lived assets. This guidance applies to retirements due to acquisition, construction, development, or the normal operation of assets and requires that the asset retirement obligation be recognized at fair value when incurred if a reasonable estimate of fair value can be made. If an obligation has been incurred, but a fair value cannot be determined, the liability does not have to be recognized. This guidance does not apply to obligations that arise solely from a plan to sell or otherwise dispose of a long-lived asset in compliance with FASB ASC 205-20 and 360-10. Any related asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. For example, if a CIRA holds property with gasoline storage tanks and state law requires the CIRA to remove the tank when the tank is retired from service, the CIRA is required to recognize a liability related to the future retirement of the gasoline storage tank. The liability should be recorded in the period that the obligation is incurred, even if it is incurred over more than one reporting period.

FASB ASC 410-20-25 defines when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. However, if a fair value is not determinable, FASB ASC 410-20-50-2 requires disclosure of that fact and the reasons for it. The CIRA must also make certain financial statement disclosures.

## Reporting Common Property in Financial Statements

If a CIRA presents its financial statements using fund accounting, capitalized common property generally is reported as assets in the operating fund or a separate fund established for that purpose.

### Financial Statement Disclosures

FASB ASC 972-360-50-1 requires CIRAs to make the following disclosures about their common property:

#### General Disclosures

- The CIRA's responsibility to preserve and maintain the common property.
- Accounting policy for recognition and measurement of common property.
- Restrictions on the use or disposition of the common property.
- Terms and conditions of existing land or recreation leases.

#### Additional Disclosures for Common Property Owned by the CIRA That Is Not Capitalized

- A description of the property to which the CIRA has title or other evidence of ownership that is not capitalized.

#### Additional Disclosures for Common Property Owned by the CIRA That Is Capitalized

- A description of the property that is capitalized.

### Depreciation

If CIRAs capitalize common property, it should be depreciated based on the property's estimated useful life using the same accounting principles that apply to commercial businesses.

If a CIRA presents its financial statements using fund accounting, depreciation should be recorded in the operating fund or other fund that reports the assets. Because depreciation is a noncash expense, some CIRAs, especially cooperatives, present it in the statement of revenues and expenses as a separate line item after the caption "Excess (deficiency) of revenues over expenses before depreciation."

**Income Tax Considerations.** GAAP requires depreciating asset cost over its estimated useful life using an acceptable method (for example, straight-line or declining balance). For tax purposes, however, property and equipment are depreciated using the Modified Accelerated Cost Recovery System (MACRS) [or the Accelerated Cost Recovery System (ACRS) for assets acquired after 1980 and before 1987], which prescribes recovery periods for assets and narrows the selection of a depreciation method. Thus, although CIRAs may elect straight-line depreciation for tax reporting, MACRS would still differ from GAAP because the recovery period is prescribed and salvage value is not considered. However, recovery periods for real estate and for three-year and five-year property under MACRS generally would be acceptable for GAAP. Accordingly, in most cases, using MACRS for financial reporting should not differ materially from GAAP provided salvage value is not material. Large acquisitions other than real estate and three-year and five-year property need to be evaluated to determine whether different depreciation lives should be used for financial reporting. Similarly, ACRS depreciation for significant pre-1987 acquisitions of buildings and heavy machinery or equipment would be expected to differ materially from GAAP. Also, for those CIRAs that elected to utilize the bonus depreciation rules under the 2002 Job Creation and Worker Assistance Act and the 2003 Jobs and Growth Tax Relief Reconciliation Act, there may be additional material differences between GAAP and tax depreciation. Accounting for differences between financial and tax depreciation, which results in assets with different bases for accounting and tax purposes, is discussed later in the lesson.

### Damage or Defect Settlements

CIRAs infrequently receive large damage or defect settlements, such as insurance proceeds for disasters or construction defect settlements. For example, the CIRA may receive an insurance settlement for damage caused by a hurricane, earthquake, tornado, or other natural disaster, or a developer may pay a CIRA for a warranty claim.

In response to accounting considerations that arose as a result of devastating and widespread losses from Hurricanes Katrina and Rita in 2005, the AICPA issued Technical Question and Answer (Q&A) 5400.05, "Accounting and Disclosures Guidance for Losses from Natural Disasters—Nongovernmental Entities." While the Q&A does not address unique CIRA concerns as a result of natural disasters, it provides guidance on various issues that may arise in accounting for losses incurred as a result of a natural disaster. Many of those issues also arise when accounting for construction defects and related settlements. The following issues, some of which also are discussed in Q&A 5400.05, are discussed later in this lesson:

- a. when an impairment loss related to a natural disaster or construction defects should be recognized.
- b. accounting for insurance recoveries.
- c. related disclosures.
- d. using a separate fund to account for the effects of natural disasters or construction defects.

Additional considerations related to damage or defect settlements include:

- Accounting for settlements related to members' property.
- Accounting for expenditures for litigation expenses.
- The CIRA board's responsibilities related to settlement proceeds.

**Impairment Losses.** If CIRAs have capitalized assets that are damaged or destroyed by natural disasters or have been affected by construction defects, the assets need to be evaluated to determine whether they are impaired and whether an impairment loss should be recognized. When the carrying amount of a long-lived asset exceeds its fair value, the asset is impaired. Generally, CIRAs would recognize an impairment loss to the extent the asset's carrying amount is not recoverable and exceeds its fair value. The impairment loss should be recognized in the period the impairment occurs.

**Insurance Settlements.** In accounting terms, when assets are totally or partially destroyed by natural disasters, the nonmonetary assets (property and equipment) generally are involuntarily converted to monetary assets (insurance recoveries). Insurance settlements represent a gain contingency as defined by FASB ASC 450-30-20. FASB ASC 450-30-25-1 indicates that contingencies that might result in gains should not be accrued since doing so might recognize revenue before it is realized. Accordingly, it seems likely that CIRAs would not record insurance recoveries until the claims for recovery are *probable* as defined in FASB ASC 450-20-20; that is, realization of the claim for insurance recovery is likely to occur. If the insurance claim is subject to litigation, settlement discussions, or other contingencies, best practices indicate it generally does not meet the *probable* criterion.

Once the insurance settlement is both probable and reasonably estimable, the settlement should be recognized in the CIRA's financial statements, even if the CIRA has not yet been able to estimate the cost of repairs or is unable to reconstruct assets or make repairs because the CIRA does not have the necessary monies. If the assets that were damaged or destroyed were not capitalized at the time of the disaster, the CIRA would recognize the settlement proceeds as revenue in its financial statements. However, if the insurance recovery relates to assets that were capitalized in the CIRA's financial statements, FASB ASC 605-40-25 requires a gain or loss to be recognized even if the CIRA reinvests in a similar assets. The gain or loss recognized on the conversion is the difference between the carrying amount of the common property and the monetary assets received.

If the insurance settlement is not recognized in the CIRA's financial statements because it is not probable or reasonably estimable, FASB ASC 450-30-50-1 requires information about the gain contingency to be adequately disclosed.

**Accounting for the Costs to Repair or Reconstruct Common Property.** Reconstructing after natural disasters often will involve repairing or replacing common property that was not capitalized but was recorded as expenses in the CIRA's financial statements. [Expenditures for common property may be recorded as expenses because either (a) the CIRA's members hold title to the common property or (b) even though the CIRA holds title to the

common property, they do not meet the criteria requiring capitalization.] In other cases, such as common personal property, the assets may be capitalized. In either case, accounting for the costs to repair or reconstruct common property follows the same principles as the initial purchase or construction of common property.

The accounting requirements for the expenditures and the related liability are specified by FASB ASC 450-20-25-2, which requires an accrual when both of the following conditions exist at the balance sheet date:

- It is probable that a liability has been incurred.
- The amount can be reasonably estimated.

In most cases, the fact that a liability has been incurred at the balance sheet date is clear, and the difficulty arises in making a reasonable estimate of the amount. For example, the cost of land improvements or buildings such as a clubhouse would include all expenditures associated with making the structure or improvements ready for use. In many cases, the cost is the agreed-upon contract price. For items such as equipment and furniture, the cost would include the purchase price and items such as sales taxes, transportation fees, insurance paid to cover the item during shipment, assembly, installation, and all other costs associated with making the item ready for use.

When the estimate is a range rather than a specific amount, FASB ASC 450-20-30-1 provides the following guidelines:

- If one amount within the range is considered to be the best estimate, it should be used as the accrual.
- If no amount within the range is considered to be the best estimate, the lowest amount in the range should be used as the accrual.

CIRAs would record costs as either expenses or assets (depending on its policy for asset capitalization) on case-by-case basis for specific components (for example, roof repair, clubhouse reconstruction, landscaping, recreational equipment, work vehicles, etc.) as it determines that it has incurred a liability for each that is reasonably estimable. CIRAs should not delay recording assets or expenses for specific elements of reconstruction plan until the total construction costs related to the insurance settlement can be estimated unless that conforms to the pattern in which it incurs the related liability. Similarly, there is generally no basis to record expenditures in a deferred expense account in the balance sheet. Issue 4 of AICPA Technical Question and Answer (Q&A) 5400.05 reminds accountants that losses and costs might be recognized in the statement of revenues and expenses in a different period (generally earlier) than the related recovery.

**Using a Separate Fund to Account for the Effects of Natural Disasters or Construction Defects.** In many cases, damage from natural disasters or construction defects and related impairment losses, if any, are recognized in different periods than insurance recoveries and subsequent repairs and reconstruction. For example, in some cases, the damages or defects are cosmetic rather than structural, and the CIRA will delay repairs until after insurance settlements are received. In other cases, construction defects litigation and sometimes insurance claims take several years to complete and the CIRA may be required to make necessary repairs immediately. In most cases, the amount of the CIRA's actual expenditures will differ from the ultimate settlement it receives, and the CIRA may have to levy a special assessment, obtain outside financing, or borrow monies from the replacement fund to complete repairs. For those reasons, among others, this course recommends that the CIRA record the activity for damage from natural disasters and construction defects in a separate fund that accounts for both settlement proceeds and expenditures for repair and reconstruction.

If restoration expenditures were recorded in the operating or replacement fund before settlement or presettlement monies were received, a transfer should be recorded from the separate fund to the fund in which the expenditures were initially recorded to reimburse it.

Establishing separate bank accounts for settlement monies and expenditures should help the CIRA to avoid commingling them with other association monies or spending funds for purposes other than those for which they were received.

**Accounting for Settlement Proceeds Related to Members' Property.** Settlements related to property owned by members are usually paid directly to them. In some cases, however, damage to real property owned by the



members and common property purchased with a condominium association's funds may be reimbursed by the insurance company in a single payment to the association. In those cases, the members generally decide whether to pay the member for the portion of the settlement proceeds related to the members' individually owned property, or whether the CIRA will be responsible for having repairs made on the members' behalf. Similarly, if a condominium association receives a payment for damage to common property, it may pay the members for their respective portions of the settlement and levy a special assessment for the necessary repairs. (The payments paid to the members decrease the bases in their units, while the special assessment increases their bases. If a payment exceeds an owner's basis, the excess amount is taxable to the owner.) In addition, when settlement funds for members are received by the CIRA as part of a master insurance policy that covers damage to the separate property of members, such as condominium interiors, the CIRA generally acts as an agent to execute repairs on behalf of the members.

**Accounting for Expenditures for Litigation Expenses.** The CIRA may incur significant costs at the outset of the litigation process for investigative work and legal fees. (Sometimes attorneys will perform litigation work on a contingent fee basis and thus require no payment of attorney's fees until the litigation is settled.) Such expenditures should be recognized and disclosed in accordance with FASB ASC 450, *Contingencies*.

**CIRA Board's Responsibilities for Settlements.** Generally, there are no specific requirements as to how the CIRA must spend the settlement monies. Once the settlement is received, the CIRA's board of directors is responsible for determining the appropriate use of any settlement proceeds (after considering any restrictions in the governing documents). If the settlement proceeds are not adequate to make all of the related repairs, the CIRA may repair as much of the damage as possible and then make no additional repairs or levy a special assessment or obtain financing for the remaining repairs. However, if the settlement proceeds are adequate to make the repairs, there may be legal consequences if the CIRA does not make those repairs.

In some situations, a CIRA may legitimately choose to defer completing all the work for which a damage settlement or insurance claim has been received. If the association's intent is to complete the remaining repairs in the future, the excess proceeds need to be set aside (either in the replacement fund or a separate fund) to complete the repairs.

In some instances, the settlement proceeds exceed the cost of the related repairs. Then, the CIRA must decide the appropriate use of the excess funds. Some CIRAs choose to transfer the monies to the replacement fund, while others choose to reduce member assessments. (There are tax implications when reducing member assessments.) In rare instances, settlement proceeds related to the CIRA's property might be distributed to CIRA members. It is a best practice that such distributions be made only after consulting with an attorney. While the calculation of such distributions is beyond the scope of this course, such a distribution would be accounted for as a reduction of members' equity that would be reflected in the statement of changes in fund balance (or the statement of changes in members' equity if a nonfund approach is used) and the cash flow statement. The association should consider informing its members what the distribution represents and let them know that they may want to contact their personal tax advisors to determine the tax impact of the distributions they received. (The tax impact may be different for every member, and the association does not have the information to know the tax impact to each member.)



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. Benbrick Townhomes voted to have a special assessment to remodel the clubhouse this year. When the remodel was completed, there were excess funds left over. The members of the CIRA have decided to apply the excess funds against next year's assessments. Which of the following is correct regarding the excess funds?
  - a. The CIRA should make no entry on the current year financial statements.
  - b. The excess funds should not be reported on the CIRA's financial statements.
  - c. The excess should be shown as a reduction of equity in the statement of changes in fund balance for the current year.
  - d. Excess assessments should be shown as a note payable on the year-end financial statements.
14. Which of the following is correct regarding ancillary operations of a CIRA?
  - a. GAAP requires that rental pool revenue be reported at the net amount earned by the association.
  - b. Ancillary operations should be able to survive based only on the direct costs.
  - c. Most CIRAs do not have a tax basis in the common area assets that are associated with ancillary operations.
  - d. CIRAs use the cash basis when accounting for the income related to ancillary operations.
15. In which of the following situations has the CIRA handled the capitalization of the common property correctly?
  - a. The Stone Ridge Farms HOA purchases new furniture for the clubhouse of the community and expenses it in the period it is purchased.
  - b. A new lawn mower is purchased by the Dawn Condos to maintain the grass at the facility and is expensed when purchased.
  - c. The Bay Street Condominiums capitalize the addition of sidewalks to connect all of the housing units in the complex.
  - d. The Street 10 cooperative creates a manager's apartment within the building so that the manager can live on-site. All related expenses are capitalized.
16. How should common and other real property be valued by a CIRA?
  - a. Common property acquired from the developer should be recorded at the acquisition cost.
  - b. Common property purchased by a CIRA should be reported on the financial statements at cost.
  - c. Acquisition cost is the only cost that can be used for purchased common property of a CIRA.

17. Which of the following is correct regarding financial reporting for a foreclosed unit in a CIRA?
- a. No assessment revenue related to the foreclosed unit should be recorded as long as the unit is held by the CIRA.
  - b. Foreclosed units should be listed a liability on the CIRA's balance sheet, along with all the assessments that the unit's owner did not pay.
  - c. All costs related to repairs or physical improvements on the foreclosed unit that the CIRA pays, regardless of amount, should be expensed in the period in which they occur.
  - d. If a CIRA plans to resell a unit that has been foreclosed on, all estimated costs to resell the unit should be subtracted from the unit's fair value.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. Benbrick Townhomes voted to have a special assessment to remodel the clubhouse this year. When the remodel was completed, there were excess funds left over. The members of the CIRA have decided to apply the excess funds against next year's assessments. Which of the following is correct regarding the excess funds? **(Page 208)**
  - a. **The CIRA should make no entry on the current year financial statements. [This answer is correct. If the members elect to apply the excess against the following year's assessments, no entry would be made in the CIRA's financial statements.]**
  - b. The excess funds should not be reported on the CIRA's financial statements. [This answer is incorrect. The excess of revenue over expenses for financial reporting in the current year will exceed amounts reported in the CIRA's tax return and the difference should be shown as an adjustment on Schedule M-1 or M3 if the CIRA files a Form 1120.]
  - c. The excess should be shown as a reduction of equity in the statement of changes in fund balance for the current year. [This answer is incorrect. If the members elect to refund the excess assessments, the refund would be shown as a reduction of equity in the statement of changes in fund balance (or statement of changes in members' equity if the CIRA presents its financial statements using a nonfund approach) in the period in which the refund is authorized.]
  - d. Excess assessments should be shown as a note payable on the year-end financial statements. [This answer is incorrect. For financial reporting, the excess assessment should be recorded as revenue.]
14. Which of the following is correct regarding ancillary operations of a CIRA? **(Page 218)**
  - a. GAAP requires that rental pool revenue be reported at the net amount earned by the association. [This answer is incorrect. If an association conducts a rental pool on behalf of its members, questions may arise as to the amount to be recorded as revenue by the association – the entire amount of rents received or simply the commission earned by the association for conducting the activity. GAAP requires that gross amounts be reported.]
  - b. Ancillary operations should be able to survive based only on the direct costs. [This answer is incorrect. Associations need to consider if they should allocate indirect costs to ancillary activities. It is virtually impossible for such activities to exist based on their direct costs alone. Providing ancillary activities will require some portion of on-site staff and/or the management company's time (indirect costs) to enable these activities to occur.]
  - c. **Most CIRAs do not have a tax basis in the common area assets that are associated with ancillary operations. [This answer is correct. For tax purposes, most CIRAs do not have any tax basis in the common area assets that are associated with ancillary operations. This disparity between the accounting and tax rules results in an automatic book-to-tax depreciation difference for most CIRA ancillary activities.]**
  - d. CIRAs use the cash basis when accounting for the income related to ancillary operations. [This answer is incorrect. Similar to commercial businesses, ancillary operations income is accounted for on the accrual basis.]
15. In which of the following situations has the CIRA handled the capitalization of the common property correctly? **(Page 225)**
  - a. The Stone Ridge Farms HOA purchases new furniture for the clubhouse of the community and expenses it in the period it is purchased. [This answer is incorrect. Per FASC ASC 972-350-25, personal property, like furnishings, is capitalized in a HOA community.]

- b. A new lawn mower is purchased by the Dawn Condos to maintain the grass at the facility and is expensed when purchased. [This answer is incorrect. As stated in FASC ASC 972-350-25, maintenance equipment associated with a condominium should be capitalized.]
- c. The Bay Street Condominiums capitalize the addition of sidewalks to connect all of the housing units in the complex. [This answer is incorrect. Real property directly associated with the units, like sidewalks, is not generally capitalized in a condominium according to FASB ASC 972-350-25.]
- d. **The Street 10 cooperative creates a manager's apartment within the building so that the manager can live on-site. All related expenses are capitalized. [This answer is correct. Real property not directly associated with the units within the cooperative, like a manager's apartment should be capitalized per FASC ASC 972-350-25.]**

16. How should common and other real property be valued by a CIRA? **(Page 228)**

- a. Common property acquired from the developer should be recorded at the acquisition cost. [This answer is incorrect. FASB ASC 972-360-30-1 states that if a CIRA acquires common property "in a nonmonetary transaction, such as by a nonreciprocal transfer from the developer, and if the property is recognized as an asset of the CIRA, the CIRA should recognize the property using fair values at the date of its acquisition."]
- b. **Common property purchased by a CIRA should be reported on the financial statements at cost. [This answer is correct. Similar to other businesses, purchased common property should be reported at cost. Future purchased additions should be recorded at cost, too.]**
- c. Acquisition cost is the only cost that can be used for purchased common property of a CIRA. [This answer is incorrect. If acquisition costs are no longer available for a CIRA of purchased common property, another reasonable basis should be used; for example, cost-based appraisals, insurance appraisals, replacement costs or property tax appraisals used for market.]

17. Which of the following is correct regarding financial reporting for a foreclosed unit in a CIRA? **(Page 230)**

- a. No assessment revenue related to the foreclosed unit should be recorded as long as the unit is held by the CIRA. [This answer is incorrect. For the period of time that the CIRA owns the unit, it should record assessment revenue from the unit so long as it has an expectation of realizing that revenue. If the CIRA no longer has a realistic expectation of collecting assessment revenue related to the unit, it should adjust receivables to the amount estimated to be collectible and no longer recognize assessment revenue.]
- b. Foreclosed units should be listed a liability on the CIRA's balance sheet, along with all the assessments that the unit's owner did not pay. [This answer is incorrect. Foreclosed units should be presented as a separate balance sheet amount or included with other assets, according to FASB ASC 310-10-45-3.]
- c. All costs related to repairs or physical improvements on the foreclosed unit that the CIRA pays, regardless of amount, should be expensed in the period in which they occur. [This answer is incorrect. The costs of repairs or physical improvements to a foreclosed unit should be capitalized if they significantly increase the fair value of the asset. Otherwise, they should be expensed as incurred.]
- d. **If a CIRA plans to resell a unit that has been foreclosed on, all estimated costs to resell the unit should be subtracted from the unit's fair value. [This answer is correct. If the CIRA expects to sell the unit, estimated costs to sell reduce the unit's fair value. Selling costs include only direct cost of selling the unit, such as sales commissions, legal and transfer fees, and other closing costs.]**

## PREPAID EXPENSES AND OTHER ASSETS

### Prepaid Insurance

Prepaid expenses—that is, advance payments for products or services that will be used in operations during the year—often are not material to the financial statements of commercial businesses. But insurance premiums represent a significant expense for most common interest realty associations, and prepaid insurance often is a material asset at the balance sheet date. Although accounting for prepaid insurance is straightforward, if the CIRA finances the payment of its insurance premiums, questions may arise about the amounts to report in the CIRA's financial statements.

Premiums for insurance that CIRAs are required to carry generally are significant. Thus, many CIRAs pay a cash downpayment toward the total premium at the beginning of the policy and enter into a "premium finance agreement" for the balance of the premium. The agreement generally requires the remaining premium to be paid in monthly installments, including interest, during the policy period. Although the premium finance agreements are similar to notes payable, they do not seem to constitute liabilities of the CIRA at the balance sheet date because, in most cases, the insurance policies are cancelable either by the CIRA or the insurance company upon appropriate notice. Thus, GAAP seems to require prepaid insurance reported in the CIRA's balance sheet to be calculated solely on the actual premium payments that the CIRA has made.

To illustrate, assume that a calendar-year CIRA enters into an insurance contract on September 1 at a total premium of \$25,550. The CIRA pays a \$6,200 cash downpayment, and the remaining premium of \$19,350 is to be paid through a premium finance agreement that requires nine monthly payments in the amount of \$2,150 beginning October 1. (To simplify the illustration, interest on the unpaid premiums is ignored.) Thus, at the balance sheet date, the CIRA will have paid \$12,650 (\$6,200 downpayment plus three payments of \$2,150), and its financial statements would report an asset for prepaid insurance calculated as follows:

Total premium paid	\$ 12,650
Premium related to expired policy period (September 1 to December 31, or $\frac{1}{3} \times \$25,550$ )	<u>8,517</u>
Prepaid insurance at December 31	<u>\$ 4,133</u>

Although the premium finance agreement does not seem to meet the definition of a liability, some CIRAs nevertheless (a) record the amount due under the premium finance agreement as a liability and (b) base the calculation of prepaid insurance on the total policy premium rather than on the amount that the CIRA has actually paid. Assuming the same facts as the preceding illustration, relevant amounts would be as follows:

Total policy premium	\$ 25,550
Premium related to expired policy period (September 1 to December 31, or $\frac{1}{3} \times \$25,550$ )	<u>8,517</u>
Balance	<u>\$ 17,033</u>
Amount due under premium finance agreement at December 31 (total financed of \$19,350 less three payments of \$2,150)	<u>\$ 12,900</u>

If the CIRA's financial statements report the prepaid amount as calculated in the preceding paragraph (\$17,033) and the amount due under the premium financing agreement (\$12,900) as a net amount, the effect on the balance sheet will not differ materially from the effect when prepaid insurance is calculated based on actual premium payments. (In this example, the prepaid insurance amounts as calculated previously are the same since, for simplicity, the example ignored interest. In reality, the amounts calculated under the two methods generally will differ by immaterial amounts.) However, presenting prepaid insurance based on the total policy premium and the amount due under a related premium financing agreement at their gross amounts is a departure from GAAP since, in that case, both assets and liabilities are overstated. Thus, in their opinion, it is acceptable to record gross amounts only if the amount of the overstatement is immaterial to both assets and liabilities.

## Other Prepaid Expenses

Prepaid insurance often is the most significant prepaid expense for many CIRAs, but some CIRAs make significant advance payments for other products or services, such as contracts for snow removal or landscaping services. If amounts involved are material at the balance sheet date, costs that apply to future periods should be classified as prepaid expenses.

## Inventories

Many CIRAs do not have inventories, but some carry inventories of supplies used in providing services to unit owners, such as fuel or snow removal supplies or related to commercial operations or member amenities, such as golf courses, restaurants, activity centers, spas, etc. Accounting for inventories is similar to commercial businesses—the same lower of cost or net realizable value pricing and obsolescence considerations apply. FASB ASC 330-10-30 provides guidance regarding inclusion of certain costs (such as abnormal freight, handling, and spoilage) in inventory and provides guidance on the allocation of fixed production overhead.

## Deposits

Deposits for utilities or similar items generally are not significant. Technically, they are assets, although recording them as expenses usually does not materially misstate the CIRA's financial statements. Nevertheless, most accountants record them in an asset account so that they are not forgotten.

Classifying deposits as current or noncurrent assets generally is not an issue for CIRAs since they usually present unclassified balance sheets. If the CIRA presents a classified balance sheet, deposits would be recorded as noncurrent assets unless they are expected to be refunded within the next year.

## FUNDS FOR FUTURE MAJOR REPAIRS AND REPLACEMENTS

One of the principal objectives of CIRAs is to maintain the development's common property. CIRAs may accumulate funds for future major repair and replacement of the common property through the following ways:

- Funding through periodic assessments over the estimated life of common property
- Funding through special assessments at the time a major repair or replacement of common property is needed
- Borrowing
- Seeking grants or other kinds of programs from governmental entities (such as, energy retrofits, landscape plantings, etc.)
- Seeking assistance from governmental agencies, for example, financial programs geared toward low to moderate income homeowners, are sometimes available
- A combination of those options

## Accounting for Assessments and Expenses

Assessments for major repairs and replacements are reported separately from assessments for operations in the period assessed as specified in the budget. If the CIRA reports its financial positions and results of operations using fund accounting, FASB ASC 972-205-45-2 also requires amounts assessed for future major repairs and replacements to be reported in a separate fund. Some CIRAs, however, also segregate expenses for repairs and replacements if they fund those costs through special assessments since the excess of special assessments over costs incurred may be refunded to members. (For tax purposes, capital and noncapital items must be accounted for separately.) Under certain circumstances, assessments collected for specific repairs are not includable in the CIRA's taxable income; rather they are treated as contributions of capital for tax purposes. For *financial reporting*,



however, the assessments are recorded as revenue. In those cases, a permanent difference between financial and tax reporting is created since the assessments will never be reported as income in the CIRA's tax return, and deferred income taxes are not required.

The types of expenses that are appropriately charged against assessments for future major repairs and replacements and, thus, replacement fund expenses, vary among CIRAs. Generally, however, they consist of the following:

- Direct costs incurred for repairing or replacing the common property, including wages if the repairs are made with association personnel
- Indirect costs related to maintaining the common property, including insurance and the costs of litigating warranty claims against builders or developers
- Allocated costs, such as income taxes
- Any other repair and replacement costs contemplated by the reserve study.

The principal decision to charge the replacement fund or the operating (or other) fund for certain expenses is governed by state statutes or the CIRA's board (or members, as state law dictates) when they adopt the CIRA's annual budget. Provided budgeted amounts do not conflict with provisions of the CIRA's governing documents, reserve study, and state statutes, best practices indicate that expenses should be reported in the fund in which they were budgeted. However, this course recommends that CIRAs adopt a consistent policy for charging expenses to particular funds so that operating results of the funds will be comparable from year to year. Having a formal policy for determining replacement fund items is especially important since CIRAs often change reserve study preparers and should seek a consistent method of determining what is included in the reserve study. Best practices indicate expenses incurred during the year that have not been budgeted should be reported in the fund that most closely relates to the nature of the expense. Occasionally uncertainty may exist over the allocation of expenditures between operating and reserve. Because of the fiduciary duty that CIRAs have over replacement fund monies, when such situations arise, the CIRA's board of directors generally is involved in making those decisions.

### Interfund Transactions

If the CIRA uses fund accounting, interfund receivables and payables are recognized between the operating, replacement, and any other funds when one fund pays amounts that are proper expenses of another fund. For example, if the operating fund pays expenses for replacing the heating system, the operating fund would record a receivable from the replacement fund, and the replacement fund would record the expense and a payable to the operating fund. Interfund receivables and payables also may result from collections of assessments or interest income earned by one fund but not transferred to another fund. The AICPA guide provides the following example in Paragraph 4.09:

A CIRA's budget includes an annual assessment of \$80,000 for future major repairs and replacements, which is reported as revenue of the replacement fund. However, due to an unexpected increase in operating costs, the CIRA's board of directors transferred only \$50,000 of the \$80,000 to the replacement fund. Under these circumstances, the CIRA's financial statements should reflect \$30,000 as a receivable from the operating fund and as a payable to the replacement fund.

Thus, using replacement funds for operations would not result in a reduction of revenue in the replacement fund. In other words, amounts assessed for replacement funds as indicated in the budget should be recorded as revenue even if the cash transfer has not occurred. The following entries should be made:

<b>Replacement Fund</b>			
Cash		\$ 50,000	
Due from Operating Fund		30,000	
Member assessments			\$ 80,000

**Operating Fund**

Cash	\$ 30,000	
Due to Replacement Fund		\$ 30,000

FASB ASC 972-205-45-10 states that interfund borrowings should be considered permanent and recorded as transfers when the borrowing fund is not able or does not intend to repay the loan. Thus, in the preceding example, if the operating fund does not intend to repay the \$30,000 to the replacement fund, the following entries should be recorded:

**Replacement Fund**

Transfer to Operating Fund	\$ 30,000	
Due from Operating Fund		\$ 30,000

**Operating Fund**

Due to Replacement Fund	\$ 30,000	
Transfer from Replacement Fund		\$ 30,000

Transfers between funds are not considered as revenues and expenses but are reported as changes in fund balances (or as changes in designated and undesignated equity if the CIRA presents its financial statements using a nonfund approach).

**Interfund Transfers versus Interfund Receivables and Payables.** Interfund transfers and interfund receivables and payables are distinguished solely by the *intent* and *ability* of the borrowing fund to repay the amounts owed. In some cases, state statutes address appropriate replacement fund expenditures. If not specified in state statutes, whether that determination may be made by the CIRA's board of directors or must be made by the CIRA's members depends on the provisions of the CIRA's governing documents. Generally, it is a best practice for budgeted but unfunded assessments (or any other types of interfund borrowings) to be recorded in the CIRA's financial statements as interfund receivables and payables rather than as transfers only if state statutes permit the borrowing and the borrowing fund has the ability to repay the lending fund and the CIRA intends to repay the amount.

It is important for CIRAs to document any interfund borrowings because such documentation:

- Documents compliance with state statutes, if applicable.
- Formalizes the intent of the board of directors.
- Notifies members of their obligation to repay the funds borrowed.
- Serves as evidence in case of a tax audit.

The IRS has not formally ruled on the issue of whether poorly documented interfund borrowings may be considered a commingling of funds. Without proper documentation, the only evidence of the intent of the association is the budget, which would not have contemplated such interfund borrowings. In an unpublished draft Audit Techniques Guide, the IRS indicated that any interfund borrowings are considered prohibited transactions that may endanger the integrity of the entire replacement fund.

Consequently, this course recommends that all interfund borrowings be documented by actions such as the following:

- Document the reason for the borrowings and the repayment terms in board minutes.
- Specify the amount of the loan, the repayment terms, and the rate of interest to be charged in writing.
- Modify the budget to reflect the loan, and notification of the change should be sent to the members.
- Modify the reserve study to reflect the altered cash flow.

An illustration of how CIRAs would report transactions between the operating and replacement funds if their financial statements are reported using fund accounting was shown previously. If the CIRA uses a nonfund approach, FASB ASC 972-605-50-1 requires assessments that were used for purposes other than those for which they were designated to be disclosed. Generally, that disclosure will be made in the notes to the financial statements. However, if the CIRA decides to reallocate amounts between appropriated and unappropriated equity, best practices indicate that the transfer would be made in the Statement of Changes in Members' Equity as follows:

	<u>Total</u>	<u>Undesignated</u>	<u>Designated for Future Repairs and Replacements</u>
BEGINNING MEMBERS' EQUITY	\$ 4,600,000	\$ 4,075,000	\$ 525,000
Excess of revenues over expenses	121,000	121,000	—
Amounts allocated to future major repairs and replacements	—	(80,000)	80,000
Transfers from future major repairs and replacements to undesignated equity	—	30,000	(30,000)
ENDING MEMBERS' EQUITY	<u>\$ 4,721,000</u>	<u>\$ 4,146,000</u>	<u>\$ 575,000</u>

**Assets Purchased with Replacement Funds.** A portion of the assessments authorized for future major repairs and replacements may be for items that are capitalized as assets, such as pool furnishings. Assets generally are recorded in the operating fund or in a separate property and equipment fund established for that purpose. For example, assume that a CIRA budgeted \$32,000 for recreational equipment, and a portion of the monthly member assessments for future major repairs and replacements is designated for that equipment. When the asset is purchased, the replacement fund would record a transfer to the operating fund, and the assets would be capitalized in the operating fund as follows:

<b>Replacement Fund</b>		
Transfer to Operating Fund	\$ 32,000	
Cash		\$ 32,000
<b>Operating Fund</b>		
Recreational equipment (asset account)	\$ 32,000	
Transfer from Replacement Fund		\$ 32,000

Transfers between funds are not considered as revenues and expenses but should be reported as changes in fund balances.

### Financial Statement Disclosure

**Disclosures about Funding for Future Major Repairs and Replacements.** FASB ASC 972-235-50-2 requires all CIRAs to make the following financial statement disclosures about their funding for future major repairs and replacements:

- Requirements, if any, in statutes or association documents (or mortgage or governmental bodies funding requirements, e.g., FHA often has such requirements), to accumulate funds for future major repairs and replacements and the CIRA's compliance or lack of compliance with them
- A description of the CIRA's funding policy, if any (including a policy to fund future major repairs and replacements by special assessments or borrowings when needs occur) and compliance with that policy
- A statement that funds, if any, are being accumulated based on estimated future (or current) costs and that actual expenditures may vary from those estimates and the variations may be material

- Amounts assessed for major repairs and replacements in the current period, if any
- A statement indicating whether a study was conducted to estimate the remaining useful lives of common property components and the costs of future major repairs and replacements

The amount assessed for major repairs and replacements usually is disclosed by presenting it as a line item in the statement of revenues and expenses or statement of changes in fund balance. The other disclosures are made in the notes to the financial statements.

The AICPA guide recommends, beginning at Paragraph 4.31, that associations may also consider making two additional disclosures (although the AICPA guide indicates these disclosures are not required):

- Disclosing the type of funding plan goal that was used in the reserve study
- Disclosing the level of service used to perform the reserve study

Disclosing the type of funding plan goal used in the reserve study allows financial statement readers to understand the implications of the method chosen and make informed and educated decisions. Three types of non-statutory funding plans are: baseline funding, full funding, and threshold funding. The funding plan goal used could contribute to significant fluctuations in assessment levels.

The National Reserve Study Standards discuss three levels of service used to prepare a reserve study and the levels vary greatly in detail. These levels of service are (a) full, (b) update—including a site visit and on-site review, and (c) update—without a site visit or an on-site review. Disclosure will allow financial statement readers to know what level of service was performed in preparing the reserve study.

**Required Supplementary Information.** In addition to the preceding general disclosures about future major repairs and replacements, FASB ASC 972-235-50-3 requires the following information to be disclosed outside of the basic financial statements:

- Estimates of current or future costs of future major repairs and replacements of all existing components, such as roofs, including estimated amounts required, methods used to determine the costs, the basis for calculations (including assumptions, if any, about interest and inflation rates), sources used, and the dates of studies made for that purpose, if any
- A presentation of components to be repaired and replaced, estimates of the remaining useful lives of those components, estimates of current or future replacement costs, and amount of funds accumulated for each to the extent designated by the board

**Disclosures about Disaster Insurance Deductibles.** Major hurricane damage in Florida and throughout the South and earthquake damage in California have resulted in increased disaster insurance deductibles for CIRAs in those states. For example, one condominium in Florida saw its deductible rise from \$500 to \$500,000. CIRAs in other states are also seeing increased premiums and deductibles.

Many CIRAs have unfunded insurance deductible reserves. Some accountants question whether the potential loss to associations due to large unfunded deductibles needs to be accrued by a charge to income or disclosed as a loss contingency under FASB ASC 450-10. However, FASB ASC 450-20-55-3 through 55-5 note that no disclosure is required for the absence of insurance (for example, the uninsured deductible amount) because there is no loss at the balance sheet date or before issuance of the financial statements; that is, the event creating the loss has not occurred. It states:

Uninsured risks may arise in a number of ways, including (a) noninsurance of certain risks or co-insurance or deductible clauses in an insurance contract . . .

The absence of insurance does not mean that an asset has been impaired or a liability has been incurred at the date of an entity's financial statements. Fires, explosions, and other similar events that may cause loss or damage of an entity's property are random in their occurrence. With respect to events of that type, the condition for [loss accrual] . . . is not satisfied prior to the occurrence of the event because until that time there is no diminution in the value of the property.

## CAPITAL IMPROVEMENT FUNDS

Capital improvement funds are different from funds for future major repairs and replacements. Repair and replacement funds are accumulated for the *major repair or replacement of existing* common area components; capital improvement funds are funds designated for the *acquisition or construction of new* common area components. Examples are the construction of a new clubhouse, the purchase of a new computer system, or the purchase of an adjacent lot for a park. After the new components are acquired, they may need to be included in the reserve study for future repair or replacement.

Some CIRAs account for capital improvement projects as separate funds and segregate any cash balances accumulated. In a columnar report presentation, the fund may be reported in a separate column. Others simply combine capital improvement funds with the reserve fund. Best practices indicate there is no significant problem with that approach, as the amounts are being set aside for a specific capital purpose and will probably require reserve funding after acquisition. Also, the funding plan for those components can be easily incorporated into the existing reserve funding plan, eliminating the need for a separate plan.

## PRACTICAL GUIDELINES FOR PERFORMING A RESERVE STUDY

Many CIRAs either prepare reserve studies internally, or engage outside professionals to perform this service. Some states have specific statutes regarding the establishment and funding of reserve funds. Other states have no similar requirement. Additionally, CIRAs may be required by mortgage or loan documents or their governing documents to set aside funds on a systematic basis for future major repairs and replacements. The supplementary information about future major repairs and replacements that FASB ASC 972-235-50-3 requires CIRAs to include in their financial statements, in essence, requires associations to perform reserve studies to determine the information.

The Community Associations Institute (CAI) most recently revised its *Guide for Association Practitioners* in 2009—titled *Reserve Funds: How & Why Community Associations Invest Assets*. In 2014, the Foundation for Community Associations Research published its *Best Practices, Reserve Studies/Management*, which provides best practices for performing a reserve study. Included in the report are three case study examples and a comprehensive listing of reserve study terminology, as well as basic reserve study information. That document is available free from the CAI Research Foundation at [www.cairf.org/research/BPRS.pdf](http://www.cairf.org/research/BPRS.pdf).

A reserve study is a plan for setting aside funds for the future major repair or replacement of the association's common property. It requires:

- An analysis of the common property components (the physical analysis)
- The preparation of a long range funding plan (the financial analysis)

### Physical Analysis

Preparers of a physical analysis need to be aware of the association's responsibility to maintain the common property and be familiar with—

- The association's governing documents
- State and local law, which may override the association's governing documents
- The association's mortgages, bonds, loans, etc.
- Construction standards and techniques
- Local conditions affecting wear and tear on components
- Alternatives to existing construction, including the possibility that new types of material and equipment may be available

- The cost of component repair and replacement
- Local standards for preparation of reserve studies

Most accountants lack the necessary technical training to perform such an analysis. However, they may perform the physical analysis by relying on specialists in certain areas to provide technical support.

The physical analysis consists of the following general steps:

- Inventory the common property components
- Assess the current condition of the components
- Estimate the remaining useful lives of the components
- Estimate the repair or replacement cost of the components

**Inventory the Common Property Components.** Before beginning the inventory of the common property components, preparers need to—

- Review the governing documents, mortgages, bonds, loans, etc., regarding the association's responsibility to maintain or repair the common property components
- Review state and local laws to determine if they override the provisions of the governing documents in any way
- Determine if the association has established any reserve policies that would affect those components to be included in the study
- Inspect the site with a knowledgeable representative of the association, such as the managing agent or a member of the board of directors

All common property components (including hidden components such as plumbing, electrical wiring, cable, or fiber optics) need to be listed appropriately to determine what to include in the study. It is also common for CIRAs to include with their overall budget, a deferred maintenance account for those components requiring periodic maintenance that does not occur annually. Deferred maintenance account components generally include painting, staining, and caulking. Preparers need to consider including items other than physical components, such as disaster insurance deductibles. Any components that are excluded should be listed in a separate section of the study with a reason for their exclusion from the study. CIRAs typically do not establish reserves for the following items:

- *Common Property Components That Are Considered "Permanent."* Permanent components are those with remaining useful lives of 30 years or more. The CIRA does not begin accumulating reserves for such items until their remaining useful lives drop below 30–40 years, or less.
- *Components That the CIRA's Members Are Responsible for Repairing or Replacing.* Reserves are established only for components that the CIRA is responsible for maintaining and replacing.
- *Components Costing an Amount Less Than or Equal to a Specified Amount.* It is common practice to capitalize only components that exceed a monetary threshold, such as, \$1,000 or more.
- *Components with Estimated Useful Lives of Two Years or Less.*

Although not specifically required, if a CIRA follows a policy of not establishing reserves for items having remaining useful lives of 30 or more years (or other specified number of years), it is a best practice for the policy to be disclosed in the notes to the financial statements as part of the CIRA's required disclosures about funding for future major repairs and replacements.

Funds are not accumulated for repairing or replacing items that are the responsibility of the CIRA's members. Reserves are established only for components that the CIRA is responsible for maintaining and replacing. Unfortunately, determining who is responsible is not always an easy task. In some cases, CIRAs have responsibility to maintain and replace an element of a component that is owned by unit owners, such as siding or roofs. In other cases, even though the governing documents specify that particular components are the responsibility of the CIRA, the members may have "unofficially" assumed responsibility for maintaining them. Examples include front doors, garage doors, garage door openers, patios, and decks. In such situations, the CIRA may need to seek legal advice to determine who has actual responsibility for repairing and replacing the components.

A prior reserve study may indicate the quantity or measurements of various components, or measurements may be obtained from architects' plans, contractors' bids for corrective work, or directly from the association. Those counts or measurements need to be reviewed for reasonableness. In the absence of reliable prior documentation, preparers will need to measure or count the components.

**Assess the Current Condition of the Components.** The site inspection mentioned previously generally includes an examination of a representative sample of each of the common property components. Maintenance staff, contractors, and consultants are excellent sources of information about the condition of components, particularly when that condition is not readily apparent. Owners (that is, the users) of common property components can also be a good source of information.

It may be possible to replace components in need of repair with alternate materials. Recently, new construction products have been manufactured that may provide a better alternative than simply replacing the existing component with the same product.

**Estimate the Remaining Lives of the Components.** It may be possible to estimate the remaining life of a component at the time preparers assess its condition. There are several sources of published material available to assist in making such a determination.

**Estimate the Repair or Replacement Cost of the Components.** The best sources of estimated repair or replacement cost data are prior costs paid by the association, existing bids for work not yet performed, engineers' estimates, and the informed judgment of association personnel. Managing agents may have managed associations for which the same or similar components have been replaced. Independent cost estimates may be obtained. It is a best practice that all information be checked for reasonableness against available published data that has been adjusted for local variables that affect cost. When relying upon published material (which is generally for new construction only), consider the additional cost to remove the old material in the total cost of the repair or replacement.

It is a good idea for a CIRA to reevaluate its funding level each year based upon changes to the common property, replacement costs, and the condition of the components.

## Financial Analysis

The association's options for replacing its common property components depend on factors such as—

- Limitations in the association's governing documents, mortgages, loans, or bonds on investment alternatives
- State and local law (which may override the association's governing documents)
- The existing financial structure of the association
- Funds presently available for reserve funding
- Local standards for preparation of reserve studies

In performing a financial analysis, preparers will need to determine the following:

- Amount of funds presently set aside (fund status), as well as, a cash flow projection that anticipates expenditures and contribution requirements over time (generally ranging from 20 to 30 years)

- Funding level at which the association intends to fund reserves (funding plan)

Depending on the particular reserve fund calculation method that is selected, preparers may also need to estimate—

- Current and projected investment earnings rates
- Current and projected cost inflation rates

**Amount of Funds Presently Set Aside (Fund Status).** The amount of funds presently set aside to fund reserves is not always easily determined. Frequently, reserve study preparers incorrectly assume that monies in a savings or investment account are reserve funds. Preparers need to ask how the association intends to allocate existing cash between the operating fund and the reserve fund.

Also, the status of any existing interfund borrowings needs to be assessed. It is necessary to determine whether such amounts will be repaid and, if so, when and how.

As an alternative, associations may borrow money from financial institutions to make necessary repairs and use the reserve fund to make the related loan payments. In that case, loan repayments are considered as part of the funding study.

**Funding Level at Which the Association Intends to Fund Reserves (Funding Plan).** After determining the initial funding requirement, preparers need to review it with association management. Some state statutes require reserves to be fully funded unless the unit owners vote to waive or reduce funding. However, if the unit owners cannot reasonably afford the monthly cost, it is unlikely that the funding plan will ever be adopted.

**Current and Projected Investment Earnings Rates.** Preparers need to document the current earnings rates on the CIRA's investments and make an estimate of the rates to be achieved in the future. The treatment of interest earnings also will affect the funding study; i.e., will the earnings be retained in the replacement fund or transferred to the operating fund? Since the funding plan is a long range study, conservative estimates are a best practice. Not all reserve studies include investment earnings.

**Current and Projected Cost Inflation Rates.** Current and projected inflation rate information is available from several sources, such as the U.S. Bureau of Labor Statistics and major banks. It is best to use a rate for construction costs only rather than the overall inflation rate for an area. Not all reserve studies take inflation into account.

### Reserve Funding Plan Goals

Funding plans may be devised to achieve differing levels of funding. There are four basic categories of goals that funding plans are typically devised to achieve:

- a. *Baseline Funding.* A baseline funding goal sets out to maintain the reserve cash balance above zero.
- b. *Full Funding.* A full funding goal sets out to achieve and maintain at or near a 100% reserve level.
- c. *Threshold Funding.* A threshold funding goal is achieved by keeping the reserve balance above a specific dollar or percentage amount (which can either be more or less conservative than full funding).
- d. *Statutory Funding.* Statutory minimum funding levels may be dictated by local statutes.



A CIRA may choose to use more than one of the above funding levels (as long as such a policy does not violate local reserve funding statutes). For example, a CIRA may use a threshold funding plan, but may stipulate that the full funding method be used for components that are near to scheduled repair or replacement (such as, within the next two or three years). It is appropriate to allocate funds to each component in the reserve study, except potentially *permanent* components.

### Reserve Fund Calculation Methods

Various methods may be used to calculate the reserve portion of the monthly assessment based on the funding plan goal to be achieved. Two frequently used methods are—

- Straight-line segregated method (also referred to as the component method)
- Pooling method (also referred to as the cash flow method)

Those methods are discussed in the following paragraphs.

**Straight-line Segregated Method.** If a CIRA has not previously established reserves for future repairs and replacements, the straight-line segregated method consists of dividing the current cost of an individual reserve item by its estimated useful life to arrive at the monthly reserve contribution amount for that item. The process is repeated for each reserve item, and the individual contribution amounts for all of the items are added together to determine the total monthly contribution needed for the association. That amount is divided by the number of units to determine each owner's respective contribution.

If a CIRA has established reserves (for example, in years after the initial analysis or if it has established reserves but has not previously conducted a reserve study), the existing reserve fund balances are considered in making the calculation. In those circumstances, the beginning reserve fund balance is subtracted from the updated current cost and that amount is divided by the updated estimated remaining useful life of the item to arrive at the monthly contribution for the item. As in the initial calculations, the total of the individual contribution amounts is calculated to arrive at the total contribution needed for the association, and that amount is divided by the number of units in the CIRA to arrive at the monthly contribution amount per unit.

Similar calculations are made annually for each reserve item until it is either repaired or replaced taking current circumstances into account; e.g., the estimated useful lives may change, current costs may increase due to inflation, reserve items may be repaired or replaced, and interest is earned on the existing reserve funds. Because the annual calculation is based on the difference between each component's current cost and the portion of the reserve fund balance allocated to that item, the annual calculations also are affected if the CIRA has reallocated reserve funds among common property components.

Exhibit 2-6 illustrates the calculations under the straight-line segregated method. The method derives its name because it does not consider time value of money factors, such as inflation or interest to be earned on the investment of replacement funds (i.e., straight-line), and because it calculates a reserve contribution for each common property component (i.e., segregated). Its principal advantage is that it is simple and easy to understand and, thus, is widely used.

**Pooling Method.** Calculations under the pooling method are similar to those under the straight-line segregated method except that, rather than calculate a specific reserve amount for each component, the pooling method considers all reserve items as a portfolio. Accordingly, the pooling method estimates reserve requirements based on a weighted average life for all components. Like the straight-line segregated method, current costs are determined for each item and totaled, and total funds required are determined by subtracting the total beginning reserve balance from total current costs for all items. Then, a weighted average remaining useful life is calculated by (a) multiplying the total current cost for each item by its remaining useful life and (b) dividing the total of the weighted average life factors for all components by total current costs. (Some reserve preparers may use other methods to calculate the weighted average life factor.) The monthly contribution amount is determined by dividing the funds required by the weighted average remaining useful life. That amount is divided by the number of units in the CIRA to arrive at the monthly contribution amount per unit. (The same type of allocation methodology may also be used to determine "percent funded" in those states that require such a disclosure.) Exhibit 2-7 shows illustrative calculations.

**Exhibit 2-6****Straight-line Segregated Method**

Analysis Date: 01/01/X3

DATE PLACED IN SERVICE	(A) BEGINNING BALANCE	(B) CURRENT COST	(C) FUNDS REQUIRED (B – A)	(D) USEFUL LIFE (MONTHS)	(E) REMAINING LIFE (MONTHS)	MONTHLY CONTRIBUTION (C ÷ E)
1/1/X0	\$ 1,600	\$ 9,000	\$ 7,400	60	24	\$ 308.33
7/1/X0	1,400	5,000	3,600	36	6	600.00
12/1/X0	800	3,000	2,200	54	29	75.86
4/1/X0	1,300	6,000	4,700	48	15	313.33
11/1/X1	300	4,000	3,700	120	106	34.91
	<u>\$ 5,400</u>	<u>\$ 27,000</u>	<u>\$ 21,600</u>			<u>\$ 1,332.43</u>
		*	*	*		

**Exhibit 2-7****Pooling Method**

Analysis Date: 01/01/X3

DATE PLACED IN SERVICE	(A) BEGINNING BALANCE	(B) CURRENT COST	(C) FUNDS REQUIRED (B – A)	(D) USEFUL LIFE (MONTHS)	(E) REMAINING LIFE (MONTHS)	(F) WEIGHTED AVERAGE LIFE FACTOR (B × E)
1/1/X0	\$ 1,600	\$ 9,000	\$ 7,400	60	24	\$ 216,000
7/1/X0	1,400	5,000	3,600	36	6	30,000
12/1/X0	800	3,000	2,200	54	29	87,000
4/1/X0	1,300	6,000	4,700	48	15	90,000
11/1/X1	300	4,000	3,700	120	106	424,000
	<u>\$ 5,400</u>	<u>\$ 27,000</u>	<u>\$ 21,600</u>			<u>\$ 847,000</u>

Weighted Average Life: \$847,000/\$27,000 = 31.3704 months

Contribution amount: \$21,600/31.3704 months = **\$688.55**

\* \* \*

The reserve requirement calculated under the pooling method is significantly less than required reserves determined under the straight-line segregated method. An additional advantage is that the arbitrary effect of allocating the beginning reserve fund balance to individual items is eliminated.

The pooling method may be used to ensure that reserve funds never fall below zero or a board-mandated cushion. Thus, the timing and amount of reserve expenses are especially important. Since the reason for a reserve fund is having the money available when needed, an expense that occurs early or is over budget can adversely affect future years, especially if there is no cushion mandated by the board. In that case, reserve studies need to be reviewed annually by the CIRA's board of directors and an updated study may be warranted.

## Time Value of Money

Most reserve studies consider both inflation and interest earned on replacement funds (compounded either annually or monthly) unless the association's policy is to transfer interest earned on replacement funds to the operating fund. In addition, more sophisticated calculation methods also take one or more of the following into account:

- Taxes to be paid on interest earned
- Cost of living increases on future contributions
- Contingencies
- Special assessments, if necessary

If the time value of money is not considered in the reserve study, the board of directors may want to consider having the study frequently updated to reflect the changes in interest and inflation rates.

## Percent Funded

*Percent funded* is a ratio, expressed as a percentage, that compares funds available for future major repairs and replacements at a point in time (often the end of an association's fiscal year) to the amount that the reserve study estimates will be needed to maintain, repair, or replace the components included in the study at the end of their useful lives. In other words, percent funded can be viewed as a comparison of the funds that an association has in its repair and replacement fund to the amount it "should have" at that point in time so that the requisite funds will be available at the end of the components' estimated useful lives for their repair or replacement. Percent funded is commonly viewed as an evaluation of the strength of an association's funds for future major repairs and replacements.

To illustrate how *percent funded* is calculated using a basic example, assume that a CIRA's reserve study includes the roofs of the units in the CIRA that have an estimated useful life of 25 years, and at the date of the calculation, the estimated remaining useful life is 10 years. The reserve study estimates that the future replacement cost of the roofs is \$500,000, and at the date of the calculation, the association has accumulated \$210,000 for roof replacement. Since 40% of the estimated life of the roofs remains (10 years/25 years), the association should have accumulated 60% of the cost of the replacement, or \$300,000 ( $\$500,000 \times 60\%$ ). However, the CIRA has accumulated only \$210,000; thus, for that component, the association is considered to be 70% funded at that date (the ratio of \$210,000 to \$300,000).

## Capital and Noncapital Pools

Noncapital items (such as tree trimming, landscaping, painting, termite treatment, the cost of the reserve study, the board-mandated cushion, disaster insurance deductibles, and contingency funds) may be included in the reserve study. Noncapital pools, also known as deferred maintenance accounts or funds, can be shown as separate columns or subtotals of the replacement fund. To facilitate tax preparation, the reserve study may be divided into capital and noncapital pools. Although assessments for noncapital purposes may be deposited in the repair and replacement fund, they are not treated as capital contributions for tax purposes.

## Frequency of Reserve Studies

Some jurisdictions have statutory requirements that dictate how often reserve study updates must be performed or reserve study updates may be addressed in a CIRA's governing documents. If not addressed, it is a best practice for reserve studies to be updated every one to five years depending upon factors such as the age of the association, changes in costs of building materials, etc. A new association generally does not need to conduct an annual update since it is not engaging in any significant repair and replacement activities yet. However, immediately after the developer turns over the association, a new CIRA may want to consider having an updated reserve study performed, as the developer may have had reasons for keeping the reserve assessments low and/or the developer-prepared study may not be totally complete or accurate due to architectural design changes that occurred as

the association community was built. An older association with a good deal of repair and replacement activity ordinarily updates its reserve study every year.

In deciding how often (or when the next) reserve study is performed, the association considers factors such as the following:

- Additions or replacements of any significant common elements
- Extreme wear and tear to the common elements from unseasonable weather, lack of maintenance, or other reasons
- Significant changes in building material or labor costs
- Catastrophic events such as hurricanes, earthquakes, etc.
- Changes to the anticipated scheduled dates of replacement
- Actual reserve income and expenses compared to the amount budgeted
- Whether the baseline or threshold funding method is used

If the association is experiencing one or more of these factors, it generally is considered prudent to conduct a new reserve study or updating the previous one. As the association ages, the need to frequently update or replace the reserve study becomes more crucial. Also, the AICPA guide suggests that CIRAs reevaluate repair and replacement funding levels each year based upon changes to the common elements as well as changes to replacement costs and component conditions of the association.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. The HOA of Trojan Fields maintains a major repairs and replacements account that is separate from the member assessments account for large repairs inside of the CIRA. What should the CIRA do in relation to the major repairs and replacement account?
  - a. The CIRA should report the major repairs and replacements as a separate fund from the member assessments.
  - b. For financial reporting, the CIRA should record the major repairs and replacements amount as a payable until used.
  - c. Any amounts the CIRA collects for major repairs and replacements should be included in taxable income.
19. Which of the following is **not** a disclosure that is required by FASB ASC 972-235-50-2 for future major repairs and replacements?
  - a. A statement explaining that funds are being accumulated for future costs and that they could vary from the actual expenditures.
  - b. A detail of the amount assessed for major repairs and replacements in the current period.
  - c. A note disclosing the type of funding plan goal that was used in the reserve study.
  - d. The funding policy that the CIRA complies with regarding future major repairs and replacements.
20. For which of the following would a reserve account be set up in a CIRA?
  - a. An account for deferred maintenance that does not occur annually.
  - b. Any common property with an estimated life of less than two years.
  - c. Common property that the CIRA members are responsible to repair.
  - d. Permanent common property.
21. Which of the following levels of reserve funding would indicate that a CIRA is above a specific dollar amount?
  - a. Full funding.
  - b. Statutory funding.
  - c. Baseline funding.
  - d. Threshold funding.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

18. The HOA of Trojan Fields maintains a major repairs and replacements account that is separate from the member assessments account for large repairs inside of the CIRA. What should the CIRA do in relation to the major repairs and replacement account? **(Page 242)**
- a. **The CIRA should report the major repairs and replacements as a separate fund from the member assessments. [This answer is correct. FASB ASC 972-205-45-2 requires amounts assessed for future major repairs and replacements to be reported in a separate fund.]**
  - b. For financial reporting, the CIRA should record the major repairs and replacements amount as a payable until used. [This answer is incorrect. For financial reporting, the assessments are recorded as revenue.]
  - c. Any amounts the CIRA collects for major repairs and replacements should be included in taxable income. [This answer is incorrect. Under certain circumstances, assessments collected for specific repairs are not includable in the CIRA's taxable income; rather they are treated as contributions of capital for tax purposes.]
19. Which of the following is **not** a disclosure that is required by FASB ASC 972-235-50-2 for future major repairs and replacements? **(Page 245)**
- a. A statement explaining that funds are being accumulated for future costs and that they could vary from the actual expenditures. [This answer is incorrect. FASB ASC 972-235-50-2 requires all CIRAs include a statement that funds, if any, that are being accumulated based on estimated future (or current) costs and that actual expenditures may vary from those estimates and the variations may be material.]
  - b. A detail of the amount assessed for major repairs and replacements in the current period. [This answer is incorrect. A requirement of FASB ASC 972-235-50-2 is that there is a disclosure that shows the amounts assessed for major repairs and replacements in the current period, if any.]
  - c. **A note disclosing the type of funding plan goal that was used in the reserve study. [This answer is correct. Although this disclosure is recommended by the AICPA guide, but not required, it is not required by FASB ASC 972-235-50-2.]**
  - d. The funding policy that the CIRA complies with regarding future major repairs and replacements. [This answer is incorrect. A description of the CIRA's funding policy, if any (including a policy to fund future major repairs and replacements by special assessments or borrowings when needs occur) and compliance with that policy is a disclosure required by FASB ASC 972-235-50-2.]
20. For which of the following would a reserve account be set up in a CIRA? **(Page 248)**
- a. **An account for deferred maintenance that does not occur annually. [This answer is correct. It is common for CIRAs to include with their overall budget a deferred maintenance account for those components requiring periodic maintenance that does not occur annually.]**
  - b. Any common property with an estimated life of less than two years. [This answer is incorrect. CIRAs typically do not establish reserves for components with an estimated useful life of two years or less.]
  - c. Common property that the CIRA members are responsible to repair. [This answer is incorrect. Reserves are established only for components that the CIRA is responsible for maintaining and replacing.]
  - d. Permanent common property. [This answer is incorrect. Permanent components are those with remaining useful lives of 30 years or more. The CIRA does not begin accumulating reserves for such items until their remaining useful lives drop below 30–40 years, or less.]

21. Which of the following levels of reserve funding would indicate that a CIRA is above a specific dollar amount?  
**(Page 250)**

- a. Full funding. [This answer is incorrect. A full funding goal sets out to achieve and maintain at or near a 100% reserve level. Full funding is the highest level of reserve funding.]
- b. Statutory funding. [This answer is incorrect. Statutory minimum funding levels may be dictated by local statutes, but is not the amount that a CIRA would set for a specific dollar amount.]
- c. Baseline funding. [This answer is incorrect. A baseline funding goal sets out to maintain the reserve cash balance above zero. This is the lowest funding goal.]
- d. **Threshold funding. [This answer is correct. A threshold funding goal is achieved by a CIRA by keeping the reserve balance above a specific dollar or percentage amount (which can either be more or less conservative than full funding).]**

## DEBT AND OTHER LIABILITIES

Historically, CIRAs other than cooperatives have had difficulty in obtaining bank financing, particularly for improvements to existing associations. Banks have been reluctant to lend due to lack of collateral and guaranteed repayment sources. For example, some states prohibit the imposition of a lien on common property of condominium associations because the associations do not have title to common property. In the case of homeowners' associations, even though they have title to all the common property, it can rarely be used as collateral because it cannot be separated from the association. The advent of state super priority lien laws, however, has enhanced a CIRA's ability to set adequate assessment levels and enforce its collection efforts, including for special assessments. Thus, the ability of CIRAs to demonstrate to lenders a steady stream of assessments that could be used to repay debt has attracted more lenders that are willing to lend to CIRAs. Today, it is not uncommon for condominium and homeowner associations to obtain loans, not only from commercial banks, but also from private investors and pension plans. In states that have significant numbers of CIRAs, lenders that specialize in lending money to CIRAs have developed. Association loans are an agreement between the lender and the association; unit owners are not directly obligated to the lender. The loans are not asset-based, like a mortgage. Rather, the collateral for the loans is the assignment of a CIRA's lien and assessment rights and may also include an assignment of any assessments (for example, special assessments) connected with the loan repayment. In addition, in some states CIRAs are able to pledge reserve funds as collateral for a loan (although membership approval may be required).

Associations obtain loans for a variety of reasons, including the following:

- Repairs or replacement of common property.
- Upgrades to renovate common property or to address safety or security issues, such as inadequate lighting.
- Correcting construction defects.
- Paying for the cost of litigation.

Some CIRAs seek to obtain loans for planned expenditures even though their replacement funds are adequate; that is, they intend to use loans proceeds for anticipated expenditures, thus, saving replacement funds for emergencies.

When associations consider obtaining a loan, they also need to consider any provisions of their state statutes or governing documents that affect their ability to borrow. In some cases, CIRAs may need to update their documents to explicitly provide them with the ability to borrow or to assign assessments as collateral. In addition, some state statutes or governing documents may limit the amount a CIRA is able to borrow or require a vote of the unit owners to authorize an association to obtain a loan.

### Typical Loan Terms and Covenants

Although more financial institutions now provide loans to CIRAs, not all will be able to qualify for a loan. Probably the most important factor that lenders consider when underwriting a CIRA loan is the CIRA's assessment delinquency rate since it is the cash flows from future assessments that will typically service the loan. Other factors that lenders may consider include the following:

- Increase in assessments required to service the loan.
- Number of units in the association, owner occupancy rate, and ownership concentration (including percentage of units owned by the developer, if any).
- Value of the units in the association in relation to the CIRA's assessments or to the amount that the CIRA is seeking to borrow.
- Whether the CIRA has a recent reserve study (for example, within the past two years), and amount accumulated for future repairs and replacements.
- Other property characteristics and intangible factors that affect the "quality" of the association.



It is not uncommon for an association loan to finance 100% of the target project. Loan terms are somewhat flexible as each CIRA presents unique circumstances. Generally, however, they are structured as a line of credit, a term loan, or some combination of the two. For example, a loan to finance major repairs might initially be structured as a line of credit that is drawn down as the CIRA enters into contracts, and, as construction is completed, the loan is converted to term loan. The loans generally do not have a prepayment penalty. The absence of a prepayment penalty allows the CIRA to repay a portion of the loan, for example, annually, based on the collection of assessments that were levied to repay the loan.) If a CIRA repays a portion of the loan, the loan is reamortized, adjusting the amount of future payments due.

The length of an association loan is typically related to the purpose for which the financing is sought. For example, the term of a loan to finance litigation costs generally will be shorter than the loan term for a significant capital improvement project. Amortization periods typically are no longer than ten years, but sometimes longer terms may be possible depending on the size of the loan and the capital improvement project.

Financial institutions that make loans to CIRAs often require the CIRA to maintain all of their deposits or a portion of them with the lending bank, and the bank has a security interest in the association's bank accounts. Alternatively, a lender may require an amount, such as equal to two years of debt service, to be maintained in a restricted account. In either case, the arrangement would be disclosed in the notes to the financial statements together with other information about the loan. Some lenders also may require a line item in the association's budget that covers the annual debt service or require the association to special assess when the loan is made.

### **Repayment of Loans**

Generally, a CIRA will need to increase regular and/or special assessments to service the association's loan payments. (In some cases, however, a CIRA may borrow to make repairs and make loan payments from reserves.) Loan covenants may affect how special assessments are issued or repaid.

If the CIRA issues special assessments, loan compliance may require the association to reduce its loan balance proportionately when a unit owner repays its assessment or when a unit is sold. (It may be desirable for the CIRA to reduce the loan balance voluntarily in those circumstances even if it is not a loan requirement to reduce interest due on the loan. However, that decision needs to be weighed against any costs that the lender might impose for recalculating the loan amortization.)

### **Special Types of Debt Financing**

**Bond Financing.** In some states, CIRAs are able to obtain financing through revenue bonds secured by assessments. In one instance, a Colorado planned community issued \$15 million in bonds to finance the construction and design of a new recreation center and outdoor pool and to pay off debt to the community's developer—without an increase in assessments.

Bonds are generally issued in stated denominations of \$5,000 or \$10,000. They may be offered on a private placement basis; that is, they may be offered to a limited number of financial institutions like banks, insurance companies, money managers, and pension funds. The purchaser receives principal and interest for a specified time period. Bonds are sold by a sales agent, and their payment and performance are monitored by a bond trustee (usually a trustee of a bank).

An association's ability to issue bonds depends on (a) whether state law and its governing documents allow the board to incur debt and (b) the rating criteria of the buyer or organizations such as Standard & Poor's. The sale of bonds is regulated by state and federal securities laws. In addition, if the bonds are sold to the public rather than to institutional investors, the association may need to comply with other laws.

One advantage of bond financing is that the association locks in its finance costs. It also allows for a larger debt than a bank may be willing to finance and for a longer period of time. In addition, the issuance of bonds offers a number of strengths to investors. For example:

- Association assessments are mandatory.

- State law generally permits unpaid assessments to be converted into liens; for example, six months of assessments may have preference over first mortgages.
- Bylaws may allow the managing agent to impose assessments if the board lacks a quorum or fails to act.
- Association bonds give banks an opportunity to comply with the Federal Community Reinvestment Act, which directs banks to lend within their communities.

**SBA Loans.** Associations may apply for low-interest, long-term loans from the Small Business Administration (SBA) to repair damage caused by hurricanes, floods, earthquakes, or other disasters. The loan contract is between the association and the SBA. Disaster loan terms may be as long as 30 years, and interest rates are generally lower than other lender rates. The payment amount is fixed and is based on the total loan amount, even if only a portion has been drawn down to pay for repairs that have been completed. Each payment is applied first to interest accrued to the date of receipt, with the balance, if any, applied to principal.

Simple interest is charged by the SBA only on funds actually advanced. Prior to repayment beginning, interest is accrued based on the full principal amount. After repayment begins, interest is based on the declining principal balance.

The amortization schedule may change several times during the term of the loan; for example, each time loan funds are drawn down, when the unit owners originally pay in full (if that amount is remitted by the association to the SBA), or when units are sold that require full payment of the outstanding loan balance. Upon request, the SBA will recalculate the amortization schedule after the total drawdown has been made. In that case, the monthly payment amount does not change, but the term is shortened.

CIRAs would record a payable only for the amount of the loan that has been advanced. Note disclosures required in GAAP financial statements (details of the note, repayment terms, etc.) are the same as for other debt.

SBA loans (and bank loans) are typically secured by future assessments to be received by the CIRA from unit owners. Generally, a CIRA will need to increase regular and/or special assessments to service the association's loan payments. If the CIRA increases regular monthly assessments, the additional amount would increase assessment receivables and revenue in the period that they are assessed.

Some associations set up separate funds and bank accounts to account for their SBA loans. Separate accounting can be especially helpful to association boards and homeowners if other disaster proceeds (such as insurance, grants from other government agencies or private organizations, or claims for civil liability) are received by the association.

### **Accounting and Disclosure Requirements for Debt**

If a CIRA prepares its financial statements using fund accounting, the fund in which the debt is recorded would likely depend on the purpose of the borrowings. For example, if funds are borrowed for repairs and replacements, best practices indicate that the debt would be recorded in the replacement fund. On the other hand, if funds are borrowed for asset acquisitions that will be capitalized in the operating fund, it would be a best practice to record the debt in the operating fund. Alternatively, some CIRAs establish a separate fund to account for the loan and any related special assessment.

When debt is recorded in the replacement fund, it is not uncommon for the ongoing activity related to the loan to be recorded over time in the operating fund. In fact, the CIRA may even start budgeting the loan activity in the operating fund instead of the replacement fund. When this situation occurs, the CIRA may either—

- a. record the necessary interfund activity to account for changes in the loan balance and the related receivable in the replacement fund, or
- b. consider whether it is appropriate to transfer the loan and any related receivable to the operating fund.

The accounting and disclosure requirements that apply to debt are the same as for commercial businesses. When CIRAs present unclassified balance sheets, as most do, loans are not allocated into current and long-term portions. (However, amounts should be appropriately classified as current and long-term if the CIRA presents a classified balance sheet.) Among other things, financial statements should disclose interest rates, maturity dates, restrictive covenants, pledged assets, and the amount of principal maturities for all long-term borrowings for each of the five years following the date of the most recent balance sheet. In addition, FASB ASC 825-10-50-10 and 825-10-50-16 require the following disclosures about the fair value of financial instruments for some CIRAs:

- Fair value. (However, for trade receivables and payables, no disclosure is required when the carrying amount approximates fair value.)
- Methods and significant assumptions used to estimate fair value and changes in those during the period, if any.
- If it is not practicable to estimate the fair value of a financial instrument or a class of financial instruments, (a) information pertinent to estimating the fair value of the financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity, and (b) the reasons why it is not practical to estimate fair value.

The following is an example of the disclosure a cooperative might include with respect to its mortgage payable if it meets the criteria of FASB ASC 825-10:

*Included in the long-term debt note:*

Based on the borrowing rates currently available to the Cooperative for loans with similar terms and average maturities, the fair value of the mortgage payable is \$125 million.

### **Interfund Transfers**

Allocations of funds between operating and replacement or other restricted funds should be shown separately either by presenting financial statements using a fund accounting approach, by reporting appropriated amounts in a Statement of Changes in Members' Equity, or by disclosure in the notes to the financial statements.

### **Environmental Cleanup Costs**

CIRAs may be exposed to environmental remediation liabilities. Federal and state laws impose legal obligations on owners of environmentally damaged properties, and those obligations can be very costly. A CIRA may be held responsible in an environmental claim, even though it may not have been directly involved in generating, disposing of, or transporting hazardous materials. In addition, CIRAs may use and dispose of regulated substances, such as paint solvents, fertilizers, or pesticides. The following are common types of environmental concerns that a CIRA may incur—

- *Underground Gasoline Storage Tanks.* Large CIRAs that have marinas, maintenance facilities, numerous vehicles, or gasoline-powered golf carts may have underground gasoline storage tanks. Those tanks need to be monitored for leaks in accordance with state, local, and federal regulations. If an underground gasoline storage tank leaks, the EPA classifies the surrounding soil as hazardous waste material. Remediation of the soil and replacement or repair of the leaking tank are very costly and only partially covered in typical CIRA insurance policies.
- *Underground Heating Oil Storage Tanks.* Some CIRAs have individual underground heating oil storage tanks that provide heating oil to individual units. Those tanks may also leak. In the court case, *Ellenheath Condominium Association, Inc. v. Pearlman*, it was ruled that the individual condominium owner was responsible for the cleanup and replacement of the leaking storage tank since the New Jersey Condominium Act excludes improvements that are limited to one unit from the definition of common elements.
- *Lead-based Paint.* CIRAs need to be aware of the regulations regarding the use and treatment of lead-based paint.

- *Clean Air Regulations.* Under the Clean Air Act, some condominiums with centrifugal chillers have to meet tough emissions and disposal standards.
- *Federal Wetlands Laws.* Those laws can restrict changes to the common areas of CIRAs located in coastal areas.
- *Regulated Substances.* CIRAs must comply with regulations regarding the use or disposal of a number of products including paint solvents, fertilizers, and pesticides. Those laws relate to various matters, including the types of containers the wastes are stored in, as well as the land and structures surrounding the containers.

A CIRA may also have environmental issues related to mold, mildew and other toxic chemicals, as construction, rehabilitation, and related property maintenance problems grow. Claims concerning problems with mold continue to be a concern, as evidenced by an increasing number of lawsuits.

**Federal Environmental Laws.** Following are the laws that most environmental cleanup obligations are based on:

- *Superfund Laws.* The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the Superfund Amendments and Reauthorization Act established the Superfund, which is used primarily to clean up facilities that are abandoned or inactive or whose owners are insolvent. The Environmental Protection Agency (EPA) has the authority to order responsible parties to remediate contaminated sites or to use Superfund money to remediate the sites and then seek reimbursement for cleanup costs from potentially responsible parties (PRPs). There are four classes of PRPs:
  - Current owners or operators of sites at which hazardous substances have been disposed of or abandoned.
  - Previous owners or operators of sites at the time of disposal of hazardous substances.
  - Parties that arranged for disposal of hazardous substances found at the sites.
  - Parties that transported hazardous substances to a site, having selected the site for treatment or disposal.
- *Resource Conservation and Recovery Act of 1976 (RCRA).* RCRA provides for comprehensive regulation of hazardous wastes from origination to final disposal. It imposes cleanup obligations on any party that has "contributed to" the disposal of waste that is causing an imminent and substantial endangerment.

**Authoritative Literature.** The authoritative literature listed below provides the primary guidance on accounting for environmental cleanup costs and liabilities:

- FASB ASC 450-20, *Contingencies*, provides general guidance on accruing liabilities for loss contingencies.
- FASB ASC 410-20, *Asset Retirement and Environmental Obligations*, provides accounting and reporting guidance for environmental remediation obligations arising from the normal operation of a long-lived asset and that is associated with the retirement of that long-lived asset. (However, environmental remediation costs and obligations that result from *other than normal* operation of an asset are not covered by FASB ASC 410-20 and may be subject to the provisions of FASB ASC 410-30.)
- FASB ASC 410-30 provides specific guidance for—
  - Recognizing, measuring, and disclosing environmental remediation liabilities.
  - Determining whether the cost of asbestos removal from buildings should be capitalized.
  - Determining whether environmental cleanup costs should be capitalized.

- FASB ASC 360-10-55 addresses whether future cash flows for environmental exit costs associated with a long-lived asset should be included in the undiscounted expected future cash flows used to test property for recoverability.

**Capitalization of Environmental Cleanup Costs.** Currently, FASB ASC 410-30-25-16 through 25-19 provides the primary guidance on capitalization of environmental cleanup costs. Environmental cleanup costs should be capitalized only if—

- a. The costs are recoverable, and
- b. At least one of the following conditions is met:
  - (1) The costs are incurred in preparing for sale property currently held for sale.
  - (2) The costs extend the life, increase the capacity, or improve the safety or efficiency of property. Also, the costs must improve the condition of the property compared to its condition when originally built (or bought, if later).
  - (3) The costs mitigate or prevent environmental contamination that has not yet occurred but might otherwise result from future operations or activities. Also, the costs must improve the condition of the property compared to its condition when originally built (or bought, if later).

Since condominium associations and time-share associations generally do not own real common property, those associations have no capitalized real property on their books. Thus, if environmental cleanup costs are incurred by those associations, best practices indicate they would be expensed rather than capitalized.

**Capitalization of Asbestos Removal Costs.** Costs incurred to treat or remove asbestos may be capitalized regardless of whether a building was acquired with a known asbestos problem or the problem was discovered in an existing building.

### **Accruing Environmental Remediation Liabilities**

It can be challenging to account for environmental remediation liabilities. First, it is difficult to determine when a liability has been incurred because it often cannot be easily associated with a single event. Second, the amount of the liability is often difficult to reasonably estimate until long after the problem has been identified. FASB ASC 410-30 provides specific guidance for recognizing, measuring, and disclosing liabilities for legally required environmental remediation. In summary, the guidance provides that environmental remediation liabilities should—

- Be accrued on a site-by-site basis when the criteria of FASB ASC 450-20-25-2 are met, using the benchmarks beginning at FASB ASC 410-30-25-15 for determining when those criteria are met.
- Include incremental direct costs, as well as compensation and benefit costs for employees who devote significant time to remediation activities.
- Include costs for the CIRA's specific share of the liability for the site, as well as the CIRA's share of costs that will not be paid by the government or other PRPs.
- Be estimated based on enacted laws and regulations.
- Be estimated based on expected improvements in remediation technology.
- Be based on the CIRA's estimated costs to perform all phases of the remediation activities when they are expected to be performed.
- Consider discounting when appropriate.

### **Refundable Security Deposits**

Many associations maintain refundable security deposits on their books for deposits received from their members. Architectural deposits may be required by some associations to ensure that the homeowner complies with the

architectural and/or landscaping requirements in the CC&Rs. Those deposits can be significant in amount (often in the range of \$5,000–\$50,000) and are only returned to the homeowner once the compliance issue is completed. Other less significant security deposits are commonly required for keys, clubhouse rentals, recreational activities, commercial leases, etc. Accounting for refundable security deposits seems simple and straightforward. The member makes a deposit, the CIRA receives the deposit and records a liability on their general ledger, the member returns the key (or performs other actions required), the CIRA then refunds the member's deposit and the liability is eliminated from the books. Unfortunately, many associations have amounts recorded in their general ledger that are not supported by detail listings for the less significant refundable security deposits, or if detail exists, the association has lost track of the member. When either a member fails to request the refund, or the association fails to properly account for the deposit refund, the amount left on the general ledger becomes unclaimed property.

Many states have escheat rules that govern unclaimed property. Auditors need to be informed about the laws applicable to these deposits to help assess the proper accounting for them and to provide advice to their CIRA clients. In many states, such as California and Nevada, unclaimed property reverts to the state. In such states, unclaimed property auditors are allowed to estimate unclaimed property if sufficient records do not exist. Accordingly, while the CIRA may be inclined to write off deposits to income, such an action runs the risk of actually creating a larger liability to the state if the action is discovered, as there are often substantial penalties for failure to comply with escheat laws.

CIRA management needs to ensure they have adequate accounting procedures for refundable security deposits and make every possible attempt to locate members and former members to refund the deposits. In order to further protect itself from state escheat laws, some associations have revised their rules over security deposits to indicate that deposits automatically become forfeited to the association if certain administrative procedures are not completed by the member (such as the member requesting the return of the deposit and providing a current address). Associations may find it beneficial to contact their attorney to determine whether they may make such revisions in the association's rules over security deposits.

## Other Liabilities

Other liabilities that CIRAs may report in their financial statements include the following:

- Assessments received in advance.
- Trade accounts payable.
- Retainages payable for contracts for major repairs and replacements.
- Wages payable and related payroll taxes.
- Sales taxes from commercial activities.
- Bed or tenant occupancy taxes (for time-share developments).
- Income taxes payable.

Accounting for income taxes in financial statements is discussed in later in this lesson. Accounting for other liabilities is similar to that of commercial businesses. A discussion of that topic is beyond the scope of this course.

## MEMBERS' EQUITY

### Contributed Capital

The concept of contributed capital for CIRAs is similar to that for commercial businesses and represents amounts contributed by owners from sources other than assessments. Accordingly, best practices indicate that the following transactions would be reported as contributed capital for *financial reporting* purposes:

- Property and equipment transferred from the developer or sponsor to the CIRA. (For cooperatives, the amount credited to contributed capital generally is the excess of the fair value of the property and

equipment for financial statement reporting, less the mortgage assumed and the amount allocated to common stock.)

- Funds contributed to the initial start-up of the CIRA, such as funds contributed by the developer to replacement funds or to the CIRA's initial working capital upon transfer of the common property to the CIRA.
- Initial contributions required by new members upon purchase of units to provide the CIRA with additional working capital (typically equal to one or two months' assessment).
- Property purchased by members with social or other funds and donated to the CIRA.

Tax rules allow CIRAs to treat the following additional amounts as contributions of capital for *tax* purposes in certain circumstances:

- Assessments for specific capital improvements or the replacement of personal property.
- Litigation proceeds from developers for warranty claims.
- Assessments received from cooperative tenant-shareholders representing amortization of mortgage principal.

However, the preceding items do not meet the definition of contributed capital for financial statements prepared in conformity with GAAP. Accordingly, they should be reported as revenue in the financial statements.

Similarly, contributed capital would not be increased for financial reporting purposes when the replacement fund purchases assets that are capitalized in the operating fund.

### **Distributions of Capital**

The principal items that decrease contributed capital for financial reporting arise from refunds of either (a) excess special assessments as discussed later in this lesson or (b) the excess of member assessments over the CIRA's expenses as discussed previously. In addition, cooperatives that qualify under subchapter T of the Internal Revenue Code are permitted to refund amounts collected from members in the form of patronage dividends, which also would be reported as a distribution of capital for financial reporting purposes.

### **Common Stock**

When cooperative housing corporations are formed as stock corporations, shares of stock are sold to tenant-shareholders, and a proprietary lease that is appurtenant to the shares sets forth the tenant's rights to the exclusive use of a specific unit within the cooperative. To qualify as a cooperative housing corporation for tax purposes, among other requirements, cooperatives may issue only one class of stock. Disclosures regarding common stock are the same as those for commercial businesses. Thus, the cooperative's financial statements should disclose the title of the stock issue (for example, common stock or capital stock), the par or stated value, and the number of shares authorized and issued. Normally, those disclosures are provided on the face of the balance sheet.

FASB ASC 505-10-50-3 through 50-5 and 505-10-50-11 require all entities that issue securities to make certain disclosures about their capital structure. The guidance defines securities as "the evidence of debt or ownership or a related right" and, thus, would apply to stock cooperatives and time-share cooperatives since they issue securities (stock) to tenant-shareholders. Although it is unclear whether nonstock cooperatives must comply with these disclosure requirements, this course recommends that they also include the required disclosures in their financial statements because membership certificates are accompanied by certain membership rights that are similar to the rights conferred through ownership. FASB ASC 505-10-50-3 through 50-5 and 505-10-50-11 do not seem to apply to condominium associations, homeowners' associations, or other types of time-share associations because their members do not have "evidence of ownership" of those entities.

The disclosures required that are most likely to apply are as follows:

- Number of shares issued during the most recent annual period.

- Participation rights, defined as contractual rights of tenant-shareholders to receive dividends or returns from the cooperative. (Participation rights would include the right to patronage dividends.)
- Unusual voting rights.

## INCOME TAXES

### Accounting for Income Taxes

Similar to commercial businesses, income taxes for financial reporting are based on amounts shown in the CIRA's financial statements. Deferred taxes should be provided if transactions are included in the determination of accounting income in one period and in taxable income in a different period. Deferred taxes generally are not as complex for CIRAs as they are for commercial businesses, however, because, in most respects, accounting for financial and tax purposes is the same or is attributed to permanent differences. Nevertheless, if differences exist between accounting and taxable income, deferred taxes should be recorded in conformity with FASB ASC 740, *Income Taxes*.

FASB ASC 740-10 requires that computations of both current and deferred income tax assets and liabilities only consider tax positions that are *more likely than not* to be sustained if the taxing authority examined the positions. *More likely than not* in this context means that there is greater than a 50% chance.

A tax position represents a position taken in a previously filed return or expected to be taken in a future return that is reflected in current or deferred income tax assets and liabilities. A tax position also includes an allocation or shift of income between jurisdictions or a decision not to file a return. As a result of a tax position, taxes payable might be permanently reduced, a current payable may be deferred to a future year, or the realizability of a deferred tax asset may be changed. Examples of tax positions that might be taken by CIRAs include the following:

- Deciding whether to file Form 1120 or Form 1120-H.
- Deciding whether a transaction or other position is tax-exempt or tax-deferred, such as:
  - Member assessments in excess of expenses that are refunded to members or that are applied against the following year's assessments.
  - Special assessments that are accounted for as contributions of capital.
  - Sales of common property, which may result in capital gains or a return of capital.
  - Developer settlements that are accounted for as recovery of capital.
- Deciding on an allocation of income and expenses between member and nonmember activities (or exempt function and nonexempt function activities).
- Deciding whether to capitalize expenditures for real or personal property acquired in connection with membership or nonmembership activities.
- Deciding whether assessments for major repairs and replacements are classified as capital contributions.

FASB ASC 740 requires a two-step approach to recognizing tax benefits: (a) determining whether a tax benefit should be recognized and (b) determining how to measure the tax benefit that is recognized. Determining whether a tax benefit should be recognized depends on whether the benefit is, or will be, derived from a tax position that meets the more-likely-than-not criterion. A tax benefit should only be recognized if the tax position meets that criterion. Thus, a CIRA assesses the likelihood that a tax position would be sustained by assuming that the taxing authority will examine the return in which the position is, or will be, taken, and that the taxing authority will examine the position. To emphasize the importance of that provision, the tax audit rate according to IRS statistics is less than 1% for CIRAs. Yet, in recognizing and measuring tax benefits, CIRAs cannot consider the possibility that a return



may not be examined or that, even if a return is examined, the position may not be examined. According to FASB ASC 740-10-30-7, the recognized tax benefit is measured as the largest amount of tax benefit that is greater than 50% likely of being realized after an assumed examination by a taxing authority with complete knowledge of all relevant information related to the tax position. The largest amount of tax benefit should be determined using facts and circumstances available and consider likely outcomes.

The likelihood that a tax position will be accepted by a taxing authority can be evaluated qualitatively or quantitatively. For example, a qualitative assessment could be based on the CIRA's experience with comparable situations or based on the CIRA's understanding of the recent trend of rulings by the taxing authority. A quantitative assessment could be based on different probability scenarios and recognizing the largest benefit that has greater than a 50% chance of being sustained. Depending on the facts and circumstances, assessing the likelihood that a tax position will be sustained may be relatively straightforward because the CIRA is only required to consider whether there is greater than a 50% chance the position will be sustained.

## Current Income Taxes

**Calculating the Current Tax Provision.** To illustrate the calculation of current tax provisions, assume that a CIRA's members were assessed for both operations and future major repairs and replacements. The assessments for major repairs and replacements were assessed only for items of a capital nature and did not include any amounts for items of a noncapital nature, such as painting. Thus, the CIRA developed a tax position that the assessments for future major repairs and replacements were contributions to capital for tax purposes and were, therefore, nontaxable. If the CIRA believes there is greater than a 50% chance that, upon examination, the tax position for treating the assessments for future major repairs and replacements as contributions to capital would be sustained and that there is greater than a 50% chance the entire amount of the assessments would be nontaxable, the CIRA would not recognize a current tax liability associated with those assessments.

On the other hand, assume that the CIRA did not hold the assessments for future major repairs and replacements in bank accounts separate from the operating portion of the member assessments. Furthermore, even though the CIRA was setting aside funds for future major repairs and replacements, it had not conducted replacement fund reserve studies. Therefore, the CIRA believed there was some risk that, upon examination by taxing authorities, a portion of the assessments for major repairs and replacements may be considered by the taxing authorities to be noncapital for tax purposes. If the CIRA believes there is no greater than a 50% chance that the tax position would be sustained, the CIRA would be prohibited from recognizing any tax benefit. Instead, the CIRA's current income tax provision would be calculated assuming that the total assessments for major repairs and replacements would be taxable. If the CIRA believes the taxing authority would consider only part of the assessments for future major repairs and replacements as contributions to capital (or if the CIRA believes it would likely settle with the taxing authority by agreeing that only a portion of the assessments were capital contributions), the CIRA would recognize a tax benefit for only that portion that it believes ultimately will be accepted. That determination can be made qualitatively or quantitatively.

Thus, the CIRA would treat the assessments for future repairs and replacements as capital contributions in preparing the current year's tax return and, as such, they would not be taxable. For financial statement purposes, the CIRA would recognize the tax benefit of treating the assessments as capital contributions (in other words, the CIRA would treat assessments the same in both the financial statements and the tax returns) if the CIRA believes there is a greater than 50% chance that the tax position would be sustained upon examination. However, if the CIRA believes that assessments did not meet the greater than 50% threshold, it would recognize the related tax benefit only to the extent that it believes the greater than 50% threshold is met. The tax benefit related to the amount that did not meet the greater than 50% threshold would be accrued as a liability. FASB ASC 740-10-25-16 describes the liability as the entity's potential future obligation to the taxing authority for a tax position that was not recognized under its requirements. The liability can be viewed as the CIRA's obligation to return the realized tax benefit to the taxing authority in the event that it disallows the tax position. Therefore, the liability would be the estimated additional tax that would be assessed if the tax position is disallowed.

The liability can also be viewed as a deferral of the tax benefit that was realized by not recognizing income in the current-year return. As such, the deferral is not a deferred tax liability, but a deferral of a current tax benefit. Recognition of the realized tax benefit in the statement of revenues and expenses is being deferred until the

uncertainty is eliminated or reduced to less than 50%. If the CIRA presents a classified balance sheet, the liability should be classified based on whether settlement is anticipated within one year. The liability for unrecognized tax benefits should not be included with deferred tax liabilities or offset against deferred tax assets.

Consistent with the deferral notion, the liability for the unrecognized tax benefit would be written off, or derecognized, in the first period in which one of the following conditions is met:

- New information, such as additional authoritative support, causes the CIRA to change its assessment of the likelihood the position would be sustained to *more likely than not*.
- The tax matter is ultimately settled; that is, the taxing authority examines the position and (a) does not accept it and the CIRA pays the additional tax assessed, or (b) accepts the position.
- The statute of limitations for the taxing authority to examine the position expires.

Conversely, a tax position should be derecognized in the period in which it no longer meets the more likely than not criterion. A valuation allowance cannot be used as a replacement for derecognition.

The effect of accounting for uncertain tax positions on deferred income taxes is discussed later in this lesson

**Interest and Penalties.** If interest would be paid on any tax underpayment that might result from a tax position, the interest would be accrued starting in the first period it would begin accruing under the tax law. The amount that would be recognized is computed by multiplying the applicable interest rate times the difference between the recognized tax benefit and the position taken or expected to be taken in the tax return. Similarly, if a position not sustained would result in a penalty being assessed, an expense for the statutory amount of the penalty would be recognized in the period in which the CIRA claims or expects to claim the tax position. If a change in judgment occurs, including a change in determining whether the position meets the more-likely-than-not threshold, that affects the amount of interest or penalty that would be recognized, the amount should be adjusted in the period in which the change occurs.

**Accounting for Uncertain Tax Positions.** When GAAP for uncertain tax positions was issued, much was written about the drastic effect it would have on financial statements. However, the guidance seems to have had limited effect on the income tax provisions of small and midsize nonpublic entities, including CIRAs. Typically, CIRAs engage the same accountants to audit their financial statements, prepare their tax returns, and assist with tax planning. Ordinarily, accountants believe the tax positions they recommend and the tax positions they accept in signing the tax returns have greater than a 50% chance of being sustained upon examination by taxing authorities because neither the accountants nor the CIRAs ordinarily are willing to accept greater risk.

As an additional observation, accounting standards for uncertain tax positions need not be applied to immaterial items. Thus, best practices indicate the following:

- A tax position that does not meet the more-likely-than-not criterion but does not yield a tax benefit that is material to the financial statements need not be subjected to the accounting requirements for uncertain tax requirements.
- A tax position that does not meet the more-likely-than-not criterion and yields a benefit that is material to the financial statements will often have been developed after discussion between the CIRA and the accountant and, thus, can be readily identified.

## Deferred Income Taxes

Deferred income taxes represent the tax effects of the difference between income taxes reported in the financial statements and the tax return that results from temporary differences (that is, differences between the basis of assets and liabilities for financial and tax purposes). However, deferred income taxes are not recorded for permanent differences. Permanent differences are differences between income for financial and tax purposes that exist because statutory provisions make specified revenues exempt from taxation or specified expenses not allowable in determining taxable income.

**Types of Temporary Differences.** FASB ASC 740-10 distinguishes between two types of temporary differences—taxable and deductible:

- A *taxable difference* leads to the recognition of a deferred tax liability. Taxable differences generally represent expenses that have been deducted in the tax returns but will be expensed in future financial statements. They also may represent income recognized in the financial statements that will be taxable in future tax returns. For example, if accelerated depreciation methods are used for tax purposes, the basis of equipment for financial reporting will exceed its tax basis during the first portion of the life of the equipment. If the equipment is sold during that period, any gain on the sale will be higher for tax reporting than for financial reporting. Therefore, a deferred tax liability exists for the excess future taxable income over future financial statement income.
- A *deductible difference* leads to the recognition of a deferred tax asset. Deductible differences generally represent expenses that have been recognized in the financial statements but will be deducted in future tax returns. For example, if an allowance for doubtful accounts is established for financial statement purposes, the tax basis of accounts receivable will exceed the basis for financial reporting. Consequently, future tax deductions for bad debts will exceed future expense for financial reporting, and a deferred tax asset for future tax deductions exists.

The distinction between taxable and deductible temporary differences is important because deferred tax assets and liabilities must be calculated separately.

**Calculating Deferred Taxes.** The basic calculation of the total income tax provision and the deferred tax liability or asset for a CIRA consists of the following steps:

- a. Compute the current provision, i.e., taxes based on taxable income reported in the tax return for the year.
- b. Identify temporary differences that relate to nonexempt or nonmembership income.
- c. Identify operating loss carryforwards that arise from nonmembership losses and tax credit carryforwards.
- d. Aggregate the taxable temporary differences separately from the deductible temporary differences.
- e. Compute the deferred tax liability by multiplying total taxable temporary differences by the applicable tax rate.
- f. Compute the deferred tax asset by multiplying total deductible temporary differences and the operating loss carryforwards by the applicable tax rate.
- g. Add tax credit carryforwards to the amount calculated in Step f. to obtain the total deferred tax asset.
- h. Evaluate the deferred tax asset calculated in Step g. to determine if a valuation allowance is needed. (A valuation allowance is needed for the portion of the deferred tax asset that has less than a 50% chance of being realized.)
- i. Determine the net change in the deferred tax liability or asset, including the valuation allowance, by subtracting the net deferred tax liability or asset at the beginning of the period from the total of the amounts calculated in Step e. and Step h. That amount is the deferred tax provision or benefit.
- j. Add the deferred tax provision or benefit to the current tax provision to obtain the total income tax provision.

**Tax Rates.** FASB ASC 740-10-30-8 through 30-12 requires that deferred taxes be determined based on the *enacted* tax rates that are expected to be in effect in the period when basis differences will reverse. The word *enacted* means that future changes in the tax law are not anticipated. Tax rates for the current year would be used if no changes have been enacted for future years, and any changes in tax rates are recognized in the period that they become known. FASB ASC 740-10-30-9 requires that a flat tax rate (generally 34% for CIRAs that file Form 1120) be used unless graduated rates are a significant factor. In those cases, the rate used is the average tax rate that would apply

to the estimated average annual taxable income during the period the temporary differences are expected to reverse. Graduated tax rates would often be significant for CIRAs that file Form 1120; therefore, they would use an average tax rate to calculate deferred taxes. On the other hand, graduated taxes are never a factor for CIRAs that file Form 1120-H, and deferred taxes would be calculated using a flat rate of 30% for condominium and homeowners' associations and 32% for timeshare associations.

**How Uncertain Tax Positions Affect the Deferred Tax Provision.** Assume that a CIRA recognizes a liability for an expense it incurred during the year related to its nonmembership activities. While the CIRA is certain the expense is not deductible in the year it is incurred, it develops a tax position for deducting the expense when it is paid. Under FASB ASC 740, whether recognizing the liability for financial statement reporting creates a deductible difference depends on whether the tax position for deducting payment of the liability meets the more-likely-than-not criterion.

- If the tax position meets the more-likely-than-not criterion and there is greater than a 50% chance that the full amount of the deduction would be allowed, the tax basis of the liability is zero.
- If the tax position does not meet the more-likely-than-not criterion, the tax basis of the liability is the same as its carrying amount for financial statement reporting. That is because the tax benefit of the future deduction cannot be considered because the deduction is based on a tax position that does not meet the more-likely-than-not criterion. Since there is no difference in basis, there is no temporary difference, and a deferred tax benefit cannot be recognized for the expense.
- If the tax position meets the more-likely-than-not criterion, but there is greater than a 50% chance that less than the full amount of the deduction would be allowed upon examination, the tax basis of the liability is its carrying amount for financial statement reporting less the amount of the future deduction that is more than 50% likely to be allowed. Therefore, there is a deductible difference equal to the future deduction from payment of the liability for which a tax benefit can be recognized.

**When Should CIRAs Provide for Deferred Income Taxes?** CIRAs (except for cooperatives taxed under IRC Section 1381) generally are taxed under either IRC Section 528 or 277 of the Internal Revenue Code. The objective of both sections is to tax the CIRA on the excess of revenues over expenses derived from sources unrelated to its function as a CIRA or on income received from nonmembers. (There are subtle differences between the two concepts.) Since a significant portion of a CIRA's income may be exempt from taxation, in many cases deferred taxes will not be material and need not be recorded.

Under IRC Section 528, deferred taxes should not be provided for any temporary differences related to the CIRA's exempt function income since it is not subject to tax. Deferred taxes should be provided, however, if temporary differences relate to the CIRA's nonexempt function income and the deferred taxes would be material. For example, gains and losses on sales of marketable securities are nonexempt function income, and any unrealized gains and losses would result in temporary differences. In many cases, however, the temporary differences would not be material. Generally, material temporary differences would be most likely to arise if the CIRA has significant commercial operations.

Under IRC Section 277, it is believed that deferred taxes generally should not be provided for any temporary differences related to membership income or membership loss. Thus, they believe that providing the CIRA complied with the provisions of Revenue Ruling 70-604, the assessments in excess of actual expenses that the members elect to apply against next year's assessments under the Revenue Ruling are considered as permanent differences because tax rules effectively exempt CIRAs from tax on net membership income. FASB ASC 740-10-05-9 and 740-10-25-30 state that deferred tax assets and liabilities should not be recognized for temporary differences that will not result in taxable or deductible amounts in future years. In other words, if the tax law provides a means to recover and settle assets and liabilities tax-free and the CIRA expects that it will ultimately use that method, deferred taxes are not required.

Best practices indicate interpreting Revenue Ruling 70-604 as allowing only a one-year carryover of excess membership income. If a CIRA has excess membership income in the year following a 70-604 election, it is a best practice for the CIRA to either (a) amend its prior-year tax return and pay tax on the previous year's excess membership income or (b) treat the remaining carryover as current year income. In those circumstances, the income taxes would be recorded as current income taxes.

Similar to CIRAs that are taxed under IRC Section 528, deferred taxes for IRC Section 277 CIRAs generally should be provided only for temporary differences related to the CIRA's nonmembership income. Furthermore, since net nonmembership income is taxable, it is a best practice for CIRAs to provide deferred tax assets for net operating loss carryforwards that arise from nonmembership losses. The deferred tax asset should be provided in the year that the NOL occurs and would be reduced by a valuation allowance if it is more likely than not that all or a portion of the asset will not be realized. Generally, material temporary differences would be most likely to arise if the CIRA has significant commercial operations. Under FASB ASC 740, a deferred tax asset can only be recognized for a carryforward if the future use of the carryforward is based on a tax position that meets the *more-likely-than-not* criterion.

For cooperatives under IRC Section 1381 (subchapter T), it seems logical that deferred taxes generally should not be provided for the excess of patronage income over patronage expenses that is refunded as patronage dividends. Those amounts are considered permanent differences, using the rationale discussed above. However, deferred tax assets should be provided for any temporary differences caused by the carryforward of patronage and nonpatronage net operating losses under IRC Section 172.

**Examples of Temporary and Permanent Differences.** Exhibit 2-8 lists temporary differences and permanent differences that CIRAs are most likely to encounter.

## Exhibit 2-8

### Common Permanent and Temporary Differences for CIRAs<sup>a</sup>

#### PERMANENT DIFFERENCES

Amounts recognized as revenue for financial reporting and as contributions of capital for tax reporting, such as special assessments for specific capital improvements or the replacement of personal property and litigation proceeds from developers for warranty claims.

For IRC Section 277 CIRAs, assessments in excess of actual expenses that the members elect to apply against the next year's assessments.

For IRC Section 1381 (subchapter T) cooperatives, any excess of patronage income over patronage expenses that is refunded as patronage dividends.

#### TEMPORARY DIFFERENCES THAT RELATE TO NONEXEMPT OR NONMEMBERSHIP INCOME

##### Marketable Securities

Unrealized gains and losses that are not deductible for tax purposes

##### Accounts Receivable

Recording allowances for uncollectible receivables for financial reporting and using the specific charge-off method for tax purposes

##### Common Property

Property transferred by the developer or sponsor with different bases for financial and tax purposes

Using different depreciation methods or periods for financial and tax purposes

##### Leases

Leases that are capitalized for financial reporting and expensed for tax purposes

Leases that are capitalized for financial and tax purposes but have different amortization periods

Operating lease payments that are expensed on the straight-line basis for financial reporting and are deducted as incurred for tax purposes

**Note:**

- <sup>a</sup> The examples of permanent and temporary differences in this exhibit assume that the tax positions underlying the differences meet the “more likely than not” criterion in FASB ASC 740.

\* \* \*

**Reporting Income Taxes in Financial Statements**

If a CIRA presents its financial statements using fund accounting, income taxes generally are allocated between funds to the extent that they relate to those funds, if material.

FASB ASC 740-10-45-25 states that interest related to income taxes may be classified as either income taxes or interest expense, and penalties may be classified either as income taxes or as another expense. The classification is an accounting policy decision, which is required to be disclosed in the notes to the financial statements. (As a practical matter, however, that disclosure is required only if penalties and interest assessed by taxing authorities are material.) FASB ASC 972-605-45-2 requires the allocation of interest income to funds based upon which fund earns the interest, unless the CIRA has a specific policy to treat the income differently. Therefore, a CIRA may also establish a policy to treat all income taxes as a liability/expense of one fund rather than allocating the taxes based upon where taxable income is earned. In the absence of specific written policy, the accountant may look to the CIRA's budget and reserve study for indication of a CIRA's policy.

As noted in FASB ASC 972-740-45-1 CIRAs usually present income taxes in the same manner as other operating expenses. It generally is not meaningful to present income taxes as a separate caption after “Excess (deficiency) of revenues over expenses before income taxes” because revenues related to member activities often are exempt from taxation, and, thus, income taxes generally are not related to the excess of revenues over expenses.

**Disclosures**

FASB ASC 740-10-50 requires certain disclosures about current and deferred income taxes. FASB ASC 220-10, *Comprehensive Income*, requires disclosure of the income tax expense or benefit allocated to each component of other comprehensive income.

In addition, FASB ASC 740-10-50-15 requires certain disclosures, including the following:

- a. The amounts of interest and penalties recognized in the statement of revenues and expenses and in the balance sheet, if those amounts are material. The amounts may be disclosed in the notes to the financial statements. Alternatively, they may be disclosed by presenting them as separate line items in the financial statements or by parenthetical notation. For example, the financial statements could disclose penalties that are included with miscellaneous expenses as follows:

Other expenses (including income tax penalties of \$X,XXX)

- b. If the CIRA has unrecognized tax benefits—

- (1) Disclosure of tax positions for which it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease with 12 months of the reporting date, noting for each:
  - The nature of the uncertainty.
  - The nature of the event that could occur in the next twelve months that would cause the change.
  - An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.

*Reasonably possible* is defined in FASB ASC 450, *Contingencies*, as more than remote but less than likely. For example, a note to the financial statements might state:

Due to resolution of federal income tax issues concerning (describe the nature of the uncertain tax positions), it is reasonably possible that the Association's liability for unrecognized tax benefits could increase within the next 12 months by approximately \$XX,XXX to \$XX,XXX.

or

Due to the expiration of the statute of limitations for the 20XX tax year, it is reasonably possible that the Association's liability for unrecognized tax benefits related to (describe the nature of the uncertainties), could decrease by a range of \$XX,XXX to \$XX,XXX.

- (2) The tax years that remain subject to examination by major tax jurisdictions. The disclosure may include only the earliest open year for each tax jurisdiction. For example, a note to the financial statements might state:

The Association's federal income tax returns for years before 2008 are no longer subject to examination by the Internal Revenue Service.





**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. The Cove at Mermaid Quay plans to upgrade and renovate all the common property to address security concerns and try to draw new tenants. The CIRA decides to obtain a loan from a financial institution to pay for the work. Which of the following is true about loan terms and covenants for CIRAs?
- a. The bank might require The Cove to open an account and maintain their deposits at the bank as part of the lending agreement.
  - b. The loan taken out by The Cove will be a set length, as financial institutions only give one term length for CIRAs.
  - c. The bank will require The Cove to make at least a 50% down payment.
  - d. Most loans extended to a CIRA have a penalty for prepayment of the loan.
23. The Welcome Acres HOA found asbestos in their clubhouse, and they are trying to determine if they should capitalize the removal of the asbestos. Which of the following sources of guidance would provide the necessary information to the HOA?
- a. FASB ASC 360-10-55.
  - b. FASB ASC 410-20.
  - c. FASB ASC 410-30.
  - d. FASB ASC 450-20.
24. Which of the following can be treated as contributions of capital for tax purposes only for a CIRA?
- a. Initial contributions from new members of the CIRA when purchasing a unit.
  - b. Litigation proceeds received from developers related to warranty claims.
  - c. A donation to the CIRA of property that was purchased by a member with social funds.
  - d. Property that is given to the CIRA by the developer.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

22. The Cove at Mermaid Quay plans to upgrade and renovate all the common property to address security concerns and try to draw new tenants. The CIRA decides to obtain a loan from a financial institution to pay for the work. Which of the following is true about loan terms and covenants for CIRAs? **(Page 259)**
- The bank might require The Cove to open an account and maintain their deposits at the bank as part of the lending agreement. [This answer is correct. Financial institutions that make loans to CIRAs often require the CIRA to maintain all of their deposits or a portion of them with the lending bank.]**
  - The loan taken out by The Cove will be a set length, as financial institutions only give one term length for CIRAs. [This answer is incorrect. The length of an association loan is typically related to the purpose for which the financing is sought. Amortization periods typically are no longer than ten years, but sometimes longer terms may be possible depending on the size of the loan and the capital improvement project.]
  - The bank will require The Cove to make at least a 50% down payment. [This answer is incorrect. It is not uncommon for an association loan to finance 100% of the target project. Loan terms are somewhat flexible as each CIRA presents unique circumstances. Generally, however, they are structured as a line of credit, a term loan, or some combination of the two.]
  - Most loans extended to a CIRA have a penalty for prepayment of the loan. [This answer is incorrect. CIRA loans generally do not have a prepayment penalty. The absence of a prepayment penalty allows the CIRA to repay a portion of the loan, for example, annually, based on the collection of assessments that were levied to repay the loan.]
23. The Welcome Acres HOA found asbestos in their clubhouse, and they are trying to determine if they should capitalize the removal of the asbestos. Which of the following sources of guidance would provide the necessary information to the HOA? **(Page 262)**
- FASB ASC 360-10-55. [This answer is incorrect. FASB ASC 360-10-55 addresses whether future cash flows for environmental exit costs associated with a long-lived asset should be included in the undiscounted expected future cash flows used to test property for recoverability.]
  - FASB ASC 410-20. [This answer is incorrect. Accounting and reporting guidance for environmental remediation obligations arising from the normal operation of a long-lived asset and that is associated with the retirement of that long-lived asset is provided in FASB ASC 410-20, *Asset Retirement and Environmental Obligations*.]
  - FASB ASC 410-30. [This answer is correct. FASB ASC 410-30 provides specific guidance for recognizing, measuring and disclosing environmental remediation liabilities, determining whether the cost of asbestos removal from buildings should be capitalized, and determining whether environmental cleanup costs should be capitalized.]**
  - FASB ASC 450-20. [This answer is incorrect. General guidance on accruing liabilities for loss contingencies is explained in FASB ASC 450-20, *Contingencies*.]
24. Which of the following can be treated as contributions of capital for tax purposes only for a CIRA? **(Page 265)**
- Initial contributions from new members of the CIRA when purchasing a unit. [This answer is incorrect. Initial contributions required by new members upon purchase of units to provide the CIRA with additional working capital would be reported as a contribution for financial reporting purposes.]
  - Litigation proceeds received from developers related to warranty claims. [This answer is correct. Tax rules allow CIRAs to treat litigation proceeds from developers for warranty claims as**

**contributions of capital for tax purposes. However it does not meet the definition of contributed capital for financial statements prepared in conformity with GAAP and should be reported as revenue in the financial statements.]**

- c. A donation to the CIRA of property that was purchased by a member with social funds. [This answer is incorrect. For financial reporting purposes, any property purchased by members with social or other funds and donated to the CIRA would be reported as contributed capital.]
- d. Property that is given to the CIRA by the developer. [This answer is incorrect. Property and equipment transferred from the developer or sponsor to the CIRA would be reported as contributed capital for financial reporting purposes.]



## EXAMINATION FOR CPE CREDIT

### Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 2—Common Interest Realty Associations and Applicable Accounting Principles and Practices (HOATG172)

#### Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

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**Note:** The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

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**EXAMINATION FOR CPE CREDIT****Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 2—Common Interest Realty Associations and Applicable Accounting Principles and Practices (HOATG172)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. Which of the following is **not** a primary function of all CIRAs?
  - a. Serving as a tax shelter.
  - b. Serving as a business.
  - c. Serving as a governance structure.
  - d. Serving as a community.
2. Associations that provide nonresidential facilities describe which type of common interest ownership development?
  - a. Condominium trusts.
  - b. Master associations.
  - c. Commercial associations.
  - d. Cohousing communities.
3. CIRA's formed as cooperatives are required to file which income tax form?
  - a. Form 1120.
  - b. Form 1120-C.
  - c. Form 1120-H.
  - d. Form 990.
4. Cooperatives generally derive their authority from which of the following?
  - a. Federal laws.
  - b. State laws.
  - c. Local government entities.
  - d. Articles of incorporation.

5. Which of the following is accurate regarding the regulatory environment of CIRAs?
- a. The CIRA industry is largely regulated at the state level.
  - b. Federal laws regulate the creation of CIRAs.
  - c. Few states have enacted statutes regulating condominium developments.
  - d. The Americans with Disabilities Act of 1990 does not apply to CIRAs.
6. Which of the following is an economic pressure driving developers to use CIRAs to reduce housing costs?
- a. The desire for an increased level of security by gated communities.
  - b. An increased desire for leisure time by an aging population.
  - c. Lack of government provided infrastructure such as streets and sewers.
  - d. The scarcity of land and land use restrictions.
7. Which of the following is correct regarding income taxes for CIRAs?
- a. Taxes services for CIRAs are usually performed by the CIRA board members.
  - b. CIRAs are generally taxed as corporations.
  - c. HOAs are tax exempt and are not required to file a tax return.
  - d. Cooperative associations are required to file an information return on Form 990.
8. Mary accepted an engagement to perform a replacement fund study for a CIRA. She is charged with determining the amount to be assessed to the members for future repairs and replacements. She will do this by conducting both a component study and a funding study. Which of the following tasks would Mary perform as part of the funding study?
- a. Provide alternative funding models.
  - b. Inventory the common property.
  - c. Estimate remaining life.
  - d. Estimate replacement cost.
9. What word do auditing standards use to indicate a presumptively mandatory requirement?
- a. Required.
  - b. Essential.
  - c. Must.
  - d. Should.



10. The Waterford Homeowner's Association is following guidance that conforms to industry practice that occurred before March 1992, but it is affected by an underlying pronouncement that become effective after March 1992. Which of the following is true?
- a. Waterford HOA is grandfathered and does not have to change their accounting practices.
  - b. Waterford HOA is not affected by the FASB Codification in their accounting practices.
  - c. Waterford HOA should follow the guidance in the FASB Codification.
  - d. Waterford HOA only has to follow nonauthoritative guidance since they are a CIRA.
11. Which of the following is considered the most influential source of nonauthoritative guidance for CIRAs?
- a. FASB Concepts Statements.
  - b. Accounting textbooks.
  - c. AICPA Issues Papers.
  - d. AICPA Common Interest Realty Association Wiki.
12. The CIRA for Liberty Townhomes uses fund accounting. How should the balance sheet represent cash on its financial statements?
- a. Group cash equivalents and investments for all funds.
  - b. Subtotal cash and cash equivalents.
  - c. Total cash, cash equivalents, and investments in one account.
  - d. Separate cash and cash equivalents.
13. Which of the following would be classified as cash equivalents per FASB ASC 230-10-20?
- a. Demand deposits.
  - b. Money market accounts.
  - c. Commercial paper.
  - d. Certificates of deposit.
14. Which of the following funds should be recorded in the CIRA's financial statements?
- a. Waterford Park Estates holds an annual July 4th picnic at the neighborhood park. The HOA collects \$15 from each family to pay for the fireworks show.
  - b. The CIRA of Chaucer Estates organizes a Christmas party at the neighborhood clubhouse. Tickets to the event are \$50 per couple.
  - c. The Branch Townhomes is attending a local major league ballgame together. The CIRA is collecting all the funds to purchase the tickets as a group.
  - d. Lakeside Condominiums requires homeowners to place a deposit with the CIRA to receive the keys to their unit.

15. Which of the following is an equity security into which a CIRA can invest its funds?
- a. U.S. government agency securities.
  - b. Common stock.
  - c. U.S. Treasury securities.
  - d. Municipal securities.
16. Securities can be categorized in three ways: held to maturity, trading, and available for sale. An available-for-sale security for a CIRA will be—
- a. recorded at fair value.
  - b. designated for sale in the short term.
  - c. held until the security matures.
  - d. carried in the balance sheet at amortized cost.
17. The King's Landing HOA purchases a \$10,000 T bill that has 96 days to maturity, a bid price of \$5.15, and an asked price of \$5.12. What is the fair value of the T bill?
- a. \$9,856.94
  - b. \$9,857.78
  - c. \$9,862.67
  - d. \$9,866.47
18. Which of the following is true if a CIRA invests in an annuity?
- a. Annuities should be accounted for based on the guidance in FASB ASC 320-10.
  - b. The fair value of an annuity contract should be disclosed in the financial statements.
  - c. Annuities should be recorded at fair value in the financial statements.
  - d. Most CIRAs invest in fixed annuities and make payments in dollars.
19. Hargrove Manor is a cooperative located in New York City. The cooperative charges its tenants a number of member assessments. Which of the following assessments is included because it is a cooperative?
- a. Common area expenses.
  - b. Maintenance fees.
  - c. Carrying costs.
  - d. Rent.

20. If a CIRA uses fund accounting and is going to levy its members to repay a debt, how should the CIRA account for the assessment?
- a. It should not be recorded in the financial statements.
  - b. In a separate fund established for the special assessment.
  - c. In the replacement fund.
  - d. In the fund for which the activity is most associated.
21. The developer of Hunter's Ridge estates is working on opening Phase II of the development. In exchange for the hassle of construction, the developer is paying 10% of the homeowners' dues for the next year. Which of the following must occur in relation to this transaction?
- a. A disclosure should be made on the financial statements.
  - b. The developer is required to pay the assessments in full and in advance.
  - c. The developer is required to pay the full amount of HOA dues for the units under construction.
  - d. The developer's contribution should be recognized in the last month of the fiscal year.
22. Which of the following would **not** be considered a financial instrument?
- a. Time deposits.
  - b. Investments in common stock.
  - c. Membership assessments received in advance and paid via services provided.
  - d. Accrued expenses receivable or payable.
23. The Bywater Cooperative has master meters for water, gas and electric service. The association is in charge of making sure the tenants pay the utility companies. Which of the following is **not** an approach to recover the costs from the members?
- a. Estimated costs are billed annually to all members.
  - b. Individual bills are created and sent by the utility companies.
  - c. Allocated costs billed as part of the monthly assessments.
  - d. Basic monthly assessments are increased to cover the utility costs.
24. What type of CIRA usually has title to the common real property owned by its members?
- a. Condominium.
  - b. HOA.
  - c. Cooperative.
  - d. Do not select this answer choice.

25. Which of the following is true regarding common personal property of CIRAs?
- a. Most CIRAs do not hold enough common personal property for it to be material.
  - b. CIRAs should expense common personal property when acquired.
  - c. If the CIRA holds title to the property, then failure to capitalize is a departure from GAAP.
  - d. A CIRA's board of directors cannot dispose of personal property of the CIRA without a vote of its members.
26. Which CIRA correctly accounted for the transfer of property?
- a. Holly Road Condos takes possession of a unit due to delinquent assessments by the homeowner. The CIRA records the unit at the owner's acquisition cost.
  - b. Sunshine Marine Cooperative has sold all the units of its new development and the developer is transferring the ownership of the storage unit to the CIRA. The CIRA records the unit on the financials as a note payable to the developer.
  - c. The developer of Stone Briar Condominiums transfers a unit to the CIRA due to litigation over defective construction on the unit. The CIRA records the unit at fair value at the time of transfer and expenses all the closing costs associated with the transfer.
  - d. The Water's Edge HOA receives an abandoned unit for nonpayment of HOA dues. On the date of the foreclosure, the HOA records the home at fair value less the estimated cost to sell the home in the future.
27. Bridlewood HOA's club house received extensive damage from a hail storm that occurred a month ago. In relation to the insurance settlement for the hail storm, what should the HOA do?
- a. Not recognize a gain or loss related to the club house on the HOA's financial statements because the HOA is going to reinvest in similar assets.
  - b. Accrue the gain if the contingencies related to the insurance settlement will result in a gain.
  - c. The HOA should recognize the insurance settlement as a gain contingency in accordance with FASB ASC 450-30-20.
  - d. Not recognize the insurance settlement in the HOA's financial statements until the check has been received and cleared the bank.
28. Which of the following is true regarding prepaid insurance for CIRAs?
- a. Insurance premiums are not a material expense for common interest realty associations.
  - b. On the balance sheet date, prepaid insurance is usually a material asset.
  - c. Premium finance agreements should be considered liabilities of the CIRA at the balance sheet date.
  - d. GAAP requires prepaid insurance be reported on the balance sheet at total premium payments due.

29. An annual assessment of \$75,000 has been voted on and put in place by the River's Edge HOA for future major repairs and replacements. The assessment is reported as revenue on the HOA's financial statements for the year, but the operating costs of the HOA exceeded the operating fund by \$25,000. The HOA only transferred \$50,000 to the replacement fund. What should the HOA do for the shortfall?
- a. Reduce revenue for the replacement fund by \$25,000.
  - b. Charge the HOA members an additional \$25,000 at the end of the year.
  - c. Write off \$25,000 to bad debt.
  - d. Enter a receivable of \$25,000 from the operating fund.
30. Which of the following is **not** a requirement for interfund borrowings?
- a. A formal loan agreement showing that one fund of the CIRA is borrowing from another fund.
  - b. A modified reserve study to reflect the altered cash flow.
  - c. A notification document to be sent to the members showing the modified budget with the loan included.
  - d. Documentation in the board minutes detailing the reason for borrowing and the repayment terms.
31. Which of the following is an example of a capital improvement fund expenditure?
- a. Replacing the roof on the clubhouse of the HOA.
  - b. Insurance for the common property of the condominiums.
  - c. Purchase of a new computer system for the CIRA.
  - d. The income taxes allocated to a cooperative.
32. Beachside Condominiums borrowed money from the bank to make repairs and is using reserve funds to make the related fund payments. How would the loan repayments be classified?
- a. As part of common property.
  - b. As part of the funding study.
  - c. As a note payable to the bank.
  - d. As an expense on the operating fund.
33. Which of the following is a characteristic of the pooling method of reserve fund calculations?
- a. Estimates based on the weighted average life for all components in the reserve fund.
  - b. Beginning reserve balances are allocated to individual items, not the overall reserve fund.
  - c. Not considering the time value of money, such as inflation or interest to be earned on the investment of replacement funds.
  - d. Dividing the current cost of an individual reserve item by its estimated useful life to determine the monthly reserve contribution amount.

34. The Mount at Cherry Corner has a reserve set up to replace the roof of the building. The roof has an estimated useful life of 25 years, and the CIRA is currently 10 years into the life of the current roof. The reserve study estimates that at the time the roof will need to be replaced, it will cost \$450,000. The association has currently accumulated \$125,000 for the roof replacement. What percentage funded is the current reserve?
- a. 28%.
  - b. 46%.
  - c. 69%.
  - d. 100%.
35. Which of the following has the easiest time obtaining bank financing?
- a. Cooperatives.
  - b. Condominiums.
  - c. Homeowner Associations.
  - d. Do not select this answer choice.
36. Associations may use SBA Loans to obtain funds to repair damage caused by natural disasters. Which of the following statements most accurately describes this type of loan?
- a. Payment is based on the amount that the association has used for repairs.
  - b. The SBA charges simple interest on advanced funds.
  - c. Payments are applied first to principal and then to the interest.
  - d. Such loans typically have a high interest rate and a short-term length.
37. Which of the following should expense environmental cleanup costs?
- a. Cooperatives.
  - b. Condominiums.
  - c. Homeowner Associations.
  - d. Do not select this answer choice.
38. What is the risk to a CIRA in relation to refundable security deposits?
- a. Deposits are not recorded on the financials.
  - b. Deposits will be significant to the CIRA.
  - c. CIRA management will not be able to locate the member associated with the deposit.
  - d. The amount is not reconciled and it becomes unclaimed property.

39. FASB ASC 740-10 distinguishes between two types of temporary differences—taxable and deductible. Which of the following is a characteristic of a deductible difference?
- a. Are future expenses for financial statements, but deducted on the tax return.
  - b. Points to the acknowledgment of a deferred tax asset.
  - c. Signifies income that is recognized in financial statements, but is taxed in future returns.
  - d. Leads to the recognition of a deferred tax liability.
40. Which of the following would be considered a permanent difference for a CIRA?
- a. Using different depreciation methods for financial and tax reporting.
  - b. Leases that are handled differently for financial and tax reporting.
  - c. Special assessments for specific capital improvement that is a contribution of capital for tax reporting.
  - d. Any unrealized gains that are not deductible for tax purposes.





## GLOSSARY

**Ancillary operations:** Any association activities other than the ordinary maintenance, security, governance and administrative activities common to most associations.

**Annuity:** An insurance contract that provides fixed or variable periodic payments made from a stated or contingent date and continuing for a specified period, such as for a number of years or for life.

**Available for sale securities:** Debt securities that do not meet the criterion to be classified as held to maturity or trading.

**Capital improvement:** An improvement made to extend the useful life of a property or add to its value. Major repairs such as the replacement of a roof are considered to be capital improvements. The costs of capital improvements to business property must be capitalized and may be depreciated.

**Cash:** Includes not only currency on hand but demand deposits with banks or other financial institutions.

**Cash equivalents:** Short-term, highly liquid investments that (a) are readily convertible into known amounts of cash and (b) are so near to their maturity that they present insignificant risk of changes in value because of changes in interest rates.

**CIRA:** Common interest realty association.

**Common property:** All real or personal property within a common interest development, except property that is owned exclusively by individuals living in the development.

**Credit risk:** The possibility that a loss may occur from the failure of another party to perform according to the terms of the contract.

**Deductible difference:** Leads to the recognition of a deferred tax asset.

**Deferred taxes:** The amount of future tax consequences attributable to temporary differences that will result in net taxable amounts (deductions) in future years, as computed currently. Recognition and measurement does not anticipate the tax consequences of losses or expenses (income) that may be incurred (earned) in future years.

**Derivative financial instrument:** A financial instrument whose value is linked to or derived from changes in the value of another financial instrument.

**Enacted:** Future changes in the tax law are not anticipated.

**Fair value:** refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts.

**Fee simple ownership:** An unrestricted ownership of rights to property, including the right to use and dispose of the property.

**Financial instrument:** Represents cash, evidence of an ownership interest in an entity, or a contractual obligation that requires the exchange of cash or other financial instrument (including exchange of a financial instrument on potentially unfavorable terms) to another entity.

**Held to maturity securities:** Debt securities for which the entity has both the positive intent and ability to hold to maturity.

**Market risk:** The possibility that future changes in market prices may make a financial instruction less valuable or more onerous.

**Marketable security:** Securities that have readily determinable fair values and are considered marketable when a day-to-day market exists and when they can be sold on short notice. The volume of trading in securities should be

sufficient to absorb a company's holdings without materially altering the market price. Fair value is considered readily determinable if sale prices or bid-and-asked quotations are currently available from a stock exchange such as the NYSE or the over-the-counter (OTC) market. Marketable securities are accounted for per SFAS 115.

**Notional amount:** A specified number of currency units, shares, bushels, pounds or other units.

**Payment provision:** A fixed or determinable settlement to be made if the underlying performs in a specified manner.

**Performance obligation:** A promise in a contract with a customer to transfer a good or service to the customer.

**Percent funded:** A ratio, expressed as a percentage, that compares funds available for future major repairs and replacements at a point in time to the amount that the reserve study estimates will be needed to maintain, repair, or replace the components included in the study at the end of their useful lives.

**Prepaid expenses:** Advance payments for products or services that will be used in operations during the year.

**Permanent difference:** A difference between accounting income and taxable income that is not expected to reverse. It is an amount that arises as a result of transactions or events recognized in the financial statements that do not have any tax consequences or vice versa (items that have a tax consequence but are not determinants of accounting income or have no effect on interperiod tax allocation). Tax payable in the current period equals the income tax expense that arises from the item.

**Presumptively mandatory requirements:** An auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances when the auditor determines it necessary to depart from a relevant requirement. In that case, the auditor should perform alternative procedures to achieve the intent of the requirement (see AU-C 200.26). Auditing standards use the word *should* to indicate a presumptively mandatory requirement.

**Reasonably possible:** More than remote but less than likely.

**SBA:** Small Business Administration.

**Taxable difference:** Leads to the recognition of a deferred tax liability.

**Trading securities:** Debt securities that do not meet the "intent to hold" criterion and equity securities that have readily determinable fair values, both of which are bought and held principally for the purpose of selling them in the near term and thus generally are held for only a short period of time.

**Transaction price:** The amount of consideration (payment) to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.

**Unconditional requirements:** Unconditional requirements are those that an auditor must follow in all cases if the circumstances apply to the requirement. Auditing standards use the word *must* to indicate an unconditional requirement.

**Underlying:** A special interest rate, security price, commodity price, foreign exchange rate, price or rate index or other variable.

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# COMPANION TO PPC'S GUIDE TO HOMEOWNERS' ASSOCIATIONS AND OTHER COMMON INTEREST REALTY ASSOCIATIONS

## COURSE 3

### FINANCIAL STATEMENT PRESENTATION AND INCOME TAXES (HOATG173)

#### OVERVIEW

<b>COURSE DESCRIPTION:</b>	This interactive self-study course provides a discussion of two issues that affect homeowners' associations and other common interest realty associations (CIRAs). Lesson 1 takes a look at financial statement presentation for these entities, and Lesson 2 follows that up with an examination of applicable income tax rules.
<b>PUBLICATION/REVISION DATE:</b>	September 2017
<b>RECOMMENDED FOR:</b>	Users of <i>PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations</i>
<b>PREREQUISITE/ADVANCE PREPARATION:</b>	Basic knowledge of homeowners' associations and the other interest realty associations
<b>CPE CREDIT:</b>	7 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **[www.nasbaregistry.org](http://www.nasbaregistry.org)** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

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<b>CTEC CREDIT:</b>	6 CTEC Federal Tax Law Hours
<b>IRS EA CREDIT:</b>	6 Federal Tax Law/Tax Related Matters Hours
<b>IRS NCRP CREDIT:</b>	6 Federal Tax Law Hours
<b>FIELD OF STUDY:</b>	Accounting, 1 hour; Taxes, 6 hours
<b>EXPIRATION DATE:</b>	Postmark by <b>September 30, 2018</b>
<b>KNOWLEDGE LEVEL:</b>	Basic

#### Learning Objectives:

#### Lesson 1—Financial Statement Presentation

Completion of this lesson will enable you to:

- Identify the general accounting considerations that apply to CIRAs, the basic financial statements they use, and the supplementary information that such organizations may be required to present.

## Lesson 2—Income Taxes

Completion of this lesson will enable you to:

- Identify the principles of tax law that apply to all types of CIRAs.
- Determine the rules that apply to CIRAs filing Form 1120-H.
- Identify the rules that apply to CIRAs filing Form 1120.
- Recognize appropriate methods for dealing with tax-exempt CIRAs, cooperative housing corporations, master associations, timeshare developments, commercial developments, and specialized tax situations that may occur with CIRAs.

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# Lesson 1: Financial Statement Presentation

## INTRODUCTION

Lesson 1 discusses the financial statement presentation of homeowners' associations and other common interest realty associations (CIRAs). This lesson begins with a brief discussion of the general accounting considerations for CIRAs, including the basis of accounting that may be used and fund accounting. It continues by taking a look at the basic financial statements CIRAs generally use—balance sheets, statements of revenues and expenses, etc. Finally, Lesson 1 concludes with a brief discussion of the supplementary information CIRAs may be required to include in their financial statement presentation.

### Learning Objectives:

Completion of this lesson will enable you to:

- Identify the general accounting considerations that apply to CIRAs, the basic financial statements they use, and the supplementary information that such organizations may be required to present.

## GENERAL ACCOUNTING CONSIDERATIONS FOR CIRA FINANCIAL STATEMENTS

### Basis of Accounting

**GAAP Requires the Accrual Basis.** The financial statements of a common interest realty association (CIRA) should be prepared on the accrual basis of accounting to be in conformity with GAAP. The AICPA Audit and Accounting Guide, *Common Interest Realty Associations*, notes that accrual basis financial statements are particularly informative since member assessments are based on annual budgets, and accrual basis financial statements enable users to compare the results of operations to budgeted amounts. Many CIRAs, however, maintain their accounting records on a modified cash basis during the year, recording assessments from members on an accrual basis but recording expenses on a cash basis. Other CIRAs maintain their accounting records on a pure cash basis of accounting. In either case, the CIRA's financial records should be adjusted to the accrual basis at year end to prepare financial statements that are in accordance with GAAP.

### Special Purpose Frameworks

CIRAs may sometimes present financial statements on a basis of accounting other than GAAP, such as the cash or income tax basis. (For example, accounting practices prescribed by income tax rules may depart from GAAP.) This course specifically addresses accounting and reporting on GAAP basis financial statements; however, the following guidance may be helpful when preparing financial statements using a special purpose framework (that is, basis of accounting other than GAAP):

- AU-C 210, *Terms of Engagement*, requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements. Ordinarily, that framework is provided by GAAP; but AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, and the SSARS also allow special purpose frameworks to be used.
- Financial statements prepared using a special purpose framework should be suitably titled. AU-C 800.15 and .A17, as well as AR-C 80.A28 and AR-C 90.A81 indicate the titles of special purpose financial statements should differ from those for similar statements prepared in conformity with GAAP so there is no implication that the statements are GAAP basis statements. However, GAAS does not specify required titles for special purpose financial statements.
- The modified cash basis of accounting is described by AU-C 800.7 and the SSARS (at AR-C 70.07, AR-C 80.05, and AR-C 90.05) as the pure cash basis of accounting incorporating modifications having substantial support. There is no authoritative guidance about acceptable modifications to the pure cash

basis of accounting. Two nonauthoritative sources of guidance on the modified cash basis of accounting are (a) the AICPA practice aid, *Accounting and Financial Reporting Guidelines For Cash and Tax-Basis Financial Statements*, and (b) *PPC's Guide to Cash, Tax and Other Bases of Accounting*. If modified cash basis statements are tantamount to accrual basis financial statements, the statements should be considered accrual basis.

- For audited financial statements, AU-C 800.15 requires auditors to evaluate whether the financial statements adequately describe how they differ from GAAP. The disclosure need not quantify the differences between GAAP and the special purpose framework because the purpose of the disclosure is not to reconcile the basis to GAAP. Instead, the disclosure should (a) put readers of the financial statements on notice that the basis of accounting may be different from what they are used to seeing and (b) disclose how the presentation would have been materially changed if GAAP had been used.
- AU-C 800.15 requires financial statements prepared using a special purpose framework to include a summary of significant accounting policies.
- Financial statement disclosures should comply with FASB ASC 972-235-50. AU-C 800.17 states, “. . . when the special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, the auditor should evaluate whether the financial statements include informative disclosures similar to those required by GAAP. The auditor also should evaluate whether additional disclosures, beyond those specifically required by the framework, related to matters that are not specifically identified on the face of the financial statements or other disclosures are necessary for the financial statements to achieve fair presentation.”
- For compiled financial statements that do not omit substantially all disclosures and reviews of financial statements, AR-C 80.18 and 90.40, respectively, requires accountants to modify their report when they become aware that the financial statements do not include (a) a description of the special purpose framework up on which the financial statements are prepared and how that differs from GAAP, (b) a summary of significant accounting policies, and (c) informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in GAAP financial statements.

## Fund Accounting

Fund accounting segregates the financial statement amounts into groupings based on the entity's specific activities. A fund can be defined as an accounting entity established to account for resources used for specific activities or objectives in accordance with special regulations, restrictions, or limitations. Most CIRAs present their financial statements using fund accounting because fund reporting generally is believed to be the most informative method of presenting a CIRA's normal operations, long-term major repair and replacement requirements, and commercial operations, if any. Fund accounting also is prevalent industry practice for most types of CIRAs, and this lesson primarily addresses that approach.

**Principal Funds.** CIRAs that use fund accounting for their financial statements generally segregate their activities into two principal funds—an operating fund and a fund for future major repairs and replacements (often called a reserve fund or replacement fund). CIRAs' financial statements may show one or more additional funds if they use separate funds to account for activities such as special assessments, significant amounts of property and equipment that are capitalized as assets, or commercial operations. When fund accounting is used, the financial statements should include a total column since a CIRA's financial statements are considered to be the financial statements as a whole and not the financial statements of the funds individually.

**Other Funds.** CIRAs often use additional funds to account for specific types of transactions. Examples of additional funds for CIRAs include:

- Property fund.
- Construction defect fund.

- Recreation fund.
- Capital improvements fund.
- Special assessments fund.
- Settlement proceeds fund (for insurance and litigation).
- Loan or debt fund.

Some CIRAs that maintain recreational facilities such as golf courses, marinas, or equestrian centers may also establish separate funds for those activities, particularly if the activity represents a significant portion of the association's overall budget.

**Financial Statement Disclosure.** If a CIRA presents its financial statements on a fund basis, the funds established and their purpose are generally disclosed in the summary of significant accounting policies.

**Using Nonfund Reporting.** GAAP does not require fund reporting. FASB ASC 972-205-45-1 states that CIRAs may not need to use fund reporting if they do not assess their members for future major repairs and replacements. (For example, the financial statements of cooperative housing corporations often are not presented using fund accounting.) If CIRAs present their financial statements using a nonfund approach, FASB ASC 972-605-50-1 requires their financial statements to disclose assessments that were used for purposes other than those for which they were designated.

### **Classified and Unclassified Balance Sheets**

CIRAs generally present unclassified balance sheets. However, CIRAs having significant commercial operations often present classified balance sheets.

### **Comparative Financial Statements**

Similar to commercial businesses, CIRAs are not required to present comparative financial statements. However, FASB ASC 205-10-45-2 recommends them. If CIRAs present their financial statements in columnar format, as is typically done, presentation of prior-period amounts for each fund may be very cumbersome and confusing. Thus, for the sake of simplicity, CIRAs generally present only total-all-funds information in a single column for the prior period. That practice is acceptable, and auditors are not required to express an opinion on the summarized comparative information. However, AU-C 700.46 requires the auditor to clearly indicate in the auditor's report the character of the auditor's work, if any, and the degree of responsibility the auditor is taking for comparative information that is presented but not covered by the auditor's opinion on the financial statements of the current period. If comparative information is presented and the CIRA requests the auditor to express an opinion on both the current period and the prior period comparative information, the auditor should consider whether the information included for the prior period contains sufficient detail to constitute a fair presentation in accordance with the GAAP.

To provide sufficient detail required by GAAP, it is a good idea for prior-year disclosures to include items such as funds designated for future major repairs and replacements. In addition, GAAP for nonprofit organizations at FASB ASC 958-205-45-8 states that the nature of the summarized prior year information should be described by the appropriate use of titles on the face of the financial statements including a phrase such as "with summarized financial information for the year ended June 30, 19PY," or column headings that indicate the *summarized nature of the information*. In addition, the summarized nature of the prior year information should be disclosed in the notes to the financial statements. The guidance further states that labeling the prior year summarized financial information "for comparative purposes only" without further disclosure in the notes to the financial statements would not constitute the use of an appropriate title. Although the FASB guidance addresses nonprofit organizations rather than CIRAs, the circumstances are similar in both types of entities, and following that guidance would be a best practice for CIRAs.

Based on the FASB guidance, the following is an example of note disclosure of summarized prior year financial information:

The financial statements include certain prior-year summarized comparative information in total but not by fund. Such information does not include sufficient detail to constitute a presentation in conformity with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the Association's financial statements for the year ended December 31 of the prior year, from which the summarized information was derived.

## A CIRA'S BASIC FINANCIAL STATEMENTS

The basic financial statements of CIRAs are as follows:

- Balance sheet.
- Statement of revenues and expenses.
- Statement of comprehensive income.
- Statement of changes in fund balances (or statement of changes in members' equity if nonfund reporting is used).
- Statement of cash flows.
- Notes to financial statements.

The remainder of this section discusses presentation issues that are unique to CIRAs, along with some specific recommendations.

### Financial Statement Titles

Even though a CIRA's financial statements typically show an operating fund, a replacement fund, and a total-all-funds column, accountants only report on the total column. Accordingly, it is best practice for the titles of financial statements to be singular (for example, Balance Sheet rather than Balance Sheets and Statement of Changes in Fund Balances rather than Statements of Changes in Fund Balances). Practice varies in that regard, however, and some accountants do use plural financial statement titles. Although that practice is acceptable, care should be taken to use singular titles in the accountants' report because the accountants are reporting only on the CIRA's financial statements as a whole and not on the financial statements of the funds individually. (If comparative financial statements are presented, however, plural titles are appropriate.)

### Balance Sheet

A CIRA's balance sheet is very similar to that of a commercial business and shows assets, liabilities, and the difference between assets and liabilities, which, for a CIRA, is usually termed "fund balance" rather than "retained earnings." (CIRAs that present their financial statements using a nonfund approach typically use the term "members' equity.") Although CIRAs generally present unclassified balance sheets, assets usually are presented in the order of liquidity and liabilities are presented in the order of maturity.

**Presenting Interfund Transactions.** GAAP does not explicitly address whether interfund transactions should be eliminated if fund accounting is used for a CIRA's financial statements (similar to the approach required when consolidated or combined financial statements are presented). This course suggests that interfund transactions be eliminated and not included in the "total" column since, as explained earlier in this lesson, the CIRA's financial statements are considered to be the financial statements as a whole. Various mechanical methods may be used to eliminate the interfund transactions. For example, the financial statements may include an elimination column, or a note to the total column may explain that interfund transactions have been eliminated.

Exhibit A-1 to Appendix A of the AICPA guide illustrates financial statements that present interfund accounts as follows:

	20X2			20X1
	<u>Operating Fund</u>	<u>Replacement Fund</u>	<u>Total</u>	<u>Total</u>
<b>ASSETS</b>				
Cash and cash equivalents	\$ 110,000	\$ 364,000	\$ 474,000	\$ 298,000
Assessments receivable	28,000		28,000	9,000
Prepaid expenses	7,000		7,000	7,000
Due from operating fund		20,000	20,000	
Due to replacement fund	(20,000)		(20,000)	
Equipment, net of accumulated depreciation of \$8,000 and \$5,000	21,000		21,000	17,000
<b>TOTAL ASSETS</b>	<u>\$ 146,000</u>	<u>\$ 384,000</u>	<u>\$ 530,000</u>	<u>\$ 331,000</u>

However, this course does not recommend that approach because, as explained earlier in this lesson, the CIRA's financial statements are considered to be the financial statements as a whole.

Instead, interfund borrowings could be presented at their net amounts (that is, net receivable or net payable). If material, interfund receivables and payables could be presented separately from receivables and payables from other sources. Lesson 2 discusses the tax implications of transfers between operating and reserve funds.

**Cash Designated for Future Repairs and Replacements.** Funds designated for future repairs and replacements should be segregated from cash available for current operations in the CIRA's financial statements. If the association uses fund accounting, it may comply with that requirement by reporting the funds for future major repairs and replacements in a separate replacement fund. When a nonfund reporting approach is used, it is a best practice to disclose funds designated by the unit owners for specific purposes on the face of the balance sheet with a caption such as, "Cash for future repairs and replacements." In addition, such amounts can be reported as a separate classification of members' equity (or disclosed in the notes).

It is not uncommon for the cash balance designated for future repairs and replacements to differ from the fund balance designated for future repairs and replacements. This situation can occur due to inadequate accounting or spending funds from the wrong account. Specific examples include—

- A journal entry to record a transfer to the replacement fund is made and recorded as operating fund expense, but no journal entry is made to record the interfund receivable (in the operating fund) and payable (in the replacement fund).
- Funds are expended from the replacement fund cash account for an operating fund expense and no interfund journal entry recorded.
- A journal entry to record the budgeted assessments for future repairs and replacements is made, but the cash transfer was not made by year end.

Differences between the cash balance designated for future repairs and replacements and the fund balance designated for future repairs and replacements that occur as a result of those situations, should be eliminated by recording the appropriate journal entry (either recording an interfund transfer or an interfund receivable/payable) to correct the account balances.

Discrepancies between the cash balance or the fund balance account on the balance sheet and the supplementary information disclosed about major repairs and replacements are also common. This situation occurs primarily because the supplementary information is based upon a reserve study prepared in advance on estimated information. To eliminate such a situation from occurring, either (a) the supplementary disclosure related to the year-end allocation of designated cash could be modified to match the actual cash and investments on hand, or (b) an

interfund journal entry could be posted to balance the amounts (either by recording an interfund transfer or an interfund receivable/payable). Reasons for material differences in amounts should be investigated and resolved.

## Statement of Revenues and Expenses

GAAP does not require the title "Statement of Revenues and Expenses" to be used, but most CIRAs do use that title. However, CIRAs with significant commercial operations and some cooperatives use the title "Statement of Operations." If there is an excess of expenses over revenues, the title "Statement of Operations and (Accumulated) Deficit" may be used.

The statement of revenues and expenses should report the excess (deficiency) of revenues over expenses for the period. CIRAs usually present income taxes in the same manner as other operating expenses. It generally is not meaningful to present income taxes as a separate caption after "Excess (deficiency) of revenues over expenses before income taxes" because income taxes generally are not related to the excess of revenues over expenses. Thus, the statement of revenues and expenses of most CIRAs generally shows only one "excess" caption. CIRAs may show the excess (deficiency) of revenues over expenses both before and after depreciation. A detailed discussion of depreciation is beyond the scope of this course, but more information is available in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

There are few strict rules for presenting statements of revenues and expenses. The principal sources of revenue and categories of expenses should either be presented separately in the statement, or amounts may be combined and additional detail disclosed in the notes to the financial statements. Information for additional analysis purposes may be presented as supplementary information.

The statement of revenues and expenses may include a reconciliation between beginning and ending fund balance by fund, or the CIRA may present a separate statement of changes in fund balance. If a combined statement is presented, the title generally is "Statement of Revenues, Expenses, and Changes in Fund Balance."

## Statement of Comprehensive Income

FASB ASC 220-10-15-2 requires comprehensive income and its components to be reported when a CIRA has items of other comprehensive income and presents a full set of financial statements that report financial position, results of operations, and cash flows. Comprehensive income may be reported in a single continuous statement of revenues, expenses, and comprehensive income or in two separate but consecutive statements. Presenting comprehensive income is discussed in more detail later in this lesson.

## Statement of Changes in Fund Balance

The statement of changes in fund balance (or statement of changes in members' equity if a nonfund approach is used) should reconcile beginning and ending fund balance with results of operations for the period. In many cases, the only reconciling item will be the excess (deficiency) of revenues over expenses for the period. Other reconciling items include:

- Permanent transfers between funds.
- Unrealized gains and losses on available for sale securities.
- Amounts that represent contributions of capital, such as the following:
  - Property and equipment transferred from the developer or sponsor to the CIRA.
  - Funds contributed at the initial start-up of the CIRA, such as funds contributed by the developer to replacement funds or to the CIRA's initial working capital upon transfer of the common property to the CIRA.
  - Initial contributions required by new members upon purchase of units to provide the CIRA with additional working capital.
  - Property purchased by members with social or other funds and donated to the CIRA.

- Amounts that represent distributions of capital, such as the following:
  - Refunds of excess special assessments or excess member assessments over the CIRA's expenses.
  - Patronage dividends.
- Corrections of errors.

### Statement of Changes in Shareholders' Equity

Cooperatives typically do not present a statement of changes in fund balance but instead disclose changes in shareholders' equity similar to commercial corporations. Thus, they disclose changes in (a) common stock, (b) additional paid-in capital, (c) fund balance or members' equity, (d) treasury stock, and (e) unrealized gains and losses on available for sale securities. Changes in fund balance or members' equity (deficit) generally are presented with a combined statement of operations. Other changes in shareholders' equity may be presented in a separate statement, on the face of the balance sheet, in the notes to the financial statements, or any combination of those formats. For example, changes in additional paid-in capital may be disclosed in a separate statement and changes in treasury stock may be disclosed on the face of the balance sheet.

### Comprehensive Income

**What Is Comprehensive Income?** *Comprehensive income* includes all changes in equity during a period *except* those resulting from investments by owners and distributions to owners. For most CIRAs, comprehensive income will include the following components:

- a. Excess of revenues over expenses.
- b. Unrealized gains and losses on investments in marketable securities classified as available for sale in accordance with FASB ASC 320-10-25.

Other components of comprehensive income generally not present in CIRAs are (a) foreign currency translation adjustments and gains and losses from certain foreign currency transactions, (b) changes in the market value of certain futures contracts that qualify as a hedge (or certain derivative instruments), and (c) minimum pension liability adjustments.

The term *comprehensive income* refers to all components of comprehensive income including the excess of revenues over expenses [for example, items (a) and (b) above]. The term *other comprehensive income* refers to revenues, expenses, gains, and losses that under GAAP are included in comprehensive income but excluded from the excess of revenues over expenses (for example, unrealized holding gains and losses that are reported as a separate component of equity). As explained below, FASB ASC 220-10-45-1A and 45-1B require the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income to be presented.

The specific terms *comprehensive income* and *other comprehensive income* are not required to be used, but those terms are often used in practice and many CIRAs may use them.

**Are All CIRAs Required to Report Comprehensive Income?** No. If CIRAs do not have investments in marketable securities classified as available for sale (or the other components of comprehensive income described above), the CIRAs are not required to report comprehensive income.

**Presentation Requirements.** FASB ASC 220-10 establishes standards for reporting comprehensive income and its components in a set of basic financial statements. As discussed earlier in this section, there are only two approaches for presenting comprehensive income: in a single continuous statement of comprehensive income or in two separate but consecutive statements.

If a CIRA is required to report comprehensive income, all components of comprehensive income are required to be presented whenever the CIRA issues a full set of financial statements. The elements to be included when

presenting a single continuous statement of comprehensive income (single-statement format) or two separate but consecutive statements (two-statement format) are as follows:

- A *single-statement format* should include the following elements: (a) the components of the excess (deficiency) of revenues over expenses, (b) a total for the excess (deficiency) of revenues over expenses, (c) the components of other comprehensive income, (d) a total for other comprehensive income, and (e) a total for comprehensive income.
- In a *two-statement format*, the statement of revenues and expenses should include the components of revenues and expenses and the excess (deficiency) of revenues over expenses. The statement of comprehensive income, which may begin with the excess (deficiency) of revenues over expenses, should present (a) the components of other comprehensive income, (b) a total for other comprehensive income, and (c) a total for comprehensive income.

Reclassification adjustments to other comprehensive income may be necessary to avoid double counting items that are included in the excess of revenues over expenses in the current period but were included in comprehensive income in prior periods. For CIRAs, reclassification adjustments will be necessary for realized gains and losses on marketable securities reported in the current year's excess of revenues over expenses (when the securities are sold) that were reported in other comprehensive income as unrealized holding gains or losses in prior periods (when the carrying amount of the securities was adjusted to fair value). Reclassification adjustments out of other comprehensive income must be presented by component. When reclassification adjustments are necessary, the CIRA may either (a) display the gross amount of each component of comprehensive income and add or subtract an amount for any related reclassification adjustments on the face of the financial statement or (b) display each comprehensive income component net of reclassification adjustments and disclose the gross change in the notes to the financial statements.

See *PPC's Guide to Preparing Financial Statements* for a detailed guidance on reporting comprehensive income.

## Statement of Cash Flows

GAAP requires CIRAs to present a statement of cash flows if their financial statements include both a balance sheet and a statement of revenues and expenses. (Financial statements prepared using a special purpose framework are not required to present cash flow statements, however.)

The statement of cash flows has five principal elements:

- Cash flows from operations.
- Cash flows from investing activities.
- Cash flows from financing activities.
- Net change in cash during the period.
- Supplemental disclosure of noncash investing and financing activities.

**Types of Cash Flows.** This lesson discusses the cash flow issues that are unique to CIRAs. Detailed guidance on preparing cash flow statements is included in *PPC's Guide to Preparing Financial Statements*. Exhibit 1-1 shows how a typical CIRA's transactions would be classified into operating, investing, and financing activities according to the criteria in FASB ASC 230-10.

**Classifying Cash Flows from Member Assessments.** The statement of cash flows for CIRAs should be classified into operating, investing, and financing activities, but GAAP does not provide guidance about how certain transactions that are unique to CIRAs should be classified. Exhibit 1-1 summarizes this lesson's recommendations for categorizing specific transactions. The discussion below provides additional guidance on classifying the following types of transactions:

- Assessments for specific purposes, such as assessments for capital acquisitions and the portion of assessments from cooperative tenant-shareholders designated for amortization of mortgage principal.



- Assessments received in advance.
- Interfund transfers and borrowings.

**Assessments for Specific Purposes.** Some accountants believe that cash receipts from assessments should be classified as operating, investing, or financing based on the types of expenses that will be paid with those receipts. Thus, for example, those accountants would classify the portion of assessments from cooperative tenant-shareholders designated for amortization of mortgage principal as cash flows from financing activities, and they would classify assessments for capital acquisitions as investing cash flows. This course disagrees with that approach, however. Because cash flows from operating activities are generally the result of transactions comprising net income, this course recommends that all assessments from members should be classified as operating cash flows regardless of the types of expenditures that will be paid with those receipts. Furthermore, those receipts do not meet the definition of financing or investing cash flows. Operating activities include transactions and events that are not defined as investing or financing activities. Thus, it is a good idea for all cash receipts from member assessments to be classified as operating cash flows unless they are reported as contributed capital.

**Assessments Received in Advance.** If a CIRA presents its cash flow statement using the indirect method, member assessments received in advance should be added to the excess (deficiency) of revenues over expenses in arriving at cash flows from operations. On the other hand, if the direct method is used, assessments received in advance need not be reported separately but may be included with other collections from members.

**Interfund Transactions.** GAAP does not provide guidance on classifying cash flows from interfund transfers and borrowings. Permanent transfers between funds do not clearly fit into any of the FASB ASC 230-10 cash flow categories. Many accountants, however, believe that they most closely resemble financing transactions. Interfund borrowings, on the other hand, may be classified according to the general guidance in FASB ASC 230-10. Following that guidance, the fund making an interfund loan should account for the related cash inflows and outflows as investing cash flows and the borrowing fund should account for the interfund loan as a financing activity. For simplicity, however, CIRAs generally use one of the following approaches:

- Classify all interfund transactions as financing activities or
- Present all interfund transactions as a separate category after operating, investing, and financing activities

For example, if the replacement fund made a \$20,000 loan to the operating fund, which the operating fund did not repay during the year and, in addition, transferred \$50,000 to the operating fund, the transactions may be presented in the CIRA's cash flow statement as follows:

	<u>Operating Fund</u>	<u>Replacement Fund</u>	<u>Total</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Interfund transfers	\$ 50,000	\$ (50,000)	\$ —
Interfund borrowings	<u>20,000</u>	<u>(20,000)</u>	<u>—</u>
NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES	70,000	(70,000)	—

Alternatively, some CIRAs present the interfund transactions in a separate section of the cash flow statement after operating, investing, and financing activities.

This course suggests that either approach for presenting interfund transactions is acceptable since they are eliminated in presenting financial statement totals, and the CIRA's financial statements are considered to be the financial statements as a whole. For the same reason, it seems logical that interfund borrowings may be reported at their net amount even though netting would not be appropriate under FASB ASC 230-10-45-9 unless the amounts had original maturities of three months or less.

**Exhibit 1-1****Types of Cash Flows**

<b>OPERATING</b>	<b>INVESTING</b>	<b>FINANCING</b>	<b>NONCASH INVESTING AND FINANCING TRANSACTIONS</b>
<b>CASH RECEIPTS FROM:</b> <ul style="list-style-type: none"> <li>• Member operating assessments</li> <li>• Member assessments for major repairs and replacements</li> <li>• Member assessments for amortization of mortgage principal (cooperatives only)</li> <li>• Developer assessments, guarantees, and subsidies</li> <li>• Special assessments</li> <li>• Interest from members</li> <li>• Investment income (interest and dividends)</li> <li>• Other income: <ul style="list-style-type: none"> <li>—Program income</li> <li>—Special use fees</li> <li>—Facility rental</li> <li>—Laundry</li> <li>—Vending machine</li> <li>—Key fees</li> <li>—Forfeited deposits</li> <li>—Transfer fees</li> <li>—Commercial operations</li> </ul> </li> <li>• Settlement of litigation</li> <li>• Refunds from suppliers</li> </ul>	<b>CASH RECEIPTS FROM:</b> <ul style="list-style-type: none"> <li>• Sale of property and equipment</li> <li>• Proceeds from certificates of deposit not classified as cash or cash equivalents</li> <li>• Sale of investments (Cash flows should be reported gross for each security classification.)</li> </ul>	<b>CASH RECEIPTS FROM:</b> <ul style="list-style-type: none"> <li>• Short-term borrowings</li> <li>• Long-term borrowings</li> <li>• Issuance of stock</li> <li>• Initial member contributions for working capital</li> <li>• Initial developer contributions</li> <li>• Interfund transfers</li> <li>• Receipts from inter-fund loans</li> </ul>	<ul style="list-style-type: none"> <li>• Assets contributed by the developer or converter</li> <li>• Assets purchased out of social or other funds and donated to the CIRA</li> <li>• Acquiring property and equipment by assuming liabilities or exchanging assets</li> <li>• Issuing stock in exchange for noncash consideration</li> </ul>

OPERATING	INVESTING	FINANCING	NONCASH INVESTING AND FINANCING TRANSACTIONS
<b>CASH PAYMENTS FOR:</b> <ul style="list-style-type: none"> <li>• Operating expenses: <ul style="list-style-type: none"> <li>—Management fees</li> <li>—Wages and benefits</li> <li>—Utilities</li> <li>—Service and contracts</li> <li>—Repairs</li> <li>—Supplies</li> <li>—Insurance and licenses</li> <li>—Legal and accounting</li> <li>—Security</li> <li>—Administrative expenses</li> </ul> </li> <li>• Replacement expenses (other than asset acquisitions)</li> <li>• Interest (excluding amounts capitalized)</li> <li>• Taxes</li> </ul>	<b>CASH PAYMENTS FOR:</b> <ul style="list-style-type: none"> <li>• Property and equipment (including capitalized interest)</li> <li>• Certificates of deposit not classified as cash or cash equivalents</li> <li>• Investment securities (Cash flows should be reported gross for each security classification.)</li> </ul>	<b>CASH PAYMENTS FOR:</b> <ul style="list-style-type: none"> <li>• Repayment of amounts borrowed (short-term debt, long-term debt, capital lease obligations)</li> <li>• Treasury stock</li> <li>• Patronage dividends</li> <li>• Interfund transfers</li> <li>• Repayment of interfund loans</li> <li>• Refunds of excess assessments or special assessments</li> </ul>	

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### Notes to Financial Statements

As for commercial businesses, GAAP requires adequate disclosures in CIRA financial statements. In addition to the general disclosures required by GAAP, there are also a number of required CIRA-specific disclosures. A complete list of such disclosures is beyond the scope of this course, but more information is available in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

### SUPPLEMENTARY INFORMATION PRESENTED BY CIRAS

CIRAs often present additional details of the basic financial statements as additional information that is not required to be presented but provides additional information about the financial statements for additional analysis purposes. Examples of such information include additional details of revenues and expenses, actual operating results compared to budgeted amounts, and details of replacement fund expenditures. However, certain supplementary information relating to future major repairs and replacements is *required* to be presented. A discussion of accountants' reporting responsibilities for supplementary information presented outside the basic financial statements (including required supplementary information) are beyond the scope of this course, but more information is available in *PPC's Guide to Homeowners' Associations and Common Interest Realty Associations*.

## Supplementary Information Required by the FASB

FASB ASC 972-235-50-3 requires CIRAs to disclose the following information about future major repairs and replacements of common property as unaudited supplementary information (that is, outside of the basic financial statements):

- Estimates of current or future costs of future major repairs and replacements of all existing components, such as roofs, including the following:
  - a. Estimated amounts required.
  - b. Methods used to determine the costs.
  - c. The basis for calculations, including assumptions, if any, about interest and inflation rates.
  - d. Sources used.
  - e. Dates of studies made for that purpose, if any.
- A presentation of components to be repaired and replaced that includes the following:
  - a. Estimates of the remaining useful lives of the components.
  - b. Estimates of current or future replacement costs.
  - c. Amount of funds accumulated for each component to the extent designated by the CIRA's board of directors.

If the CIRA issues comparative financial statements, it seems likely that the required supplementary information only needs to be disclosed for the current period because that is the approach taken in the illustrative financial statements in the AICPA guide.

Accountants should be aware that some CPAs have been sued when audited financial statements did not disclose information about future major repairs and replacements of common property and the related reserves. The litigating parties felt that excluding information about the CIRA's future major expenditures and the reserves accumulated to meet those expenditures led to financial statements with inadequate disclosures.

The authoritative accounting literature requires the supplementary information to be presented because it is considered to be essential for placing the basic financial statements in an appropriate operational, economic, or historical context.

Exhibit 1-2 illustrates how the required supplementary information might be presented in two scenarios: (a) estimates of current costs of future major repairs and replacements based on a study conducted by the CIRA's board of directors and (b) estimates of future costs of future major repairs and replacements based on a study conducted by a consulting firm.

### Exhibit 1-2

#### Required Supplementary Information on Future Major Repairs and Replacements

##### Alternative A—Based on a study conducted by the CIRA's board of directors<sup>a</sup>

The board of directors conducted a study in November 20X2 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were obtained from licensed contractors who inspected the property.

The following table is based on the study and presents significant information about the components of common property.

Components	Estimated Remaining Useful Lives (Years)	Estimated Current Replacement Costs <sup>b</sup>	20X7 Funding Requirement <sup>c</sup>	Components of Fund Bal- ance at Dec. 31, 20X6 <sup>d</sup>
Roofs	5 to 14	\$ 1,620,000	\$ 120,000	\$ 154,000
Streets	5 to 14	96,000	40,000	57,000
Recreation facilities	2 to 11	120,000	12,000	55,000
Exterior siding	7 to 11	760,000	72,000	48,000
Pools, spas, solar equipment	2 to 14	112,000	36,000	39,000
Tennis courts	5 to 10	64,000	10,000	14,000
Furniture and equip- ment	3 to 7	<u>80,000</u>	<u>12,000</u>	<u>12,000</u>
		<u>\$ 2,852,000</u>	<u>\$ 302,000</u>	<u>\$ 379,000</u>

**Notes:**

- <sup>a</sup> As illustrated in Exhibit A-8 of the AICPA guide.
- <sup>b</sup> CIRAs may disclose either estimated current replacement costs or estimated future replacement costs. Estimated current costs are those necessary to replace the common elements today. Estimated future costs are those necessary to replace the common elements at the end of their remaining useful lives. Estimated future costs consider both the rate of inflation and interest to be earned on replacement funds. (See Alternative B.)
- <sup>c</sup> The funding requirement for the subsequent year, although illustrated in the AICPA guide, is not required to be disclosed.
- <sup>d</sup> FASB ASC 972-235-50-3 requires that the amounts accumulated for each component be displayed *to the extent designated by the board*. Thus, if the board has allocated fund balance to each component, that information should be displayed. Otherwise, such information is not required to be presented.

Alternative B—Based on a study conducted by a consulting firm<sup>a</sup>

The ABC Consulting Company conducted a study in November 20X2 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were based on future estimated

replacement costs. Funding requirements consider an annual inflation rate of 5% and interest at 8%, net of taxes, on amounts funded for future major repairs and replacements.

The following table is based on the study and presents significant information about the components of common property.

Components	Estimated Remaining Useful Lives (Years)	Estimated Future Replacement Costs <sup>b</sup>	20X7 Funding Requirement <sup>c</sup>	Components of Fund Balance at Dec. 31, 20X6 <sup>d</sup>
Roofs	5 to 14	\$ 3,023,000	\$ 152,000	\$ 154,000
Streets	5 to 14	179,000	46,000	57,000
Recreation facilities	2 to 11	180,000	15,000	55,000
Exterior siding	7 to 11	1,256,000	93,000	48,000
Pools, spas, solar equipment	2 to 14	174,000	42,000	39,000
Tennis courts	5 to 10	97,000	12,000	14,000
Furniture and equipment	3 to 7	<u>107,000</u>	<u>14,000</u>	<u>12,000</u>
		<u>\$ 5,016,000</u>	<u>\$ 374,000</u>	<u>\$ 379,000</u>

**Notes:**

- <sup>a</sup> As illustrated in Exhibit A-8 of the (inactive) AICPA guide.
- <sup>b</sup> CIRAs may disclose either estimated current replacement costs or estimated future replacement costs. Estimated current costs are those necessary to replace the common elements today. (See Alternative A.) Estimated future costs are those necessary to replace the common elements at the end of their remaining useful lives. Estimated future costs consider both the rate of inflation and interest to be earned on replacement funds.
- <sup>c</sup> The funding requirement for the subsequent year, although illustrated in the (inactive) AICPA guide, is not required to be disclosed.
- <sup>d</sup> FASB ASC 972-235-50-3 requires that the amounts accumulated for each component be displayed *to the extent designated by the board*. Thus, if the board has allocated fund balance to each component, that information should be displayed. Otherwise, such information is not required to be presented.

\* \* \*

There is no requirement that a new study be conducted each year. Paragraph 3.07 of the AICPA guide recommends that the board annually reevaluate changes to the common elements, as well as estimates of remaining useful lives and costs of replacements or repairs. In addition, some states require the board to conduct studies periodically, such as every three years, and to review the study annually. Since a new study is not required each year, how is the required supplementary information presented in, for example, the financial statements for the year after a study was conducted? Do the ranges of years in the estimates of useful lives of the components need to be reduced by one year? Should the estimated costs of replacements or repairs be reduced by the actual amounts spent in the

first year? Some associations make such adjustments to the schedule. However, in subsequent years, the information from the study may not need to be changed unless there have been material changes made in the estimates. A note on the face of the schedule should clearly disclose the date of the study up on which the information is based.

An alternative issue arises if the CIRA has two reserve studies. One reserve study may relate to the current financial statement period. A second reserve study might be prepared near the end of the current financial statement period and would begin with the current year end and project reserve information for the following year. The AICPA guide does not discuss which reserve report should be used when preparing the supplementary information. The authors recommend that the CIRA include information from the most recently prepared reserve report. The more recent reserve study contains information that generally can be assumed to be more reliable as it is based on actual information from the current financial statement period. As noted above, the schedule should clearly disclose the date of the study on which the supplementary information is based.

Authoritative literature does not preclude a CIRA from attaching a copy of the reserve study in lieu of preparing a separate schedule of the required supplementary information, provided the reserve study conveys all required information about future major repairs and replacements of the CIRA's common property as explained above. However, a reconciliation of the amounts for the common area components and the ending fund balance for each component (if designated by the CIRA's board) between the reserve study and the CIRA's financial statements will probably be necessary.

A discussion about performing a reserve study is beyond the scope of this course, but more information is available in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.





**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. If a common interest realty association (CIRA) uses fund accounting, what two principle funds will typically be used?
  - a. Capital improvements fund and special assessments fund.
  - b. Debt fund and settlement proceeds fund.
  - c. The operating fund and the reserve fund.
  - d. The property fund and the recreation fund.
2. The Greenbriar Homeowner's Association runs a golf course and an association restaurant. Association members get discounts, but the enterprises are also open to the public. Profits from running these enterprises are material to Greenbriar's financial statements. Which of the following is this CIRA most likely to present based on these circumstances?
  - a. A classified balance sheet.
  - b. Comparative financial statements.
  - c. Financial statements that use fund accounting.
  - d. Financial statements presented using the cash basis of accounting.
3. Which of the following is considered part of a CIRA's *other comprehensive income*?
  - a. Distributions made to homeowners.
  - b. The excess of its revenues over its expenses.
  - c. Unrealized gains and losses on investments in marketable securities that are classified as available for sale.
  - d. Revenues included in comprehensive income but not in excess of revenues over expenses.
4. The Landsdown Neighborhood Association receives cash receipts from the following activities during the year. Which would be considered a cash flow from operations?
  - a. Funds from sale of an empty lot owned by the association.
  - b. Payments collected from members to repair the roof of the pool house.
  - c. Initial contributions collected from new members used as working capital.
  - d. The value of new books for its library received in a trade with another CIRA.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. If a common interest realty association (CIRA) uses fund accounting, what two principle funds will typically be used? **(Page 300)**
  - a. Capital improvements fund and special assessments fund. [This answer is incorrect. CIRAs' financial statements may show one or more additional funds if they use separate funds for certain activities, such as special assessments; however additional funds such as the two listed here would not be considered a CIRA's principle funds.]
  - b. Debt fund and settlement proceeds fund. [This answer is incorrect. These are examples of additional funds that a CIRA may show in its financial statements if it uses fund accounting; however, neither of these funds would be a CIRA's principle funds when this type of accounting is used.]
  - c. **The operating fund and the reserve fund. [This answer is correct. CIRAs that use fund accounting for their financial statements generally segregate their activities into two principle funds—an operating fund and a fund for future major repairs and replacements (often called a reserve fund or a replacement fund). When fund accounting is used, the financial statements should include a total column since a CIRA's financial statements are considered to be the financial statements as a whole and not the financial statements of the funds individually.]**
  - d. The property fund and the recreation fund. [This answer is incorrect. CIRAs often use additional funds to account for specific types of transactions. Examples of additional funds for CIRAs include a property fund, a construction defect fund, and a recreation fund. However, these additional funds are not the principle funds that a CIRA will present when its financial statements are prepared using fund accounting.]
2. The Greenbriar Homeowner's Association runs a golf course and an association restaurant. Association members get discounts, but the enterprises are also open to the public. Profits from running these enterprises are material to Greenbriar's financial statements. Which of the following is this CIRA most likely to present based on these circumstances? **(Page 301)**
  - a. **A classified balance sheet. [This answer is correct. CIRAs generally present unclassified balance sheets. However, CIRAs having significant commercial operations often present classified balance sheets. Because Greenbriar's golf course and restaurant would be considered a significant commercial operation, it is likely that this CIRA will present a classified balance sheet.]**
  - b. Comparative financial statements. [This answer is incorrect. Similar to commercial businesses, CIRAs are not required to present comparative financial statements. However, FASB ASC 205-10-45-2 recommends them. Therefore, while Greenbriar may choose to follow this recommendation, nothing about its commercial operations as described in this scenario requires the CIRA to present comparative financial statements, which means there is a better answer to this question.]
  - c. Financial statements that use fund accounting. [This answer is incorrect. GAAP does not require fund accounting. FASB ASC 972-205-45-1 states that CIRAs may not need to use fund reporting if they do not assess their members for future major repairs and replacements. Therefore, since repairs and replacements are not mentioned in the scenario above, Greenbriar is not likely to need to present financial statements that use fund accounting at this time.]
  - d. Financial statements presented using the cash basis of accounting. [This answer is incorrect. CIRAs may sometimes present financial statements on a basis of accounting other than GAAP, such as the cash or income tax basis. However, there is nothing specific to Greenbriar's situation in this particular scenario that necessitates use of the cash basis of accounting. Therefore, there is a better answer to this question.]

3. Which of the following is considered part of a CIRA's *other comprehensive income*? (Page 305)

- a. Distributions made to homeowners. [This answer is incorrect. *Comprehensive income* includes all changes in equity during a period *except* those resulting from investments by owners and distributions to owners. Therefore, as other comprehensive income is part of comprehensive income, such distributions cannot be considered other comprehensive income.]
- b. The excess of its revenues over its expenses. [This answer is incorrect. For most CIRAs, comprehensive income includes two components. One of those components is excess of revenues over expenses. However, comprehensive income and other comprehensive income are two different terms, and just because something is part of a CIRA's comprehensive income that does not necessarily mean it is part of a CIRA's other comprehensive income.]
- c. Unrealized gains and losses on investments in marketable securities that are classified as available for sale. [This answer is incorrect. One of the two components of comprehensive income that most CIRAs will need to include is unrealized gains and losses on investments in marketable securities classified as available for sale in accordance with FASB ASC 320-10-25. However, other comprehensive income is a smaller part of comprehensive income; therefore, all items considered to be comprehensive income are not necessarily considered to be other comprehensive income.]
- d. **Revenues included in comprehensive income but not in excess of revenues over expenses. [This answer is correct. The term *comprehensive income* refers to all components of comprehensive income including the excess of revenues over expenses. The term *other comprehensive income* refers to revenues, expenses, gains, and losses that, under GAAP, are included in comprehensive income but excluded from the excess of revenues over expenses (for example, unrealized holding gains and losses that are reported as a separate component of equity).]**

4. The Landsdown Neighborhood Association receives cash receipts from the following activities during the year. Which would be considered a cash flow from operations? (Page 308)

- a. Funds from sale of an empty lot owned by the association. [This answer is incorrect. Cash receipts from the sale of property and equipment are classified as a cash flow from investing. Therefore, the association's property sale is not considered a cash flow from operations.]
- b. **Payments collected from members to repair the roof of the pool house. [This answer is correct. Cash receipts from member assessments for major repairs and replacements are classified as cash flows from operations. Therefore, Landsdown should classify the assessments for the roof repair in this manner.]**
- c. Initial contributions collected from new members used as working capital. [This answer is incorrect. Initial member contributions used by the association for working capital should be classified as a cash flow from financing. Therefore, when Landsdown collects these funds, it would not be appropriate for the association to classify them as operating cash flows.]
- d. The value of new books for its library received in a trade with another CIRA. [This answer is incorrect. Making such a trade would be considered a noncash investing and financing transaction; therefore, it would not be appropriate for Landsdown to classify this as a cash flow from operations.]



# Lesson 2: Income Taxes

## INTRODUCTION

Lesson 2 takes a look at how CIRAs deal with income taxes and all the applicable rules, laws, and regulations. It begins with a brief overview of tax law for CIRAs. Next, it discusses tax law principles that are common to all CIRAs. After that, this lesson examines two forms that CIRAs can submit to the IRS—Form 1120-H and Form 1120—and related rules that can apply. This lesson then takes a brief look at tax issues that affect different types of CIRAs, including tax-exempt CIRAs, cooperative housing corporations, master associations, timeshare developments, and commercial associations. Finally, Lesson 2 concludes with a discussion of specialized tax situations that can affect CIRAs, such as the sale of common property and ancillary operations.

### Learning Objectives:

Completion of this lesson will enable you to:

- Identify the principles of tax law that apply to all types of CIRAs.
- Determine the rules that apply to CIRAs filing Form 1120-H.
- Identify the rules that apply to CIRAs filing Form 1120.
- Recognize appropriate methods for dealing with tax-exempt CIRAs, cooperative housing corporations, master associations, timeshare developments, commercial developments, and specialized tax situations that may occur with CIRAs.

## TAX LAW BASICS FOR CIRAS

### Tax Filing Options

All CIRAs generally are taxed as corporations, but the available tax options depend, in part, on the specific type of CIRA—condominium association, homeowners' association, cooperative housing corporation, or timeshare association.

- Residential condominium associations, homeowners' associations, and timeshare associations may be taxed either under IRC Section 277, which applies to *certain membership organizations*, or may elect to be taxed under IRC Section 528, which applies specifically to homeowners' associations as that term is defined for tax purposes. Qualified CIRAs that elect to be taxed under IRC Section 528 file Form 1120-H, U.S. Income Tax Return for Homeowners Associations. CIRAs that are taxed under IRC Section 277 file the standard Form 1120 (or 1120-A).
- Commercial condominium associations file Form 1120.
- Cooperatives are subject to subchapter T and file Form 1120-C (beginning in 2007).
- As discussed later in this lesson, a few homeowners' associations qualify as tax-exempt organizations and file Form 990, Return of Organization Exempt From Income Tax.

All CIRAs must file a return (either a Form 1120, 1120-A, 1120-C, 1120-H, or 990), whether or not they have taxable income.

Many CIRAs choose which tax form to file by selecting the form that yields the lowest tax. However, the decision whether to file Form 1120 or Form 1120-H is a complex one that requires a full understanding of the tax treatment of the components of a CIRA's income and expenses. If a condominium or homeowners' association elects to be taxed under IRC Section 528, it must allocate its income and expenses between its *exempt function activities* and its *activities for the production of gross income* (or nonexempt function activities). It is not taxed on its exempt function activities but is taxed at the rate of 30% on its net nonexempt function income (referred to as its *homeowners' association taxable income*.) If a qualifying timeshare association elects to be taxed under IRC Section 528, it is taxed at the rate of 32% on its net nonexempt function income. Under IRC Section 277, a CIRA must allocate its

income and expenses between *membership* and *nonmembership* activities, and, by making certain tax elections as discussed later in this lesson, only its net nonmembership income is taxed at regular corporate tax rates. While exempt function and membership activities are similar in some respects, there are important differences.

The taxation of condominium associations, homeowners' associations, and timeshare associations presents an option that is not available in any other area of taxation: the ability to choose which tax form to file and, therefore, which tax rate applies. The decision, however, is not as clear-cut as it may appear at first glance. Form 1120-H is a relatively simple form to prepare but has certain qualification requirements and a higher tax rate for most associations than the alternative Form 1120. On the other hand, Form 1120 is extremely complex. While it will normally result in a lower tax rate than Form 1120-H (for example, 15% for the first \$50,000 of taxable income), its complexity and the lack of specific rulings in several areas create a much higher tax exposure risk when using that form. The ultimate decision is the association's, not the accountant's. Few associations, however, will be knowledgeable enough to make the decision alone. Rather, they will rely on the professional advice of their tax preparer. Exhibit 2-1 presents the tax filing options and tax treatments available to CIRAs.

### Exhibit 2-1

#### Tax Filing Options and Tax Treatments

##### IRC Section 277

Applies to: Condominium associations, homeowners' associations, and timeshare associations that are not exempt and do not or cannot elect to file Form 1120-H.

Form filed: Form 1120 for both membership and nonmembership income and expenses.

Tax treatment:	<b>Net Membership <u>Income</u></b>	<b>Net Nonmembership <u>Income</u></b>
	Taxed at regular corporate rates but may be able to make an annual election to defer income, such as a Revenue Ruling 70-604 election.	Taxed at regular corporate rates.

<b>Excess Membership <u>Deductions</u></b>	<b>Net Nonmembership <u>Loss</u></b>
Carried forward to future years to offset net membership income.	Treat as net operating loss under IRC Section 172.

##### IRC Section 528

Applies to: Qualified electing condominium associations, homeowners' associations, and timeshare associations only.

Form filed: Form 1120-H for only nonexempt function income and direct and allocable indirect expenses relating to nonexempt function income.

Tax treatment:	Net Exempt Function <u>Income</u>	Net Nonexempt Function <u>Income</u>
	Not taxed. Under Regulation 1.528-9, and association may elect to either rebate or apply excess assessments to the folioing year.	Taxed at 30% rate for condominium and homeowners' associations.  Taxed at 32% rate for timeshare associations.
	Net Exempt Function <u>Loss</u>	Net Nonexempt Function <u>Loss</u>
	No exempt function loss carryover or carryback allowed.	No net operating loss deduction allowed. May not be carried forward or back.

**Subchapter T**

Applies to: Cooperative corporations. Does not require that the cooperative also qualify as a cooperative housing corporation under IRC Section 216.

Form filed: Form 1120-C for both patronage and nonpatronage income and expenses.

Tax treatment:	Net Patronage <u>Income</u>	Net Nonpatronage <u>Income</u>
	Taxed at regular corporate rates, but may refund excess revenue as patronage dividends.	Taxed at regular corporate rates.
	Net Patronage <u>Loss</u>	Net Nonpatronage <u>Loss</u>
	Treated as net operating loss under IRC Section 172 to offset patronage income only.	Treat as net operating loss under IRC Section 172 to offset nonpatronage income only.

**IRC Section 501(c)**

Applies to: Homeowners' associations exempt under IRC Section 501(c)(4) or Section 501(c)(7).

Form filed: Form 990 informational return for all exempt associations and Form 990-T for associations with unrelated business income of \$1,000 or more.

Tax treatment:	Net Income from Exempt <u>Activities</u>	Net Unrelated Business <u>Income</u>
	Exempt from tax.	Amount in excess of \$1,000 is taxed at regular corporate rates.
	Net Loss from Exempt <u>Activities</u>	Net Unrelated Business <u>Loss</u>
	No carryforward or carryback.	Treated as a net operating loss under IRC Section 172.
	*       *       *	

### Historical Perspective of the Taxation of CIRAs

It is important to know the purpose of the enactment of IRC Section 528 in order to understand its intent and to contrast it with the application of IRC Section 277. IRC Section 528 was added to the Internal Revenue Code in 1976 to provide CIRAs two benefits. They were given a simple method of filing their tax returns, and exempt function income that was inadvertently being taxed on Form 1120 was exempted from taxation. As discussed later in this lesson, it was the intent of Congress that a CIRA, as defined in IRC Section 528, be taxed in the same manner as the individual homeowners in the CIRA; i.e., the CIRA receives no benefit or suffers no penalty compared to the tax treatment accorded the individual members of the CIRA. Specifically, IRC Section 528 allows the CIRA to build reserves with no tax consequences other than taxation of the interest earned on such amounts. IRC Section 528 is elective and may generally be considered to be an *elective, beneficial* code section.

The other filing option available to the majority of CIRAs is to file Form 1120. When Form 1120 is filed, the CIRA may be subject to the provisions of IRC Section 277, which was enacted in 1969. The intent of IRC Section 277 was to prevent abuse by nonexempt membership organizations in the same manner that IRC Section 513 prevented abuse by exempt organizations. As discussed later in this lesson, its purpose was to prevent taxable membership organizations from avoiding tax on nonmembership income by operating membership activities at a loss and using that loss to offset the nonmembership income. IRC Section 277 may be considered to be a *mandatory anti-abuse* section because it automatically applies if the organization meets the criteria specified in the section. Those criteria are:

- The entity is a membership organization.
- The entity was formed primarily to provide services to its members.
- The entity is not exempt under any other section of the Code. (Thus, CIRAs exempt under IRC Section 528 and subchapter T are not subject to the provisions of IRC Section 277.)

Subchapter T cooperatives file Form 1120-C, subject to subchapter T.

### Tax Posture Adopted in This Lesson

The tax posture adopted by this lesson is generally a conservative one in which the recommendations do not vary significantly from known positions of the IRS. In most cases, it is less expensive to comply with a law or regulation than to adopt a more aggressive posture. An aggressive tax posture that is known to be at variance with laws, regulations, rules, or guidelines is usually unsuccessful when it is challenged during an audit. Providing tax services for CIRAs is complicated because definitive tax laws, regulations, rules, and guidelines often do not exist in this area. Additionally, as discussed below, there is not one comprehensive set of rulings for CIRAs, making tax research and interpretation difficult for tax preparers.



As part of that conservative posture, when an IRS interpretation is used by this lesson as the basis for a recommendation, it is the interpretation made by the *national* office of the IRS. Since there is no national training program for this specialized industry group within the IRS, any field office may make its own interpretation of a point of law. That interpretation may differ from ones made by other field offices or the national office of the IRS.

The positions in this lesson may change from year to year because tax law affecting CIRAs is still evolving. Some positions taken in the past may no longer be viable, either because new rulings are issued or new interpretations are made of existing rulings. The guidance in this lesson is based on informal contact with employees at the national office of the IRS who specialize in CIRAs in order to gain insight into the evolution of tax laws and interpretations affecting CIRAs. Accountants should be aware that, based on that insight, changes may be made in the annual updates to the recommendations in this lesson. Accountants are urged to consider the interpretations and recommendations in this lesson carefully and to conduct additional research as necessary.

### **Complexity of Tax Laws**

The vast number and complexity of tax rulings relating to CIRAs makes it difficult for preparers to research and interpret tax laws so that accurate tax returns can be prepared. As discussed above, that is especially true when a CIRA elects to file Form 1120 rather than Form 1120-H. Since there is not one comprehensive set of rulings for CIRAs, accountants must go far beyond merely reading the Code. Many of the primary interpretations are found in the regulations, revenue rulings, tax court cases, and even private letter rulings.

As discussed above, the annual updates of this lesson keep accountants informed of changes to technical standards and the tax effect that those changes have on CIRAs. To assist preparers in researching and interpreting tax laws, PPC has issued *PPC's Homeowners' Association Tax Library*. It contains the full text of all primary tax rulings and partial text of other significant tax rulings related to the industry, with added emphasis and annotations. That *Guide* may be ordered at [tax.thomsonreuters.com](http://tax.thomsonreuters.com). Most of the citations in this lesson are included in *PPC's Homeowners' Association Tax Library*.

### **Preparer Penalties**

IRS Notice 2007-54, issued June 11, 2007, raised the bar on penalties for tax preparers. Prior to issuance of this notice, for preparer penalties under IRC Section 6694, the penalty applied to understatement of tax liability due to a position for which there was not a realistic possibility of being sustained on its merits, and—

- a. the tax preparer knew, or should have known, of such position, and
- b. there was a willful attempt in any manner by the tax preparer to understate the tax, or
- c. there was any reckless or intentional disregard of rules or regulation by the tax preparer.

IRC Section 6694 has been amended so that the penalty would apply if—

- a. the tax preparer knew, or reasonably should have known, of such position, and
- b. there was not a reasonable belief that the position would more likely than not be sustained on its merits, and
- c. the position was not disclosed as provided in Section 6662(d)(2)(B)(ii), or
- d. there was no reasonable basis for the position.

Tax practitioners are cautioned to consider preparer penalties in establishing positions taken on tax returns, particularly on Form 1120. IRS tax audits in recent years have so far demonstrated that there is a severe lack of compliance on Form 1120 tax returns.

## Lesson Overview

This lesson discusses the tax filing options available to CIRAs in detail and presents recommendations for selecting the best alternative. The material is not laid out in Code order but rather discusses taxes in the following order:

- Discussion of the basic tax law principles that are common to CIRAs *regardless* of the tax filing option selected.
- Discussion of Form 1120-H (the most commonly used form based on IRS statistics) and IRC Section 528.
- Discussion of Form 1120 and IRC Section 277, contrasted to IRC Section 528.
- Discussion of Form 990 and IRC Section 501 (exempt associations).
- Brief discussion of cooperative housing corporations.
- Discussion of master associations.
- Brief discussion of timeshare developments.
- Discussion of commercial associations.
- Discussion of specialized tax situations.

## TAX LAW PRINCIPLES THAT ARE COMMON TO ALL CIRAS

Many tax law principles apply to all CIRAs, regardless of the tax option selected when filing returns. Those principles are:

- The definition of gross income under IRC Section 61.
- Prepaid assessments.
- Agency relationships.
- Contributions to the capital of a corporation under IRC Section 118.
- Litigation settlements.
- The basis in assets received from a developer/sponsor or others under IRC Sections 351 and 362.
- Capital expenditures under IRC Section 263.

Those tax law principles are discussed in the following paragraphs. The difference in treatment of specific transactions for financial reporting and tax purposes is also discussed.

### Definition of Gross Income

IRC Section 61 defines gross income by stating "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived. . . ." IRC Section 61 should be considered in conjunction with IRC Sections 118, 277, and 528 in determining taxable income for a CIRA. Types of gross income may be treated differently depending upon the tax filing option selected.

The receipts of a typical condominium or homeowners' association may generally be categorized as follows:

- Member operating assessments (IRC Sections 277 and 528).

- Member replacement fund (reserve) assessments (IRC Section 118 if capital in nature; IRC Section 277 if noncapital in nature).
- Member fees for services (IRC Sections 277 and 528).
- Nonmember fees for services (IRC Sections 277 and 528).
- Litigation settlements (IRC Sections 61 and 118).
- Passive income, such as interest income (IRC Sections 277 and 528).

While most of those categories of receipts are treated as gross income for tax purposes, IRC Section 118 excludes (a) assessments for specific capital improvements or the replacement of personal property and (b) litigation proceeds from income and treats them as contributions to capital.

### **Prepaid Assessments**

Member assessments received in advance should be treated as deferred revenue for financial reporting purposes. However, the tax treatment of prepaid assessments may depend on the nature of the amounts received. Revenue Procedure 2004–34 allows deferral of income for only 12 months, from one tax year to the next succeeding tax year. That deferral is allowed only if all the services to be received by the members will be performed by the end of the succeeding tax year. If the deferral is properly recorded but for any reason the services are not performed by the end of the succeeding tax year, the amount deferred must be included in income for the succeeding year.

The IRS has held in its examination of a Florida timeshare association that assessments received in advance were partially for “reserves,” with services to be performed several years in the future. Thus, the prepaid assessments would not qualify for deferral under Revenue Procedure 2004–34, since all services would not be performed by the end of the succeeding tax year. The “reserve” portion of the prepaid assessments was, in that case, characterized by the IRS as operating assessments because the association failed to clearly earmark the reserve funds for specific capital purposes and to segregate the reserve fund cash into a separate bank account from the operating funds. It seems likely that, if the reserves had been adequately earmarked (thus qualifying as contributions to capital rather than operating assessments), the IRS would not have reached that conclusion.

A CIRA may also make an election under IRC Section 456(c) in its first taxable year to defer income on prepaid dues received. An election may be made in a later tax year only with the consent of the Secretary of the Treasury. The election applies to the current and all subsequent tax years and may be revoked only with the consent of the Secretary of the Treasury. An election under IRC Section 456(c) would preempt the provisions of Revenue Procedure 2004–34.

### **Agency Relationships**

The receipt of funds for a specific limited purpose from which the CIRA will derive no benefit may result in an agency relationship for tax purposes. The most common types of agency relationships for CIRAs are special assessments for the reserve fund, litigation settlements from developers, and disaster insurance proceeds. In each case, the CIRA merely acts as an agent for its members, has only ministerial duties over the funds (including collection, record keeping, and disbursement), and cannot divert the funds for its own purposes. The funds may be received in the form of cash or an annuity. Assessments for routine maintenance and continuing operations do not result in agency relationships because the funds are not spent for a specific purpose.

When the CIRA receives funds as an agent for its members, it should set up a separate bank account (and perhaps a separate fund) for the proceeds and expenditures. Since the CIRA is acting merely as an agent, the proceeds may not be commingled with CIRA monies nor may they be spent for any other purpose.

An example of an agency relationship involving a special assessment is further discussed later in this lesson.

## Contributions to the Capital of a Corporation

Contributions to the capital of a CIRA generally arise from:

- Monthly replacement fund assessments.
- Special replacement fund assessments.
- Capital improvements assessments.
- Litigation settlements.
- Insurance proceeds settlements.

However, not all of those receipts necessarily qualify as being capital in nature. The IRS defines a “special” assessment as any assessment for capital purposes, whether assessed monthly, as a single assessment, or as a series of one-time assessments. Thus, most accountants agree that any assessment for special capital improvements or the replacement of personal property may be classified as contributed capital if the association complies with the factors listed below in the “Factors to Consider in Assessing Capital Contributions” paragraph.

IRC Section 118 states that “In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.” Other rulings have interpreted IRC Section 118 as it relates to CIRAs by placing strict limitations on which receipts may be characterized as contributions to capital. Other Code sections, particularly IRC Section 263, assist accountants in identifying those assessments that qualify as capital in nature. Exhibit 2-2 lists the guidance applicable when determining whether a receipt is a capital contribution.

### Exhibit 2-2

#### Summary of Selected Tax Citations Related to Capital Contributions<sup>a</sup>

Reference	Summary	Factors Addressed <sup>b</sup>
<b>IRC Sections</b>		
IRC 118	All contributions to capital (reserves) are excluded from gross income under IRC Section 118.	Accounted for as a capital contribution
IRC 263	No deduction may be taken for capital expenditures. Amounts paid or incurred for restoring property (such as painting) are not capital expenditures.	Purpose
<b>Court Cases</b>		
<i>United Grocers v. U.S.A.</i>	The dominant factor in determining whether the amounts were contributions to capital or payment of goods or services was the motive or purpose and intent in making the contribution.	Expended for the intended purpose

Reference	Summary	Factors Addressed <sup>b</sup>
<i>Board of Trade of the City of Chicago and Subsidiaries v. Commissioner</i>	<p>Certain fees paid to the membership organization were nontaxable contributions to capital because there was an investment motive, as supported by the following factors:</p> <ul style="list-style-type: none"> <li>• The fee was earmarked for a capital acquisition or expenditure. <ul style="list-style-type: none"> <li>•• The organization had a definite commitment to engage in capital activity.</li> <li>•• Both the organization and the members intended that funds collected were to be used for capital purposes.</li> <li>•• Funds were accounted for at the time of payment and were held for that purpose and no other purpose.</li> </ul> </li> <li>• The payors were equity owners in the corporation, and there was an increase in equity capital as a result of the payment.</li> <li>• Members had an opportunity to profit from their investment in the corporation.</li> </ul>	<p>Purpose</p> <p>Accounted for as a capital contribution</p> <p>Held for that purpose</p> <p>Increase the capital account</p>
<i>Gibbons v. United States</i>	<p>The amount or proportion to be used for capital improvements must be stated at the time of the assessment and <i>earmarked</i> for that purpose at the time of receipt.</p>	<p>Advance notice</p>
<i>Maryland Country Club, Inc. v. United States</i>	<p>Three basic conditions are required for earmarking:</p> <ul style="list-style-type: none"> <li>• There must be a definite commitment to engage in some capital construction.</li> <li>• At the time of the initial payment, both the club and the member must be operating under the assumption that the funds so collected <i>will be used only for qualified capital purposes</i> to be completed within three years.</li> <li>• The funds must be accounted for at the time of payment and <i>held for that purpose and for no other purpose</i>.</li> </ul> <p>Although the regulations may not require a separate bank account for capital funds, use of capital funds for operating expenses shows a lack of intent to hold those funds solely for capital purposes. That has the effect of invalidating the exemption of the entire sum collected because an earmarking of funds never took place.</p>	<p>Purpose</p> <p>Advance notice</p> <p>Held for that purpose</p>

Reference	Summary	Factors Addressed <sup>b</sup>
<b>General Counsel Memorandum</b>		
GCM 35929 (Memorandum issued regarding IRC Section 118)	<p>Special assessments are capital contributions because:</p> <ul style="list-style-type: none"> <li>• They were paid voluntarily by the members.<sup>c</sup></li> <li>• The equity of the members in the association increased.</li> <li>• The assessments were used to pay capital expenditures.</li> <li>• The everyday operating expenses were covered from other sources.</li> </ul> <p>Earmarking of funds, by itself, is not sufficient to create a contribution to capital.</p>	<p>Advance notice</p> <p>Accounted for as a capital contribution</p> <p>Increases the capital account</p>
<b>IRS Revenue Rulings</b>		
RR 74-563	A special assessment collected by an incorporated homeowners' association from its members and set aside in a special bank account for paving a community parking area constitutes a contribution to the capital of the association.	<p>Purpose</p> <p>Separate bank accounts</p>
RR 75-370	Special assessments collected by a condominium management corporation from its unit owner-stockholders and accumulated in a separate bank account for replacement of the roof and elevators in the condominium qualify as a capital contribution and are not includable in the corporation's gross income. Painting was specifically noted as <i>not</i> qualifying for capital treatment.	<p>Purpose</p> <p>Advance notice</p> <p>Separate bank accounts</p>
RR 75-371	Special assessments for the replacement of personal property collected by a condominium management corporation from its unit owner-stockholders and accumulated in a separate bank account are contributions to capital. Contingency reserve additions were specifically noted as <i>not</i> qualifying for capital treatment.	<p>Purpose</p> <p>Advance notice</p>

**Notes:**

<sup>a</sup> PPC's *Homeowners' Association Tax Library* (HTL) contains a comprehensive presentation of all tax citations relevant to CIRAs, accompanied by practice insights on the citations. For ordering information, visit the website at [ppc.thomsonreuters.com](http://ppc.thomsonreuters.com).

<sup>b</sup> See discussion later in this section.

<sup>c</sup> However, the Courts held in *Chicago Board of Trade* that nonvoluntary transfer fees may qualify as capital contributions.

\* \* \*

Private Letter Ruling 201144006 re-emphasized that "... if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation."

For a CIRA that files Form 1120-H, there are no tax consequences associated with misclassifying receipts as contributions to capital that should be reported as exempt function income. Exempt function income is not taxable

under IRC Section 528. Failure to separate capital contributions from operating assessments is a fairly common error. Because the excess exempt income is not taxable on Form 1120-H, it does not enter into the calculation of taxable income on Form 1120-H.

However, failure to separate capital contributions from operating assessments has a significant impact on calculating compliance with the 60% test. The 60% test is performed prior to any attempt to calculate taxable income and is completely independent of the calculation of taxable income. If capital contributions are not separated from operating assessments, both the numerator and denominator of the calculation are overstated and it could result in the appearance that the 60% test is met, when in fact it may not be met. The 60% test is based on gross income and capital contributions are not considered part of gross income for tax purposes.

A CIRA that files Form 1120 should be careful to comply with the IRS requirements discussed in the next paragraph to ensure that it is allowed to classify receipts from owners as contributions to capital when appropriate. Failure to comply can have significant implications. If the CIRA fails to fully comply, the IRS may, on audit, reclassify the capital contributions as membership income. This will normally give rise to an excess of member income over member expenses, which is taxable income. (This has been asserted on numerous IRS audits.) Many in the industry have become complacent on this issue because a number of associations that did not fully comply with the criteria discussed below have been audited and did not have any problem with the IRS regarding their reserve funds and contributions. With the availability of the draft IRS Audit Techniques Guide discussed later in this lesson failing to fully comply is a higher risk position now than it was in the past.

**Factors to Consider in Assessing Capital Contributions.** In order for a CIRA to record an assessment as a contribution to capital for tax purposes, the CIRA must (1) show that the purpose of the assessment is *capital* in nature and (2) demonstrate its *intent* for making the assessment. The following seven factors should be considered when documenting the CIRA's intent for an assessment to qualify as a capital contribution: (See Exhibit 2-2 for a summary of the referenced tax citations.)

- The *purpose* of the assessment must be capital in nature. (IRC Section 263; *Chicago Board of Trade*, *Maryland Country Club*; Revenue Rulings 74-563, 75-370, and 75-371)
- Members or unit owner-stockholders must have *advance notice* as to the intent of the purpose of the contribution. (*Gibbons*, *Maryland Country Club*; GCM 35929; Revenue Rulings 75-370 and 75-371)
- The money contributed must be *accounted for* as a capital contribution. (IRC Section 118, *Chicago Board of Trade*, GCM 35929)
- The money must be *held for that purpose* and for no other purpose. (*Chicago Board of Trade*, *Maryland Country Club*)
- The money must be held in *separate bank accounts* from the operating (noncapital) monies of the CIRA. (Revenue Rulings 74-563, 75-370, and 75-371)
- The money must be *actually expended for the intended purpose*. (*United Grocers*)
- The money must *increase the capital account* of the member or unit owner-stockholder. (*Chicago Board of Trade*, GCM 35929)

Each of the factors, as well as agency relationships, tax consequences for not complying, and amending tax returns are discussed in the following paragraphs.

**Purpose of Assessment.** IRC Section 263 is not an elective section. It is a mandatory, anti-abuse section intended to prevent a taxpayer from claiming a current deduction for “capital” expenditures that the taxpayer is required to capitalize and depreciate. IRC Section 263(a), under its general rule, states “No deduction shall be allowed for—

- (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

- (2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance [for depreciation] has been made.”

The principal decision to charge the replacement fund for certain expenses is governed by the CIRA's members when they adopt the budget. Thus, the replacement fund may include expenditures for items other than capital improvements, such as painting, pest control, landscape maintenance, insurance, and fees for studies to estimate the costs of future major repairs and replacements. Since the revenue rulings discussed in Exhibit 2-2 indicate that only assessments for specific capital expenditures qualify as contributed capital, most associations will report a portion of the assessments for future major repairs and replacements as contributed capital for tax purposes and the remainder as membership income. Likewise, they may only deduct noncapital expenditures (for example, painting expenses) from the replacement funds for tax purposes. Since assessments for future capital repairs and replacements are excluded from membership income, however, expenditures for capital repairs and replacements cannot be treated as membership expenses. To do so would allow associations to exclude the “income” but deduct the “expenses.”

Many accountants argue that major expenditures for painting the common elements should qualify as capital in nature because normally they are being “reserved” for in the replacement fund. However, it is the nature of the activity that is controlling. Painting does not meet the criteria for capitalization under IRC Section 263, and several court cases hold that painting is a deductible expense. Also, Revenue Ruling 75-370 explicitly states that funds collected “to provide the services for which [The Association] was formed such as maintenance of the common elements” are not considered as contributions of capital but are includable in the association's gross income. The revenue ruling states that funds for painting the common elements and for repairs, gardening, and janitorial services are not considered as contributions of capital. In addition, Revenue Ruling 75-371 states that any funds accumulated for contingencies are includable in the association's gross income since they are not set aside for specific capital improvement purposes.

The issue of treating reserve fund assessments for painting as capital contributions continues to be raised. The basic forces driving that issue are:

- Treating painting reserve assessments as *capital* in nature allows most associations to take advantage of the lower corporate tax rates of only 15% on the first \$50,000 of taxable income by filing Form 1120. Since *capital* assessments may be excluded from member income, treating the painting reserve assessments as capital contributions excludes them from member income and treats them like any other capital reserve assessment (such as for roofing or streets). By excluding the painting reserve assessments from membership income, it is much easier to arrive at excess membership deductions for tax purposes.
- Treating painting reserve assessments as *noncapital* in nature generally results in excess net membership income for any year except the year the monies are expended. That net membership income is subject to taxation on Form 1120 under IRC Section 277. Consequently, treating painting as noncapital in nature is more likely to result in a decision to file Form 1120-H to avoid being taxed on net membership income. The downside of that decision is that the association is subject to a 30% tax rate on Form 1120-H (or 32% for timeshare associations), which is at least double the lowest tax rate on Form 1120.

Those accountants who treat painting reserve assessments as capital in nature base their decisions on the following criteria:

- Painting is a reserve item as are a variety of other common area components that clearly qualify as capital in nature.
- Painting is generally a very large dollar expenditure, and the IRS typically requires capitalization of large dollar expenditures rather than allowing current deductions for them.
- The specific mention of painting in Revenue Ruling 75-370 does not constitute absolute authority to consider painting to be noncapital in nature.

None of those criteria are based on supportable tax law, and they ignore the most critical element; i.e., the nature of the activity. The IRS has made it clear that it considers painting to be *noncapital* in nature. There is a considerable body of tax law supporting the IRS position. Exhibit 2-3 summarizes those laws and regulations.



**Exhibit 2-3****IRS Citations on Painting As a Noncapital Expenditure**

<b>Citation</b>	<b>Applicable Quotation</b>
IRC Section 263	"No deduction shall be allowed for any amount paid out for new buildings <i>or for permanent improvements or betterments made to increase the value of any property or estate.</i> "
IRC Section 277	"In the case of a . . . membership organization which is <i>operated primarily to furnish services or goods to members</i> , and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services . . . to members shall be allowed only to the extent of income derived during such year from members . . ."
IRC Section 528	"The term 'homeowners association' means an organization which is . . . organized and operated to provide for the acquisition, construction, management, <i>maintenance</i> , and care of association property . . ."
Treasury Regulations Section 1.118-1	"In the case of a corporation, Section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer . . . <i>However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered.</i> "
Treasury Regulations Section 1.263(a)-1	"Except as otherwise provided in Chapter One of the Code, no deduction shall be allowed for . . . any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate . . . In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. <i>Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph.</i> "
Treasury Regulations Section 1.277-1 (Proposed in 1972, withdrawn in 1986.)	" <i>Membership deductions are the expenses, depreciation, and similar items of deduction attributable to membership activities.</i> "
Revenue Ruling 75-370	"However, this Revenue Ruling does not apply to the funds collected by a condominium management corporation to provide the services for which it was formed such as <i>maintenance of common elements (painting, repairs, gardening, janitorial services and so forth). Thus, for example, funds accumulated to paint the common elements would not qualify under this Revenue Ruling.</i> " A ruling was requested as to whether or not special assessments for replacement of roofs and elevators would qualify as contributions to capital.

**Citation****Applicable Quotation**

Revenue Ruling 75-371	<p>"Advice has been requested whether . . . a special assessment collected [for replacing outdoor furniture] by a nonexempt condominium management corporation from its unit owner stockholders . . . will qualify as a contribution to the capital of the corporation under Section 118 of the Internal Revenue Code of 1954 . . . Section 1.118 of the Code provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer . . . But the exclusion does not apply to any money or property transferred in consideration of goods or services rendered. In <i>United Grocers, Ltd. v. United States</i> . . ., the Court said <i>the dominant factor in determining whether the amounts were contributions to capital or payment for goods or services was the motive or purpose and intent in making the contribution</i> . . . Moreover, the availability of various types of personal property, including outdoor furniture, adds to the attractiveness or usefulness of the condominium project and, therefore, <i>enhances the value</i> of a unit owner-stockholder's property. . . this enhanced value is sufficient to show the motive or purpose and intent for paying the special assessment is something other than a payment for services rendered by the taxpayer to its unit-owner stockholders."</p>
General Counsel Memoranda 35929	<p>"There must be some showing of increased homeowner-members' equity as a result of the payment. It is our opinion this factor is satisfied in the proposed ruling (Revenue Ruling 74-563) because the value of a homeowner-member's property is enhanced as a direct result of the payment . . . <i>Because of the nature of a homeowners association, determining if amounts paid by its members are in consideration for its services to them or as contributions to capital is difficult</i> . . . The dominant factor in determining whether the amounts were contributions to capital or payment for goods or services was the motive or purpose and intent in making the contribution."</p>

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Each of the citations in Exhibit 2-3 lends weight to the IRS position that painting is not capital in nature. Furthermore, Exhibit 2-4 presents numerous court cases about painting expenditures, most of which specifically hold that painting expenditures in other areas of taxation (for owners of property other than homeowners' associations) are considered as currently deductible operating expenditures. Given the fact that property owners in those other areas have fought to obtain a current deduction for painting expenses, homeowners' associations cannot logically argue that, only in their cases, are painting expenditures capital in nature.

**Exhibit 2-4****Court Cases about Painting Expenditures****Currently Deductible as Operating Expenditures**

The cost of *painting*, papering, whitewashing, etc., income-producing or business buildings is deductible.

- *Haverty Furniture Co.*, (CA-5) 1927 CCH P7012, 15 F.2d 345.
- *Kurtz*, 8 BTA 679, Dec. 2921 (Acq.).
- *Leedom & Worrall Co.*, 10 BTA 825, Dec. 3563.
- *Jones Hollow Ware Co.*, 12 BTA 48, Dec. 3982 (Acq.).

- *Markovits*, 11 TCM 823, Dec. 19,138(M).
- *R.O. Watts*, 34 TCM 613, Dec. 33,184(M), TC Memo 1975-131.
- *V.M. Walker*, 64 TCM 255, Dec. 48,368(M), TC Memo. 1992-416.

Painting and decorating expenditures in connection with residential property prior to sale were not capital expenditures since there was no substantial or appreciable increase in value of the property as a result of the expenditures.

- *J.L. Kirkland*, DC Neb., 67-1 USTC P9328, 267 F. Supp. 259.

That case relates to the issue of additions to the "capital account." The rules clearly state that painting expenditures do not add to the capital account of a principal residence. Painting is considered to be a periodic maintenance expense for the normal wear and tear that occurs to a property over a period of time.

### Capital in Nature

The cost of painting must be capitalized when done as part of or incidental to a general reconditioning or remodeling of the property.

- *J.M. Jones*, (CA-5) 57-1 USTC P9517.
- *Bank of Houston*, 19 TCM 589, Dec. 24,204(M), TC Memo 1960-110.

The cost of papering and *painting* a dwelling house purchased for rental purposes to make it more suitable for tenants was allowed as a part of the capital cost thereof when the house was purchased and sold within the year.

- *L. Allen*, 2 BTA 1313, Dec. 1008 (Acq.).

The same was allowed for a business building.

- *Republican Co.*, BTA memo., Dec. 8426-B.

\* \* \*

The cases in Exhibit 2-4 clearly indicate that, except as part of a general reconditioning (with all reconditioning activities done at the same time), painting never has been considered capital in nature. Accountants who take the opposite position may be needlessly exposing their association clients to substantial undue tax audit risk. By either filing Form 1120-H or making an election under Revenue Ruling 70-604, the association can minimize its tax liability without playing tax audit roulette.

**Advance Notice.** The CIRA can give advance notice to the members or unit shareholder/owners by distributing copies of the budget and the replacement fund reserve study. The budget signals the CIRA's intent in making the assessment. The budget must clearly delineate between member (operating) activities and capital (reserve or replacement fund) activities. The replacement fund reserve study should agree to and support the budget. While the budget supports the current year's capital assessment, the reserve study supports the purpose for which the assessment is being made over the long term. Minutes of the meetings of the board of directors should document adoption of the budget and reserve study and authorize expenditure of funds for specific capital purposes.

**Accounted for as a Capital Contribution.** The CIRA's general ledger and financial statements should clearly delineate capital assessments from operating assessments. The budget and reserve study should support the amount collected for capital assessments. Also, there should be a clear tax return reconciliation (on Schedule M-1 or Schedule M-3) separating capital transactions from operating transactions. It seems likely that assessments recorded as contributions to capital for tax purposes should be recorded as revenue for financial reporting

purposes. Since they will never be reported as revenue for tax purposes, however, they should be shown as a Schedule M-1 (or Schedule M-3) adjustment on the association's federal income tax return.

The replacement fund balance can be reported in the "Appropriated Retained Earnings" or "Paid-in-Capital" section of the balance sheet on Schedule L of Form 1120 and that capital contributions to and capital expenditures from the replacement fund be accounted for as Schedule M-1 or M-3 adjustments. It is also a best practice for the CIRA to attach a supporting schedule reflecting the activity in the replacement fund for the year.

Many CIRAs have not conducted replacement fund reserve studies but still may be setting funds aside for future major repairs and replacements. Since they have not conducted a study, it is more difficult for them to document that the funds are designated for specific capital expenditures. While many CIRAs have excluded such funds from revenue and classified them as contributions to capital, the lack of a reserve study may increase the risk associated with documenting intent. A CIRA that does not have a reserve study must rely solely on its annual budget as documentation of intent. Although the annual budget may suffice, it is a good idea for CIRAs to document both the specific capital purpose for accumulating funds and the amounts allocable to each common area component, including those that are capital in nature (such as roofing) and noncapital in nature (such as painting, contingency, or tree trimming).

Another difficulty that often arises in determining whether or not a contribution to reserves also qualifies as a capital contribution for tax purposes is due to the CIRA's choice of funding calculation method. For reserve studies that rely upon a straight-line, segregated calculation, it is easy to determine how the annual contribution to reserves is allocated among reserve components. But when the reserve study relies upon a pooled, cash flow calculation, by definition there is no allocation amongst reserve components. Most pooled calculation reserve studies will force an allocation based upon some reasonable criteria. This may usually be relied upon in determining the capital versus noncapital portions of the annual reserve contribution.

Because of the issues discussed above (or for other reasons such as unclear accounting for all financial transactions), the independent accountant may be required to assist management in making a decision regarding the capital or non-capital nature of reserve contributions. Some CPAs take the position that all reserve fund additions are considered capital in nature unless otherwise specified. Other CPAs take the stance that all reserve fund additions are considered noncapital in nature unless otherwise specified. This course suggests taking a conservative position that strictly complies with tax law. Unless additions to the reserve fund are designated for a specific capital purpose, they should be considered noncapital in nature. If it is unclear from the accounting records or other evidence that reserve contributions have a specific capital purpose, it is best to consider them noncapital in nature.

**Funds Held for That Purpose.** The CIRA can demonstrate to the IRS that the funds were held for a capital purpose by segregating the funds for future major repairs and replacements from operating funds. Many court cases have discussed the importance of this *earmarking* of funds to show the CIRA's intent for the assessment. In *Chicago Board of Trade*, the Courts considered the fact that the funds were accounted for at the time of payment and were held for capital acquisition or expenditure and no other purpose as an indication that the fees were contributions to capital. *Gibbons* also commented on the earmarking of the assessment for capital improvements at the time of receipt. However, GCM 35929 notes that simply earmarking funds, by itself, is not sufficient to create a contribution to capital. Thus, the CIRA should consider this factor in concert with the other six factors listed in the "Factors to Consider in Assessing Capital Contributions" paragraph. (The IRS may interpret this requirement stringently, which might require separate bank accounts and prohibit borrowing or transfers between operating and replacement funds.) See the discussion of separate bank accounts below.

*Maryland Country Club* denied IRC Section 118 treatment of certain funds by the club for several reasons. With respect to the segregation of cash into separate bank accounts the Court stated ". . . the regulations may not require a separate bank account for capital funds, but use of capital funds for operating expenses *shows a lack of intent* to hold these funds solely for purposes authorized by the statute. *This has the effect of invalidating the exemption of the entire sum collected, because an earmarking of funds never took place.*" While this wording leaves the door open for not physically segregating capital bank accounts, the fact that other rulings specific to homeowners associations (see Exhibit 2-2) *do* require segregation is a compelling reason for doing so. The fact that *Maryland Country Club* noted that failure to segregate funds "shows a lack of intent" indicates that the Court views this as a very unfavorable exception. The noted "effect of invalidating the exemption of the entire sum collected, because an

earmarking of funds never took place” is so severe that it could dissuade a CIRA from knowingly running the risk by not segregating the funds in a separate bank account.

**Separate Bank Accounts.** The proper segregation of funds is a crucial procedure in demonstrating the CIRA's intent to classify some assessments as contributions of capital. Failure to segregate cash may taint the entire replacement fund with respect to the capital versus operating issue. There is a difference between the terminology used in IRS rulings and that commonly used by CIRAs. IRS rulings (see Exhibit 2-2) recognize only two categories of cash accounts—membership activity accounts and capital accounts. CIRAs generally refer to operating cash and reserves (or the replacement fund). “Membership activity” and “operating” are comparable terms. However, “capital” as used by the IRS is not comparable to “reserves,” which may contain both capital and noncapital items (such as painting reserves). For tax purposes, it is best practice for the CIRA to have the following three categories of cash accounts:

- Operating bank account(s).
- Noncapital replacement fund bank account(s) for items such as painting, tree trimming, and contingencies.
- Capital replacement fund bank account(s) for items that are clearly capital in nature.

This does not mean that the CIRA must have a separate bank account for every reserve component (roofs, streets, fences, lighting, etc.).

**Expended for Intended Purpose.** The CIRA can show this factor by actually spending the capital contribution for its intended purpose. There is some flexibility in showing that funds are expended for their intended purpose, as the IRS will lump all capital items together. This means that if the CIRA assessed the funds for roof reserve funds, but spent them on streets, another capital component, the CIRA will not be out of compliance. This is because both are capital items in the eyes of the IRS. See the discussion of transfers between reserve funds later in this lesson.

**Increase Capital Account.** Increases in the reserve accounts automatically increase the capital accounts of the members. While some people attribute little value to reserves when buying into a common interest development, the reserves have significant value. A unit in a CIRA with fully funded reserves should command a higher price than an equivalent unit in a CIRA with no reserves.

**Example.** Exhibit 2-5 is an example of how to apply the seven factors discussed earlier in the “Factors to Consider in Assessing Capital Contributions” paragraph to an assessment made for an addition to the reserve fund for roofing. It is possible that some CIRAs will be able to consider an assessment as a contribution to capital without giving formal consideration to each of the seven factors. Separately addressing each of the factors may provide the most effective documentation in the event the CIRA faces an IRS audit.

### Exhibit 2-5

#### Example Reserve Assessment for Roofing

Factor	Comment
1. The purpose of the assessment must be capital in nature.	Major roofing expenditures are considered capital in nature.
2. Members or unit owner-stockholders must have advance notice as to the intent of the purpose of the contribution.	The CIRA notified its members by distributing copies of a reserve study and budget that showed part of the assessment was for a roofing reserve.

Factor	Comment
3. The money contributed must be accounted for as a capital contribution.	The CIRA accounts for the money received as a reserve capital contribution. The reserve study and budget support the amount collected, and the funds are accounted for separately from any noncapital reserve items, such as painting. The CIRA's general ledger and financial statements clearly account for and identify these funds.
4. The money must be held for that purpose and for no other purpose.	The funds, once segregated by the accounting process (and deposited in a separate bank account as discussed in step 5), are not commingled with any noncapital reserve funds or operating funds.
5. The money must be held in separate bank accounts from the operating (non-capital) monies of the CIRA.	The CIRA has two reserve bank accounts—one for capital components of the reserve fund and a separate account for noncapital reserve items such as painting, termite repairs, etc.
6. The money must be actually expended for the intended purpose.	When it was time to replace or repair the roofs, the CIRA spent the money for that purpose. There was no attempt to use it for painting, current operations, or any other noncapital purpose.
7. The money must increase the capital account of the member or unit owner-stockholder.	If the funds are accounted for as specified in factors 1–6, the increase in the reserve accounts automatically increases the capital account of the member.

**Conclusion:** Based on the CIRA's compliance with the seven factors, the assessment for roofing would be properly accounted for as a contribution to capital under IRC Section 118.

\* \* \*

It may be difficult at times to distinguish between contributions to capital and membership income. The IRS acknowledged that difficulty in GCM 37466, which states "A shareholder's payment to a corporation may, at once, resemble a contribution to capital, a payment for services, or an ordinary business expense." In GCM 37857, the IRS elaborated further on the concept, stating "If the transfer of money or property to the corporation was a precondition to the receipt of goods or services from the corporation, then the courts have ordinarily found that the transfer was *not* a contribution to capital."

For example, a homeowners' association charges a one-time \$5,000 membership fee to hook up to existing water lines when a new house is occupied for the first time. Annually, each homeowner pays a \$500 fee for water usage. The membership automatically transfers if the house is subsequently sold. Is the \$5,000 membership fee a contribution to capital or membership income?

The best way to decide between a contribution to capital and membership income is to determine if the fee meets the criteria for a contribution to capital that are discussed in the "Factors to Consider in Assessing Capital Contributions" paragraph. If not, the fee should be recorded as membership or exempt function income. In the example given in the previous paragraph, the fees were not put in a separate bank account and they were used to fund operating activities of the homeowners' association. The fees were not designated for future major repairs and replacements. They appear to be fees paid for the privilege of obtaining member services and should be treated as membership or exempt function income.

**Special Assessments as Agency Relationships.** A special assessment may result in an agency relationship for tax purposes. Assume, for example, that a condominium association levies a special assessment to repair extensive earthquake damage to its common areas. The expenditures also include attorneys' fees and management fees incurred in conjunction with the repairs. Although the common area belongs to the owners, the CIRA acts as their agent in making the repairs. For tax reporting, the special assessment should be treated as a contribution to

capital, and the expenditures are capital expenditures, even though they include attorneys' fees and management fees. Such special assessments were discussed earlier in this lesson and are not discussed in the following paragraphs.

**Consequences of Not Complying with IRS Regulations.** While the additional bank accounts recommended earlier in this lesson may be an extra administrative burden on the CIRA, they may be critical in demonstrating intent to the IRS in the event of an audit. All of this course's recommendations about reserves should be carefully considered to avoid problems with the IRS. The IRS has asserted the position that it will apply IRC Section 481 adjustments to reserve balances. The IRS has asserted that CIRAs that commingle operating and reserve bank accounts have used an impermissible accounting method (i.e., their reserves were not accounted for properly). In that case, those CIRAs would be required to adjust beginning reserve balances for the earliest open year under audit, bringing the full amount into taxable income as previously untaxed member income; that is, a cumulative adjustment for all prior years. Significant tax assessments by the IRS for any CIRA with large opening reserve balances would result, even if the CIRA had already expended the reserve funds.

**Amending Tax Returns Due to Significant Exposure.** If a CIRA determines it has significant exposure because of an impermissible accounting method, it may, prior to being selected for audit, amend prior year returns from Form 1120 to Form 1120-H (assuming it qualifies to file Form 1120-H). Guidance for making such an amendment is set forth in Treasury Regulations Sections 301.9100-1-3.

Treasury Regulation Section 301.9100-2 provides an automatic 12-month extension for amending a return and no reason must be specified. For periods of time beyond the automatic 12-month extension period, the CIRA must request permission from the Commissioner to change from one form to the other. The regulations provide guidance on when the CIRA will be allowed to amend the returns. The generally applicable provisions are:

- The CIRA acted reasonably and in good faith.
- The IRS will not prejudice the interests of the government in allowing the change.

Treasury Regulation Section 301.9100-3 gives examples of applying the provisions of the regulations. Example 2, "Reliance on a qualified tax professional," will generally be the most commonly used provision for relief by the CIRA industry. The example indicates that, if the CIRA was not advised that an election under IRC Section 528 was available, it may seek relief under the regulation. However, if the CIRA has ever previously filed a Form 1120-H, the IRS will probably not allow the change. Their reasoning is that the CIRA, by having previously filed the Form 1120-H, had knowledge of the benefits of IRC Section 528 and may not attempt to use the excuse that it later received inadequate advice, causing it to file Form 1120 in a subsequent year.

Under Revenue Procedure 92-20, an association that is not presently under examination may amend prior year Form 1120 tax returns (rather than filing an amended Form 1120-H) to correct the impermissible method of accounting by recognizing the appropriate adjustment and reporting the income over a three-year period. An association under examination may also do so within 90 days after being contacted for examination.

**Transfers between Reserve Funds and Operating Funds.** CIRAs may discover that they have excess operating funds they wish to transfer to their reserve fund or, alternatively, that they are overfunded on reserves and desire to transfer the excess to their operating account. Another transfer circumstance can occur when a reclassification of reserve categories is made. If an updated reserve study recommends a reallocation of reserve monies on hand to shift funds from a capital category (such as roofs) to a noncapital category (such as painting), a transfer of funds may be appropriate. What would the tax effect of those transfers be? For example, assessments collected for contingencies are taxable when levied. If those assessments were spent for a capital item in a future year, would they be treated as additional capital contributions in that year? There would be no tax effect if a Form 1120-H is filed in the year of the transfer. There may or may not be a tax effect if a Form 1120 is filed.

Accountants disagree on whether monies may be transferred between operating and reserve funds without tax effect on a Form 1120. Some feel that a transfer from the reserve fund to the operating fund may be made tax free because the taxability of assessments is determined based on their original purpose and intent in making the contribution (as a capital contribution), not their ultimate use. Revenue Ruling 75-371 and GCM 35929 (see Exhibit 2-3) seem to support that position. An analogy is drawn to a manufacturing company or CPA firm, where

shareholder contributions may be used for operating purposes and where the shareholder's basis is increased by the contributions (as is the unit owner's basis increased for a capital contribution). They also note that there are no authoritative rulings that those transfers are taxable.

Other accountants believe that reserve funds are taxable when transferred to operating funds. Several authoritative citations hold that the nature of the assessment is determined by how the money is spent. Regulations Section 1.118-1 states that "the exclusion [of contributions to capital from gross income] does not apply to any money or property transferred to the corporation in consideration for goods or services rendered." In addition, the conference agreement in the Committee Reports to IRC Section 118 indicates that the ultimate expenditure of funds controls the nature of the activity, which is also consistent with IRC Section 277.

The court cases discussed in Exhibit 2-2 set forth rules that must be considered when classifying assessments as capital contributions. The clearest statement regarding transfers between funds was set forth in the *Maryland Country Club* case, which states, "Plaintiff's actions in diverting capital funds to operating expenses were willful under the statute. This does not imply that there was an evil motive or a bad purpose in the activity of the Plaintiff. But in collecting capital funds with no intent to leave them undisturbed until the time they were to be expended for qualified purposes, the Plaintiff's violation of the earmarking requirement was voluntary, knowing, and intentional."

It seems that both the original intent in making the contribution *and* the expenditure of funds are critical to safely establish a capital contribution. Without "capital" intent at the outset, a contribution of money would fail a critical test in being classified as a capital contribution. Likewise, the ultimate expenditure of the funds contributed for a capital purpose is necessary to keep the intent intact. Expenditure of the funds for any noncapital purpose would destroy the original intent and would cause the contribution to fail the "capital" test. Exhibit 2-6 illustrates the tax effect of several types of transfers between operating and reserve funds.

## Exhibit 2-6

### Transfers between Reserve Funds and Operating Funds

The tax effect of interfund transfers varies depending on whether operating funds are transferred to reserves or reserves are transferred to operating funds. (See also the discussion above regarding the disagreement among accountants as to the treatment of such transfers.) This exhibit presents the tax effects of various scenarios when different actions are taken by the CIRA.

#### 1. Operating Funds Are Moved to Reserves—An association discovers during the year that it has \$50,000 in excess operating funds.

Action	Effect on Form 1120-H	Effect on Form 1120
a. The association transfers the \$50,000 from its operating to its reserve bank account during the current year without following the guidance provided earlier in this lesson.	The \$50,000 represents exempt function income since the rules for making a capital contribution were not complied with.	The \$50,000 represents membership operating income since the rules for making a capital contribution were not complied with.
b. The association republishes the budget for the remainder of the year to decrease operating dues revenue by \$50,000 and increase reserve assessments by \$50,000, keeping overall dues assessments the same. At the same time, the reserve study is revised to reflect the additional \$50,000 funding in the current year. The association clearly earmarks the funds for a specific capital purpose. No transfer of money between funds occurs, as that will be accomplished by normal, recurring transactions during the remainder of the year.	The \$50,000 has been successfully (and safely) converted from exempt function income to a capital contribution. The association must still meet the 60% income test to qualify to file Form 1120-H.	The \$50,000 has been successfully (and safely) converted from membership operating income to a capital contribution.



Action	Effect on Form 1120-H	Effect on Form 1120
c. At its annual membership meeting, the association makes an election under Revenue Ruling 70-604 to carry over the \$50,000 in excess operating funds to the next tax year. The association publishes a budget for the next year (Year 2) decreasing operating dues revenue by \$50,000 and increasing reserve assessments by \$50,000, keeping overall dues assessments the same. At the same time, the reserve study for Year 2 is revised to reflect the additional \$50,000 funding. The association clearly earmarks the funds for a specific capital purpose. No transfer of money occurs during the current year (Year 1).	<p>The \$50,000 is excluded from exempt function income in Year 1 under the provisions of Regulation 1.528-9.</p> <p>The \$50,000 is included in exempt function income in Year 2 under the provisions of Regulation 1.528-9.</p>	The \$50,000 has effectively been removed from membership income for the current year (Year 1). It becomes an excess income carryover to the next tax year (Year 2), when it must be reconsidered. The association must incur a \$50,000 operating loss in Year 2 (exclusive of the carryover) to offset the \$50,000 membership income carryover. If it does not, any excess membership income in Year 2 will be taxed along with net nonmembership income. Assuming the \$50,000 operating loss is achieved in Year 2, the association will have successfully converted the excess \$50,000 from membership operating income to a capital contribution by spreading it over a two-year period.
d. The association publishes a budget for the next year (Year 2) to reflect a one-time contribution of \$50,000 to reserves. At the same time, the reserve study is revised to reflect the additional \$50,000 funding in Year 2. The association clearly earmarks the funds for a specific capital purpose, then transfers the money to a segregated capital bank account in Year 2.	The \$50,000 still represents exempt function income in Year 1. The \$50,000 will represent a capital contribution in Year 2.	The \$50,000 still represents membership operating income in Year 1. The \$50,000 will represent a capital contribution in Year 2.

**2. Reserves Are Moved to Operating Funds**—An association discovers during the year that its operating fund has a \$50,000 deficiency.

Action	Effect on Form 1120-H	Effect on Form 1120
a. The association transfers the \$50,000 from its reserve bank account to its operating bank account during the current year.	The \$50,000 is converted from a contribution to capital to exempt function income.	The \$50,000 is converted from a contribution to capital to membership operating income. (In addition, the IRS may view such an arrangement as endangering the <i>entire</i> reserve fund since the funds have clearly not been held or spent for the specific capital purpose for which they were originally assessed.)
b. The association republishes the budget for the remainder of the year to increase operating dues revenue by \$50,000 and decrease reserve assessments by \$50,000, keeping overall dues assessments the same. At the same time, the reserve study is revised to reflect the decreased \$50,000 funding in the current year. No transfer of money between funds occurs, as that will be accomplished by normal, recurring transactions during the remainder of the year.	The \$50,000 has been successfully (and safely) converted from a capital contribution to exempt function income.	The \$50,000 has been successfully (and safely) converted from a capital contribution to membership operating income.

Action	Effect on Form 1120-H	Effect on Form 1120
c. The association incurs a \$50,000 membership operating loss and has \$50,000 in excess reserve funds for the year. It publishes a budget for the next year increasing operating dues revenue by \$50,000 and decreasing reserve assessments by \$50,000, keeping overall dues assessments the same. At the same time, the reserve study is revised to reflect the decrease of \$50,000 in funding for the next year. No transfer of money occurs during the current year.	The \$50,000 still represents a capital contribution in the current year.	The \$50,000 still represents a capital contribution in the current year. The \$50,000 membership operating loss must be carried over to the next tax year under IRC Section 277. The revised budget for the next year should result in \$50,000 net operating (membership) income that will be offset by the loss carryover from the prior year, effectively eliminating any tax on net membership income. The association will have successfully converted the excess \$50,000 capital contribution to membership income with no tax effect.

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While the existing body of rules and court cases seems to indicate no arbitrary or unplanned transfer between funds may be safely made (in either direction), that is clearly an area where the *form* of the transaction is as important as its *substance*. Accountants should be cautious when treating any transfer as having no tax effect on a Form 1120. In an audit case in Hawaii, the IRS ruled against an association on the capital contribution issue simply because of the association's *ability* to use capital reserve funds for another purpose. The association had set forth a specific capital purpose for the assessments, separately accounted for the funds, segregated the monies into a separate bank account, and expended them only for the specific capital purpose that was intended. The IRS contended the fact the association's bylaws allowed it to invade the capital reserve funds for operating purposes invalidated the IRC Section 118 treatment.

Since a transfer from the reserve fund to the operating fund generally would only be done if the association was in a deficit position in the operating fund, the following steps could be taken to nullify any tax effect:

- The members could vote to refund money equalling the amount of the deficit from reserves to themselves.
- The members could then vote to contribute the same amount of money as operating assessments.

Under that scenario, there would be no tax effect because of the deficit in the operating fund.

A CIRA may also attempt to mitigate any negative tax impact of interfund transfers by treating them as temporary loans rather than as permanent transfers. While there is no official (or unofficial) guidance on that matter, IRS officials have verbally conceded that such a position may be valid. For an interfund transfer to be considered a loan, that intent must be well documented. The CIRA should document the loan in its minutes, create a written note, charge interest, arrive at a reasonable repayment plan, and repay the loan as scheduled.

## Litigation Settlements

**Litigation Proceeds from Developers.** CIRAs may receive construction defects litigation settlements, many times on a pre-trial basis within 10 years after their formation. (It takes some time for the defect to be discovered and corrected and to complete negotiations with the developer.) Litigation proceeds are typically recorded as income in the financial statements of the association. However, tax treatment of the proceeds is generally different. For example, the proceeds may not be the property of the CIRA; rather, they may belong to the members, with the CIRA simply acting as their agent.

On the CIRA's side, the possible parties to a litigation settlement are:

- The CIRA—The CIRA files the lawsuit on its own behalf. It is the taxpayer in that instance and will be required to report any taxable consequences.

- The members—
  - The CIRA files the lawsuit as an agent for the members and, for convenience, typically executes all transactions. From a tax perspective, the members are the taxpayer in that instance, not the CIRA. The CIRA must report the results to the members so that they may determine how they should treat the transactions for tax purposes. Since each member has a different tax basis, it is possible (although unlikely) that each one could report a different taxable event.
  - The members individually or collectively file the lawsuit. In that instance, they are the taxpayers, and it is unlikely that the CIRA would be significantly involved.
- A designated settlement fund—The fund is established on behalf of the members and becomes a separate taxable entity for purposes of reporting activity during the settlement period. Any net proceeds of the settlement not taxed to the fund are reported to the members when a final settlement is reached and monies are distributed.

*Who gets taxed* is a function of the mechanics of the lawsuit. If the association is merely acting as an agent for the members for purposes of filing the legal action, the members may be considered to be the taxpayers. Private Letter Ruling 9238021 states that a construction defect award paid to an association acting as an agent for the condominium owners is not income or return of capital to the association. Since the association retained the funds to repair or replace the damaged property, the retained funds are treated the same as a capital assessment against the unit owners. Legal advice should be obtained if there is any question about whether the members or the association is the taxpayer.

Based on Private Letter Ruling 8004028 and the *Raytheon Production Corporation* case, such settlements generally are treated as a nontaxable return of capital to the *association and/or its members* to the extent of basis. (In the facts stipulated in the private letter ruling, litigation proceeds did not exceed the aggregate basis of the capital assets involved in the litigation, were not commingled with assessments from normal operations, and were used only for payment of attorneys' fees and legal costs, correction of the construction defects, and other capital and extraordinary expenses.)

Revenue Ruling 81-152 further clarified that issue by reiterating that litigation proceeds generally represent a return of capital to the extent of basis. It further held that any excess is a taxable gain. However, to the extent that the association expends or retains the proceeds to correct the damages or for other capital reserve component purposes, the amount expended or retained will increase basis and may accordingly eliminate any otherwise taxable gain.

Generally, damage awards are consumed by the repairs that are the subject of the award. Sometimes, however, there may be excess award funds remaining because members may previously have been assessed to perform the corrective work, repairs were made at lower than estimated costs, or for other reasons. Any such excess funds are potentially subject to taxation. If the excess funds are retained by the association for any capital purpose, such as capital reserve additions to more fully fund reserves or to make a capital improvement or addition to the association (even if it was not included in the reserve study or mentioned in the settlement), it seems likely that no taxable event should occur. If the excess award funds are refunded to the members, the burden of determining the tax effect is shifted to the members, who are guided by Revenue Ruling 81-152 in making that determination. If the excess award funds are retained by the association and used for operating purposes (rather than for capital purposes), the association should treat the award funds as a special assessment for operating purposes. A notice should be given to members since the transaction would be treated the same as if the funds were refunded to the members and then paid back to the association as a special assessment.

The following are examples of different types of proceeds:

- Payments in lieu of dues (past, present, or future) and for under-assessments are generally considered to be membership income or exempt function income.
- Compensatory damages (amounts received for actual damages) are generally considered to be a return of capital to the extent of amounts expended or to be expended or to the extent of the aggregate bases of

the underlying assets. That tax treatment is consistent regardless of whether the members or the association is the "taxpayer."

- Punitive damages are generally considered to be nonmembership income or nonexempt function income.
- Cumulative interest awards are generally considered to be nonmembership income or nonexempt function income because they are not received from members.

**Damages Settlement Illustration.** A condominium association receives a settlement from an insurance company related to a damage claim in the amount of \$1,500,000. The association's law firm that negotiated the claim receives \$500,000. Since repairs have already been made and paid for by a special assessment to all members, no additional repairs expenditures are required from the settlement proceeds. The association retains \$350,000 of the proceeds for the association's reserve fund, and \$50,000 for the association's operating fund. The remaining \$600,000 is disbursed to the members.

GAAP requires that this transaction be included in the association's financial statements for financial reporting purposes. However, for tax purposes, the association has only acted as an agent on behalf of the members. The settlement proceeds are not taxable to the association, because it is not the taxpayer in this instance; the members are the taxpayers. However, since the association has received all the settlement proceeds, it must determine the tax impact of the transaction and communicate that information to its members. The tax impact of this illustrative transaction is as follows:

- The \$1,500,000 gross settlement proceeds would generally represent compensatory damages to the members, and accordingly, would not generally be taxable. Revenue Ruling 81-152 indicates that such proceeds would reduce each member's basis to the extent of their basis, and any excess would be taxable.
- The \$500,000 legal fees are treated as a reduction of the settlement proceeds, and may not otherwise be deducted currently.
- The \$350,000 retained for the association's reserves would generally qualify as an IRC Section 118 capital contribution (assuming the purpose was for a specific capital expenditure) from the association's perspective. From the members' perspective, this amount would represent a capital contribution that increases their tax basis in the association, which is not separable from their real property interest.
- The \$50,000 retained for the association's operating fund would represent either member income on Form 1120, or exempt function income on Form 1120-H from the association's perspective. To the members, the \$50,000 would represent a regular operating assessment that is nondeductible, unless connected to a business activity of the member.
- The \$600,000 disbursed to members represents a capital distribution from the association's perspective. To the members, the \$600,000 is a nontaxable recovery of capital, unless such amount exceeds the member's basis in their property. The capital distribution is not a dividend, as it is not part of "earnings and profits". Most associations will provide a summary explanation of the transaction that is the basis for the capital distribution and advise members to consult with their own tax advisors regarding tax treatment of the proceeds they receive. The Association should not provide tax advice to its members.

**Structured Settlements.** *Structured settlements* are a concept sometimes applied to CIRAs in cases of construction defects litigation. In those circumstances, the payout of the construction defects settlement is *structured* to help reduce the tax burden of the association while at the same time making it less expensive for the developer to settle the claim. The *structured settlements* language is borrowed from the area of personal injury law in which IRC Section 104(a)(2) treats any awards for personal injury (other than punitive damages) as nontaxable awards for the recipients. (Also see IRC Section 130.) Revenue Rulings 79-220 and 79-313 extended that concept to include payments received from an annuity as part of the original settlement agreement when the annuity was owned by the payor and the recipient could not modify either the amount or timing of the payments to be received.

The obvious attraction for similar treatment in the CIRA industry is the potential that large sums of interest income might be rendered nontaxable through proper structuring. Even though a lump sum settlement is generally treated

as a tax-free recovery of capital, the interest income on the payment is taxable. Alternatively, under the *structured settlement* concept, an association may elect instead to receive an annuity rather than a lump sum settlement. Applying the theories of personal injury law, some contend that the annuity payments also would not be taxable. As an additional benefit, a developer might be more willing to settle simply because the latter alternative is less costly.

There are several associations that have applied the “structured settlement” concept to lump sum settlements they have received in amounts in excess of \$10 million. While the benefits are substantial if structured settlements in construction defects litigation are held to be nontaxable, it is wise to be cautious in this area, particularly since there are no tax rulings on point.

**Designated Settlement Funds.** The construction defects litigation process may stretch over a period of several years. Many times, the proceeds are immediately spent when received to make the necessary repairs. Less often, one of the following situations occurs:

- The defendant pays a portion of the proceeds in an early year before other parts of the dispute are settled.
- The proceeds are paid into an attorney’s trust fund for later disbursement to the plaintiff(s), either in a lump sum or over an extended period of time.
- The proceeds are paid to the association, which retains them for a lengthy period of time until they are expended for the specific purposes included in the settlement.

Such proceeds are invested and earn interest. Revenue Ruling 92-51 clarified that such interest should be taxed each year as it is earned. It is not to be accumulated and reported as income at the time it is paid to the plaintiff. (The tax treatment of interest on a designated settlement fund is different from that of a lump sum award of “interest” as a part of a settlement, which is intended to compensate the plaintiff for the time value of money related to the award.)

IRC Section 468B, “Special Rules For Designated Settlement Funds,” establishes procedures for the tax treatment of designated settlement funds. It defines a qualified settlement fund as a “fund, account, or trust” that “is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event . . . that has occurred and that has given rise to at least one claim asserting liability . . . arising out of a tort, breach of contract, or violation of law . . .”

IRC Section 468B establishes the fund as a “United States person” subject to tax on its modified income, as follows:

- Generally, the amounts transferred to the fund are not taxable. However, any interest earnings are taxable.
- A deduction is allowed for administrative costs and other incidental expenses incurred in connection with the operation of the qualified settlement fund. Legal fees incurred on behalf of plaintiffs are specifically excluded from the fund’s deductible expenses.
- Distributions or payments on behalf of claimants are not deductible.
- The taxable year of a designated settlement fund is the calendar year.
- The fund must use the accrual method of accounting.

The fund administrator must elect to have the IRC Section 468B rules apply. A separate election statement is required following the form and content specified in Treasury Regulation 1.468B-5. Once made, the election may be revoked only with the consent of the IRS.

A settlement fund, escrow account, or similar fund that does not qualify as a designated settlement fund is taxed as a grantor trust.

**Earnings on Investment of Proceeds.** Earnings (i.e., interest or dividends) from the investment of the proceeds of a settlement or award can often be significant. Unless the proceeds are invested in tax free securities, the earnings

will always represent taxable income, regardless of the nature of the underlying award. Since the investment earnings are taxable, they either may be transferred to other funds (such as the operating fund) or retained in the fund that earned the income.

If investment earnings on an award to the association (i.e., where the association is the taxpayer) are intended to be distributed along with compensatory damages to members, accountants are advised to exercise extreme caution. IRC Section 528 prohibits private inurement or the distribution of earnings. An association could inadvertently lose its exempt status by a distribution of interest income. Also, some state laws could be affected.

### **Basis in Assets Received from a Developer/Sponsor or Others**

**Assets Received from a Developer/Sponsor.** Cooperative housing corporations and homeowners' associations own the common property of the CIRA. IRC Sections 351 and 362 provide that assets received from a developer/sponsor will have the same basis in the hands of those associations as they did in the hands of the developer/sponsor if the developer/sponsor receives membership shares in exchange for the assets contributed. IRC Section 351 is a mandatory section. The timing of the transfer and whether "control" requirements are met ultimately determine if IRC Section 351 applies. Since the developer/sponsor's basis in the membership shares is the same as the assets contributed to the association, the association will have a tax basis in assets received in such a manner and may depreciate any depreciable assets. However, it is rare for a developer/sponsor to receive membership shares in exchange for the assets contributed.

A more common occurrence is that the developer/sponsor does not transfer the common area assets to the association in exchange for membership shares. Rather, the developer/sponsor simply allocates the cost of developing those assets (for example, swimming pools) to the lots/housing units being sold and takes a deduction on its income tax return for their cost. Consequently, there is no remaining basis in the common area assets when they are transferred to the association. As a result, the association does not record the transfer for tax purposes since it has no tax basis in the common area assets.

Condominium units may be received from a developer in settlement of litigation arising from defective construction or from payment of inadequate assessments relating to units held by the developer before their initial sale. In that case, the units received would have no basis for tax purposes unless *taxable* income was recognized on the transfer. However, the units would be reflected in the financial statements at fair market value. The difference between the zero basis for tax purposes and fair market value for financial reporting purposes represents a permanent, book-to-tax difference, as would any depreciation expense recorded for book purposes. A more detailed discussion is beyond the scope of this course, but accounting for other real property transferred to a CIRA is discussed further in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

**Assets Received from Others.** IRC Section 118 and related authoritative interpretations hold that an organization receiving an asset as a contribution to capital has no basis in that asset if it is received from a nonmember. For instance, property received in settlement of a lawsuit from a nonmember would have no basis unless income (such as interest or from punitive damages) was recognized in connection with such receipt. That means that the association would not capitalize or depreciate, for tax purposes, such an asset.

### **Basis in Assets Purchased with Association Funds**

Assets purchased from operating funds would presumably have a tax basis since membership income is potentially taxable to the association. Assets purchased from reserves (repair and replacement funds) would generally not have a tax basis as the monies contributed to reserves were specifically excluded from income under the provisions of IRC Section 118.

IRC Section 362(c) governs the basis of assets received by a corporation, including contributions of capital under IRC Section 118. IRC Section 362(c) states:

If money is received by a corporation . . . as a contribution to capital, and is not contributed by a shareholder as such, then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of the contribution.

A practical interpretation is that, unless they are able to otherwise substantiate through careful recordkeeping, many associations will not be able to provide documentation that the specific monies used to purchase assets were not received during the preceding 12-month period, and consequently, will not have a tax basis in assets purchased. Under most reserve funding plans, at least a portion of the funds used to purchase assets will be received immediately prior to the purchase of the assets.

The primary question is whether or not members of a homeowners' association are considered to be the equivalent of "shareholders" for purposes of application of this IRC Section. Not surprisingly, this matter has been considered by the courts. In *Lake Petersburg Association v. Commissioner*, the Court determined that "... petitioner's members are its only owners and are in the nature of shareholders." However, *Board of Trade of the City of Chicago and Subsidiaries v. Commissioner* and *Washington Athletic Club v. United States* both reached the opposite conclusion. The arguments raised in the latter two cases seem more persuasive than in the *Lake Petersburg* case and recommend that tax practitioners generally take the conservative position and assume that assets purchased from reserves have no tax basis.

The IRS issued Temporary Regulation 1.263(a) in late 2011, with an effective date of 2014. Those regulations effectively require capitalization of certain expenditures, which are defined within the regulations. Since the regulations apply to all taxpayers, they apply to common interest realty associations. The difference between common interest realty associations and most other taxable entities relates not to the expenditures, but to the source of funds from which the expenditures are made, i.e., from reserves. IRC Section 362 and Treasury Regulation 1.362-1 effectively require the basis of expenditures for capital assets purchased to be offset by amounts funded from reserve contributions that were excluded from taxable income under IRC Section 118.

A tax position taken by some practitioners applies to assets that are purchased for taxable activities where user fees are generated. In that situation, the aggressive tax position treats the taxable user fees generated as what gives rise to tax basis in those purchased assets. This course takes no position on this matter and urge practitioners to perform their own research and reach their own conclusions before taking a position on the tax basis issue.

Another tax position utilizes the "12-month rule" by deferring any asset purchases from reserve funds for 12 months. Once the 12-month period has passed, funds from the reserve fund can be used to purchase assets. Those asset purchases will not have to reduce the basis by amounts received during the previous 12 months.

## Capital Expenditures

The tax rules with respect to capital expenditures (or most expenditures from the replacement fund) are different from the rules for membership and nonmembership deductions (or exempt and nonexempt deductions) and are unique to CIRAs. Since (a) most expenditures from the replacement fund qualify as capital in nature under IRC Section 263, (b) the assessments that were accumulated to pay for those expenditures are treated as capital contributions, and (c) such expenditures are for nonbusiness purposes, generally no deductions will be allowed for the expenditures. Reporting replacement fund transactions on Form 1120 was discussed earlier in this lesson.

Expenditures from the replacement fund will fall into one of the following categories:

- *Expenditures for Major Repair or Replacement of the Real Property Common Areas Related to Membership Activities.* Such expenditures may not be capitalized or deducted on the tax return of a condominium, homeowners', or timeshare association because they are nonbusiness in nature and, generally, are not capitalized for financial statement purposes under GAAP. Cooperatives capitalize all real property because they hold title to it.
- *Expenditures for Major Repair or Replacement of the Real Property Common Areas Related to Nonmembership Activities.* Assuming the tax practitioner takes the position that the association can have a tax basis in purchased assets, such expenditures should be capitalized and depreciated both for financial statement and tax purposes since they relate to a profit-making (unrelated business) activity.
- *Expenditures for Personal Property Acquired in Connection with the Membership Activities of the Association.* Assuming the tax practitioner takes the position that the association can have a tax basis in purchased assets, such expenditures are capitalized and depreciated for financial statement purposes.

Industry practice is to capitalize and depreciate such expenditures for tax purposes. However, a strict interpretation of IRS rulings on the issue would deny a depreciation deduction to residential associations as no depreciation may be deducted in connection with a personal residence.

- *Expenditures for Personal Property Acquired in Connection with the Nonmembership Activities of the Association.* Assuming the tax practitioner takes the position that the association can have a tax basis in purchased assets, such expenditures should be capitalized and depreciated both for financial statement and tax purposes since they relate to a profit-making (unrelated business) activity.

**Cooperative Association vs. Condominium and Homeowners' Association Capital Expenditure Treatment.** It is important to distinguish the differences in legal structure and in the nature of activities between cooperative associations and condominium or homeowners' associations. The differences in legal structure, nature of activities, and tax law result in vastly different tax results for organizations that may *look* virtually identical.

Cooperative Association Treatment. Cooperative associations operate as businesses. They are in the business of owning, operating, and leasing to members (primarily) residential real estate property. Subchapter T of the Internal Revenue Code specifically recognizes cooperative associations as unique business enterprises. Subchapter T applies to all cooperative associations, even if they fail to qualify under IRC Section 216 as cooperative housing corporations. Because of the legal structure of the cooperative and the nature of its activities, the cooperative association should generally capitalize and depreciate its capital expenditures both for financial statement and tax purposes. Additional information about cooperatives is beyond the scope of this course, but the topic is discussed further in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

Condominium and Homeowners' Association Treatment. Condominium and homeowners' associations do not operate as for-profit businesses. These associations act simply as agents for their members, on a not-for-profit basis. IRC Section 263 disallows deductions (either as a direct current deduction or as depreciation expense) for activities that are not engaged in for profit. Consequently, condominium and homeowners' associations may not legitimately claim tax deductions for capital expenditures, nor for depreciation expense, unless those expenditures are related activities engaged in for profit. In order to avoid the trap of creating *income* from assessment proceeds when such proceeds are used for capital expenditures, these associations will generally make *capital* assessments qualifying for exclusion from income under IRC Section 118. This means, for tax purposes, no income and no deduction. If the association engages in activities on a for-profit basis (fee for service activity), the nature of the activity and the existence of income may allow the association to then capitalize and depreciate capital expenditures.

### **Difference in Treatment of Specific Transactions for Financial Reporting and Tax Purposes**

As discussed throughout this lesson, some transactions may be treated differently for financial reporting and tax purposes. For example, initial contributions required by new members upon purchase of their units to provide the CIRA with additional working capital are treated as contributed capital for financial reporting purposes but are generally treated as revenue for tax purposes.

### **IRS Audit Activity**

The following paragraphs provide a brief summary of known IRS tax audit activity.

The IRS does not have any specific program to perform audits of associations. Most audits are a result of random selection. However, in the mid 1990s, IRS agents in California and Florida initiated nearly 30 audits, in just two groups, by two agents. The two largest current, most recent audits resulted from dissident members of the associations campaigning for the IRS to audit their associations because of perceived irregularities. IRS audits over the last 23 years include at least the following 63 audits:

- 16 audits in California in 1993–94.
- 6 audits in California since 2000.
- 12 audits in Florida in 1994–95.



- 2 audits in various states 1998–2002.
- 2 audits in Nevada 2011–2012.
- 6 audits in Arizona 1999–2012.
- 3 audits in Hawaii 2010–2012.
- 1 audit in Ohio 2011–2012.
- 15 audits in various states 2013–2016.

The following types of tax returns were audited:

- 2 Form 990—501(c)(4) status revoked.
- 3 Form 1120-H—no change.
- 57 Form 1120—all audits completed have resulted in additional taxes, penalties and interest.
- 1 Form 1120—no change.

Tax audit issues related to the Form 990 audit revolved around continued qualification for exempt status. All of the Form 1120-H audits were random selections with no specific audit issues. The Form 1120 audits tended to focus on two primary issues—multiple year rollovers of excess member income using Revenue Ruling 70-604 and related issues of improper election procedures, and failure to follow proper procedures to exclude reserves from member income under IRC Section 118. Although arising only once, a very significant dollar amount related to transfer fees assessed on new members that were designated as reserves without adequate supporting documentation.

The primary audit defense strategy employed for many of these associations was to amend to Form 1120-H (where possible) under the provisions of Treasury Regulations 301.9100-3 to “close off” high-risk areas. It has been successfully argued in several cases that the membership does not have to make the election under Revenue Ruling 70-604, that the board of directors may make the election, as only they have authority to make decisions regarding disposition of association funds under state law. It has been successfully argued on several occasions that the IRS position of single year carryovers of excess member income under Revenue Ruling 70-604 is very weak, and that multiple year carryovers should be permissible. It has also been successfully argued that excess member income from year one is the first money spent in year two, as year-two revenues have not yet been collected; therefore, the association has met the requirements of Revenue Ruling 70-604.

Associations that do not qualify to file Form 1120-H are the most difficult to represent. In one case, it was believed that the association qualified for exempt status under IRC Section 501(c)(4). It filed the application and was granted exempt status to completely resolve the IRS audit.

The IRS has created two draft Audit Techniques Guides (ATG) under its MSSP (Market Segment Specialization Program) to assist IRS auditors in conducting the audits of all types of homeowners associations. Those two guides are “Timeshare Vacation Plan Owners Associations” and “Country Clubs.” It is noteworthy that neither of those guides has ever been issued in a final format. Both guides are available through an industry resource website **[www.hoapulse.com](http://www.hoapulse.com)**, in the bookstore under “Free Stuff.” The Timeshare Guide is produced in its entirety; only chapter five of the Country Club Guide is reproduced, as that is the only chapter related to homeowners associations.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. Assuming all other criteria are met, under which of the following circumstances does IRC Section 277 apply to a CIRA?
  - a. It is a membership organization.
  - b. It was founded to provide services to the community at large.
  - c. It is exempt from taxation under IRC Section 528.
6. Which of the following statements best describes an aspect of tax law that applies to all CIRAs?
  - a. If member assessments are received in advance, a CIRA can defer this income for up to two years as long as all services are received by the members within 12 months.
  - b. If a CIRA serves as an agent for member funds, it should aggregate the proceeds and expenditures into its operating fund and its general bank account.
  - c. For a CIRA to record a contribution as capital for income tax purposes, the purpose of the assessment must be shown to be capital in nature.
  - d. When a CIRA purchases a new building, it can deduct the amount of this capital expenditure on its income tax return.
7. Which of the following CIRAs is most likely to be able to support reporting assessments as capital funds instead of operating funds?
  - a. The Everman Association assessed funds for roof repairs but then spent the funds on street repairs instead.
  - b. The Folly's Gap Neighborhood Association sets aside funds for future major repairs and replacements without doing a replacement fund reserve study.
  - c. The Grantham Building Homeowner's Association uses a pooled, cash flow calculation for its replacement fund reserve study.
  - d. The Harwell Association classifies its entire reserve fund as capital, even though items such as pest control will also be covered by the fund.
8. Under which of the following circumstances could funds paid to a CIRA become nontaxable?
  - a. When increases to reserve accounts increase members' capital accounts.
  - b. When transfers are made between the operating and reserve funds.
  - c. When a structured settlement is used.

9. What type of capital expenditure are homeowners', timeshare, and condominium associations prohibited by the tax rules from capitalizing and deducting on their tax returns?
- a. Those for major repairs or replacements of real property common areas related to nonmembership activities.
  - b. Those for major repairs or replacements of real property common areas related to membership activities.
  - c. Those for personal property acquired in connection with the association's nonmembership activities.
  - d. Those for personal property acquired in connection with the association's membership activities.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. Assuming all other criteria are met, under which of the following circumstances does IRC Section 277 apply to a CIRA? **(Page 322)**
  - a. **It is a membership organization. [This answer is correct. The intent of IRC Section 277 was to prevent abuse by nonexempt membership organizations in the same manner that IRC Section 513 prevented abuse by exempt organizations. Its purpose was to prevent taxable membership organizations from avoiding tax on nonmembership income by operating membership activities at a loss and using that loss to offset the nonmembership income. IRC Section 277 may be considered to be a *mandatory anti-abuse* section because it automatically applies if the organization meets the criteria specified in the section, one of which is that the entity is a membership organization.]**
  - b. It was founded to provide services to the community at large. [This answer is incorrect. One of the criteria that must be met for IRC Section 277 to apply is that the entity was formed primarily to provide services to its members. Therefore, if the entity was founded to provide services to the community at large, IRC Section 277 would not apply.]
  - c. It is exempt from taxation under IRC Section 528. [This answer is incorrect. For IRC Section 277 to apply, the entity must not be exempt under any other section of the Code. Thus, CIRAs exempt under IRC Section 528 and subchapter T are not subject to the provisions of IRC Section 277.]
6. Which of the following statements best describes an aspect of tax law that applies to all CIRAs? **(Page 329)**
  - a. If member assessments are received in advance, a CIRA can defer this income for up to two years as long as all services are received by the members within 12 months. [This answer is incorrect. Member assessments received in advance should be treated as deferred revenue for financial reporting purposes. However, the tax treatment of prepaid assessments may depend on the nature of the amounts received. Revenue Procedure 2004-34 allows deferral of income for only 12 months, from one tax year to the next succeeding tax year. That deferral is allowed only if all the services to be received by the members will be performed by the end of the succeeding tax year.]
  - b. If a CIRA serves as an agent for member funds, it should aggregate the proceeds and expenditures into its operating fund and its general bank account. [This answer is incorrect. When a CIRA receives funds as an agent for its members, it should set up a separate bank account (and perhaps a separate fund) for the proceeds and expenditures. Since the CIRA is acting merely as an agent, the proceeds may not be commingled with CIRA monies nor may they be spent for any other purpose.]
  - c. **For a CIRA to record a contribution as capital for income tax purposes, the purpose of the assessment must be shown to be capital in nature. [This answer is correct. In order for a CIRA to record an assessment as a contribution to capital for tax purposes, the CIRA must (1) show that the purpose of the assessment is *capital* in nature and (2) demonstrate its *intent* for making the assessment.]**
  - d. When a CIRA purchases a new building, it can deduct the amount of this capital expenditure on its income tax return. [This answer is incorrect. IRC Section 263 prevents taxpayers from claiming current deductions for "capital" expenditures that the taxpayer is required to capitalize and depreciate. IRC Section 263(a), under its general rule, states, "No deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."]
7. Which of the following CIRAs is most likely to be able to support reporting assessments as capital funds instead of operating funds? **(Page 335)**
  - a. **The Everman Association assessed funds for roof repairs but then spent the funds on street repairs instead. [This answer is correct. The CIRA can show the IRS that it spent funds for their intended**

**purpose by actually spending the capital contribution for its intended purpose. There is some flexibility in showing that funds are expended for their intended purpose, as the IRS will lump all capital items together. This means that if the CIRA assessed the funds for roof reserve funds but spent them on streets (as in this scenario), the CIRA will not be out of compliance as streets are another capital component in the eyes of the IRS.]**

- b. The Folly's Gap Neighborhood Association sets aside funds for future major repairs and replacements without doing a replacement fund reserve study. [This answer is incorrect. Many CIRAs have not conducted replacement fund reserve studies but still may be setting aside funds for future major repairs or replacements. Since they have not conducted a study, it is more difficult for them to document that the funds are designated for specific capital expenditures. While many CIRAs have excluded such funds from revenue and classified them as contributions to capital, the lack of a reserve study may increase the risk associated with documenting intent. Therefore, if Folly's Gap does this, the association will have to rely only on its annual budget as documentation of intent, which is a more risky position to be in. It would be better if the association conducted a replacement reserve study to help document capital expenditures.]
  - c. The Grantham Building Homeowner's Association uses a pooled, cash flow calculation for its replacement fund reserve study. [This answer is incorrect. A difficulty that often arises in determining whether or not a contribution to reserves also qualifies as a capital contribution for tax purposes is due to the CIRA's choice of funding calculation method. For reserve studies that rely upon a straight-line, segregated calculation, it is easy to determine how the annual contribution to reserves is allocated among reserve components. Unless the study forces an allocation based upon some reasonable criteria, it will be different to determine capital versus noncapital portions of the annual reserve contribution. Therefore, it would be easier for Grantham to ensure a capital classification if it used the straight-line, segregated calculation instead.]
  - d. The Harwell Association classifies its entire reserve fund as capital, even though items such as pest control will also be covered by the fund. [This answer is incorrect. The principal decision to charge a replacement fund for certain expenses is covered by the CIRA's members when they adopt the budget. Thus, the replacement fund may include expenditures for items other than capital improvements, such as pest control, landscape maintenance, insurance, and others. According to IRS revenue rulings, only assessments for specific capital expenditures qualify as contributed capital, so Harwell should only report a portion of the assessments for future major repairs and replacements as contributed capital for tax purposes and the remainder as membership income.]
8. Under which of the following circumstances could funds paid to a CIRA become nontaxable? **(Page 342)**
- a. When increases to reserve accounts increase members' capital accounts. [This answer is incorrect. Increases in the reserve accounts automatically increase the capital accounts of the members. While some people attribute little value to reserves when buying into a common interest development, the reserves have significant value. A unit in a CIRA with fully funded reserves should command a higher price than an equivalent unit in a CIRA with no reserves. However, such increases do not automatically make the funds nontaxable, so there is a better answer to this question.]
  - b. When transfers are made between the operating and reserve funds. [This answer is incorrect. CIRAs may discover that they have excess operating funds they wish to transfer to their reserve fund or, alternatively, that they are overfunded on reserves and desire to transfer the excess to their operating account. What would the tax effect of those transfers be? For example, assessments collected for contingencies are taxable when levied. If those assessments were spent for a capital item in a future year, would they be treated as additional capital contributions that year? There would be no tax effect if a Form 1120-H is filed in the year of the transfer. There may or may not be a tax effect if a Form 1120 is filed. However, the funds will not automatically be made nontaxable, so there is a better answer to this question.]
  - c. **When a structured settlement is used. [This answer is correct. *Structured settlements* are a concept sometimes applied to CIRAs in cases of construction defects litigation. In those circumstances, the payout of the construction defects settlement is *structured* to help reduce the tax burden of the association while at the same time making it less expensive for the developer to settle the claim. The obvious attraction for such treatment in the CIRA industry is the potential that large sums of interest**

**income might be rendered nontaxable through proper structuring. Under the structured settlement concept, an association may elect to receive an annuity rather than a lump sum settlement. Applying the theories of personal injury law, some contend that the annuity payments also would not be taxable.]**

9. What type of capital expenditure are homeowners', timeshare, and condominium associations prohibited by the tax rules from capitalizing and deducting on their tax returns? **(Page 345)**
- a. Those for major repairs or replacements of real property common areas related to nonmembership activities. [This answer is incorrect. Assuming the tax practitioner takes the position that the association can have a tax basis in purchased assets, such expenditures should be capitalized and depreciated both for financial statement and tax purposes since they relate to a profit-making (unrelated business) activity.]
  - b. Those for major repairs or replacements of real property common areas related to membership activities. [This answer is correct. Expenditures for the major repair or replacement of the real property common areas related to membership activities may not be capitalized or deducted on the tax return of a condominium, homeowners', or timeshare association because they are nonbusiness in nature and, generally, are not capitalized for financial statement purposes under GAAP. Cooperatives, on the other hand, capitalize all real property because they hold title to it.]**
  - c. Those for personal property acquired in connection with the association's nonmembership activities. [This answer is incorrect. Because they related to a profit-making (unrelated business) activity, if the tax practitioner takes the position that the association can have a tax basis in purchased assets, CIRAs should capitalize and depreciate these expenditures both for financial statement and tax purposes.]
  - d. Those for personal property acquired in connection with the association's membership activities. [This answer is incorrect. Assuming the tax practitioner takes the position that the association can have a tax basis in purchased assets, such expenditures are capitalized and depreciated for financial statement purposes. Industry practice is to capitalize and depreciate such expenditures for tax purposes. However, a strict interpretation of IRS rulings on the issue would deny a depreciation deduction to residential associations as no depreciation may be deducted in connection with a personal residence.]

## TAXATION UNDER IRC SECTION 528 (FORM 1120-H)

### Applicability of IRC Section 528

IRC Section 528 applies to homeowners' associations as that term is defined by the IRS. According to the IRS, there are three kinds of homeowners' associations:

- Condominium management associations organized and operated to acquire, build, manage, and care for the property in a condominium project substantially all of whose units are homes for individuals.
- Residential real estate management associations organized and operated to acquire, build, manage, and care for a subdivision, development, or similar area substantially all of whose lots or buildings are homes for individuals.
- Timeshare associations in which the members hold rights to use or ownership interests in real property of the association.

Thus, the IRS definition of homeowners' associations includes residential condominium associations, homeowners' associations, and timeshare associations, but it excludes cooperative housing corporations. Incorporated homeowners' associations and unincorporated associations that elect to be taxed as corporations may elect to file Form 1120-H. Based on IRS statistics, Form 1120-H is the form most commonly used.

IRC Section 528 specifies the following additional provisions under which those associations must qualify before they may file Form 1120-H. If a CIRA qualifies, Form 1120-H is the simplest tax alternative, although generally it may be considered less favorable because net nonexempt function income is taxed at the rate of 30% for condominium and homeowners' associations and 32% for timeshare associations.

- *Substantially Residential Test.* Substantially all of the units must be held for residential purposes (except in the case of timeshare associations).
- *60% Income Test.* At least 60% of the association's gross income for the tax year must consist of exempt function income.
- *90% Expenditure Test.* At least 90% of the association's expenses for the tax year must be for the purpose of carrying on one or more of the exempt functions of a condominium or homeowners' association. Timeshare associations must spend at least 90% during the taxable year for activities provided to *or on behalf of* their members.
- *Lack of Private Benefit Test.* No member may profit from the association's net earnings.

If a condominium or homeowners' association meets the "substantially residential test," it will also generally meet the 60% income test and the lack of benefit test. However, a condominium or homeowners' association with significant commercial operations or recreational or nonmembership activities may not meet the 90% expenditure test. If the association does not meet all of the tests listed above, it will be taxed under IRC Section 277 and must file Form 1120.

If a condominium association, homeowners' association, or timeshare association meets the preceding tests, it may elect to have IRC Section 528 apply. Treasury Regulation 1.528-8 requires that the election, which must be made annually, be made simply by filing Form 1120-H for the tax year *on a timely basis, including extensions*. (Extension forms should specify Form 1120-H. However, if the tax preparer has not determined whether to file Form 1120-H or Form 1120 by the filing date, Form 1120 should be specified. It seems logical that it is not the filing of an extension, but the actual filing of Form 1120-H that constitutes making an election under IRC Section 528. After Treasury Regulations Section 1.528-8 was issued, Treasury Regulations Section 301.9100-2 was released granting an automatic 12-month extension to make the election to have IRC Section 528 apply. The homeowners' association is required to take corrective action by filing an original or amended return for the year the election should have been made within that 12-month period for the automatic extension to be valid. Regulations Section 301.9100-3



provides guidance for extensions of time to make an IRC Section 528 election past that 12-month period. It seems that the IRS typically pays little attention to the "timely filing" requirement. The IRS usually takes little action other than to send letters to associations that have several years of delinquent returns (accompanied by Forms 1120-H for each of the delinquent years) requesting that the associations complete and file the forms.

**Substantially Residential Test.** As noted above, the substantially residential test does not apply to timeshare associations. For a condominium or homeowners' association to be considered residential, at least 85% of the units in the association must be used as residences on the last day of the association's taxable year. The 85% test is applied to a condominium and a homeowners' association as follows:

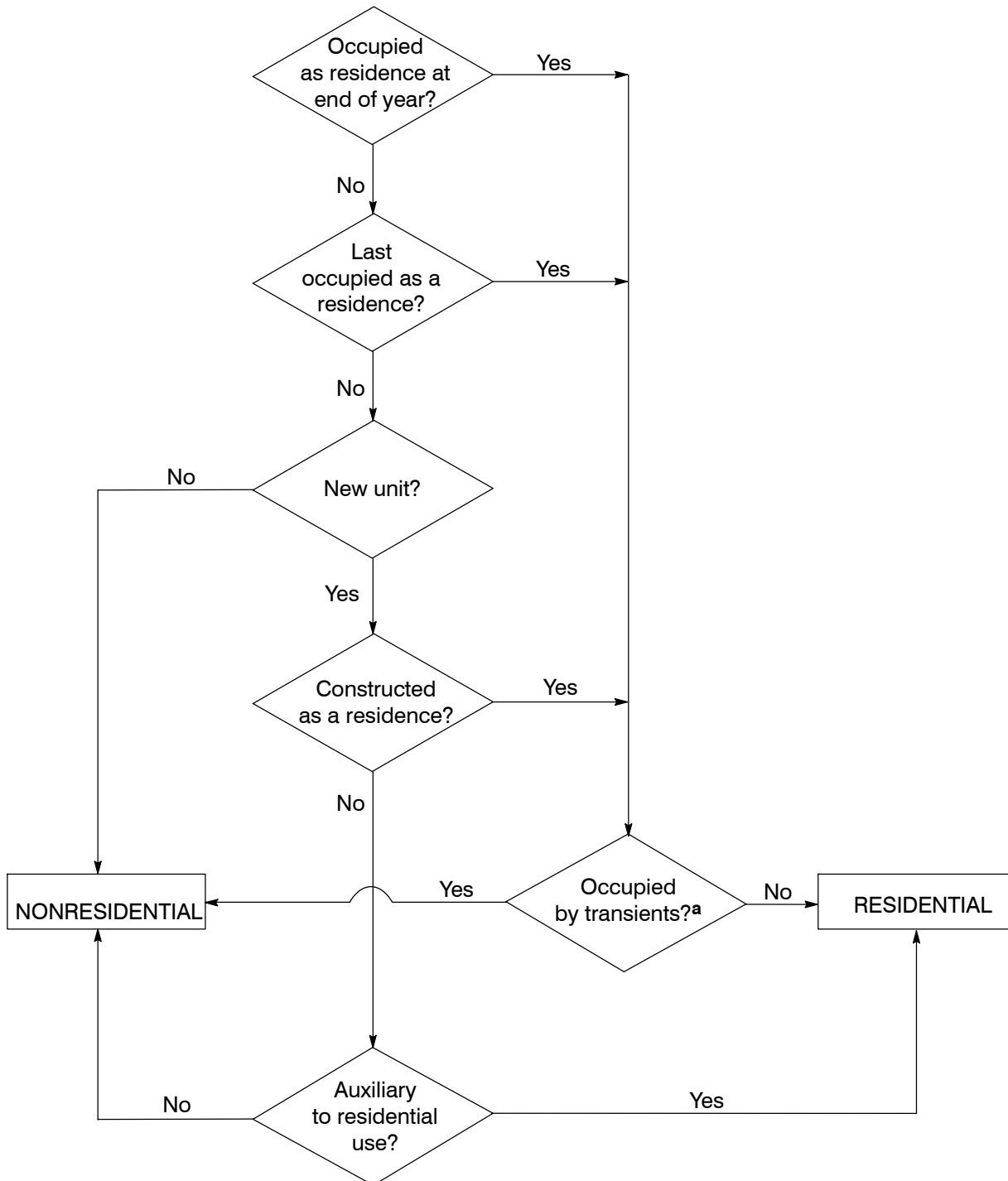
- *Condominium Associations.* 85% of the square footage of all of the units must be used for residential purposes.
- *Homeowners' Associations.* 85% of the lots must be zoned for residential use.

Some associations are mixed use in nature. An example is a high-rise association in the downtown area of a major city that has office or retail space on lower floors, with parking and residential space on upper floors. In such a case, the square footage for each different type of usage must be determined to properly calculate the 85% test. In the above example, parking space may also require an allocation between residential and nonresidential use. Each situation is unique and must be examined individually.

In making the 85% calculation, IRS regulations allow certain property to be considered as residential even though it is not occupied as dwelling units. For example, condominium associations may consider unoccupied units as residences if they were constructed for use as residences (in the case of new units) or if they were both constructed and used as residences (in the case of used units). Property that is not part of the units, such as swimming pools, tennis courts, storage rooms, and areas used by maintenance personnel, also is considered as residential. Similarly, in the case of homeowners' associations, lots zoned for residential purposes are included in the 85% calculation even if the lots are actually used for purposes such as parking areas, tennis courts, and swimming pools. However, commercial shopping areas and their parking lots are excluded from the calculation.

How does the residential test affect a purely recreational association that consists only of a pool, tennis courts, and other recreational facilities for the use of its members? Developers occasionally form two associations rather than one, with one association for recreational purposes and the other for dwelling purposes. Or, associations may divest themselves of their recreational facilities to form a second association. If membership in the recreational association is mandatory based on ownership of units or lots in the other association, the recreational association would appear to satisfy the substantially residential test of IRC Section 528. However, it might prefer to seek exemption under IRC Section 501(c)(7) as a recreational organization to avoid the 30% tax rate of Form 1120-H on its nonexempt function income.

The substantially residential test (which does not apply to timeshare associations) actually is a two-part test. Although a unit may be occupied as a residence at the end of the association's taxable year, a special provision applies if it is occupied for transient purposes. In that case, units are not considered as residential for purposes of the 85% test if, for more than one-half of the days in the year, each of the persons living in the unit occupies it for less than 30 days. Exhibit 2-7 presents a flowchart that may be used to determine whether property of a condominium association is residential or nonresidential for purposes of the substantially residential test. That determination can be particularly critical for resort condominium developments in which many of the units are held as second or vacation homes and rented out on a weekly basis.

**Exhibit 2-7****Residential Test for Condominium Associations****Note:**

- <sup>a</sup> Property that has been occupied for transient purposes cannot be considered as residential for purposes of the 85% test if, for more than one-half of the days in the year, each of the persons living in the unit occupies it for less than 30 days.

\* \* \*

**60% Income Test.** To qualify for taxation under IRC Section 528, at least 60% of the association's gross income for the year must consist of exempt function income; that is, it must be received from owners in their capacity as association members, rather than in their capacity as customers for goods or services. Amounts, such as qualifying contributions to capital reserves, that are excluded from the association's gross income are not considered in determining whether the association meets the 60% test, however. Consequently, it is not a good idea to transfer operating funds to reserve funds if that transfer would make the association fail the 60% test. Under IRS regulations, certain amounts in addition to membership dues, fees, or assessments may qualify as exempt function income. The IRS tests for determining exempt function income are discussed later in this lesson. The 60% test is performed before the calculation of taxable income and is completely independent of the calculation of taxable income.

**90% Expenditure Test.** An association (other than a timeshare association) cannot qualify under IRC Section 528 unless at least 90% of its expenditures are *qualifying expenditures*. For condominium and homeowners' associations, qualifying expenditures are either current operating expenditures or capital expenditures that are made for the acquisition, construction, management, maintenance, and care of *association property*. For timeshare associations, qualifying expenditures are those made for activities provided to or on behalf of their members. Association property is not precisely the same as common property. Generally, it is all property that provides benefits to the association members regardless of who actually owns the property. As defined for tax purposes, association property includes the following:

- a. Real and personal property owned by the association or by the members in common that benefits all of the members and enhances the enjoyment of their units. (Property in this category is the same as common property for financial reporting purposes.
- b. Certain property within the development that is owned privately by association members.
- c. Property owned by a governmental unit that benefits all of the members, such as roads, sidewalks, and streetlights.
- d. In the case of a timeshare association, property in which the timeshare association or its members have rights arising out of recorded easements, covenants, or other recorded instruments to use property related to the timeshare project.

The 90% test is performed before the calculation of taxable income and is completely independent of the calculation of taxable income. Many practitioners have failed to realize that these calculations are independent of each other. Expenditures that are "qualifying expenditures" for purposes of the 90% test may be allocated against nonexempt income for purposes of calculating taxable income. Association property excludes facilities that are set aside for nonmembers or are used primarily by nonmembers; e.g., property leased to groups of nonmembers for a meeting place.

For a condominium or timeshare association, association property includes all of the common property as defined in item a. above. For a homeowners' association, association property includes not only common property titled to the association as described in item a. but, in certain circumstances, also includes property owned by the individual homeowners or by a governmental unit. For example, expenditures incurred by homeowners' associations for exterior maintenance of privately owned units generally would be offset against exempt function income if the members' annual assessments encompassed that maintenance.

Qualifying expenses include *any* expenditures for association property, even if the property may result in nonexempt function income. Thus, for example, qualifying expenses include expenditures for recreational facilities that guests may use for a fee, provided that the recreational facilities are reserved for use primarily by members. The example presented in Exhibit 2-8 illustrates how the same expenses are treated differently for purposes of the 90% test and to calculate taxable income. However, qualifying expenses exclude expenditures related to commercial activities because that property is used primarily by nonmembers and, therefore, is not classified as association property. Similarly, qualifying expenses exclude expenditures related to an association's investments because that property does not enhance the members' enjoyment of their units and, thus, also is not classified as association

property. IRS regulations also stipulate that the following amounts are not treated as expenditures for purposes of the 90% test:

- Excess assessments that are refunded to members or applied against the following year's assessments.
- Transfers of funds to be held to meet future costs, such as roof replacement, even if the roof meets the definition of association property.

### Exhibit 2-8

#### Treatment of Expenses for Purposes of the 90% Test and the Calculation of Taxable Income

	90% Test		Taxable Income	
	Qualifying	Nonqualifying	Exempt Function	Nonexempt Function
Swimming Pool Guest Fee Income (represents 10% total usage)	\$ —	\$ —	\$ —	\$ 2,000
Swimming Pool Expenses				
Monthly Pool Service	2,000	—	1,800	200
Lifeguard	12,000	—	10,800	1,200
Reserve Expenditure—Acid Wash	4,500	—	4,050	450
Janitorial and Maintenance	6,000	—	5,400	600
Total Expenses	24,500	—	22,050	2,450
Net	\$ (24,500)	\$ —	\$ (22,050)	\$ (450)
	*	*	*	

Other expenditures specifically considered to be qualifying expenditures by Treasury Regulation 1.528-6 are legal fees (such as those incurred when litigating warranty claims against builders or developers), security, and insurance premiums on association property.

Expenditures that relate to both association property and nonassociation property should be allocated between the two for purposes of determining whether an association meets the 90% test. IRS regulations state that the allocation should be made on a "reasonable basis." One method for providing a reasonable basis is to estimate employee time devoted to specific activities, asset use, or consumption would constitute a reasonable basis. If an association depends on such expense allocations to meet the 90% test, it is a good idea for the allocations be documented.

Most associations qualify under the 90% expenditure test if they have only interest income and no commercial facilities or significant sources of nonexempt function income. When an association allocates only a minor portion of its management and accounting expenses toward nonexempt interest income, it typically loses only 1% to 2% of gross expenditures for the year, which is well within the 10% maximum allowed for nonexempt function activities. However, providing additional services that are not directly related to the acquisition, construction, management, maintenance, or care of condominium or homeowners' association property (e.g., providing a laundry facility, maid or valet services, extensive recreation services, meals, or health care facilities) may cause those associations to fail to meet the 90% expenditure test. Providing those services to timeshare associations may not affect their ability to qualify under the 90% expenditure test because the amendment to IRC Section 528 by the Taxpayer Relief Act of 1997 defines qualifying expenditures for timeshare associations as those made for activities provided to or on behalf of members of the association. A detailed discussion of that amendment to IRC Section 528 is beyond the scope of this course, but more information is available in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

**Lack of Private Benefit Test.** IRS regulations preclude qualifying homeowners' associations from distributing earnings to their members. Refunds of excess member assessments or fees, however, are not considered to be

distributions of earnings. Treasury Regulation 1.528-7 on inurement specifically addresses net earnings. Obviously, individual members benefit from the association's providing management and maintenance services and caring for association property. Since that is the primary exempt purpose of the association, such a benefit would not constitute inurement. Likewise, a developer may receive some intangible benefit from control over the association, generally by a two-class membership structure until a scheduled number of units is sold or a certain time period elapses, but that would not be considered inurement as long as there are no distributions of net earnings.

### Exempt Function Activities

Qualifying associations that elect to be taxed under IRC Section 528 are not taxed on the income from their exempt function activities. The tax rules exempt those associations from tax on income attributed to their specified statutory functions of acquiring and managing the property in the development. The presentation of exempt function income on Form 1120-H is discussed later in this lesson.

**Determining Exempt Function Income.** As previously explained, exempt function income basically consists of amounts received from association members solely as a function of their membership in the association. To qualify as exempt function income, income must meet the following four tests:

- *Source Test.* Generally, exempt function income must be received as membership dues, fees, or assessments from owners of residential units (in the case of a condominium association), residential lots (in the case of a homeowners' association), or rights to use or ownership interests in association property (in the case of a timeshare association). Amounts paid by a developer on unsold units or lots also are considered exempt function income even though the developer does not actually use the units or lots. Likewise, a litigation settlement with the developer for prior under-assessments is considered exempt function income. Income on membership assessments, such as interest, however, is not exempt function income.
- *Nature Test.* Amounts received from members must be paid solely as a result of membership in the association. As a general rule, they must be assessed ratably to all members. Amounts assessed based on the value or size of the property meet the nature test, but fees paid for services and per use admission fees do not, even though the amounts are paid by members and the facilities are restricted to members' use.

IRS regulations provide an exception to the preceding provisions by allowing special use fees to be classified as exempt function income if—

- Amounts are paid by members not more than once in any 12-month period.
- The privilege obtained from the payment of those amounts lasts for the entire 12-month period (or other period if the facility is not used for the entire 12-month period).

Thus, for example, yearly fees for use of recreational facilities are exempt function income.

- *Purpose Test.* Amounts received must be used for qualified purposes. Generally, a qualified purpose for this test is the same as for the 90% expenditure test.
- *Gross Income Test.* The gross income test excludes from exempt function income any amounts that the tax rules exclude from gross income. For example, the following amounts are not includable in an association's gross income and, therefore, are not exempt function income. (Thus, they should not be included on Line A of Form 1120-H.)
  - Tax-exempt interest.
  - Excess assessments that are refunded to members or are applied against future years. (However, excess assessments applied against a future year will be considered exempt function income for that year.)

- Assessments for capital improvements that are treated as capital contributions for tax purposes. The concept of capital contributions or capital improvements is identical to the concept of "contributions to capital" discussed earlier in this lesson. One of the most common errors made by tax preparers in filing Form 1120-H is in calculating the 60% test based on *total* member assessments. The test should be based on *operating* assessments only; that is, total assessments less capital assessments.

Exhibit 2-9 provides examples of classifying various income amounts as either exempt function income or nonexempt function income for condominium and homeowners' associations.

### Nonexempt Function Activities

As explained above, under IRC Section 528, associations are not taxed on their exempt function activities. Instead, they are taxed only on their nonexempt function activities. The tax is calculated on nonexempt function income less expenses appropriately charged to nonexempt function income. That amount, which is similar in concept to the unrelated business income of nonprofit organizations, equals "homeowners' association taxable income."

**Nonexempt Function Income.** Nonexempt function income results primarily from three principal sources: (a) revenue from nonassociation property, (b) revenue from nonmembers for use of association property, and (c) amounts charged to association members for specific services. The first category principally includes income from commercial operations and interest income (on both operating and replacement funds); the second category includes guest fees and other amounts received from nonmembers; and the third category generally includes all special use charges that are not assessed ratably to all members. Exhibit 2-9 provides examples of nonexempt function income for condominium and homeowners' associations.

**Charging Expenses to Nonexempt Function Income.** In calculating homeowners' association taxable income, nonexempt function income may be reduced by (a) expenses attributable solely to that income (such as state income taxes) and (b) other expenses that are "directly connected" to the nonexempt function income. Although the tax regulations provide little guidance on the other types of expenses that may be considered "directly connected," it can be inferred that they relate to the allocation of expenses for either facilities, services, or personnel that are used for both exempt and nonexempt functions. Court cases support the position that accounting and management fees may be allocated against investment income.

Exhibit 2-10 illustrates expenditures many believe can be allocated to various categories of nonexempt function income. The types of expenditures illustrated in Exhibit 2-10 may cause associations problems in meeting the 90% test if they exceed 10% of gross expenditures. It is not possible to list in Exhibit 2-10 every type of income or deduction that might occur for an association. Practitioners are urged to use the exhibit as a general guideline only; individual facts and circumstances may dictate different responses than indicated.

IRS regulations state that expenses with elements of both exempt and nonexempt activities should be allocated between them on a "reasonable basis." Although the regulations do not explain what constitutes a reasonable basis, one option is to estimate employee time devoted to specific activities, asset usage, or consumption. Also, it is a good idea to document the basis for the allocations in the accountants' tax working papers, although they need not be filed with the tax return itself. (Deductions were allowed in at least one court case even though there was no documentation.

One relatively new source of income for a number of associations has been lease income from telephone companies for granting space to locate cell phone towers on association property. It seems reasonable to allocate expenses against this income, particularly in the initial year. There is often considerable legal expense and management expense incurred in negotiating the agreement. Legal fees can generally be supported by invoices from the lawyer, while management expenses rely on an allocation based on estimated time spent performing various functions. Additional expenses would include estimates for allocation of insurance, security, possible janitorial costs, ongoing minor allocation of management costs, utilities if used by the tower, and allocation of tax preparation fee and audit fee. Because the income is passive in nature, expenses would be expected to be relatively minor in comparison to the income generated. Arrangements have commonly been seen wherein a lump sum payment is made in year one, which is intended to cover the entire first five or so years of the lease agreement. In such a situation, it is appropriate to record a liability for deferred income and recognize the income over the period.

**Exhibit 2-9****Tax Treatment of Certain Income Items  
for Condominium and Homeowners' Associations**

	SECTION 528		SECTION 277	
	Exempt Function Income	Nonexempt Function Income	Membership Income	Non- membership Income
<b>Type of income:</b>				
Member operating assessments	X		X	
Member assessments for major repairs and replacements (noncapital in nature) <sup>a</sup>	X		X	
Interest on delinquent member assessments <sup>b</sup>	X		X	
Fees, fines, and penalties charged to members <sup>b</sup>	X		X	
Transfer and move in/move out fees <sup>c</sup>	X		X	
Investment income (other than tax-exempt income <sup>d</sup> ) on both operating and replacement funds		X		X
Fees charged for services to members: <sup>e</sup>				
Laundry facilities		X	X	
Vending machine		X	X	
Community room rental		X	X	
Storage area rental		X	X	
Garage parking area <sup>f</sup>		X	X	
Key fees—nonrefundable <sup>g</sup>		X	X	
Recreation facilities		X	X	
Transportation van		X	X	
Dock and boat rentals		X	X	
Golf courses		X	X	
Restaurants		X	X	
Fees charged for services to nonmembers:				
Laundry facilities		X		X
Vending machine		X		X
Community room rental		X		X
Storage area rental		X		X
Garage parking area		X		X
Rental for unit owned by association		X		X
Guest fees		X		X
Resale certificates to prospective buyers		X		X
Recreation facilities		X		X
Dock and boat rentals		X		X
Golf courses		X		X
Restaurants		X		X
Utility pass-through charges <sup>h</sup>	X	X	X	
Litigation proceeds: <sup>i</sup>				
Payments in lieu of assessments	X		X	
Punitive damages		X		X
Imputed interest		X		X

**Notes:**

- a** Under IRC Section 277, member assessments for major repairs and replacements are nontaxable contributions of capital if they meet certain criteria. Under IRC Section 528, even member assessments for future major repairs and replacements that are considered to be noncapital in nature (for example, painting) are nontaxable because they relate to the CIRA's exempt function activities.
- b** Under IRC Section 277, late fees, fines, penalties, and interest on delinquent accounts from members are membership income because they result from transactions with members. There are differences of opinion, however, about whether they are taxable or nontaxable under IRC Section 528. Some accountants believe that they are taxable because they are not assessed proportionately to all members. They are similar to "if-and-when-used" charges, which are considered to be nonexempt function income. In the authors' opinion, however, these items are exempt function income because they are derived from owners in their capacity as owner-members rather than in some other capacity, such as customers for services. Furthermore, the legislative intent of IRC Section 528 is not to tax members of an association for doing on a mutual basis that which they could do on an individual basis and not be taxed. On an individual basis, the only taxable income is from other unrelated business activities.
- c** Under IRC Section 277, transfer fees and move in/move out fees are membership income because they result from transactions with members. For the reasons discussed in b above, there are differences of opinion about whether they are taxable or nontaxable under IRC Section 528. This course suggests that they are exempt function income.
- d** Interest on state or local government obligations is not taxable by statute.
- e** Under IRC Section 277, fees charged for services to members generally are considered to be membership income because they result from transactions with members. That conclusion is supported by Revenue Ruling 68-387, which held that "income derived from tenant-shareholders" of a cooperative housing corporation included amounts paid for the use of a swimming pool on an "if-and-when-used basis" because such payments are "associated with the occupancy of the corporation's property." Furthermore, proposed Regulation 1.277-1 required associations to allocate rents or lease income from concessionaires that operated facilities by charging fees between membership and nonmembership based on usage, and it permitted expenses to be allocated in that same proportion. Although the proposed regulation has been withdrawn, it does indicate IRS thinking on the matter. Under IRC Section 528, fees paid by members for services and per use admission fees are not exempt function income unless (a) amounts are paid by members not more than once in any 12-month period and (b) the privilege obtained from the payment of those amounts lasts for the entire 12-month period (or other period if the facility is not used for the entire 12-month period).
- f** Private Letter Ruling 8216056 stated, however, that parking fees received from members of a condominium association for assigned parking spaces are exempt function income because each owner owned a portion of the common area garage, and all were charged based on their pro rata share. Thus, income was derived based on their capacity as owners, not as customers receiving services.
- g** Refundable key fees should be recorded as a liability.
- h** Under IRC Section 277, utility pass-through charges are membership income because they result from transactions with members. Under IRC Section 528, those charges can be either exempt or nonexempt function income, as discussed later in this lesson.
- i** Litigation proceeds from developers for construction defect warranty claims may be contributions of capital in certain circumstances.

\* \* \*



**Exhibit 2-10****Tax Treatment of Certain Expenditure Items**

The items listed below are examples of expenditures that may be allocable against nonexempt function income. Note that only those expenditures directly connected to the activity may be allocated, and they must be allocated on a reasonable basis.

EXPENDITURE CATEGORY <sup>a</sup>	INCOME CATEGORY				
	Interest	Parking Garage	Vending/ Laundry	Community Room	Rentals
Accounting and bookkeeping activities	X	X	X	X	X
Investment management	X				
Audit fees	X	X	X	X	X
Tax preparation	X	X	X	X	X
Fidelity bond	X				
Insurance (liability, physical premises, personal property, vandals)		X	X	X	X
Management	X	X	X	X	X
Utilities		X	X	X	X
Repairs and maintenance		X	X	X	X
Security		X	X	X	X
Janitorial		X	X	X	X
Housekeeping					X

**Note:**

- <sup>a</sup> Those expenditures may cause condominium and homeowners' associations problems in meeting the 90% test if they exceed 10% of gross expenditures.

\*                      \*                      \*

As a result of the shale oil boom arising since 2010 in certain parts of the country, a number of associations have received income from the sale of mineral rights or from oil and gas royalty income. Allocable deductions would be similar to those discussed above, with the possible addition of a depletion deduction on royalty income. Depending on the amount of royalty income generated, the association may have difficulty meeting the 60% exempt function income test. Practitioners should carefully evaluate the association's ability to qualify for and file Form 1120-H.

**Portland Golf Club v. Commissioner.** Since associations are taxed on nonexempt function income less related expenses, it is beneficial to take advantage of all allowable allocations to reduce nonexempt function income. In *Portland Golf Club v. Commissioner*, the U.S. Supreme Court affirmed the Ninth Circuit's decision in *North Ridge Country Club v. Commissioner*, thus requiring nonexempt function activities to be profit motivated before losses from them may be offset against investment income. Effectively, the decision prevents offsetting losses from other activities against interest income.

Portland Golf Club, a 501(c)(7) exempt organization, is a private country club whose operations include a golf course and restaurant for its members, their guests, and nonmembers. Portland realized profits on sales of food to nonmembers based on its variable costs but always incurred losses after allocating fixed costs. In filing its income tax return, Portland offset those losses against the club's investment income. However, the Supreme Court held that the food sales activity lacked a profit motive and, therefore, could not be aggregated against interest income. The Court ruled that, since Portland allocated fixed costs to the food sales activity in determining whether the food sales showed a net gain or loss for income tax purposes, it could not use a different allocation method (i.e., allocating only variable costs) to support the contention that the food sales activity was profit motivated. Rather, the same

allocation method must be used in determining intent to profit as in computing actual profit or loss. Thus, while IRC Section 512 requires aggregation of activities for tax purposes, *Portland* refines that requirement to include only activities with profit motive.

The Court's reasoning was that "taxes are levied on unrelated business income (UBI) only in order to prevent tax exempt organizations from gaining an unfair advantage over competing commercial enterprises." Taxable income was defined as gross income less deductions directly connected with the production of that gross income but excluding exempt function income and deductions. Since *Portland* failed to support a profit motive, the food sale activity losses should not offset investment income. Congressional intent was that investment income of social clubs should be subject to federal tax, and Congress devised a definition of unrelated business taxable income (UBTI) with that in mind. Furthermore, "the statutory scheme for the taxation of social clubs was to achieve tax neutrality, not to provide these clubs with a tax advantage."

Although associations that elect IRC Section 528 using Form 1120-H are exempt organizations under IRC Section 528 rather than 501(c)(7) as is *Portland*, the preceding decision may still be significant to them since those associations are exempt organizations. The applicability of *Portland* to CIRAs that file Form 1120 under IRC Section 277 is discussed later in this lesson.

### Utility Pass-throughs

A detailed discussion of the differences in accounting for utility pass-throughs is beyond the scope of this course, but more information is available in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*. The accounting method selected may affect the tax shown on Form 1120-H.

- Increasing monthly assessments so that utility costs are *not* passed through or billing utilities separately and reporting gross utility revenues and expenses separately in the statement of revenues and expenses may disqualify an association from filing Form 1120-H. This is because nonmaintenance expenses such as janitorial costs and utilities related to unit owners' property versus association common property do not qualify as exempt function expenses for the 90% test.
- Reporting the net difference in the statement of revenues and expenses or handling the collections and disbursements through a clearing account on the balance sheet generally would not disqualify the association under the 90% test. However, additional problems arise if the revenues and expenses do not offset exactly. If the association attempts to recover its administrative costs or rounds a cable rate up to avoid taking a loss, it has potentially introduced a profit motive. An activity with a profit motive falls into the nonexempt function area. In addition, IRC Section 61 appears to require including utility pass-through revenues in gross income rather than netting them because it states that ". . . gross income means all income from whatever source derived."

Reporting gross utility revenues and expenses seems to be most appropriate.

Regulations Section 1.528-9(d) provides that, if billing and payment for services provided by an association are made just once during a tax year for the entire tax year, the payment is considered exempt function income. That exception may allow associations to bill annually for cable television or utility services to avoid unfavorable treatment as nonexempt income. However, the expenses would still be nonqualifying under the 90% test because IRC Section 528(c)(1)(C) requires that qualifying expenditures be made for the acquisition, construction, management, maintenance, and care of association property, not unit owners' property.

In determining the proper tax treatment of utility pass-through costs, accountants should remember that the legislative intent of IRC Section 528 is not to tax members of an association for doing on a mutual basis that which they could do on an individual basis and not be taxed.

### Deductibility of Interest Expenses

Borrowing money is often the least costly financing alternative available to CIRAs; it is often less expensive to pay interest on borrowed funds than to pay penalties on early withdrawals from long-term investments. Under other circumstances, if a CIRA is unable to raise sufficient funds through regular or special assessments to make

necessary repairs, borrowing funds will allow necessary repairs to be made. Reserve studies now frequently include loans as part of the funding plan.

The Internal Revenue Service holds the position that interest on loans of a CIRA is not deductible. This is based on the reasoning that the interest paid is directly related to the underlying purpose of the loan, generally to make repairs to the association's common areas. Since repairs to the association's common areas are exempt function expenditures under IRC Section 528, and membership deductions under IRC Section 277, the related interest payments are also exempt function or membership expenditures, and therefore nondeductible. IRC Section 528(d)(1)(b) is generally cited as the authority for denying the interest deduction, as that section states "the deductions allowed by this chapter [528] which are directly connected with the production of the gross income . . ." Since interest on loans taken out to make repairs to common area property is not considered to be directly connected with the production of gross income, the interest deduction is denied. This will probably hold true for the majority of association loans.

The same concept and language in tax law upon which the IRS is relying may also lead to a different conclusion under the right circumstances. Although the IRS has not issued a ruling on this subject, the IRS has informally stated that if the interest deduction is directly connected to the production of gross income, then it will be deductible. When an association can document that a loan is taken out solely as a financing decision—meaning it has more reserve funds on hand than the amount borrowed—then it can be established that the primary purpose of the loan is to preserve working capital, not to make repairs (as the repairs could clearly have been made from existing funds on hand). Accordingly, the interest deduction is directly connected to the production of interest income, and is therefore deductible. Such an assertion cannot be justified if the funds on hand are less than the amount of the loan.

It seems to make little difference whether Form 1120 or Form 1120-H is filed in performing the above-described analysis, so long as the relationship between interest deduction and production of interest income can be established. However, keep in mind that IRC Section 528 (Form 1120-H) requires that deductions be directly connected to the production of gross income, while IRC Section 277 (Form 1120) requires that the deductions only be reasonably related to the production of gross income.

### **Advantages and Disadvantages of Filing Form 1120-H**

Form 1120-H is specifically designed for qualifying homeowners' associations. In enacting IRC Section 528, Congress reasoned that individual homeowners would not be taxed for carrying out the functions typically performed by those CIRAs (that is, managing and maintaining the development's common property). Thus, the CIRAs should not be taxed on those activities merely because the homeowners form an association to carry out those activities on their behalf. Accordingly, would not an association always find it beneficial to file Form 1120-H rather than Form 1120? Not necessarily. The following chart describes the advantages and disadvantages of filing Form 1120-H:

#### **Advantages of Filing Form 1120-H**

1. Form 1120-H is a one-page form. It is easier to complete than Form 1120.
2. Less risk is associated with filing Form 1120-H.

#### **Disadvantages of Filing Form 1120-H**

1. Taxable income is taxed at a 30% (or 32% for timeshare associations) rate versus the regular corporate rates available when filing Form 1120.
2. Associations are not entitled to net operating loss deductions. The association may not claim a net operating loss generated during the year if a Form 1120-H is filed for that year, nor can the association carry the NOL forward. (However, while a net operating loss generated in a prior year when the association filed a Form 1120 may not be deducted in a year the association files a Form 1120-H, it can be carried forward and deducted in subsequent years on Form 1120 returns.)

**Advantages of Filing Form 1120-H**

3. Exempt function income is not taxable.
4. Large associations are not subject to the alternative minimum tax on Form 1120-H. (Small associations are not subject to AMT, as discussed later in this lesson.)
5. Some states exempt associations that file Form 1120-H from state income taxes.

**Disadvantages of Filing Form 1120-H**

3. Associations are not entitled to write off organizational costs.
4. Associations are not entitled to the deductions allowed under Part VIII of Subchapter B of the Code.

**Recommendations from This Course.** Accountants are encouraged to consider whether the income tax liability of their CIRA clients may be reduced through tax planning and filing Form 1120. If the financial affairs of a qualifying homeowners' association are properly structured, Form 1120-H, although simpler, rarely yields a lower tax than Form 1120. Even so, the additional risk associated with filing Form 1120 may not outweigh the tax savings.

It is a good idea to consider filing Form 1120-H in the following circumstances:

- The difference between the tax calculated on Form 1120 and Form 1120-H does not warrant the additional risk assumed by filing Form 1120.
- The risk of filing Form 1120 is too great due to a lack of compliance with IRS regulations and rulings.
- Cost-benefit considerations make filing the simpler return the better alternative.
- The association's taxable income is either (a) \$100 or less or (b) approximately \$186,200 or greater. In those circumstances, the 30% tax rate for condominium and homeowners' associations on Form 1120-H yields a lower tax than the regular corporate rates on Form 1120. (The breakeven point for timeshare associations, which are taxed at a 32% rate, would be different.)
- Form 1120-H may be preferable because of the effect of the alternative minimum tax on large associations when Form 1120 is filed.
- The association's total tax liability is lower because it can avoid state income taxes.

In most circumstances, a decision to file either Form 1120-H or Form 1120 is made by considering a combination of the preceding factors. How an overall tax plan for an association might include alternate use of both Form 1120-H and Form 1120 is discussed later in this lesson. *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* includes further information on Forms 1120 and 112-H.

**Tax-planning Opportunities When Form 1120-H Is Filed.** If the association decides it is preferable to file Form 1120-H, tax-planning opportunities should be considered to minimize the association's tax liability. The main tax-planning objective is to convert nonexempt income into exempt income. Generally, that is accomplished by the following methods:

- Eliminating user fees for facilities and increasing member assessments to compensate for the loss of income.
- Reducing user fee income to the point that the activity breaks even.
- Charging special-use fees only once during a 12-month period rather than on a per use basis.

A discussion of how Form 1120-H may interact with Form 1120 for effective tax planning is provided later in this lesson.

## Filing Form 1120-H

The procedures for filing Form 1120-H are as follows:

- a. Determine that the association is qualified to file Form 1120-H. Practitioners should perform the 60% and 90% tests very early in this process to make sure that the association will qualify. For most associations, the residential test (either qualifying or not qualifying) is a given based on the type of association and it is extremely rare to fail the private inurement test.
- b. Segregate exempt function income from nonexempt function income.
- c. Allocate expenses to nonexempt function income.
- d. Determine taxable income; i.e., nonexempt function income as determined in step b, less expenses allocated to nonexempt function income as determined in step c, less a specific deduction of \$100.
- e. Determine the association's tax liability.
- f. Compare the tax liability to that obtained by filing Form 1120 to see which tax return results in the lowest tax. Even if Form 1120 results in a lower tax, the circumstances listed above (particularly the risk of filing Form 1120) should be considered when determining which form to file.

For tax calculation purposes, only nonexempt function income and direct and allocable indirect expenses relating to nonexempt function income are shown on the return. Exempt function income and expenses are shown on the return but are not actually a part of the tax calculation process. Exempt function income is shown on Line B of the return, and exempt function expenses are shown on Line C. Thus, the calculations of the 60% and 90% tests for qualifying under IRC Section 528 can easily be made. Capital contributions are completely excluded from the return. Any subsequent reclassification of reserves to exempt function income would likewise avoid taxation.

One of the unique effects of filing a Form 1120-H is the tax treatment of excess exempt function income and expenses. With Form 1120-H, any excess of exempt function income over exempt function expenses avoids taxation, and any excess of exempt function expenses over exempt function income is lost. It does not become a carryover item.

As explained at the beginning of this lesson, association taxable income less a specific deduction of \$100 (which is preprinted on Form 1120-H) is taxed at a flat rate of 30% for condominium and homeowners' associations and 32% for timeshare associations. Additional considerations in determining the association's tax liability are as follows:

- Associations may qualify for the following tax credits:
  - Foreign tax credit.
  - Credit for fuels produced from nonconventional sources.
  - Qualified electric vehicle credit.
  - General business credit, but not the investment credit, the Indian employment credit, the work opportunity credit, the welfare-to-work credit, or the empowerment zone employment credit.
- Associations are not entitled to a net operating loss deduction.
- Associations are not entitled to the dividends received deduction or to write off organizational costs.
- Associations are subject to the capital loss limitation rules.
- Associations are not subject to the alternative minimum tax.

Form 1120-H has the same due dates and extension dates as other corporate tax returns. Due dates of corporate returns starting in 2016 were revised by the *Surface Transportation and Veterans Health Care Choice Improvement Act of 2015*. This act repealed Code Section 6072(b), which previously required corporate tax returns to be filed by the 15th day of the third month following year end (the 75-day rule). The repeal left corporations subject to IRC Section 6072(a) with a tax return due date of the 15th day of the fourth month following year end, except for June 30 year end corporations that are still subject to the 75-day rule.

Associations may file Form 7004 to receive an automatic extension for filing the return. (Form 7004 must indicate that the extended return is a Form 1120-H for that election to remain valid. However, if the tax preparer has not determined whether to file Form 1120-H or Form 1120 by the filing date, both returns may be specified on the extension form.) Although associations are not required to pay estimated taxes if they file Form 1120-H, it often is preferable for them to do so to avoid penalties if they ultimately decide to file Form 1120 instead (which requires estimates to be made). For all corporate year ends except June 30, the automatic extension period is for five months. For June 30 year end corporations, the automatic extension period is seven months.

### **Revoking the 1120-H Election**

Once an association has elected IRC Section 528 treatment for a tax year by filing Form 1120-H, it is considered binding; the election for a previously filed 1120-H may not be revoked without the consent of the IRS. Chief Counsel Advice (CCA) 201149023, issued December 9, 2011, provided clarification of the applicability of Treasury Regulation 301.9100-1-3 to revocation of the election. The Chief Counsel's office stated that the twelve-month extended time period for making an election does not apply to the revocation of the election. Consent of the commissioner is required to revoke the election. In Revenue Rulings 83-74, the IRS ruled that, under certain circumstances, it will allow revocation of the election because of inadequate tax advice provided by a professional tax advisor. However, in Revenue Ruling 82-203, a homeowners' association was not allowed to revoke IRC Section 528 elections made in previous tax years in order to obtain the benefit of a net operating loss incurred in a subsequent year. The IRS stated that would be taking advantage of hindsight at the government's expense.

Although the regulations clearly state that consent must be obtained from the commissioner to revoke an election, practitioners nationwide report that associations have successfully revoked their elections by simply filing amended returns changing from Form 1120-H to Form 1120 and attaching an explanation of the facts and a statement such as the following:

The amendment is made pursuant to the provisions of Revenue Ruling 83-74, which provide that an amendment may be made if the association originally filed Form 1120-H (copy attached) based upon erroneous advice from the tax preparer.

The attached Form 1120 represents an amendment to the Form 1120-H as originally filed.

However, that practice seems risky. An informal amendment changing from one form to the other (1120 to 1120-H or 1120-H to 1120) may be accepted by the IRS, but it still does not represent a valid revocation of election. Revenue Ruling 83-74 provides very specific guidance on obtaining relief from an inadvertent election. Failure to comply with specific formal procedures will be viewed by the IRS as the equivalent of having done nothing. If substantial tax is at risk, the authors believe that the appropriate procedure for revocation of election should be followed.

Exhibit 2-11 lists select citations about associations that have attempted to revoke their election under IRC Section 528, or have requested an extension of time to make the election under IRC Section 528.

**Exhibit 2-11****Selected IRC Section 528 Requests for Revocation and Extension**

<b>Requests for Revocation</b>		<b>Requests for Extension</b>	
<b>Approved</b>	<b>Denied</b>	<b>Approved</b>	<b>Denied</b>
8234102	8225136	8252031	8332020
8244028	8405104	8612017	8348021
8301026	8429049	8617019	8433077
8352100	8430945	9035045	9604009
8405104	8934038	9201022	
8405105		9250023	
8439045		9348018	
8604009		9413046	
8612010		9604009	
8627011		9816008	
8637056		9820011	
8644065		9931045	
86490125		200203027	
8704007		200511001	
8801003		200701009	
8804009		200752004	
8815019		201016008	
8824029		201126001	
8827054		201131004	
8831043		201210007	
8910024			
8940025			
8944029			
9003031			
9007022			
9042045			
9045019			
9102008			
9214020			
9233025			
9242018			
9315020			
9406032			
200034006			
200344017			
200652004			
201327008			

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**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. Which of the following statements best describes Form 1120-H?
  - a. To file Form 1120-H a CIRA must be classified as an incorporated homeowners' association.
  - b. Form 1120-H is the least common tax form filed by homeowners' associations.
  - c. Form 1120-H is more difficult to file but is considered to provide more favorable tax results.
  - d. To file Form 1120-H, a CIRA must meet four tests, including the substantially residential test.
11. The Cliffside Heights Homeowner's Association has the following properties. Expenditures made to maintain which property do **not** qualify as part of the 90% expenditure test?
  - a. A swimming pool complex open to all members.
  - b. A building leased to a local entrepreneurs group for meeting space.
  - c. The sidewalks and streetlights that adjacent to association residences.
  - d. Front lawns and flower beds of units owned individually by association members.
12. Which of the following would be considered exempt function income for a homeowners' association?
  - a. Fees paid by association members for services.
  - b. Excess assessments refunded to members.
  - c. Income earned on membership assessments.
  - d. Amounts paid by a developer on unsold units.
13. Which of the following is a disadvantage of Filing Form 1120-H?
  - a. The form has multiple pages.
  - b. More risk is associated with this form.
  - c. The association will be subject to the AMT.
  - d. The association will not get certain deductions.
14. Which of the following is one of the procedures for filing Form 1120-H?
  - a. Aggregate exempt function and nonexempt function income.
  - b. Estimate the association's typical tax liability.
  - c. Determine whether the association can file this form.
  - d. Compare the association's tax liability to that which could be filed on Form 990.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

10. Which of the following statements best describes Form 1120-H? **(Page 354)**
- a. To file Form 1120-H a CIRA must be classified as an incorporated homeowners' association. [This answer is incorrect. Incorporated homeowners' associations and unincorporated associations that elect to be taxed as corporations may elect to file Form 1120-H. Therefore, it is possible for an unincorporated homeowners' association to file this form.]
  - b. Form 1120-H is the least common tax form filed by homeowners' associations. [This answer is incorrect. Based on IRS statistics, Form 1120-H is the form *most* commonly used.]
  - c. Form 1120-H is more difficult to file but is considered to provide more favorable tax results. [This answer is incorrect. Form 1120-H is the *simplest* tax alternative, although generally it may be considered *less* favorable because net nonexempt function income is taxed at the rate of 30% for condominium and homeowners' associations and 32% for timeshare associations.]
  - d. **To file Form 1120-H, a CIRA must meet four tests, including the substantially residential test. [This answer is correct. IRC Section 528 specifies the following additional provision under which associations must qualify before they may file Form 1120-H: (1) the substantially residential test, (2) the 60% income test, (3) the 90% expenditure test, and (4) the lack of private benefit test.]**
11. The Cliffside Heights Homeowner's Association has the following properties. Expenditures made to maintain which property do **not** qualify as part of the 90% expenditure test? **(Page 357)**
- a. A swimming pool complex open to all members. [This answer is incorrect. As defined for tax purposes, association property includes real and personal property owned by the association or by the members in common that benefits all of the members and enhances the enjoyment of their units. Therefore, since this swimming pool complex is available to all members of the Cliffside association, it would be considered association property when applying the 90% expenditure test, so expenses made for maintaining the complex would qualify as part of the 90%.]
  - b. **A building leased to a local entrepreneurs group for meeting space. [This answer is correct. Association property excludes facilities that are set aside for nonmembers or are used primarily by nonmembers; e.g., property leased to groups of nonmembers for a meeting place. Therefore, expenditures for this building will not qualify as part of the 90% expenditures test for Cliffside.]**
  - c. The sidewalks and streetlights that adjacent to association residences. [This answer is incorrect. Per IRC Section 528, property owned by a governmental unit that benefits all of the members, such as roads, sidewalks, and streetlights, are considered association property for purposes of the 90% expenditure test. Therefore, expenses for maintaining this property would qualify as part of Cliffside's 90%.]
  - d. Front lawns and flower beds of units owned individually by association members. [This answer is incorrect. Under IRC Section 528, certain property within the development that is owned privately by association members can be considered association property. Expenditures for maintenance of such property will be part of Cliffside's 90% when applying the 90% expenditures test.]
12. Which of the following would be considered exempt function income for a homeowners' association? **(Page 359)**
- a. Fees paid by association members for services. [This answer is incorrect. Under the *nature test*, amounts received from members must be paid solely as a result of membership in the association. As a general rule, they must be assessed ratably to all members. Amounts assessed based on the value or size of the property meet the nature test, but fees paid for services and per-use admission do not, even though the amounts are paid by members and the facilities are restricted to members' use.]

- b. Excess assessments refunded to members. [This answer is incorrect. One of the tests of an association's exempt function income is the *gross income test*. Under this test, any amounts that the tax rules exclude from gross income are also excluded from gross function income. Therefore, examples of amounts not includable in an association's gross income (and, therefore, not considered exempt function income) include (1) tax-exempt interest, (2) excess assessments that are refunded to members or are applied against future years, and (3) assessments for capital improvements that are treated as capital contributions for tax purposes.]
  - c. Income earned on membership assessments. [This answer is incorrect. Income on membership assessments, such as interest, is not considered exempt function income because it does not pass the *source test*.]
  - d. **Amounts paid by a developer on unsold units. [This answer is correct. Generally, to pass the *source test*, exempt function income must be received as membership dues, fees, or assessments from owners of residential units (in the case of a condominium association), residential lots (in the case of a homeowners' association), or rights to use or ownership interest in association property (in the case of a timeshare association). Amounts paid by a developer on unsold units or lots also are considered exempt function income even though the developer does not actually use the units or lots.]**
13. Which of the following is a disadvantage of Filing Form 1120-H? **(Page 365)**
- a. The form has multiple pages. [This answer is incorrect. Form 1120-H is a one-page form. It is easier to complete than Form 1120.]
  - b. More risk is associated with this form. [This answer is incorrect. One of the advantages of filing this form is that a CIRA faces less risk when filing Form 1120-H.]
  - c. The association will be subject to the AMT. [This answer is incorrect. Large associations are not subject to the alternative minimum tax on Form 1120-H. Small associations are not subject to AMT, per the Code.]
  - d. **The association will not get certain deductions. [This answer is correct. Disadvantages of filing Form 1120-H include that the associations are not entitled to write off organizational costs or the deductions allowed under Part VIII of Subchapter B of the Code.]**
14. Which of the following is one of the procedures for filing Form 1120-H? **(Page 367)**
- a. Aggregate exempt function and nonexempt function income. [This answer is incorrect. When filing Form 1120-H, exempt function income and nonexempt function income should be *segregated*, not aggregated.]
  - b. Estimate the association's typical tax liability. [This answer is incorrect. To file Form 1120-H, the association's actual tax liability needs to be determined. A general estimation would not be enough information to complete this procedure.]
  - c. **Determine whether the association can file this form. [This answer is correct. The first step for filing Form 1120-H is to determine that the association is qualified to file Form 1120-H. Therefore, this procedure must be completed before any others related to this tax form.]**
  - d. Compare the association's tax liability to that which could be filed on Form 990. [This answer is incorrect. One of the procedures for filing Form 1120-H is to compare the tax liability to that obtained by filing *Form 1120* (not Form 990). Even if Form 1120 results in a lower tax, there are other considerations that should be made before determining which form to file.]

## TAXATION UNDER IRC SECTION 277 (FORM 1120)

### Applicability of IRC Section 277

**Condominium and Homeowners' Associations.** As explained at the beginning of this lesson, if *condominium associations, homeowners' associations, or timeshare associations* do not elect to be taxed under IRC Section 528 and file Form 1120-H, they are taxed under IRC Section 277 and must file Form 1120. IRC Section 277 applies to *certain membership organizations formed primarily to provide services to members that are not exempt under any other section of the Code*. Although IRC Section 277 was initially enacted to apply to social clubs, it is clear from the language of IRC Section 277 that it is a mandatory section that applies to all nonexempt membership organizations.

Beginning in 1992, IRS private letter rulings relating to the revocation of an election under IRC Section 528 specifically state that IRC Section 277 will apply when the IRC Section 528 election is revoked.

**Cooperative Housing Corporations.** Beginning with tax years ending on or after December 31, 2006, the IRS indicates that all subchapter T cooperatives should file Form 1120-C. The requirement to use Form 1120-C was proposed to be effective for taxable years ending on or after December 31, 2006. Because the regulations were not finalized before the end of 2006, the final regulations, which amend IRS Section 1.6012-2(f) (found in TD 9336), delay the proposed effective date. (The IRS website at [www.irs.gov](http://www.irs.gov) provides .pdf documents of Form 1120-C and the related instructions for filing the new federal tax form.) In the past, accountants have had differing opinions about whether IRC Section 277 applies to *cooperative housing corporations*. The IRS ruled in Revenue Ruling 90-36 that cooperatives are to be taxed under IRC Section 277 by stating that "Section 277 of the Code applies to limit the deductions of cooperative housing corporations, as defined in Section 216(b)(1)." However, several court cases (*Landmark, Inc. v. the United States*; *Buckeye Countrymark, Inc. v. Commissioner*; *Trump Village Section 3, Inc. v. Commissioner*; and *Thwaites Terrace House Owners Corp. v. Commissioner*) reached the opposite conclusion by holding that the named cooperatives are not subject to IRC Section 277 because they are subject to subchapter T (IRC Section 1381) of the Code.

As a result of the efforts of a task force comprised of the National Association of Housing Cooperatives, the Council of New York Cooperatives, and the Federation of New York Housing Cooperatives, the Section 277 issue has apparently been resolved. The IRS in 1999 agreed that *all* cooperatives are covered by subchapter T (not Section 277) and has indicated that it will no longer assert IRC Section 277 against a cooperative in any pending or new audit, or in dealing with refund claims. Cooperatives that filed under IRC Section 277 for any year should file a claim for refund (if applicable) under subchapter T. This applies to any years still open under the three-year statute of limitations. Subchapter T and other tax issues unique to cooperative housing corporations are discussed more fully in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

### General Rules

IRC Section 277 is not a comprehensive set of rules for taxing membership organizations. Instead, it was added to the Internal Revenue Code to prevent taxable membership organizations from avoiding tax on nonmembership income by operating membership activities at a loss and using that loss to offset the nonmembership income. Thus, IRC Section 277 focuses primarily on the activities of and deductions incurred by membership organizations. It states:

In the case of a . . . membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year attributable to furnishing . . . items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members.

When taken in conjunction with IRC Section 118, which states "contribution to the capital of the taxpayer does not include any . . . contribution as a customer or potential customer," an association is effectively confined to a very narrow and strict set of rules. Those two sections define member activities and state that any amounts received from members must apply either as a capital contribution or as membership income. Furthermore, the Committee Reports to IRC Section 118 state that it is the *expenditure of funds that determines the nature of the activity*. Thus, if an association makes a capital assessment, then expends the monies on membership activities in the same year,

the IRS would recharacterize the assessments as membership income. (However, see the discussion earlier in this lesson on transfers between reserve funds and operating funds in years after they were collected.)

Under IRC Section 277, CIRAs are taxed on their nonmembership activities just as they are taxed on their nonexempt function income under IRC Section 528. In addition, they may also be taxed on any excess of membership income over membership expenses. That provision differs from IRC Section 528, under which all of an association's exempt function income is not taxable. Unfortunately, most of the guidance for filing tax returns under IRC Section 277 is not found in the Internal Revenue Code—the Code section itself is less than one page long. Thus, the guidance in this lesson is based on Revenue Rulings, Private Letter Rulings, Tax Court case law, and the proposed, but later withdrawn, Regulation 1.277-1. Additionally, Revenue Ruling 2003-73, which applies to organizations subject to IRC Section 277, restates the positions originally set forth in Proposed Regulation 1.277-1.

## Membership and Nonmembership Income

Under IRC Section 277, CIRAs are taxed on both net membership and net nonmembership income. Accordingly, they must segregate (a) membership and nonmembership income and (b) membership and nonmembership expenses.

**Membership Income.** Membership income is the gross income received by a membership organization from its members in consideration for membership activities. In most respects, membership income is similar to exempt function income under IRC Section 528 and, thus, includes membership assessments and other amounts that are assessed ratably to members. However, it also includes fees paid for services by members that are considered nonexempt function income under IRC Section 528. (See Exhibit 2-9.) Interest income paid by members if their initial membership fees are paid in installments is classified as membership income. In addition, interest income on delinquencies is also classified as membership income. In contrast, interest income on investments is classified as nonmembership income.

Technical Advice Memorandum (TAM) 9637007 addressed the question of whether a social club that operates a golf and country club could treat the proceeds from the sale of condominium units developed by the club on unused property as membership income. The purchasers were required to become members of the club prior to their purchase of the condominium units. The TAM stated that such sales were membership income and that the development and selling costs of the units were deductible only against membership income.

Although TAM 9637007 cannot be cited as a precedent and applies only to the subject taxpayer, it addresses another question about which there has been disagreement. Some accountants believe that only recurring-type transactions for which the CIRA was formed qualify as membership transactions. The TAM clearly shows that nonrecurring transactions may qualify as long as they involve only members of the CIRA.

**Nonmembership Income.** Nonmembership income is defined by exception; it is gross income exclusive of membership income. In concept, nonmembership income is similar to unrelated business income of tax-exempt organizations. It results primarily from two principal sources: (a) income on investments and (b) income from commercial operations and other services provided to nonmembers.

**Examples of Membership and Nonmembership Income.** Exhibit 2-9 provides examples of classifying various income amounts as either membership income or nonmembership income.

## Membership and Nonmembership Deductions

Tax rules do not provide specific guidance about allowable deductions under IRC Section 277. Instead, all of the tax rules that apply to the deductibility of expenses by corporations also apply to associations. Expenses incurred by CIRAs are required to be allocated against membership and nonmembership income. Membership deductions are broadly defined only in proposed Regulation 1-277.1 (which has been withdrawn) as “the expenses, depreciation, and similar items of deduction attributable to membership activities.” Nonmembership deductions are defined as all expenses other than membership deductions. The only guidance about allocating deductions between membership and nonmembership activities (also provided in proposed Regulation 1-277.1) states that “items of deduction attributable in part to nonmembership activities and in part to membership activities shall be allocated between the two classes of activities on a reasonable and consistently applied basis.”

Nonmembership deductions include deductions that are directly attributable to nonmembership income, such as expenses associated with commercial activities. More frequently, however, they will consist of costs that relate to activities used by both members and nonmembers that should be allocated between the two activities. For example, if recreational facilities such as tennis courts or golf courses are available to both members and nonmembers, costs such as utilities, maintenance, and insurance should be allocated between membership and nonmembership income. Generally, the authors believe that estimates of employee time devoted to specific activities, asset usage, or consumption would constitute a reasonable basis for allocation.

**Allocating Expenses to Investment Income.** The only type of nonmembership income that many CIRAs have is interest income. In that case, a portion of indirect expenses (such as audit and accounting fees, tax preparation fees, clerical office expenses, management fees, fidelity bonds, and state income taxes) may be considered as nonmembership expenses and be used to offset interest income. In *Concord Consumers Housing Cooperative v. Commissioner*, the Tax Court did not dispute that some portion of certain expenses was allocable to nonmembership interest income and allowed a 5% deduction of certain expense categories even though no written documentation existed to support such deductions. According to the Court in that case, the following services provided by a management company could be allocated against interest income:

- Preparing financial statements.
- Making reports to the board of directors (that is, attending board meetings).
- Reviewing investments.
- Making requests to withdraw monies.
- Reconciling interest.
- Checking interest rates at various financial institutions.
- Changing financial institutions or moving accounts at financial institutions.
- Making requests for reimbursements from reserve funds.

The decision in *Concord Consumers Housing Cooperative* seems to give CIRAs some latitude in claiming minor allocations against nonmembership interest income although there is no specific written documentation; however, written documentation is much superior evidence. The Court's decision provides associations and management companies with guidelines on how to calculate the portion of their expenses or fees that associations may deduct against nonmembership interest income. Best practices suggest that accountants advise their CIRA clients to encourage management companies to allocate their management fees to appropriate nonmembership activities and, preferably, to invoice separately for that amount. Similarly, the portion of accountants' fees for audit, accounting, and tax services that relate to nonmembership activities also should be invoiced separately.

**Allocating Expenses to Other Categories of Nonmembership Income.** In addition to expenditures for management, financial, and tax services, it is possible that expenses such as insurance, utilities, repairs and maintenance, security, and janitorial services can be allocated to types of nonmembership income other than investment income.

### **Determining Net Income or Loss**

After segregating both income and expenses into membership and nonmembership categories, CIRAs will arrive at net membership income or loss and net nonmembership income or loss. In determining net nonmembership income, income and losses from all nonmembership activities may be aggregated. Thus, interest income may be offset by losses from other nonmembership activities, provided that the nonmembership activities are profit motivated. See the discussion of *Portland Golf Club v. Commissioner* both below and earlier in this lesson.

A CIRA's tax liability under IRC Section 277 depends on whether membership and nonmembership activities result in income or loss as follows:

### Membership Activities

**Net membership income**—Consider deferring tax on net membership income by electing under the provisions of Revenue Ruling 70-604 (as modified by Revenue Rulings 75-370 and 75-371) to either (a) apply the excess net membership income to the following year or (b) refund the excess net membership income to the association's members.

**Excess membership deductions**—The excess membership deductions must be carried forward to offset net membership income in future years. Under the provisions of IRC Section 277, it may not be carried back nor may it be offset against net nonmembership income.

### Nonmembership Activities

**Net nonmembership income**—Net nonmembership income is taxed at regular corporate rates.

**Net nonmembership loss**—Net nonmembership losses are treated as net operating losses under IRC Section 172.

**Net Nonmembership Loss When No Profit Motive Exists.** *Portland Golf Club v. Commissioner* raises an interesting question about the nature of a loss from an activity for which profit motive cannot be documented. The income and expense of the activity meet neither the definition of exempt income or expense for an exempt organization nor membership income or expense for a nonexempt membership organization. The *Portland* case prohibits combining such a loss with profit-motivated nonmembership activities (such as investing activities) to reduce or eliminate taxable income. Combining the loss with membership activities may not be appropriate because the CIRA might conclude it had an IRC Section 277 carryover when, in fact, the loss might be masking taxable membership income. Consequently, it would be better to treat the loss as a net operating loss from a specific activity that the association could carry forward.

### Using Revenue Ruling 70-604 to Defer Tax on Net Membership Income

**Basic Provisions.** Revenue Ruling 70-604 allows CIRAs to remove any *excess membership assessments* from taxable income by effectively refunding the excess assessments to the members. (This course uses “excess membership assessments” and “net membership income” interchangeably.) Under the revenue ruling, associations may make an annual election to exempt or defer net membership income from taxation by, in effect, returning the excess to its members. As stated in the revenue ruling, associations have the following options:

- Apply the excess of membership income over membership expenses to the following year's assessments.
- Refund the excess of membership income over membership expenses to the association's members. (However, accountants should be wary of this alternative, as it could conflict with certain state statutes.)

Accountants should use caution in applying Revenue Ruling 70-604. The IRS has specifically stated that the ruling allows only a *one-year* carryover of excess membership income. In addition, in 2009, the IRS issued Information Letter 2009-0233, clarifying that an association cannot use Revenue Ruling 70-604 to accumulate a working capital reserve. In 2013, IRS reaffirmed that position in Information Letter 2013-0013. Further, the IRS has suggested that Revenue Ruling 70-604 may not be used by timeshare associations. That ruling may have implications beyond the timeshare industry if the IRS applies it in audits of other CIRAs, such as condominium and homeowners' associations.

**Making the Election.** There is virtually no authoritative guidance about how associations may properly make a 70-604 election although the revenue ruling has been in effect since 1970. Frequently encountered issues about making the election and recommendations for addressing them are discussed below.

a. *The 70-604 election should be made by the members.*

Recent audit activity indicates that IRS agents are requiring the election to be made by the members. Absent clarification, it is best practice for associations to interpret the wording of Revenue Ruling 70-604 literally and make the election in the form of a resolution adopted by the membership. Furthermore, it is a good idea for the board of directors of the association to reaffirm that election, since under most state laws and governing documents only the board has authority to determine the disposition of funds of the association.

b. *The 70-604 election must be made before the tax return is filed.*

Revenue Ruling 70-604 simply states, "A meeting is held each year. . . ." It does not specify whether the meeting should be held before year end or merely before the tax return is filed. Tax rules do not establish a consistent time for making tax elections; rather, the timing of most tax elections is spelled out either in the Internal Revenue Code, regulations, revenue rulings, or other authoritative tax sources. The timing of the 70-604 election is not addressed, however. Thus, to minimize the risk of losing the benefit of the election, it is best for associations to make the election before the end of the fiscal year for which it is to apply. The election *must* be made before the tax return is filed.

c. *It is not necessary to state the specific dollar amount of excess membership income in the election.*

Since the 70-604 election should preferably be made before year end and the excess membership income cannot be determined until after the end of the year when separate calculations of membership and nonmembership income are made, some accountants recommend that associations make the election, but leave a blank for the amount to be filled in later. When the specific amount is determined, it could be documented in the minutes of an association meeting and added to the resolution. However, it may not be necessary to include a specific dollar amount in the resolution because Revenue Ruling 70-604 literally states that "any excess assessments" may be carried over or refunded. Some accountants also believe that it is prudent not to specify a dollar amount in the election. Thus, if an association is audited and a capital contribution denied or the allocation of expenses questioned, a blanket 70-604 election serves to keep the membership income untaxed.

d. *The 70-604 carryover of excess membership income over membership expenses that is applied to the following year's assessments should be included on Schedule M-1 (or M-3) on the association's tax return.*

It is a best practice for the carryover to be shown as a Schedule M-1 (or M-3) adjustment since (as a tax-only election) it is not recorded in the financial statements. Associations that file Form 1120 will have either a Revenue Ruling 70-604 net membership income carryover (70-604 carryover) or an IRC Section 277 net membership loss carryover (277 carryover) at the end of each tax year. Only if the association had net membership income equal to zero at the end of the tax year could a different situation result. Since that situation is highly unlikely to occur at any given year end, either a 70-604 carryover or a 277 carryover will generally result. The two carryovers cannot coexist at year-end, as the larger carryover will offset (or use up) the other carryover. For example, a 70-604 carryover from Year 1 gets carried into Year 2. It may remain unchanged (if the net membership income equals zero, which is unlikely), it may increase as the result of additional net membership income generated in Year 2 [and assuming that you subscribe to the theory that 70-604 carryovers continue indefinitely (see point e.)], or it may decrease as a result of being offset (reduced) by net membership losses generated in Year 2. If the IRC 277 losses generated in Year 2 exceed the 70-604 carryover from Year 1, then a 277 loss carryover will exist at the end of Year 2 and will carry over to Year 3. (See Exhibit 2-12 for a graphic presentation of the treatment of 70-604 and 277 carryovers.)

e. *It does not seem appropriate for 70-604 carryovers to a subsequent year to be made indefinitely.*

While many tax practitioners believe that Revenue Ruling 70-604 permits an indefinite carryover of excess membership income, this course suggests that Revenue Ruling 70-604 be construed as a *one-year only*



carryover allowance. Although the indefinite carryover position is prevailing industry practice, the one-year only carryover position is supported by the following:

- Revenue Ruling 70-604 states the association should "have the excess applied to the following year's assessments." Note that the ruling uses the singular term "year's" rather than the plural term "years'."
- General Counsel Memorandum (GCM) 34613 clearly states that the carryover is a one-year only carryover.
- Technical Advice Memorandum 9539001 indicates that Revenue Ruling 70-604 was intended to be a one-year only carryover.
- 98ARD 176-4, FSA 1992-0208-1 states, "It is our view that Rev. Rul. 70-604 is an exercise of administrative authority to provide a convenient tool for condominium management associations to deal with an inadvertent collection of excessive membership payments for a *given year* [emphasis added]. In effect, it is an exception to the general rule of IRC Section 61 which would otherwise require any excessive assessment to be fully taxable in the year collected. As such, the revenue ruling should be strictly construed . . . If a decision is made to apply the excess to the next year's assessments and that in fact does not occur, the excess is taxable because the amount has not, in effect, been returned to the members, which is the underlying theory of the revenue ruling. *We do not read the ruling as providing authority to continually carry over that excess amount beyond the next year* [emphasis added]."
- The draft IRS *Timeshare Vacation Plan Owners Associations Audit Techniques Guide* (dated April 28, 1999) states that Revenue Ruling 70-604 is a one-year only carryover.

The IRS has also consistently held to the one-year interpretation in recent IRS tax audit activity. Several significant IRS deficiency notices have been issued against associations on that subject.

- f. *If an association has been carrying over excess membership income indefinitely from year to year, the association should take the following steps regarding unused carryover amounts from previous years in the year that the association decides to implement the one-year only carryover provision.*

When the decision is made to implement the one-year only carryover provision, the carryover amount will be reduced. There is no official guidance that addresses the correct procedure for reporting that reduction. However, the IRS recommends that (1) amended returns for the affected years be filed or (2) the carryover be recognized as taxable income in the current year. One IRS official has indicated that he believes an amendment of prior year returns is the correct procedure. The association, not the accountants, should make the decision about whether or not amended returns will be filed. Treasury Regulation 1.172-1(c) indicates that any carryovers to a current tax year should be corrected on the current year's tax return.

It is a best practice to make a disclosure of the change in the carryover amount in the return. Therefore, a statement should be included in the current year's return showing the recalculation. An example of possible wording of the statement is as follows:

Disclosure of Change in Carryover	
Carryovers as shown on 20X5 tax return:	
Revenue Ruling 70-604 carryover	\$ 29,660
Adjustment to carryover:	
Reduction of carryover to reflect one-year carryover only	<u>(23,743)</u>
Corrected carryover to 20X6:	
Revenue Ruling 70-604 carryover	<u>\$ 5,917</u>

- g. *If an association has been filing Form 1120 and has an excess membership income carryover to the following year, and upon a change of accountants, the association files a Form 1120-H instead of a Form 1120 for the following year, the status of the carryover may be subject to interpretation.*

Accountants have differing opinions on this issue. Three alternatives are possible:

- (1) The filing of Form 1120-H eliminates further carryover.

Accountants holding this position place their reliance on current IRS audit posture; that is, that the IRS tends to stop looking backwards in time once they encounter a year in which the association filed Form 1120-H. However, no justification in tax law has been found for permanently suspending carryovers of excess membership income because a Form 1120-H is filed in an intervening year. That treatment would prevent the remaining excess from ever entering into the calculation of future association income, which likely would be unacceptable to the IRS.

There are similar examples of tax law that would indicate that no such interpretation would be valid:

- Proposed Treasury Regulation 1.277-1 states “Change in status—If in any taxable year a membership organization ceases to operate as such an organization. . . , a net membership loss sustained by such organization in a prior taxable year may not be carried over to such a taxable year.”
- C corporation loss carryovers may not be carried over to a year in which the corporation changes its status to S corporation (*St. Charles Investment Company vs. Commissioner*).
- IRC Section 1371(b)(2) prohibits carryovers to or from a year in which an S election is in place.
- IRC Section 528(d)(2)(b) prohibits deduction of a net operating loss for any year in which an association makes an election to file Form 1120-H.

- (2) The association calculates the excess that would have been applied if Form 1120 had been filed rather than Form 1120-H and carries the adjusted excess forward to future Form 1120 years.

Accountants holding this position generally cite Treasury Regulation 1.528-9, Exempt Function Income, which states, “regardless of the organization’s method of accounting, *excess assessments during a taxable year which are either rebated to the members or applied to their future assessments are not considered gross income and therefore will not be considered exempt function income for such taxable years*. However, if such excess assessments are applied to a future year’s assessments, they will be considered gross income and exempt function income for that future year.”

There seems to be no basis for this position as the definitions of *member income* and *expense* used in Form 1120 are different than the definitions of *exempt function income* and *expense* used in Form 1120-H. There cannot be a carryover from one year to the next because of the differing calculations of the carryover. For example, while fees received from members for services are considered nonexempt function under IRC Section 528 and are part of the calculation of taxable income, fees received from members for services are considered member transactions under IRC Section 277 and do not enter into the calculation of taxable income. Since the language of both Revenue Ruling 70-604 and Treasury Regulation 1.528-9 refer to a carryover of *excess assessments*, and the calculation of excess assessments is different under each tax form, a carryover from a nonexempt membership organization (Form 1120) to an exempt organization (Form 1120-H) cannot reasonably be made.

- (3) The suspended carryover “passes through” the year in which the Form 1120-H was filed to the next year in which the association files a Form 1120.

This alternative seems to have support from the existing body of tax law because (a) the definitions of income and expense are different on Forms 1120 and 1120-H (membership/nonmembership vs.

exempt function/nonexempt function) and (b) the concept in alternative 2 is similar to the treatment of losses or income when a corporation elects between C or S corporation status; that is, the income or losses are frozen until the former status is regained. Treasury Regulation Section 1.277-1(e)(2) specifically addresses the issue of loss carryovers by stating that the loss may not be carried over to a year in which there is a "change in status" of the organization.

- h. *If an association had an excess of membership income over membership expenses in the prior year that was not included in taxable income but the association did not make a 70-604 election (or made an inadequate election), a successor accountant should take the following action.*

First, the successor accountant can review the association's tax returns for several prior years to determine whether a prior IRC Section 277 loss carryover would offset the net membership income of the immediately prior year. If that is not the case, the association may not have a valid 70-604 carryover into the current year since no election was made. Instead, the successor accountant could notify the association that the prior-year income tax return was improperly prepared and suggest the return be amended.

### Exhibit 2-12

#### Interaction of 70-604 Income Carryovers and Section 277 Deduction Carryovers (Assuming Only a One-year Carryover)

Tax Year	1	2	3	4	5	6	7
Current year's net membership income (loss)	\$ 5	\$ 3	\$ (5)	\$ (1)	\$ 4	\$ (3)	\$ 2
<b>ACTION TAKEN</b>							
1 70-604 election	(5) → 5						
Subtotal		8					
2 70-604 election		(3) → 3					
Subtotal			(2)				
3 277 loss carryover <sup>a</sup>			2 → (2)				
Subtotal				(3)			
4 277 loss carryover <sup>a</sup>				3 → (3)			
Subtotal					1		
5 70-604 election					(1) → 1		
Subtotal						(2)	
6 277 loss carryover <sup>a</sup>						2 → (2)	
<b>TAXABLE NET MEMBERSHIP INCOME</b>							
	<u>\$ 0</u>	<u>\$ 5<sup>b</sup></u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>

**Notes:**

- <sup>a</sup> This action is automatic; no election is required.
- <sup>b</sup> This illustration treats the amount carried over from Year 1 but not "used up" as being taxable in Year 2. However, at least one IRS official believes that an amendment would be required to the Year 1 tax return rather than having the excess amount taxed in Year 2.

\* \* \*

**Recommendations from This Course**

**Making the Election.** It is a best practice for every residential association to make a formal 70-604 election. Under the election, any excess membership income is excluded from taxable income. Thus, only net nonmembership income is subject to tax at regular corporate rates (for example, 15% of the first \$50,000 of taxable income). By failing to make the election, the excess membership income would be taxed along with the net nonmembership income, possibly at higher tax rates. If the circumstances indicate that a 70-604 election would not apply to a particular year (for example, because an association did not have excess membership income), it simply may be ignored.

Some CIRAs do not make a formal election under Revenue Ruling 70-604. Instead, they "make" the election merely by filing the tax return with the appropriate calculations. In the *Mission Heights Homeowners' Association* case, an association filed Form 1120 but made no formal effort to document its election under Revenue Ruling 70-604. The Court ruled that the association had not made an election under Revenue Ruling 70-604, so the association's excess assessment income became taxable. Thus, if an association does not properly make a formal election, it does not seem to have a valid 70-604 carryover. Absent the election, preparers may be subject to penalties for taking a position on a tax return without "substantial support." (As stated above, recent IRS activity has shown that the 70-604 election must be made by the *general membership*.)

**Applying Revenue Ruling 70-604 to Nonresidential Associations.** The issue of whether Revenue Ruling 70-604 applies to nonresidential associations has not been settled by the IRS. Through recent audit activity of nonresidential associations, the IRS asserted, in a 1994 District Office technical advice letter, the position that Revenue Ruling 70-604 only applies to residential associations. However, in a June 1995 technical advice memorandum (TAM 9539001), the National Office of the IRS ruled that Revenue Ruling 70-604 did not apply to a nonresidential association (a timeshare development) because *the scope of its activities far exceeded the scope of the activities of the association covered by the revenue ruling*. The TAM did not explore the issue of whether a *nonresidential* association qualifies to use Revenue Ruling 70-604. Since the memorandum was addressed to a nonresidential association, an inference may be drawn that *residential or nonresidential* is not the determining factor for application of Revenue Ruling 70-604 but rather the determining factor is the scope of activities of the association. Following that logic, it may be possible for a nonresidential association, such as an office condominium, to apply Revenue Ruling 70-604, depending on the scope of its activities. Accountants should be alert for future developments.

**Applying Excess Membership Income to Replacement Funds.** Applying excess membership income to replacement funds is not permissible under Revenue Ruling 70-604. However, it may be possible under the provisions of IRC Section 118. The IRS has taken the position in General Counsel Memorandum (GCM) 37857 that excess membership income may not be applied to replacement funds. The IRS's position is based on the theory that, since funds were not earmarked for capital items through the budget, the original usage of the funds was not capital in nature. The IRS also holds that an organization may not change the nature of the intent for which the money was originally to be spent. That position is consistent with its position on capital contributions.

The IRS's position, as stated in the previous paragraph, does not consider that circumstances change after budget approval or that many associations could easily apply additional monies to their replacement funds. Also, as discussed earlier in this lesson, several authoritative citations hold that the nature of the assessment is determined by how the money is spent. It seems that it may be acceptable to continue to apply excess membership income to

replacement funds, but only if the change in the nature of the budgeted expenditures is documented by observing the following recommendations:

- The budget must be republished to reflect the change in the nature of the budgeted expenditures very early in the year. This constitutes both notice to members and earmarking of funds. A change occurring late in the year or after year end would not be acceptable.
- The replacement fund (reserve) study funding plan should be modified to correspond to the changed conditions. (This addresses the earmarking of funds.)
- The cash in replacement funds should be segregated from that in operating funds.
- The cash must be available to be transferred and must actually be transferred to segregated replacement fund accounts. Simply making accounting entries will not be sufficient to document the nature of the change.

The effect on a CIRA that only funds its reserves once a year as opposed to the more common monthly funding of reserves is not known.

### Excess Membership Deductions

As explained earlier in this lesson, IRC Section 277 only permits membership expenses to be deducted to the extent of membership income. If CIRAs have excess *membership* deductions, they may not be used to offset net *nonmembership* income. The excess deductions may not be carried back; however, they may be carried forward indefinitely to offset future net membership income. Excess membership deductions are not treated as an operating loss. Instead, they are a carryforward of excess deductions. It is a best practice to show excess membership deductions as a separate line item in the detail schedule for Line 26 of Form 1120. It can be titled "IRC Section 277 excess membership deductions carryover."

Many accountants prepare tax returns that improperly characterize an IRC Section 277 loss carryforward as a net operating loss (NOL). Regulation 1.172-1(c) seems to require disclosure of any change in the treatment of a carryforward under such circumstances, including the previous amount of the carryforward, the corrected amount of the carryforward, and the reason for the change. For example, assume an association's 20X1 tax return incorrectly reflects a NOL of \$50,000 because \$15,000 of interest income was inappropriately offset by membership losses and the carryforward was for membership losses instead of a net operating loss. Consequently, the correct carryforward is \$65,000, consisting entirely of IRC Section 277 excess membership deductions. The following disclosure should be included as a supplemental schedule with the 20X2 return:

#### DISCLOSURE UNDER REGULATIONS SECTION 1.172-1(c)

##### Net Operating Loss

IRC Section 172 net operating loss as previously reported	\$ 50,000
Adjustment to net operating loss	<u>(50,000)</u>
Corrected net operating loss carryover	<u>\$ -0-</u>

##### Excess Membership Deductions

IRC Section 277 excess membership deductions carryover as previously reported	\$ —
Adjustment to excess membership deductions	<u>65,000</u>
Corrected excess membership deductions carryover	<u>\$ 65,000</u>

## Net Nonmembership Income

**Regular Tax.** An association's net nonmembership income is taxed at regular corporate rates. (Excess membership income also is taxed if the association has not made a 70-604 election. See discussion earlier in this lesson. Tax rates are as follows:

<u>If Taxable Income Is</u>	<u>The Tax Is</u>
First \$50,000	15% of taxable income
\$50,001 to \$75,000	\$7,500 plus 25% of the amount over \$50,000
\$75,001 to \$100,000	\$13,750 plus 34% of the amount over \$75,000
\$100,001 to \$335,000	\$22,250 plus 39% of the amount over \$100,000
\$335,001 to \$10,000,000	\$113,900 plus 34% of the amount over \$335,000
\$10,000,001 to \$15,000,000	\$3,400,000 plus 35% of the amount over \$10,000,000
\$15,000,001 to \$18,333,333	\$5,150,000 plus 38% of the amount over \$15,000,000
Over \$18,333,333	35% of taxable income

Associations are entitled to the same tax credits as C corporations.

**Alternative Minimum Tax.** The Taxpayer Relief Act of 1997 repealed the Alternative Minimum Tax (AMT) for small corporations for tax years beginning after December 31, 1997. A small corporation is defined as one with three-year average annual gross receipts not exceeding \$5 million for its first tax year beginning after 1996 that does not have three-year average annual gross receipts exceeding \$7.5 million for any later year. However, in determining their tax liability, large CIRAs that file tax returns as corporations on Form 1120 must consider the AMT. Under the AMT rules, a corporation calculates two tax amounts: one based on the regular tax rules and a tentative minimum tax (TMT) based on the AMT rules. If TMT exceeds the regular tax, an additional tax equal to the excess, referred to as the alternative minimum tax, also must be paid. Thus, in reality, a corporation's tax liability is the greater of taxes calculated using either the regular tax system or the alternative minimum tax system.

Taxable income under the AMT system is referred to as AMT income or AMTI. It consists of taxable income under the regular tax system adjusted by the preference items and adjustments specified in IRC Sections 56, 57, and 58. Most of the preference items and adjustments do not affect the typical CIRA although the depreciation adjustment may affect CIRAs with respect to depreciable personal property placed in service after 1986 and before December 31, 1998. However, in addition to the preference items and adjustments, the AMT calculation is affected by an adjustment for adjusted current earnings (ACE adjustment). The calculation of adjusted current earnings starts with tentative AMTI. The adjustment is 75% of the difference between ACE and AMTI before the adjustment (generally taxable income for most associations). It may either increase or decrease AMTI.

## Net Nonmembership Losses

**Net Operating Loss.** If associations have a net loss from nonmembership activities, the loss is a net operating loss as defined in IRC Section 172 and may be carried back or forward. It is likely rare for a homeowners' association to have net nonmembership losses. After the segregation of member and nonmember activities and the elimination of nonmember loss activities that have no profit motive (see *Portland Golf Club*), the association is generally left with interest income less allocable expenses. Given the very low interest rates of recent years and indications from the Federal Reserve that low interest rates may continue at least until 2014, many associations are now experiencing situations where their allocable costs (the same as used in higher interest rate time periods) exceed interest income, resulting in a Section 172 net operating loss. A question that arises under the *Portland Golf Club v. Commissioner* decision is whether or not losses from investment activity may be offset against other taxable nonmember activities.

**Capital Loss.** A CIRA may also have a capital loss. That is more common now that many associations are investing in U.S. Treasury Notes and other investment vehicles to obtain a higher yield than on certificates of deposit. Fluctuating interest rates affect the market value of such investments. Gains on investment sales are capital gains and are fully taxable. Losses on investment sales, however, are considered capital losses and may only be offset against capital gains. They are not deductible. Capital losses may be carried back three years and carried forward five years.

A significant book to tax difference in reporting capital losses may also require calculating and reporting a deferred tax provision for financial reporting purposes.

### Advantages and Disadvantages of Filing Form 1120

Some accountants question why CIRAs take the time and effort to file their tax returns on Form 1120 when Form 1120-H is designed specifically for qualified homeowners' associations and is very simple to prepare in comparison. The principal reason is that association income is only subject to a 15% tax rate on the first \$50,000 of taxable income versus a 30% tax rate (32% for timeshare associations) on Form 1120-H. Exhibit 2-13 shows the effect on a condominium association's tax liability using the two forms under two different assumptions. The following describes other advantages and disadvantages of filing Form 1120:

#### Advantages of Filing Form 1120

1. Taxable income is taxed at the regular corporate rates (15% on the first \$50,000 of taxable income) versus the 30% (or 32%) tax rate required when filing Form 1120-H.
2. Certain tax-planning opportunities may exist.

#### Disadvantages of Filing Form 1120

1. The risk of compliance is much higher for Form 1120 than for Form 1120-H.
2. Form 1120 is a longer, more complex tax form to complete, and the cost of preparing Form 1120 may offset the tax benefits received.
3. Large associations are subject to the alternative minimum tax on Form 1120 (see the discussion above).
4. Associations that file Form 1120 may be subject to state income taxes.

As noted above, the risks of filing Form 1120 under the provisions of IRC Section 277 are *much* higher than filing Form 1120-H. As discussed previously in this lesson, the risks of attempting to use Form 1120 are:

- Correct characterization of income and deductions.
- Ability to adequately document additions to the replacement fund as being contributions to capital rather than membership income.
- The risk of being taxed on excess membership income.

Recommendations for deciding whether Form 1120 or Form 1120-H is most advantageous were provided earlier in this lesson and are discussed further below.

**Exhibit 2-13****Comparison of Forms 1120 and 1120-H**

**Example 1:** A condominium association has excess membership income.

	<u>Form 1120</u>	<u>Form 1120-H</u>
Interest income	\$ 14,000	\$ 14,000
Deductions allocated against interest income	(3,000 )	(3,000 )
Income from members	\$ 200,000	
Deductions applicable to income from members	<u>(195,000 )</u>	
Net taxable membership income	5,000	N/A
Specific deductions	<u>N/A</u>	<u>(100 )</u>
Taxable income	<u>\$ 16,000</u>	<u>\$ 10,900</u>
Tax rate	15 %	30 %
Tax	<u>\$ 2,400</u>	<u>\$ 3,270</u>

The preceding example illustrates how \$5,000 of excess membership income is taxable on Form 1120, yet using Form 1120 still yields a lower tax. It also emphasizes the need for advance tax planning since tax on the \$5,000 excess membership income could have been avoided on Form 1120 by applying the provisions of Revenue Ruling 70-604. See discussion earlier in this lesson.

**Example 2:** A condominium association has excess membership deductions.

	<u>Form 1120</u>	<u>Form 1120-H</u>
Interest income	\$ 14,000	\$ 14,000
Deductions allocated against interest income	(3,000 )	(3,000 )
Income from members	\$ 200,000	
Deductions applicable to income from members allowable only to the extent of income from members	<u>(200,000 )</u>	
Net taxable membership income	0	N/A
Specific deductions	<u>N/A</u>	<u>(100 )</u>
Taxable income	<u>\$ 11,000</u>	<u>\$ 10,900</u>
Tax rate	15 %	30 %
Tax	<u>\$ 1,650</u>	<u>\$ 3,270</u>

The preceding example illustrates the benefits of filing Form 1120 when a condominium association has excess membership deductions.

\* \* \*



## Tax-planning Opportunities

**Alternating Form 1120-H and Form 1120.** One of the most significant tax planning tools a CIRA has is alternating the use of Form 1120 and Form 1120-H to take advantage of the inherent differences in the tax rate structure of the two forms and timing differences. Specific strategies might include the following:

- A CIRA might file Form 1120-H in its initial years before its reserves have accumulated significant balances. Since interest income on reserve balances will be low, the tax due on Form 1120-H should not be materially larger than that owed on Form 1120. During those early years, the association should attempt to build its operating surplus since exempt function income is not taxable on Form 1120-H.
- In later years, when material cash balances have created larger tax liabilities for interest income, the association could switch to Form 1120 to benefit from that form's lower tax rates. At the same time, the association could change its budgeting strategy to reduce operating dues and increase reserve dues while keeping the overall dues amount the same, resulting in IRC Section 277 excess membership deductions. The operating surplus that was accumulated untaxed in earlier years could be drawn down and Form 1120 filed with little or no risk of excess membership income.
- The timing of painting expenditures, which are deductible when incurred or paid (not assessed), may be used to an association's advantage. It may want to file Form 1120-H when initially accumulating painting reserves to avoid a tax liability on those funds. However, Form 1120 should be filed in the year the painting funds are expended. Since painting is considered to be a membership deduction, a large membership loss should be created to be carried forward to future years as an IRC Section 277 loss carryover.

Some practitioners have reported that they received notices from the IRS indicating that they had filed an incorrect tax form when either changing from 1120 to 1120-H or changing from 1120-H to 1120. Apparently, IRS software identifies organizations based on last tax form filed and makes the assumption that the last type of form filed is the form the organization is required to file. It appears the IRS software cannot appropriately address the fact that Form 1120 is the default tax form and Form 1120-H is an annual election. An appropriate response to such a notice is to advise the IRS that the association is in compliance with tax law and that the IRS software is the problem.

**Use of the Revenue Ruling 70-604 Election to Reduce Taxes.** Revenue Ruling 70-604 is perhaps the most powerful tax planning tool that exists for associations filing Form 1120. However, taking a conservative approach when using the revenue ruling is a best practice because it is so vague on key issues. Specific strategies that may be considered relating to the use of Revenue Ruling 70-604 include the following:

- An association may find during the year that it is projected to end the year with excess membership income. It may want to *avoid* having to use Revenue Ruling 70-604 by revising its budget to eliminate that excess membership income. The revised budget should be distributed to members to provide them adequate notice of the reallocation of their dues.
- Associations generally make an election under Revenue Ruling 70-604 whenever excess membership income exists at year end. Since the IRS requires that any excess from Year 1 be utilized in Year 2, the association should create a membership (or operating) loss in Year 2. The Year 2 budget may be revised to create the necessary loss by a reallocation between the operating and reserve budgets. Consequently, the operating surplus created in Year 1 will be drawn down by the operating loss in Year 2.

In September 2010, the IRS issued Information Letter 2010-233 in response to a question regarding application of Revenue Ruling 70-604. In that letter, the IRS clarified that Revenue Ruling 70-604 may not be used to set aside funds in a working capital reserve.

## Risk Analysis with Association Income Tax Return Preparation

When viewed at the highest level, preparation of CIRA tax returns appears to be deceptively simple. Given the choice between Form 1120-H and its 30% flat tax rate, and Form 1120 with its 15% to 39% graduated tax rate, it would seem that any CIRA with less than \$186,111 of taxable income (the breakeven point between the two tax forms) would benefit from filing Form 1120 and paying a lower income tax.

Many tax practitioners make the decision as to which tax form to file on behalf of their CIRA clients with no consideration of the other factors that should enter into the decision-making process, nor the consequences of that decision. When a tax practitioner makes the filing decision without proper consideration, he or she is at significant risk for a malpractice claim.

The decision-making process is actually quite complex and should take into consideration many factors. The tax practitioner's role is to advise his or her client and make a recommendation based upon their expertise. It is the client's responsibility to make the final decision as to which form to file. However, the client can appropriately make that decision only when properly educated and advised by his or her tax practitioner as to the factors involved.

There is generally no risk involved in filing Form 1120-H if the association qualifies to file that form. However, a risk exists that the association may overpay tax when filing Form 1120-H if the CIRA could have actually safely qualified to file Form 1120.

The filing of Form 1120 carries a high degree of inherent risk because it is so difficult for the CIRA to comply with all of the requirements upon which a proper filing of this form is based. Further, since the majority of those risk factors are under the sole control of the CIRA, there is little the tax practitioner can do to rehabilitate a bad set of circumstances.

Some tax practitioners informally take the position that because the tax audit rate for CIRAs is so low (approximately 1% according to IRS statistics), the risk factor is very low that the association will be "caught" even if it does not strictly comply with all the requirements of Form 1120. Unfortunately, some tax practitioners advise their clients based upon that fact. However, IRS Circular 230 and the AICPA's Statements on Standards for Tax Services (TS 100.03) both state that it is unethical for a tax practitioner to consider the audit selection process of a taxing authority in establishing a client's tax position.

**Form 1120-H.** If the tax practitioner ensures that the CIRA meets the criteria to qualify as a homeowners' association, there exists little other risk in filing Form 1120-H. However, should a Form 1120-H be filed in error, the association may find itself required to make a mandatory change to Form 1120, which exposes the association to greater risk. To qualify as a homeowners' association, and thus to utilize Form 1120-H, the association must meet the following requirements.

- *Lack of Private Benefit Test.* Most associations will automatically meet the lack of benefit test. Thus, that risk is considered to be low.
- *Substantially Residential Test.* It is generally clear for most associations whether they meet the substantially residential test which requires that 85% of the lots or square footage must be used for residential purposes. The greatest risk in meeting the substantially residential test is for resort-type associations where there is a high degree of short-term rental use of condominium units.
- *The 60% Income Test.* The 60% income test often presents qualification problems for associations that submeter utilities, provide valet or maid services, or provide extensive recreational amenities and services.
- *The 90% Expenditure Test.* This test is the most difficult qualification for associations to achieve. Generally, any association that fails the 60% income test will also fail the 90% expenditure test. For example, associations that provide even a simple laundry room facility to their members may discover that their costs related to support of the laundry room facility will exceed 10% of total expenditures, causing the association to fail the 90% expenditure test.

**Form 1120.** There are two significant and broad issues under the sole control of the CIRA that reduce the ability to safely file Form 1120. These issues are discussed in items a. and b. below. A third issue, discussed in item c., is under the control of the tax preparer. A final issue related to IRC Section 481 arises from the first three issues and is discussed in item d.

a. Revenue Ruling 70-604 issues.

- The IRS has consistently held that it is the members of the association, not the association's board of directors, who must approve the annual election under Revenue Ruling 70-604 in order for it to be

effective. However, under most states' laws, the members do not have legal authority to make such a determination. That right is held solely by the elected board of directors. Since the IRS cares only about its own rulings and is not interested in state law, this course has consistently stated that the election be approved by the members at each annual meeting, and also approved separately by the board of directors, preferably at the same time.

- The calculation of whether an excess income carryover exists depends upon the underlying calculations of assessments excluded from income under IRC Section 118 and capital reserve expenditures under IRC Section 263. These calculations are often ignored or improperly made by tax practitioners in determining the Revenue Ruling 70-604 carryover amount.
- The question of whether there is an excess income carryover from a prior year, which itself depends upon the tax practitioner's interpretation of whether Revenue Ruling 70-604 allows multiple consecutive elections (the Revenue Ruling does not seem to allow multiple consecutive carryovers), and if such carryovers pass through any intervening Form 1120-H filings.

(Revenue Ruling 70-604 was discussed earlier in this lesson.)

b. IRC Section 118 issues.

- The association should not commingle operating and capital funds because doing so indicates to the IRS that monies are not being *set aside* properly under IRC Section 118. Associations commonly violate this rule by keeping painting reserves, which are specifically defined as noncapital by the IRS, in the same bank accounts with roofing, fencing, and other capital monies. The IRS considers the existence of one reserve bank account for both capital and noncapital monies to be a commingling. This issue arises as result of the definitional differences between the IRS and the homeowners' association industry. The IRS has determined that painting is not a capital expenditure (it is classified as a nonannual maintenance expenditure), and IRC Section 118 requires a specific capital purpose in order to not be included in income. Yet, it is appropriate for associations to reserve for painting. The solution to this problem is for associations to keep painting reserve funds in bank accounts separated from both current operating funds and capital reserve items, such as roofing and fencing repair or replacement.
- Both the reserve study and budget must identify specific capital purposes in order to comply with IRC Section 118. Additionally, the two documents must agree with each other or it will negate any benefit to be gained. If differences exist between the two documents, the IRS may take the position that the specific capital purpose has not been clearly identified, and therefore the reserve assessments do not qualify for IRC Section 118 treatment.
- The association's accounting records and financial statements must also clearly identify segregated capital and noncapital reserves, and that accounting must match the actual funds set aside in separate bank accounts. Failure to segregate the accounting of the reserves, as well as the reserve funds, invites the IRS to take the position that there is a commingling of operating and capital funds.
- Any interfund transfers or loans between operating and reserve funds will be viewed by the IRS as a commingling of funds which will taint the entire reserve fund balance.
- Many associations initially disburse payments for reserve (capital) expenditures from their operating account because it is the only account on which they can issue checks. Such payments must be reimbursed immediately from the reserve bank accounts for the exact amount of the disbursement made from the operating account, or it will be viewed by the IRS as a commingling of funds.
- Capital reserve expenditures are generally treated as current expenses on GAAP basis financial statements, but are not deductible (under IRC Section 263) for tax purposes. Failure to properly report such expenditures on Schedule M-1 (or M-3) of Form 1120 will be viewed by the IRS as engaging in an unacceptable form of tax accounting.

c. The preparation of tax Form 1120 must contain sufficient documentation to provide:

- a clear delineation between member and nonmember transactions,
- a clear delineation between operating and capital transactions, and
- a schedule of carryovers from the prior year to the succeeding year of excess member income or excess member deductions.

Such documentation requires, at a minimum, a supporting schedule for member and nonmember transactions and inclusion of the other items in the Schedule M-1 (or M-3) reconciliation. Failure to clearly delineate these items on the tax return invites the IRS to assert the position of engaging in an improper tax accounting method as discussed in item d.

d. If the association fails to properly account for capital transactions as indicated above, the IRS has consistently taken the position that the association (taxpayer) has engaged in an unacceptable method of tax accounting. IRC Section 481(a) allows the IRS to protect the government's interest in such a situation by making a cumulative calculation of the items deemed improperly accounted for. Such calculation is made as follows: the balance in the reserve fund at the start of the oldest tax return open under the statute of limitations is added to all reserve assessments during the period open under the statute of limitations, with no deductions allowed (because they are all "capital" expenditures). This balance is then added to current taxable income and subjected to applicable tax rates, interest, and penalties. Such a calculation can result in tax liabilities that exceed the association's gross annual budget.

### Operating as a Cooperative Organization

Revenue Ruling 75-371 states that a condominium management corporation may be able to operate as a cooperative organization under subchapter T to accumulate adequate working capital without having to pay income taxes on that reserve. That goal is achieved by declaring patronage dividends, which allows the association to retain up to 80% of the dividend amount as working capital free from taxation. Patronage dividends are treated as deductions from the gross income of the cooperative organization. However, the governing documents of the corporation must indicate that it is operating on a cooperative basis and also must provide for making patronage dividends. The governing documents of most condominium associations do not include that language.

Other sections of the Code provide additional information on operating as a cooperative organization:

- IRC Section 1382 provides that a cooperative organization is allowed a deduction for all patronage dividends.
- IRC Section 1385 provides that any person *receiving* a patronage dividend should include such amount in gross income unless it "is attributable to personal, living, or family items." Thus, any individuals receiving patronage dividends related to their personal residences in a condominium association may *not* have to recognize the patronage dividends as income.
- IRC Section 1388 provides that a cooperative organization may issue a "Written Notice of Allocation" for up to 80% of the amount of the patronage dividend. The remaining 20% must be paid to the members by qualified check. IRC Section 1388 also provides that consent to receive patronage dividends is deemed automatically given by the members if the organization has adopted a bylaw providing that membership in the organization constitutes such consent.

Assuming that a condominium qualifies as a cooperative organization, the rules in the previous paragraph *may* provide a safe way to allow it to escape taxation and still retain adequate working capital without the risks associated with applying Revenue Ruling 70-604.

The *Thwaites Terrace* case determined that a corporation qualified under subchapter T, even though its bylaws did not authorize it to pay patronage dividends. The Court held instead that the following three guiding principles established by the *Puget Sound Plywood* case were the controlling factors:

- Democratic control.
- Operating at cost.
- Subordination of capital.

In the Court's opinion, any organization that meets those criteria is operating on a cooperative basis and falls under subchapter T.

Following that theory (and noting the specific inclusion in Revenue Ruling 75-371 of a statement that a condominium corporation may operate in such a manner as to qualify under subchapter T), some accountants have taken the position that condominium corporations may also be taxed under subchapter T. The benefit of being taxed under subchapter T is that, in any (patronage) loss year, interest income on reserves may avoid taxation if it is an integrally intertwined activity. To ensure losses, many of those accountants have also taken the position that capital expenditures expensed for book purposes should be capitalized and depreciated for tax purposes. Depreciation deductions are allowed only for entities that own property in connection with a trade or business. Depreciation deductions for major repairs or replacements should not be allowed for condominium corporations because they do not hold title to the common area assets. The authors caution accountants to research the issue further before applying IRC Sections 1381–1388 to condominium associations.

### Preparing Form 1120

The procedures for filing Form 1120 are as follows:

- a. Segregate membership and nonmembership income.
- b. Exclude transactions that are treated as contributions of capital for tax purposes from income.
- c. Allocate expenses to membership and nonmembership activities.
- d. Calculate net membership and net nonmembership income or loss.
- e. Make certain that an election to defer current year excess membership income, if any, under Revenue Ruling 70-604 has been made by the association, if appropriate.
- f. Review the CIRA's carryover status for available—
  - (1) IRC Section 277 deduction carryovers from membership activities.
  - (2) Net operating loss carryovers (under IRC Section 172) from nonmembership activities.
  - (3) Capital loss carryovers.
  - (4) Revenue Ruling 70-604 income carryovers from the prior year.
- g. Determine taxable income.
- h. Determine the CIRA's tax liability.
- i. Compare the tax liability to that obtained by filing Form 1120-H to see which tax return results in the lowest tax.
- j. Determine the risk of filing Form 1120 by considering the CIRA's documentation, particularly as it relates to capital contributions and the Revenue Ruling 70-604 election.

- k. Schedules M-1 and M-2 should normally be completed for CIRAs that file Form 1120. Schedule M-3 is required in lieu of schedule M-1 for any CIRA that has assets exceeding \$10,000,000. The CIRA must also check item A on page 1 of Form 1120 to indicate that Schedule M-3 is attached.

### **Amending a Form 1120 to Change to Form 1120-H**

As discussed earlier in this lesson, a CIRA may determine, subsequent to filing a Form 1120, that it should have filed Form 1120-H instead. For example, the CIRA may have used an impermissible accounting method, received inadequate tax advice, or have significant tax exposure because it did not procedurally comply with the requirements of IRC Section 118 on contributions to capital or Revenue Ruling 70-604 on carryovers of excess membership income. Unless amending Form 1120 within 12 months from the original due date of the return under the provisions of Treasury Regulation 301.9100-3, amending a Form 1120 to change to Form 1120-H involves requesting an extension of time to make an election under IRC Section 528. Since an election under IRC Section 528 may be made only on a timely filed return, it is not possible to simply file an amended return replacing the Form 1120 with Form 1120-H. To assist in the amendment process, the IRS has provided administrative relief in the form of Treasury Regulations Sections 301.9100-1–301.9100-3.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. Which of the following statements best describes IRC Section 277?
  - a. It is a complete set of rules for the taxation of membership organizations.
  - b. It was added so that membership organizations could not avoid certain taxes.
  - c. It states that fund expenditures determine that nature of an organization's activity.
  - d. It specifically applies to homeowners' associations, as they are defined by the IRS.
16. Which of the following homeowners' associations has correctly addressed an issue related to the 70-604 election?
  - a. The Northside Association makes the election itself without membership input.
  - b. The Southside Association's election is made after it files its tax return.
  - c. The Eastside Association records 70-604 carryover on Schedule M-1.
  - d. The Westside Association makes 70-604 carryovers to subsequent years indefinitely.
17. The Parker Heights Neighborhood Association has excess membership deductions in the current year. How should it deal with these deductions?
  - a. It should carry them over indefinitely to offset future net membership income.
  - b. It should carry them back to offset net membership income in a previous year.
  - c. It should use them to offset nonmembership income in the current year.
  - d. It should treat them as an operating loss.
18. The Breakwater Association has \$60,000 of taxable income in the current year. Assuming it has not made a 70-604 election and that no other credits or deductions apply, what is the total amount of income tax the association will have to pay?
  - a. \$9,000.
  - b. \$10,000.
  - c. \$13,750.
  - d. \$21,000.
19. Which of the following is an advantage of filing Form 1120 instead of Form 1120-H?
  - a. Income is taxed at regular corporate rates.
  - b. Filing this form has lower risk for the CIRA.
  - c. It is cheaper to prepare Form 1120.
  - d. It exempts the CIRA from alternative minimum tax.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. Which of the following statements best describes IRC Section 277? **(Page 374)**

- a. It is a complete set of rules for the taxation of membership organizations. [This answer is incorrect. IRC Section 277 is *not* a comprehensive set of rules for taxing membership organizations. It focuses primarily on the activities of and deductions incurred by membership associations.]
- b. It was added so that membership organizations could not avoid certain taxes. [This answer is correct. IRC Section 277 was added to the Internal Revenue Code to prevent taxable membership organizations from avoiding tax on nonmembership income by operating membership activities at a loss and using that loss to offset the nonmembership income. IRC Section 277 was initially enacted to apply to social clubs, but it is clear from the language that it is a mandatory section that applies to all nonexempt membership associations.]**
- c. It states that fund expenditures determine that nature of an organization's activity. [This answer is incorrect. Committee Reports to IRC Section 118 state that it is the *expenditure of funds that determines the nature of the activity*. Though, while this statement was not made by IRC Section 277, IRC Section 277 and IRC Section 118 work together to confine membership associations to a narrow and strict set of rules.]
- d. It specifically applies to homeowners' associations, as they are defined by the IRS. [This answer is incorrect. IRC Section 528 (not IRC Section 277) applies to homeowners' associations as that term is defined by the IRS.]

16. Which of the following homeowners' associations has correctly addressed an issue related to the 70-604 election? **(Page 377)**

- a. The Northside Association makes the election itself without membership input. [This answer is incorrect. Recent audit activity indicates that IRS agents are requiring the election to be made by the members. Absent clarification, it is a best practice for associations to interpret the wording of Revenue Ruling 70-604 literally and make the election in the form of a resolution adopted by the membership. Therefore, to avoid issues with the IRS, Northside needs to involve its membership in the election process.]
- b. The Southside Association's election is made after it files its tax return. [This answer is incorrect. Revenue Ruling 70-604 simply states, "A meeting is held each year . . ." It does not specify whether the meeting should be held before year end or merely before the tax return is filed. Tax rules do not establish a consistent time for making tax elections; rather, the timing of most tax elections is spelled out either in the Internal Revenue Code, regulations, revenue rulings, or authoritative tax sources. The timing of the 70-604 election is not addressed, however. Thus, to minimize the risk of losing the benefit of the election, it is best for associations to make the election before the end of the fiscal year for which it is to apply. The election *must* be made before the tax return is filed; therefore, if Southside waits until after filing, it will most likely not be able to benefit from the election during this tax year.]
- c. The Eastside Association records 70-604 carryover on Schedule M-1. [This answer is correct. It is a best practice for the 70-604 carryover of excess membership income over membership expenses that is applied to the following year's assessments to be shown as a Section M-1 (or M-3) adjustment since (as a tax-only election) it is not recorded in the financial statements. Associations that file Form 1120 will either have a Revenue Ruling 70-604 net membership income carryover (70-604 carryover) or an IRC Section 277 net membership loss carryover (277 carryover) at the end of each tax year. Only if the association had net membership income equal to zero at the end of the tax year could a different situation result. Since that situation is highly unlikely to occur at any given year end, either a 70-604 carryover or a 277 carryover will generally result. Based on this guidance, Eastside has appropriately recorded its 70-604 carryover in this scenario.]**



- d. The Westside Association makes 70-604 carryovers to subsequent years indefinitely. [This answer is incorrect. While many tax practitioners believe that Revenue Ruling 70-604 permits an indefinite carryover of excess membership income, this course suggests that Revenue Ruling 70-604 be construed as a *one-year only* carryover allowance. Although the indefinite carryover position is prevailing industry practice, the one-year only carryover position is supported by Revenue Ruling 70-604; General Counsel Memorandum 34613; Technical Advice Memorandum 9539001; 98ARD 176-4, FSA 1992-0208-1; and the draft IRS *Timeshare Vacation Plan Owners Associations Audit Techniques Guide*. The IRS has also consistently held to the one-year interpretation in recent IRS tax audit activity. Therefore, it would be more appropriate to Westside to use the one-year interpretation, as well.]
17. The Parker Heights Neighborhood Association has excess membership deductions in the current year. How should it deal with these deductions? **(Page 383)**
- a. **It should carry them over indefinitely to offset future net membership income. [This answer is correct. IRC Section 277 only permits membership expenses to be deducted to the extent of membership income. If CIRAs have excess membership deductions, they can be carried forward indefinitely to offset future net membership income. Therefore, the Parker Heights association will be in compliance with the Code if it treats the excess deductions in this manner.]**
- b. It should carry them back to offset net membership income in a previous year. [This answer is incorrect. According to IRC Section 277, a CIRA *cannot* carry excess membership deductions back; therefore, the Parker Heights association cannot use this treatment.]
- c. It should use them to offset nonmembership income in the current year. [This answer is incorrect. Based on the guidance provided in IRC Section 277, CIRAs with excess member deductions *cannot* use them to offset net nonmembership income. Therefore, if Parker Heights treats these excess deductions in this manner, it will not be in compliance with the Code.]
- d. It should treat them as an operating loss. [This answer is incorrect. Under IRC Section 277, excess membership deductions are not treated as an operating loss; therefore, the Parker Heights association should not use this treatment. Instead, the association will use these deductions to offset other income.]
18. The Breakwater Association has \$60,000 of taxable income in the current year. Assuming it has not made a 70-604 election and that no other credits or deductions apply, what is the total amount of income tax the association will have to pay? **(Page 384)**
- a. \$9,000. [This answer is incorrect. This is 15% of Breakwater's taxable income. If the association had taxable income of \$50,000 or less, 15% would be the appropriate percentage. Since Breakwater's taxable income is more than \$50,000, the calculation must be made differently.]
- b. **\$10,000. [This answer is correct. Because Breakwater's taxable income falls into the \$50,001 to \$75,000 range, it should be calculated as follows: \$7,500 + 25% of the amount over \$50,000 (for Breakwater, that would be 25% of \$10,000). Therefore, Breakwater's taxable income is \$7,500 + \$2,500 = \$10,000.]**
- c. \$13,750. [This answer is incorrect. Entities with taxable income between \$75,001 and \$100,000 calculate their taxable income by taking 34% of the amount over \$75,000 and adding that amount to \$13,750. Since Breakwater's taxable income is lower than \$75,001, the \$13,750 amount does not apply.]
- d. \$21,000. [This answer is incorrect. This is 35% of Breakwater's taxable income. However, that tax rate is only used when taxable income is over \$18,333,333. Since Breakwater's taxable income is much lower than that, a different calculation amount should be used.]
19. Which of the following is an advantage of filing Form 1120 instead of Form 1120-H? **(Page 385)**
- a. **Income is taxed at regular corporate rates. [This answer is correct. One of the advantages of filing Form 1120 is that taxable income is taxed at the regular corporate rates versus the 30% (or 32%) tax rate required when filing Form 1120-H.]**

- b. Filing this form has lower risk for the CIRA. [This answer is incorrect. This risk of compliance is much *higher* for Form 1120 than for Form 1120-H.]
- c. It is cheaper to prepare Form 1120. [This answer is incorrect. Form 1120 is longer and more complex, so it has a greater cost to prepare than Form 1120-H.]
- d. It exempts the CIRA from alternative minimum tax. [This answer is incorrect. Large associations will be subject to the alternative minimum tax on Form 1120.]

## WHEN A CIRA QUALIFIES AS TAX EXEMPT

The majority of CIRAs will not qualify for tax exemption under IRC Section 501. For those few that will qualify, they will qualify either under IRC Section 501(c)(4) as a “social welfare organization,” or under IRC Section 501(c)(7) as a “recreational organization.” It is also known that three associations have qualified for exempt status under IRC Section 501(c)(3) as “charitable organizations.” These three organizations all had the very unique status of being able to document that they served low income membership. The fact that there are so few of these is an indicator of the difficulty of qualifying under this section. There are two main reasons that associations seek tax exempt status. One reason is to eliminate the risks associated with filing Form 1120. The other reason is to reduce or eliminate federal taxes. [Associations in Texas have another reason to seek tax exemption; they are not required to pay state sales tax if they are exempt under IRC Section 501(c)(4).] IRC Section 501(c)(4) organizations pay no taxes on exempt function activities, including investment earnings. However, the net income of unrelated business activities (such as newsletter advertising) is still subject to taxation. IRC Section 501(c)(7) organizations are treated similarly, except that investment earnings are taxable, as well as transactions with nonmembers.

Unlike the election under IRC Section 528, which is made annually by filing Form 1120-H, qualification for exemption under IRC Section 501 generally requires a formal application process, and submission of Form 1024, (Application for Exemption) to the IRS. Applications are submitted to the IRS Exempt Section central processing facility in Covington, Kentucky, after which they may be distributed to other IRS offices for processing. While it generally takes 120 days for the IRS to begin processing the application, the time to complete the application process varies from weeks to as much as two years.

In 2013, the IRS clarified that organizations seeking exemption under IRC Section 501(c)(4) and IRC 501(c)(7) have the option to “self-declare” exempt status and can simply start filing Form 990 as an exempt organization without having to go through the extensive application process on Form 1024. The association is required to complete Form 14449 (Self-Declarers Questionnaire), which asks for virtually the same information as contained on the application Form 1024. See further discussion later in this lesson.

CIRAs generally do not qualify as tax-exempt organizations primarily because they serve only their members and do not serve the “community” as defined by the IRS in Revenue Ruling 80-63. Condominium associations that perform maintenance of building exteriors are deemed to primarily serve their members, and thus will not qualify for exemption under either IRC Section 501(c)(4) or (7). Planned developments consisting of single family homes may qualify if their activities are determined to primarily serve the community.

In early 2011, the IRS released its 2010 report on Exempt Organizations, which was the IRS’s internal report card on their activities for 2010 and discussed IRS plans for 2011. The report indicated that the IRS intended to step up audit activity for 501(c)(4) organizations in 2011. Tax practitioners should be aware of the potential for increased IRS audit activity. It is reasonable to assume that much audit activity will focus on compliance with Form 990 disclosures.

Given recent IRS activity, it is also reasonable to assume that IRS may also address the issues of public disclosure or access to Form 1024 and annual Form 990 filings. Many associations are choosing to place this information on their websites as opposed to having it available when requested. Practitioners should also be aware that the website **[www.guidestar.org](http://www.guidestar.org)** publishes many Form 990 tax returns on its website.

IRS rules prior to 2006 stated that small exempt organizations with gross receipts of less than \$25,000 were not required to file Form 990. This was an attempt by the IRS to eliminate the burden of filing the relatively complex Form 990 on very small organizations. In doing so, the IRS created the problem of having thousands of exempt organizations not filing tax forms of any sort. As a result, the IRS did not even know if the organizations still existed.

In 2006, IRS Code Section 6033(i) established the requirement for small exempt organizations with gross revenues of less than \$50,000 to file Form 990-N, which is essentially an electronic postcard with only eight items of information requested. Form 990-N can only be filed electronically, and only through the IRS website.

In 2006, IRS added Code Section 6033(j), which states that any organization described in Section 6033(a)(1) that is required to file an annual return but that fails to do so for three consecutive years will have its tax-exempt status revoked on the date of the filing deadline for the third such return. On October 15, 2010, when the voluntary

compliance amnesty period ended, some 320,000 exempt organizations had their exempt status revoked. The time period for automatic reinstatement ended December 15, 2012, and any organization that had its exempt status revoked must now reapply for exempt status.

In 2011, the IRS issued Notice 2011-43, which established transitional relief for small organizations meeting certain criteria. The relief is that reinstatement would be granted retroactively, meaning that no penalties would be assessed.

In 2013, IRS issued Revenue Procedure 2013-9, which included a revised section 11 (as compared to prior Revenue Procedures issued). Section 11 now refers to IRC Section 6033(j). The effect of the change is that if exempt status is now granted, the effective date of exemption is the *postmark date* of the application. This is a significant change from Publication 557, which states that the effective date of exemption is the date of formation. The impact of this is that associations are no longer able to amend tax returns open under the statute of limitations to obtain refunds.

In 2016, IRS added Code Section 506, which requires notification to the IRS by any organization that intends to be recognized as a social welfare organization under IRC Section 501(c)(4). The IRS also issued Notice 2016-9 to provide guidance to taxpayers for implementation of IRC Section 506. Notification to the IRS is required no later than 60 days after the organization is established. The notice is required to include:

- The name, address, and taxpayer identification number of the organization.
- The date on which, and the state under the laws of which, the organization was organized.
- A statement of the purpose of the organization.

IRS is required to acknowledge receipt of the notice within 60 days of receipt, but may grant an extension for reasonable cause. The IRS may also establish a "reasonable" user fee for submission of the notice. There is no definition of what shall constitute reasonable cause or a reasonable fee for purposes of this section. The effective date of Section 506 is six months after the date of adoption of the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act), enacted on December 18, 2015, or June 18, 2016.

Existing associations or other organizations that have not already received a determination letter from IRS or have not filed a Form 990 (or 990 EZ) must file the notice described above by June 18, 2016. IRS Notice 2016-9 states that the IRS will issue temporary regulations for Section 506. Those regulations have not been issued as of the date of this case. The IRS Notice 2016-9 states that, until those regulations are issued, the June 18, 2016 deadline is indefinitely extended. The new deadline will be 60 days from the date the temporary regulations are issued. This notice does not constitute a request for determination. Such a request for determination must still be made by filing Form 1024.

Section 405(c) of the PATH Act amended section 6652(c) to impose penalties for failure to file the notification by the date and in the manner prescribed in Section 506 (and implementing regulations). In particular, Section 6652(c)(4)(A) imposes a penalty on an organization that fails to submit the notification equal to \$20 per day for each day the failure continues, up to a maximum of \$5,000. Additionally, Section 6652(c)(4)(B) imposes a similar penalty on persons who fail to timely submit the notification in response to a written request by the Secretary of the Treasury.

Most associations that eventually seek exemption under IRC Section 501(c)(4) are long past the "60 days after the organization is established" deadline, and don't even know that they will qualify for exemption until it is brought to their attention. Accordingly, the practical impact of the above is that, for any existing association that decides to seek exemption at some point in the future, they will automatically be subject to the maximum \$5,000 penalty. It remains to be seen if the failure to earlier recognize the possibility of exempt status will constitute "reasonable cause" for seeking a waiver of the penalty.

### **Homeowners' Associations under Section 501(c)(4)**

Section 501(c)(4) requires that the exempt organization serve a "community," but does not define "community." Additionally, to date, no subsequent rulings or court cases have defined "community." Revenue Rulings 74-99 and

80-63 reinforce the concept of service to a single community. There are three criteria by which an organization can serve a community:

- a. The organization can offer to the general public, i.e., "the community," (relatively) unrestricted access to its facilities (its common areas).
- b. The organization can itself constitute a "community."
- c. The organization can occupy a geographic area "which bears a reasonable recognizable relationship to an area ordinarily identified as governmental."

The Internal Revenue Code defines 501(c)(4) organizations as follows:

Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, education, or recreational purposes.

To qualify for the 501(c)(4) exemption, a CIRA (other than a cooperative) must meet the following requirements:

- a. The CIRA must serve a "community" that bears a reasonably recognizable relationship to an area normally identified as a governmental unit.
- b. It must not conduct activities directed to the exterior maintenance of any private residence. (That automatically excludes condominium associations from qualifying under IRC Section 501(c)(4); only homeowners' associations are able to qualify if they do not perform exterior maintenance on private residences.)
- c. Common areas of the CIRA must be for the use and enjoyment of the general public.

The IRS has issued a number of rulings that provide guidelines for exemption under IRC Section 501(c)(4). In addition, a number of court cases and revenue rulings refine the definition of *community* for purposes of applying IRC Section 501(c)(4). The most significant decisions are summarized in Exhibit 2-14.

#### **Exhibit 2-14**

##### **Selected Citations for Tax-exempt CIRAs**

<b>Citation</b>	<b>Summary</b>
Revenue Ruling 66-179	Revenue ruling 66-179 provides that the extent to which an organization engages in social activities for the benefit of its members is a factor in determining whether it is primarily engaged in social welfare activities.
Revenue Ruling 69-280	Revenue Ruling 69-280 provides an example of a nonprofit organization formed to provide maintenance of exterior walls and roofs that failed to meet the 501(c)(4) tests. The IRS held that the organization was operated "primarily for the private benefit of the members and any benefits to the community are not sufficient to meet the requirement of the regulation that the organization be operated primarily for the common good and general welfare of the people of the community."
Revenue Ruling 72-102	Revenue Ruling 72-102 held that an organization was exempt; that any "benefits to the developer and . . . owner-members are merely incidental . . . to the goal to which the organization's activities are directed, the common good of the community." The ruling further stated that "for the purposes of Section 501(c)(4) of the Code, a neighborhood, precinct, subdivision, or housing development may constitute a community."

**Citation****Summary**

Revenue Ruling 74-17	Revenue Ruling 74-17 stated that "by virtue of the essential nature and structure of a condominium system of ownership . . . the maintenance and care [of common areas] . . . necessarily constitutes the provision of private benefits for the unit owners. Since the organization's activities are for the private benefit of its members, it cannot be said to be operated exclusively for the promotion of social welfare."
Revenue Ruling 74-99	<p>Revenue Ruling 74-99 has provided the most detailed explanations to date of the IRS definition of "community." It modified Revenue Ruling 72-102 to clarify that a homeowners' association of the kind described in Revenue Ruling 72-102 must, in addition to otherwise qualifying for exemption under IRC Section 501(c)(4), satisfy the following requirements:</p> <ol style="list-style-type: none"><li>1. It must engage in activities that confer benefit on a community comprising a geographical unit that bears a reasonably recognizable relationship to an area ordinarily identified as a governmental subdivision or a unit or district of such an area.</li><li>2. It must not conduct activities directed to the exterior maintenance of private residences.</li><li>3. It owns and maintains only common areas or facilities such as roadways and parklands, sidewalks, and streetlights, access to, or the use and enjoyment of which, is extended to members of the general public and is not restricted to members of the homeowners' association.</li></ol>
Revenue Ruling 80-63	<p>Revenue Ruling 80-63 was intended to specifically clarify Revenue Ruling 74-99 with respect to homeowners' associations. For example, it states the following:</p> <ol style="list-style-type: none"><li>1. A "community" does not embrace a minimum area or number of homeowners. Although the area represented by an association may not represent a community as defined in Revenue Ruling 74-99, the association may still qualify for exemption if it maintains common areas and facilities for the use and enjoyment of the general public (as distinguished from areas and facilities whose use is restricted to members of the association). That interpretation would generally exclude all "gated" associations that cannot meet the definition of "community" in Revenue Ruling 74-99.</li><li>2. An association would not qualify for exemption if it restricts the use of its recreational facilities to members.</li><li>3. An association may form a separate organization, which may qualify for exemption under IRC Section 501(c)(7), to own and maintain recreational facilities that are restricted for use by members of the association.</li><li>4. An association would not qualify for exemption if it owns and maintains parking facilities only for its members.</li></ol>

<b>Citation</b>	<b>Summary</b>
<i>Rancho Santa Fe Association v. U.S.</i>	This case reinforces the concept of a "community." The court held that Rancho Santa Fe Association met the definition of a "community" and, thus, fell within the definition of a tax-exempt organization devoted to the promotion of the general welfare even though access to its golf course was restricted to members and their guests. The case further established "there is no requirement, however, that if the work of the association benefits the entire community that it must also benefit the general public in terms of the world-at-large."
<i>Flat Top Lake Association, Inc. v. U.S.</i>	In this case, Flat Top Lake Association was denied 501(c)(4) exempt status because it denied the public access to its lake. The association was held to exist for the benefit of members only.
Treasury Regulation 1.337(d)-4	Treasury Regulation 1.337(d)-4 assesses a tax on the transfer of assets from a taxable corporation to a tax-exempt entity. (The regulation excludes Section 528 homeowners' associations. Thus, associations that simply elect to switch from filing Form 1120 to Form 1120-H are exempt from the tax.)
<i>Ocean Pines Association, Inc. v. Commissioner</i>	In this case, the court ruled that a parking lot at a beach club that was not open to the public was not related to the Association's exempt purpose of promoting social welfare, so income from parking lot was unrelated business taxable income.

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The private letter rulings issued by the IRS in recent years also provide information about IRS audit activity for 501(c)(4) organizations and insight as to the audit issues involved. Exhibit 2-15 summarizes some of those rulings.

#### Exhibit 2-15

##### Selected Private Letter Rulings Relating to Tax-exempt CIRAS

<b>PLR</b>	<b>Disposition</b>	<b>Summary</b>
9815061	501(c)(4) status revoked	The association's business activity was found to be its primary activity.
9539005	501(c)(4) status upheld	The operation and maintenance of recreational facilities did not cause the association to lose its exempt status because the amount was nominal and not the core purpose of the association.
200809035	501(c)(4) status revoked	Organization was not operating as a tax-exempt organization because the services it provided were limited only to members.
201040019	501(c)(4) status denied	Exempt status denied because the association was found to be organized and operated by and for the benefit of the developer, which controlled the board and held two officer positions and title to common areas.
201234028	501(c)(4) application denied	This lake oriented community included parks maintained by the association that contained signs restricting use to members only.

PLR	Disposition	Summary
201224034	501(c)(4) status revoked	Organization did not meet the requirements of 501(c)(4) status because of political activities and failure to benefit a community.
201224035	501(c)(4) status revoked	This was a condominium project conducting maintenance of condominium unit exteriors, which was determined to be a private benefit and did not benefit a community.
201252029	501(c)(4) status revoked	Association was not a community and did not provide access to a community.
201313031	501(c)(4) status revoked	Association did not have restrictive gates when exempt status was approved but later added restrictive gates that limited public access.
201318010	501(c)(4) status revoked	Activities conducted excluded the public, and association itself did not qualify as a community.
201318016	501(c)(4) status revoked	Association failed to file tax returns for many years, so exempt status was automatically revoked. In addition, gates eliminated all public access. Documentation in minutes and newsletters indicated that nonmembers should not be allowed access. Signs were erected that limited access to members and guests only.
201318020	501(c)(4) status revoked	Association's only activities were to contract with the police department for patrol service and to publish a newsletter containing crime statistics. IRS determined this was not sufficient to qualify for exempt status.
201318022	501(c)(4) status revoked	Association's pool and park were considered private, and access was limited to members and guests. Association had the right to maintain members' property if they failed to do so and to bill members for that service.
201318023	501(c)(4) status revoked	A non-mandatory association did not have sufficient voluntary membership to maintain common areas, so it formed a tax district that imposed mandatory property taxation to pay for the expenses of the 550 acre, 268-home development. Activities were police protection and road maintenance. Signs at entrances indicated it was a private development.
201318024	501(c)(4) status revoked	Association's activities served only its members, not general public.
201321032	501(c)(4) status revoked	Association's activities served only its members, not general public.
201321035	501(c)(4) status revoked	Association's activities served only its members, not general public.
201321039	501(c)(4) status revoked	Association's activities served only its members, not general public.



PLR	Disposition	Summary
201313031	501(c)(4) status revoked	Association's activities served only its members, not general public.
201318010	501(c)(4) status revoked	Association's activities served only its members, not general public.
201318020	501(c)(4) status revoked	Security services only, no public benefit exists.
201318022	501(c)(4) status revoked	Association's activities served only its members, not general public.
201318024	501(c)(4) status revoked	Association only provided limited access to general public.
201321035	501(c)(4) status revoked	Association's activities served only its members, not general public.
201321039	501(c)(4) status revoked	Association's activities served only its members, not general public.
201329022	501(c)(4) status revoked	Association's activities served only its members, not general public.
201338055	501(c)(4) status revoked	Association was office condo with only private benefit.
201349018	501(c)(4) status revoked	Association's activities served only its members, not general public.
201429030	501(c)(4) status revoked	The homeowners association served only its members; it did not serve a community.
201505043	501(c)(4) status revoked	The association failed to provide records supporting its exempt status.
201518018	501(c)(4) status revoked	The homeowners association served only its members; it did not serve a community, even though it maintained a public forest service area.
201548020	501(c)(4) status revoked	Condominium association served only its members; did not serve a community.
201548020	501(c)(4) status revoked	Access was restricted to association members only. No public access existed.
201623013	501(c)(4) status denied	Access was restricted to association members only. No public access existed.
201636044	501(c)(4) status denied	This was a condominium project conducting maintenance of condominium unit exteriors, which was determined to be a private benefit and did not benefit a community.
201642037	501(c)(4) status denied	Access was restricted to association members only. No public access existed.

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PLR 201505043 illustrates the importance of both responding to IRS demands timely and with sufficient documentation to support the association's position.

It is possible that, if properly defended, exempt status could have been preserved. Tax representatives should be fully versed in the area of tax law before representing associations in a tax audit situation.

**“Gated” Associations.** The IRS routinely takes the position that, if an association is a “gated community,” the association has denied access to the public, and, therefore, it does not serve the “community” as defined in the code, regulations, and revenue rulings. Having a gate does not necessarily disqualify an association from obtaining exempt status, however. Each association must be evaluated on a case-by-case basis. Consider the following examples:

- Two gated associations in California were granted 501(c)(4) exemptions because they were able to show that the “community” existed *behind the gate*. An association need not admit the world-at-large to establish that it serves a “community.”
- A gated association qualified because its main common area components—roads, equestrian trails, and equestrian center—were deemed accessible to the public. Although the equestrian center was accessible only to individuals who actually rented stalls, the rentals were available on an unrestricted basis to members and nonmembers alike.
- The geographic area covered by an association in California was virtually identical to that covered by a “California Community Services District.” (A “community services district” is a governmental unit having statutory powers similar to those of a city.) The association was granted an exemption because it was serving a community that bore a reasonably recognizable relationship to an area normally identified as a governmental unit.
- Two gated associations in South Carolina were granted exempt status because the associations and the incorporated town shared essentially the same geographic boundaries. Therefore, the public and the associations were considered to be the same.
- A gated association in Florida qualified because it established that it effectively had unrestricted access because the world-at-large had access if they rented rooms at one of the resort hotels located behind the gate. The association also performed beach and marshland maintenance services, and, under Florida law, the world-at-large had access to beaches (high tide line). The association’s security staff included several part-time employees that were also full-time police officers, and the security staff regularly interfaced with the local police to the extent that the main gate house served as a Sheriff’s substation. In addition, several high-profile tennis events brought thousands of visitors behind the gates annually.

In 2007, the IRS issued PLR 200706014 that reached an adverse determination regarding a 501(c)(4) organization. The organization, previously exempt under IRC Sec. 501(c)(4), was determined to no longer qualify for exemption under the Section. The reason for revocation was solely because the association installed a security gate which prevented public access that previously existed. This ruling points out the necessity of properly informing the IRS on Form 990 of any changes in nature of operations of a tax exempt organization. For planning purposes, it also illustrates the requirement to have public access. PLR 8028010 did allow some restrictions on public access, stating “the general public is permitted to utilize X’s common areas and facilities except for some restrictions to its community centers, swimming pools, and tennis courts. Based on the circumstances in this case, we feel that X meets the requirements of Rev. Rul. 74-99 and 80-63. Limited nonpublic access should not be fatal to Section 501(c)(4) exemption when considered in relation to the overall activities and services provided by X vis-à-vis the public-at-large and the community which it serves.”

In 2009, the IRS issued PLR 200910067 revoking the tax-exempt status of an organization previously exempt under IRC Sec. 501(c)(4). The IRS determined that the association served the private benefit of its members and was not operated for the promotion of social welfare. The primary service of the organization was providing a security patrol service for its members.

**Other 501(c)(4) Issues.** The issuance of Revenue Procedure 2013-9 (subsequently combined into Revenue Procedure 2016-5 and successors) and the change by the IRS in recognizing the effective date of exemption from the date of formation to the postmark date of the application have potential significant impact on associations. Combined with the extended processing time for application (now between 18 to 24 months), they substantially limit the association’s

right to claim refunds for prior years and introduce the possibility of a negative impact from the application of Treasury Regulation 1.337(d)-4. However, the language in Revenue Rulings 80-108 and 81-177 seems to be in conflict with the effective date of exemption as set forth in Revenue Procedure 2013-9 and may override it. The specific language in Revenue Rulings 80-108 and 81-177 indicate that “. . . the organization . . . may be exempt under section 501(c)(4) from the date of its inception.” The IRS is presently maintaining that the IRS recognition date controls whether or not prior year refunds can be claimed. There are several claims that are presently being appealed or shortly will be appealed regarding this IRS position.

Prior to the issuance of Revenue Procedure 2013-9, it was common practice to submit the exemption application on Form 1024 being reasonably confident that the application would be processed and approved within six months. Occasionally, it would be necessary to file a protective claim for refund as the statute expiration approached on a fourth-year tax return because of the timing of filing of the application and the processing time of the application. However, on approval, it was the common practice to then submit claims for refunds for the three years open under the statute, and perhaps a fourth year for which a protective claim had been filed. That was based on the fact that exempt status was recognized retroactively to date of formation, as is still stated in IRS Publication 557.

Since issuance of Revenue Procedure 2013-9 with its revised effective date of exemption, a strict limitation is placed on the ability to request refunds of prior year taxes paid. There are two approaches to attempting to protect refund claims. One way is to “self-declare” exempt status and immediately begin filing Form 990, both before and while the exemption application is processed. Another way is to file protective refund claims for the three open years at the same time the Form 1024 is mailed.

The “self-declare” option has always been available, but rarely used because processing time for the exemption application was not unreasonably long. The self-declare option is not expressed in any code section but is allowed by the absence of any code section that requires an application and approval from the IRS. This was validated in the *IRS Exempt Organization FY 2012 Annual report and 2013 Work Plan*, which stated the following:

In FY 2012, EO [Exempt Organizations] developed a project focusing on Section 501(c)(4),(5), and (6) organizations. These entities, which include social welfare organizations; labor, agricultural and horticultural groups; and trade associations, *can declare themselves tax-exempt* without seeking a determination from the IRS.

Revenue Procedure 2013-9 also established a requirement that the application be submitted within 27 months of the date of formation. However, there could be reasons to argue that the 27-month deadline from Revenue Procedure 2013-9 is not valid. One argument is that Code Section 508 gave the Service authority to issue that kind of deadline only with respect to Section 501(c)(3) organizations, but that Section 508 has not been revised by congressional legislation to include other sub-sections of Section 501(c). So, while the Service has statutory authority to write and impose such a deadline for Section 501(c)(3) charities, the authority does not apply to all of the other sub-sections that define what qualifies as a tax-exempt organization. Another argument is that all of the related IRS statements of policy and practice previously published to explain the rationale for recognizing such organizations as tax-exempt from the date of information (no matter how long the interval between the date of formation and the date of application) are still in good standing and have not been revised or revoked.

The potential for triggering a taxable gain on the unrealized difference between basis and fair market value of assets as set forth in Treasury Regulation 1.337(d)-4 needs to be considered. That Regulation establishes a tax on transfers from a taxable corporation to a tax-exempt entity. When the formation date is recognized as the date of exemption, that tax does not apply. When the exemption date is a date after the date of formation, the possibility exists that the IRS may attempt to assess that tax. However, the arguments stated in the previous paragraph should invalidate any tax assessment. Another argument is that no gain can exist for common area assets, because they generally may not be sold and have no market value.

### **Homeowners' Associations under Section 501(c)(7)**

The major benefit of an IRC Sec. 501(c)(7) exemption is that an association's *net membership income* is not subject to taxation. Thus, associations that are exempt under IRC Sec. 501(c)(7) *automatically avoid* having to deal with the complexities of Rev. Rul. 70-604's “excess membership income” provisions. One disadvantage to the Section

501(c)(7) exemption, as compared to the Section 501(c)(4) exemption, is that associations must pay taxes on interest income. [Interest income is not taxable for associations that are exempt under IRC Sec. 501(c)(4).]

IRC Sec. 501(c)(7) applies to "social" or "recreational" organizations. That section and its related regulations require that an organization be operated *exclusively* for "pleasure, recreation, and other nonprofitable purposes" to qualify under IRC Sec. 501(c)(7). Rev. Rul. 75-494 provides examples of activities that will disqualify an organization that would otherwise qualify under IRC Sec. 501(c)(7), such as *any* of the following:

- Maintaining private streets serving a residential area.
- Enforcing architectural covenants.
- Providing other services, such as:
  - Trash collection.
  - Police protection.
  - Fire protection.

Organizations seeking exemption under IRC Section 501(c)(7) need to satisfy the following statutory requirements:

- a. be a club;
- b. be organized for pleasure, recreation, and other nonprofit purposes;
- c. have substantially all of its activities devoted to such purposes;
- d. have no part of its net earnings inure to the benefit of any private shareholder;
- e. have no written policy that discriminates against individuals seeking membership on the basis of race, color, or religion; and
- f. must have individual members that have personal contact and fellowship.

Private Letter Ruling 201425016 involved an easement sale where proceeds were used to improve the golf course and other facilities. The IRS ruled that the proceeds from the easement sale would not jeopardize exempt status, and as long as the purchases occurred within three years from the easement sale, they would qualify as capital improvements used directly in the performance of the exempt function.

In 2007, the IRS issued Private Letter Ruling 200728048, which reached an adverse determination regarding a 501(c)(7) organization. The organization, previously exempt under IRC Section 501(c)(7), was determined to no longer qualify for exemption under this Section. The adverse determination resulted because the association exercised architectural control (a prohibited activity). As a result, it was not considered to be operated exclusively for pleasure, recreation, and other non-profitable purposes. It seems that a number of associations that probably never qualified were granted 501(c)(7) exempt status prior to the existence of IRC Section 528. This appears to be an example of such an association. The private letter ruling indicated that the association should file Form 1120-H in the future. This course disagrees with the IRS statement that the association must file Form 1120-H, as that ignores the option of the association to file Form 1120 under IRC Section 277.

In 2008, the IRS issued Private Letter Ruling 200817064, which also reached an adverse determination regarding a 501(c)(7) organization. This was the result of an examination of the association's tax returns on Forms 990 and 990-T. The organization had been granted exemption under IRC Section 501(c)(7) prior to 1976, when IRC Section 528 was enacted. The result of the examination was that the IRS determined that the association no longer qualified for exemption under this Section because the association was not a social club.

The association maintained a marina, tennis courts, and other common area property. The IRS held that the mere holding of some recreational amenities did not qualify the association as a social club under IRC Section 501(c)(7).

The IRS held that the association did not meet the test of being organized for pleasure or recreational purposes. Practitioners should be cautioned to consider this factor with 501(c)(7) organizations.

In both PLR 200728048 and PLR 200817064, the IRS indicated that the association should file Form 1120-H in the future. This course disagrees with the IRS statement that the association must file Form 1120-H, as that ignores the option of the association to file Form 1120 under IRC Section 277.

In 2008, the IRS issued Private Letter Ruling 200846034 revoking the exempt status of a homeowners' association previously exempt under IRC Section 501(c)(7). The IRS noted that the association enforced architectural covenants, provided police and fire protection and trash collection services, and received more than 15% of its revenues from nonmember sources, all in violation of the requirements of IRC Section 501(c)(7).

The IRS has been busy in recent years examining organizations exempt under IRC Section 501(c)(7). There is a common theme that is apparent in the following recent Private Letter Rulings that represent revocations of exempt status:

- 201029038—Failure to maintain adequate records to determine nonmember activities.
- 201038021—Consistent violation of 15% nonmember activities revenue rule.
- 201039036—Consistent violation of 15% nonmember activities revenue rule.
- 201040037—Failure to maintain adequate records to determine nonmember activities.
- 201107029—Failure to maintain adequate records to determine nonmember activities.
- 201107030—Consistent violation of 15% nonmember activities revenue rule.
- 201108039—Failure to maintain adequate records to determine nonmember activities.
- 201111015—Failure to maintain adequate records to determine nonmember activities.
- 201222049— Nonmember income consistently exceeding 35% of total income.
- 201329025—Failure to maintain adequate records to determine nonmember activities; Failure to file Form 990-T; Exceeded 15% and 35% tests.
- 201330041—Exceeded 15% and 35% tests.
- 201333019—Exceeded 15% and 35% tests.
- 201337017— Failure to maintain adequate records to determine nonmember activities.
- 201338044— Private inurement existed.
- 201338050— Nontraditional activities conducted.
- 201342014—Exceeded 15% and 35% tests.
- 201343024—Failure to maintain adequate records to determine nonmember activities.
- 201343025—Exceeded 15% and 35% tests.
- 201344010—Failure to maintain adequate records to determine nonmember activities; Exceeded 15% and 35% tests.
- 201418056—Failure to maintain adequate records to determine nonmember activities; exceeded 15% and 35% tests.

- 201445027—Failure to meet 15% test; Nature of operations not in accordance with 501(c)(7) status.
- 201428020—Failure to meet 15% test.
- 201428027—Status denied; Failure to meet administrative technical deadline.
- 201429028—Failure to meet 15% test.
- 201434022—Failure to meet administrative technical deadline.
- 201442058—Failure. Nature of operations of homeowners association was not in accordance with 501(c)(7) status; Does not meet 501(c)(4) requirements.
- 201445027—Failure to qualify—No individual members.
- 201448021—Failure to meet 15% test.
- 201448022—Failure to file 990-T; Maintained architectural covenants; Maintained roads serving residences rather than recreational areas.
- 201450023—Failure to qualify,—Nature of operations not in accordance with 501(c)(7) status.
- 201451039—Failure to meet 15% test; Nature of operations not in accordance with 501(c)(7) status.
- 201501015—Failure to qualify,—Nature of operations not in accordance with 501(c)(7) status.
- 201517016—Failure to meet 35% test.
- 201517017—Failure. Nature of operations not in accordance with 501(c)(7) status.
- 201529011—Failure to qualify due to private inurement.
- 201544026—Revoked, exceeded 15% test.
- 201551010—Revoked due to private inurement.
- 201605021—Failure to qualify, not organized for pleasure, recreation, or other nonprofitable purposes.
- 201615019—Failure to qualify, not organized for pleasure, recreation, or other nonprofitable purposes.
- 201615021—Failure to qualify due to more than 35% of income being received from an oil lease.
- 201623012—Revoked; Exceeded 15% test.
- 201635007—Revoked; Exceeded 15% test.
- 201635008—Denied; Exceeded 15% test.
- 201636045—Revoked; Exceeded 35% rule.
- 201638028—Revoked; Not recreational in nature.
- 201640020—Revoked; Not a club, open to public.
- 201642036—Denied; Not operated as a club.
- 201644021—Denied; Not operated as a club.

- 201702043—Denied; Not operated as a club and private inurement issues.
- 201706020—Denied; Not operated as a club and exceeded 15% test.

### **Applying for Recognition of Tax-exempt Status**

The association should apply for recognition of its tax-exempt status on Form 1024, "Application for Recognition of Exemption under Section 501(a)." That form is used for requesting exemption under IRC Sections 501(c)(4) and 501(c)(7). Accountants should request retroactive application of exempt status when filing Form 1024. Upon receipt of a favorable determination letter, it may be possible to amend prior year tax returns to obtain refunds of taxes previously paid.

Treasury Regulation 1.337(d)-4 assesses a tax on the gain on any assets transferred from a taxable to a tax-exempt organization. This applies to any association seeking exemption under IRC Sections 501(c)(4) or 501(c)(7). The tax is assessed on the gain of any assets transferred. The gain is measured as the excess of the fair market value of assets transferred over their tax basis. There are certain exceptions, in that 501(c)(7) organizations have seven years from the date of incorporation to apply for exemption without having the "transfer tax" rules apply. Sections 501(c)(4) organizations have three years. Tax practitioners are advised to use extreme caution in this area to avoid triggering an inadvertent tax obligation.

Since the tax rules concerning tax-exempt CIRAs are still evolving, any CIRAs that qualify for tax-exempt status should review their activities annually to ascertain that they still qualify for exemption and that no new activities would disqualify them. For example, associations may charge different fees to members and nonmembers for the same services without jeopardizing their tax-exempt status.

### **Tax-exempt Cooperatives**

Associations operated on a cooperative basis for the purpose of purchasing supplies and equipment for members or other persons at cost plus expenses may qualify for tax-exempt status under IRC Section 521. Some housing cooperatives previously asserted that they were exempt from tax under IRC Section 521. However, Revenue Ruling 90-36 states that "... there is no provision exempting cooperative housing corporations described in IRC Section 216(b)(1) from federal taxation." Thus, a previously ambiguous area was clarified in 1990.

### **Revocation of Exempt Status**

In Technical Advice Memorandum (TAM) 9747003, the IRS revoked an exempt organization's exempt status for the following reasons:

- By opening its activities to the general public, the entity engaged in activities other than those primarily related to its tax-exempt purpose. The activities engaged in for its members were tax-exempt activities; however, the same activities engaged in for the general public constituted an unrelated trade or business and were greater than the activities for members.
- The organization failed to keep adequate books and records of its nonmember transactions. Associations are advised to keep adequate records of nonmember activities to avoid adverse tax consequences.

### **Surrender of Exempt Status**

The IRS issued Private Letter Ruling 201123035 in June 2011 regarding the proper procedure for surrender of exempt status. The PLR stated that "... an organization that no longer wants to be exempt under section 501(a) of the Code will need to file a final return as described in section 6043(b). Once the final return is filed, the organization will no longer be described under section 501(a)." The authors believe it is an extremely rare circumstance in which it would be beneficial to voluntarily surrender tax-exempt status.

### **Unrelated Business Income and Form 990-T**

In addition to filing Form 990, an association exempt under either IRC Section 501(c)(4) or 501(c)(7) must file Form 990-T, "Exempt Organization Business Income Tax Return," to report unrelated business income of \$1,000 or more.

(The form need not be filed and no tax is due if gross unrelated business income is less than \$1,000.) Net taxable income from an unrelated trade or business is reported on Form 990-T, and the tax on the unrelated business income is computed based on corporate rates and paid with that Form. The IRS has issued several private letter rulings addressing unrelated business income. See Private Letter Rulings 9805001, 9811003, and 9815061 for a full discussion of those issues. See also *PPC's 990 Deskbook*, which provides detailed instructions for filing Form 990-T and can be ordered by calling (800) 431-9025 or online at [tax.thomsonreuters.com](http://tax.thomsonreuters.com).

In simple terms, *unrelated business income* is income that comes from an activity not related to the association's exempt purpose. For income to be unrelated business income, the revenue must come from an *unrelated trade or business*. Section 501(a) defines an unrelated trade or business as "any trade or business, the conduct of which is not substantially related . . . to the exercise or performance . . . of its [exempt] purpose."

Essentially, there are three key conditions that must be present for an association to be conducting an unrelated trade or business:

- a. The activity must be a trade or business.
- b. The trade or business must be regularly carried on.
- c. The trade or business must not be substantially related to the association's exempt purpose. (The fact that the income generated is used only for tax-exempt purposes does not matter. What matters is how the money is obtained, not how it is spent.)

If *all three* of these conditions are present and the income is not otherwise excluded from tax, the income is probably unrelated business income and subject to tax. There are certain activities that are specifically excluded from being an unrelated trade or business, such as activities that are performed substantially by volunteers (generally, "substantially by volunteers" is considered 85%).

There are no clear principles or hard-and-fast rules to determine whether an income-producing activity is *related* or *unrelated* to an association's exempt purpose. What may be unrelated for one association may be related for another. In other words, the circumstances surrounding the business activity are usually the main factors that determine whether an activity is related or unrelated.

An association's unrelated business income is its gross income from unrelated business activities less the deductions directly connected with earning the income. The first \$1,000 of unrelated business income is not subject to tax. With the exception of exempt trusts, an entity's unrelated business income tax is computed as if the association were a taxable corporate entity. Therefore, the tax rates on unrelated business income are the same as the corporate tax rates. Similar to corporate taxes, associations must pay either regular tax or alternative minimum tax, whichever is higher. In addition, associations liable for unrelated business income tax are normally required to make estimated tax payments.

Capital gains are excluded from taxation as unrelated business income. While IRC Section 511 imposes a tax on unrelated business income, IRC 512(a)(1) defines unrelated business income, in part, as a business "regularly carried on." In addition, IRC Section 512(b)(5) states that all gains and losses from the sale, exchange, or other disposition of property (other than property held for sale to customers in the ordinary course of business or that would be includable in inventory) are excluded from unrelated business income.

**Special Considerations for Section 501(c)(7) Social Clubs.** Excess unrelated business income can result in an exempt social club losing its tax-exempt status. To illustrate, assume an association club rents facilities to nonmembers at a profit. This situation can be viewed as benefiting club members by reducing charges that members would otherwise need to pay to maintain the facilities. The situation can actually jeopardize the club's tax-exempt status, because IRS rules say that no part of the club's earnings may inure to the benefit of a shareholder/member. The tax rules lack specific guidance on the percentage limits that apply to nonmember receipts before a club's exempt status is in jeopardy. However, in practice, this income is normally not a problem if it is less than 5% of gross receipts.

Another consideration is that unrelated business income tax is calculated differently for social clubs than it is for other nonprofit organizations. The calculation could actually result in a social club having an overall loss but still



having to pay tax on unrelated business income. Social clubs must keep detailed records of member and nonmember activities for tax purposes. The IRS' audit efforts have included Section 501(c)(7) social clubs that report investment income (such as interest and dividends) on Forms 990 or 990-EZ but fail to file Form 990-T. Unlike most nonprofit organizations, social clubs generally are taxed on their investment income unless they make an election to set it aside for certain religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals.

The IRS has issued numerous Private Letter Rulings revoking exempt status of 501(c)(7) organizations, primarily for two reasons:

- Failure to maintain adequate accounting records to properly identify member versus nonmember income.
- Failure to meet the 85% test of revenue from club members.

In practice, many clubs discover over time that they have insufficient revenues, so they "open" their club to expanded or additional nonmember sources of revenue. However, IRC Section 501(c)(7) has a strict 15% limitation on such nonmember revenues.

The IRS issued Private Letter Rulings 201213034 and 201213035 to distinguish 501(c)(7) organizations from 501(c)(4) organizations regarding the sale of assets. While 501(c)(4) organizations are specifically provided protection under IRC Section 512 from recognizing taxable capital gains on the sale of assets, that protection does not extend to 501(c)(7) organizations. The letter rulings state that while the sale of assets does not cause the organization to lose its exempt status, the assets sold are considered to be unrelated business taxable income under IRC Section 512.

## TAX ISSUES THAT AFFECT COOPERATIVE HOUSING CORPORATIONS

Many of the topics discussed in this lesson apply to all CIRAs, including cooperative housing corporations. However, there are several tax issues that are unique to cooperatives. Due to the complexity of the subject, a discussion of those tax issues is beyond the scope of this course, as is a discussion of accounting and financial statement presentation considerations of cooperatives. More information on both of these issues is available in *PPC's Guide to Homeowners' Associations and Common Interest Realty Associations*.

## RULES FOR MASTER ASSOCIATIONS

The tax rules that apply to condominium and homeowners' associations generally also apply to master associations. IRS Regulation 1.528-1 states, ". . . if the membership of an organization consists of other homeowners associations, the owners of units, residences, or lots who are members of such homeowners associations will be treated as the members of the organization for the purposes of the regulations under Section 528." Thus, so long as a master association meets the qualifying tests under IRC Section 528, it may file its income tax return on Form 1120-H. If the master association does not qualify under IRC Section 528 (for example, because it owns recreational facilities that are available for use by nonmembers as well as members), it should file its income tax return on Form 1120 under the provisions of IRC Section 277.

### Residential or Nonresidential?

It may be difficult to determine if a master association is residential or nonresidential when it is made up of a combination of different types of associations; e.g., homeowners' associations plus commercial condominium associations. That determination is critical when deciding whether the master association qualifies—

- to file Form 1120-H or
- for a carryover of excess membership income under Revenue Ruling 70-604.

The only guidance dealing with the qualification of a master association as a residential homeowners' association is found in Treasury Regulations 1.528-1 and 1.528-4. Treasury Regulation 1.528-4 requires that 85% of the square

footage of a condominium association be used for residential purposes or that 85% of the lots of a residential real estate management association be zoned for residential purposes. Timeshare associations are not affected by the substantially residential test.

If a master association is a mixed-use association, consisting of a combination of condominiums, residential lot associations, timeshare associations or units, and commercial use lots, the substantially residential determination is made by applying the criteria in the regulations to all subsidiary association members as a whole. A detailed discussion of the substantially residential test was provided earlier in this lesson.

### **Filing Form 1120-H**

As explained above, to qualify to file Form 1120-H, the master association as a whole should meet the provisions in IRC Section 528 discussed earlier in this lesson. As a first step, the transient use test should be applied to see if the CIRA is residential or nonresidential. Based on the answer to the transient use test, a determination must be made about whether the master association as a whole meets the substantially residential test. If it does, the 60% income test, 90% expenditure test, and the lack of benefit test should be applied to see if the master association qualifies to file Form 1120-H under IRC Section 528.

### **Carryover of Excess Membership Income**

To qualify for a carryover of excess membership income under Revenue Ruling 70-604, a master association *may* have to meet the substantially residential test discussed earlier in this lesson. As previously discussed, the IRS has released contradictory advice about whether the revenue ruling applies only to residential associations. Accountants should be alert for future developments in that area.

## **INFORMATION ABOUT TIMESHARE DEVELOPMENTS**

Timeshare developments are a specific form of CIRA that entitles the owner to the right to use a unit for a specified period of time each year (usually at weekly intervals) or a fee simple ownership interest in a unit. They may be taxed the same as residential associations that choose to be taxed on Form 1120 as regular corporations under IRC Section 277, or they may file Form 1120-H under IRC Section 528 if they meet its qualifications.

On April 28, 1999, the IRS issued a draft of the *Timeshare Vacation Plan Owners Associations Audit Techniques Guide* (Audit Techniques Guide). Although the Audit Techniques Guide is targeted at timeshare associations, the scope section of the document states that it may also be useful to IRS examiners in their examinations of other types of owners' associations as well as timeshare associations. That statement appears to indicate the IRS's intent to hold all associations to the same principles of tax law.

An in-depth discussion of the Audit Techniques Guide is beyond the scope of this course, but it and other issues related to the operation and taxation of timeshare developments are discussed further in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

## **INFORMATION ABOUT COMMERCIAL ASSOCIATIONS**

Commercial associations provide nonresidential facilities and generally are either condominiums or planned developments. Some examples are office parks, industrial parks, shopping centers, professional buildings, parking facilities, marinas, and docks. Commercial associations perform the same essential functions for their owners as typical residential CIRA management corporations perform for their owners; i.e., the management, maintenance, and care of common elements.

Commercial associations are taxed the same as residential associations that are taxed on Form 1120 as regular corporations under IRC Section 277. (As explained earlier in this lesson, IRC Section 528 applies to residential associations and timeshare associations. Thus, commercial condominiums cannot elect to file Form 1120-H.)

IRC Section 277 is not an elective section of the Code. If an organization meets the qualifications, it must apply the provisions of IRC Section 277, which applies to all nonexempt membership organizations. Its purpose is to apply

existing tax law consistently for a group of individuals acting together as they would apply to those members acting individually. Thus, nonexempt organizations are denied any tax benefit of using membership losses to offset nonmembership income. (However, see the discussion of associations conducting themselves as cooperative organizations subject to the provisions of subchapter T instead of IRC Section 277 earlier in this lesson.)

The issue of whether Revenue Ruling 70-604 (allowing a carryforward of excess membership income to the next year—discussed earlier in this lesson) applies to nonresidential associations has not been settled by the IRS. Through audit activity of nonresidential associations, the IRS asserted, in a 1994 District Office technical advice letter, the position that Revenue Ruling 70-604 only applies to residential associations. However, in a June 1995 technical advice memorandum (TAM 9539001), the National Office of the IRS ruled that Revenue Ruling 70-604 did not apply to a nonresidential association (a timeshare development) because *the scope of its activities far exceeded the scope of activities of the association covered by the revenue ruling*. The TAM did not explore the issue of whether a *nonresidential* association qualifies to use Revenue Ruling 70-604. Since the memorandum was addressed to a nonresidential association, an inference may be drawn that “residential or nonresidential” is not the determining factor for application of Revenue Ruling 70-604 but rather the determining factor is the scope of activities of the association. Following that logic, it could be possible for a commercial condominium to apply the revenue ruling, depending on the scope of its activities. Accountants should be alert for future developments.

Since commercial associations have the same type of organization and operation as residential associations, it seems logical that the same tax rules would apply, including IRC Section 118, Revenue Ruling 75-370, and Revenue Ruling 75-371. (See Exhibit 2-2.) For example, dues paid by the members of a commercial association are treated as membership income. However, if a portion of the monthly dues that tenants of a commercial condominium are assessed has been designated by the association for specific capital items, that portion is not a deductible business expense to the member-tenants. The tenants may only deduct the portion of their monthly dues that represents the association's operating expenses. The lack of deductibility may make the member-tenants reluctant to fund the replacement fund.

## SPECIALIZED TAX SITUATIONS THAT MAY APPLY

### Sale of Common Property

The sale of common property may take one of the following forms:

- Sale by the association of personal property.
- Sale by the association of common area real property to which it has title:
  - Acquired from the developer.
  - Acquired by purchase.
- Sale of common area real property to which the members have title, with the association merely acting as an agent or conduit for the members.
- Sale of easements:
  - Association has title.
  - Members have title.

Sales involving combinations of the preceding elements also are possible, such as a sale of dwelling units constructed by an association on property transferred to it by the developer.

Proceeds from the sale of common area assets generally are received from nonmembers of the association and, therefore, usually constitute nonmembership income on Form 1120. However, in Technical Advice Memorandum 9637007, a country club was allowed to treat the sale of condominium units to nonmembers as membership

income because the units were sold to them on the condition that they become members prior to purchasing the units. Since the proceeds do not meet any of the qualifying tests for exempt function income under IRC Section 528, they constitute nonexempt function income on Form 1120-H, assuring the organization could otherwise qualify to file Form 1120-H.

In the event that a sale of common area assets is made to a member of the association, the tax treatment may be different. If the association files Form 1120-H, it will still be classified as nonexempt function income and will not be distinguishable from a sale to a nonmember. However, if the association files Form 1120, this sale will be classified as member income, as opposed to nonmember income. This fact may be used as a tax planning technique in determining which tax form to file for a given year. If an association has a current year operating loss excluding the sale of common area assets to a member, they would benefit by filing Form 1120 and using the operating loss to offset the gain on sale of assets. Given the same circumstances utilizing Form 1120-H, the operating loss (exempt function activities) would not be available to offset the nonexempt function gain on sale of assets.

Sales of common area property are taxable events. In determining the appropriate tax treatment for the particular transaction, the important question to ask is "Who is the taxpayer?" since that affects the basis of the property sold and ultimately the amount of gain or loss on the sale. In most cases, basis and gain or loss may be determined according to the following general rules:

- *Purchased Property.* The basis is equal to acquisition cost less any allowable depreciation.
- *Real Property Acquired from the Developer; Association Has Title.* According to IRC Sections 351 (transfers to a controlled corporation) and 362 (basis of property transferred to a controlled corporation), the association's basis is the same as the basis of the property in the hands of the developer. (As discussed earlier in this lesson, there is often no tax basis in property transferred from the developer to the association.) Revenue Procedure 92-29 provides an alternate cost method for developers that allow the developer to deduct estimated prorated development costs. Under this method, since all costs are presumed to be deducted by the developer, there is no remaining basis to transfer to the association.
- *Real Property Acquired from the Developer; Members Have Title.* In this case, the members, not the association, are the taxpayers. The association is merely acting as an agent in accommodating the transaction. In contrast to the preceding circumstances, when the members have title to the property, it seems likely that the developers do not transfer their basis to the members but rather sell the property directly to the members. Thus, they have some basis in the property allocable from the purchase price. If the association receives the proceeds from the sale, regardless of whether or not the proceeds are disbursed to the members, the association should inform all members of the sale and advise them to seek professional tax advice in reporting the sale on their tax returns.
- *Easements—*
  - a. If the association has title to the property but no basis, the total sales proceeds should be reported as a gain when the easement is sold.
  - b. If the association has both title to the property and a basis in it, the sales proceeds first reduce the basis of the property, and any excess should be reported as a gain.
  - c. If it is a short-term easement and the association has title (regardless of whether or not they have basis), any gain should be treated entirely as ordinary income (similar to rental income).
  - d. If the members, rather than the association, have title, the sale should be treated by the individual members as described in b. and c. above.

## Condemnation of Common Property

Condemnations of common property generally are taxable events; however, they may be treated as nontaxable or tax-deferred events in some circumstances.

**Condemned and Replaced.** If the property is replaced with similar property within the required time period, the transaction may be considered to be a like-kind involuntary conversion with no immediate tax effect. Assume that a city condemns an equipment building owned by a condominium association so that a street may be widened. The board of directors decides to replace it within the required time period. The gain from the condemnation of the equipment building may be deferred as a like-kind involuntary conversion.

**Condemned and Not Replaced.** If common property is condemned and not replaced, generally the gain would be taxable. However, in some instances, it may be possible for proceeds from the condemnation may be treated as a payment in lieu of future assessments. Assume that a city condemns two residential buildings in a condominium association to make room for a new highway, and the board of directors decides not to replace them. The owners of the condominiums in the two condemned residential buildings are separately compensated by the city. The proceeds from the condemnation of the two residential buildings could be considered as a payment in lieu of future assessments (membership or exempt function income) to compensate for the monthly assessments that would have been paid by the owners of the condominiums that will not be replaced. To avoid significant excess membership income carryover, the association should file a Form 1120-H in the year of the condemnation.

As an alternative, as discussed in Revenue Ruling 81-152, the condemnation proceeds may be distributed to the remaining owners as a reduction of basis in their condominiums. If desired, the board could then declare a special assessment in that amount to be put in the replacement fund for capital improvements.

### Rental Pools

There are two types of rental pools common to condominium associations. In the first type of pooling arrangement, a unit owner makes his or her unit available to the pool for rental use, but not on a shared basis. The unit owner receives rental income only when the unit is rented and remains responsible for the unit's direct expenses. Any costs associated with the rental activity (such as maid and laundry service) are generally deducted from rental income to be paid to the unit owner. Such expenses are generally based upon a formula (such as \$x per day or week rented) or as a flat percentage of rental income. The association as rental agent is responsible for sending a Form 1099 to the unit owner, but has no other reporting obligation.

In the second type of pooling arrangement, the rental pool is composed of individually owned units or rooms that are operated by the association as a hotel. Since the association does not keep all rooms rented at all times and does not favor one owner (or room) over another, all income is *shared* by the *group* of owners. Due to the shared income and expense features, this type of pooling arrangement is considered an active trade or business. Accordingly, PLR 8413003 and 99ARD 077-11, FSA 9999-9999-187 indicates that the rental pool should be treated as a partnership, and a partnership return should be filed. All owners who are part of the rental pool are partners. The association merely acts as an administrator and (presumably) receives a fee for its services. Alternatively, some associations that actively manage the rental pool also have the responsibility for preparation of the partnership tax return.

The tax rules that apply to commercial associations apply to rental pools. Commercial associations were discussed earlier in this lesson.

### Rebates

Many associations have reported receiving rebates from utility companies for installing energy-saving devices, e.g., energy efficient lights and low water usage toilets. Along with the rebates, however, the associations are receiving Form 1099s reporting the rebate amounts as income. While it seems illogical to report income for expending funds that do not generate a tax deduction, that is the net result. Failure to report the income virtually guarantees a tax adjustment under the IRS Form 1099 matching program. There is no apparent relief under tax law. However, several practitioners have reported preparing tax returns that list the income with an offsetting deduction and attaching a statement to the return stating that the association is reporting the rebate as a reduction of the cost of installing nondeductible energy-saving equipment.

### Effect of Capital Assessments on Owner's Basis

A question arises regarding what additions to the unit owners' tax bases occur from capital assessments by an association. Revenue Ruling 81-152 provides some guidance in that area.

Revenue Ruling 81-152 deals with a developer lawsuit for construction defects and tax treatment to the association of the proceeds received. The ruling held that the amounts received were not income to the association but constituted a return of capital to the individual unit owners. (The revenue ruling is consistent with several other citations in similar areas.) However, the ruling went further and stated that:

The money received from the builder is not income to the individual unit owners, but instead represents a return of capital to each unit owner to the extent the recovery does not exceed that owner's basis in his or her property interest in the condominium development. The unit owners must reduce their individual bases in their property interests in the development by their proportionate share of the reward recovered from the developer. Requiring the individual unit owner to reduce their bases in their respective property interest in the condominium development is consistent with the congressional purpose in enacting Section 528 of the code. The essential purpose of Section 528 is to provide homeowner associations with the same tax treatment as individual homeowners. . . .

The most important aspect of the ruling, however, is that the IRS stated in the last paragraph:

*To the extent capital assessments are, or have been made against the unit owners for the purpose of making the necessary repairs or replacements, or the association retains the amounts recovered in the suit against the builder and uses them for capital repairs, replacement, or improvements, the unit owners' bases, under Section 1016, will be increased.*

Thus, Revenue Ruling 81-152 is the clearest statement that exists on the issue. It expressly states that, if a capital assessment is made by the association, the unit owners' bases will be increased. It does not indicate that the association must have expended such monies for the actual major repair or replacement of the common areas.

The only logical conclusion seems to be that the unit owners' bases will include any capital assessments paid by the unit owners to the association, whether or not the association has expended such funds. Practitioners will probably have to wait for a contested court case or specific ruling in this area to get a more strongly supported answer than the one the authors have presented above. Nevertheless, the existing evidence does seem to support this conclusion.

The unit owner is generally able to obtain information on capital assessments from the association's budget for each fiscal year. The unit owner should remember, however, that not all funds set aside in the replacement fund may qualify as capital in nature. The IRS has indicated in Revenue Rulings 75-370 and 75-371 that *funds set aside for painting and contingencies are not considered capital in nature*. (See a complete discussion of painting expenditures earlier in this lesson.)

The following is an example of how capital assessments serve to increase an owner's tax basis. Assume that a homeowner pays \$150,000 for a condominium unit and incurs closing costs of \$1,000. In subsequent years, the homeowner directly spends \$2,500 for interior improvements and pays capital (repair and replacement fund) assessments of \$400 per year for four years. The homeowner's tax basis in the residence is calculated as follows:

Cost/purchase price	\$ 150,000
Closing costs	1,000
Direct improvements	2,500
Capital assessments (4 years @ \$400)	<u>1,600</u>
Total basis	<u>\$ 155,100</u>

The homeowner's basis is increased by an additional \$1,600 simply by considering the capital assessments. Assuming a 40% combined federal and state tax rate, that will save the homeowner \$640 in taxes on the gain on the sale of the residence (if taxable).

### Ancillary Operations

The tax treatment of ancillary operations varies depending upon the tax form filed. However, no matter which tax form is filed, it is important that the association produces accurate revenue and expense information. Additionally,

all tax forms require the association to allocate expenses to both member and nonmember revenues. Such allocation is critical in determining the taxable income of an activity. For example, the association may determine that 10% of the total rounds of golf played were played by nonmembers. This would lead to an allocation of 10% of total golf course expenses against nonmember golf revenues. The *Portland Golf Club* case provides specific guidance on the allocation of indirect costs against activities revenue. Other tax considerations unique to each tax form are discussed below.

**Form 1120-H.** If user fees are charged, then ancillary operation revenues are classified as nonexempt function income and must be considered in the 60% income test calculation. Any expenses attributable to the ancillary activities not directly related to the maintenance of common areas will be nonqualifying expenditures for purposes of the 90% expenditure test. This situation is what causes many associations to fail the 90% expenditure test.

If no user fees are charged, the nonexempt function income and 60% test issues do not exist. No attempt should be made to determine the implied revenue based on expenses. Any expenses attributable to the ancillary activities not directly related to the maintenance of common areas will still be considered to be nonqualifying expenditures for purposes of the 90% expenditure test. This situation is what causes many associations with significant ancillary operations to fail the 90% expenditure test.

**Form 1120.** If user fees are charged, the association must determine nonmember revenues and expenses, as nonmember net income will be considered "taxable" income. Member income and expenses for the ancillary activities may be combined with all other member revenues and expenses.

**Form 990-T [Under 501(c)(7)].** Use of this tax form presumes that user fees are charged. The association must determine nonmember revenues and expenses, as this will be considered UBTI (unrelated business taxable income). In addition to the matter of net UBTI being considered taxable income, the association must also consider the level of nonmember income. If nonmember revenues exceed 15% of total revenues, it triggers an automatic termination of exempt status. Member income and expenses for the ancillary activities may be combined with all other member revenues and expenses. Under the provisions of IRC Section 501(c)(7), as a social recreational organization, member transactions are considered exempt and nonmember transactions are considered nonexempt. A discussion of homeowners' associations that file under IRC Section 501(c)(7) appeared earlier in this lesson.

**Form 990-T [Under 501(c)(4)].** Use of this tax form also presumes that user fees are charged. The association must determine nonmember revenues and expenses, as this will be considered UBTI. In addition to the matter of net UBTI being considered taxable income, the association must also consider the level of nonmember income. If nonmember revenues exceed 15% of total revenues, it triggers an automatic termination of exempt status. Member income and expenses for the ancillary activities may be combined with all other member revenues and expenses. Under the provisions of IRC Section 501(c)(4), as a social welfare organization, activities related to the association's exempt purpose are considered exempt, but activities not substantially related to the exempt purpose of the organization are considered nonexempt. Thus, transactions with members could be considered nonexempt transactions if those transactions related to a nonexempt activity. A discussion of homeowners' associations that file under IRC Section 501(c)(4) appeared earlier in this lesson.

**Other Tax Considerations.** There are other tax considerations that may affect a CIRA's ancillary operations including non-highway fuel credits, tip credits, sales taxes, the Transient Occupancy Tax (TOT), rental pools, and foreign interests. Those topics are discussed in the following paragraphs.

Non-highway fuel tax credits may often be claimed by large associations that have extensive private roadways, golf courses, or marinas. In each of these situations, the association is likely to operate vehicles or watercraft on private property. Federal Form 4136 allows the association to claim a credit for federal highway taxes paid upon purchase of fuel. That credit can be claimed on either Form 1120 or Form 1120-H. This is a refundable credit, even if there is no other tax liability.

A tip credit may often be claimed by associations that have food and beverage operations where employee tips are reported on the quarterly payroll tax returns. The tip credit is not a refundable credit.

The association should be knowledgeable about sales taxes as they relate to various sales activities such as pro shop sales, food and beverage sales, and sales tax on service activities, including rental income. Sales taxes are local issues and are not unique to CIRA operations. Accordingly, they are not addressed in this course.

The Transient Occupancy Tax (TOT), otherwise known as a bed tax or room tax, is a tax assessed by local governments on hotels based upon occupied room nights. TOT is the charge added to hotel bills. Most local governmental agencies have adopted the policy that TOT may not be assessed on owners or timeshare members that are staying in *their* rooms, as those individuals' full or fractional ownership privileges keep them from being considered *transients*. But, nonmembers staying in those same rooms are truly *transients* and are subject to the TOT. Consequently, timeshares or associations operating rental pools are obligated under local law to account for, collect, and remit the TOT to the local governmental agency.

Rental pool activity requires the association to be knowledgeable about the manner in which it conducts such activity to ensure that proper tax reporting occurs. See the discussion on rental pools earlier in this lesson.

Rental of units owned by foreign interests (that is, non-USA citizens) is subject to the requirements of the Foreign Investment in Real Property Tax Act (FIRPTA). This Act requires agents (or associations) who manage property on behalf of foreign owners to withhold income tax at a rate of 30% of the gross rent received unless the agent (association) receives an exemption certificate from the owner.

### **Foreclosures and Abandonments**

Due to financial difficulties, a unit owner may be unable to meet his or her personal mortgage obligations. If the unit is not readily sold because of declining real estate prices, the owner may abandon the unit or the association may have to foreclose on the unit for delinquent assessments. Units may also be abandoned by developers or financial institutions due to declines in market values of the units. The tax treatment of such occurrences differs slightly for cooperative housing corporations and condominiums or homeowners' associations.

Condominiums and homeowners' associations do not issue ownership shares. They do, however, receive abandoned units and foreclose on units for nonpayment of delinquent assessments. When a unit is received in that manner, it is a best practice for the acquisition to be treated as an investment in real estate, with a gain or loss recognized when the unit is resold. The CIRA's basis in a foreclosed unit for tax purposes may be different than the CIRA's basis for financial statement purposes. A discussion of reacquired shares of cooperatives is beyond the scope of this course, but more information is available in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty*.

### **Disabled Access Credit**

Several provisions of the Americans with Disabilities Act of 1990 apply to CIRAs. In addition to making reasonable accommodations to enable disabled employees to perform their jobs, the public accommodation provisions apply to CIRAs that own facilities that may be used by nonmembers; e.g., recreational facilities and sales offices. CIRAs are eligible for a tax credit on Form 8826 for expenses incurred to provide access to disabled persons if, for the preceding year:

- They did not have more than 30 full-time employees, or
- They did not have more than \$1 million in gross receipts.

The credit is 50% of eligible access expenses for the year that are more than \$250 but not more than \$10,000. Therefore, the maximum credit allowed in any one year is \$5,000.

### **Energy Credits and Subsidies Energy Credits**

In March 2011, the IRS issued the nonauthoritative Information Letter 2011-0048 to address the issue of nonbusiness energy credits for condominium and cooperative associations. The IRS stated that IRC Section 25C clearly applies to individuals. Paragraph E of IRC Section 25C specifically states that joint ownership does not disqualify the credit. The IRS concluded that certain energy credits are to be treated as individual tax credits of the members



of the association based upon their proportionate share of expenditures. Consequently, the burden falls upon the association to timely notify its members of their share of energy property expenditures.

### **Energy Subsidies**

Private Letter Ruling 201607004 clarified that subsidies received from state organizations for installation of a residential solar photovoltaic system do not represent income to the recipient, but are amounts excludable from income as “*energy conservation subsidies*” excluded under IRC Section 136.

### **Deduction of Property Taxes by Members of Homeowners' Associations**

A related issue was clarified by in IRS Private Letter Ruling 201202004, wherein the developer built condominium units on leased land owned by a governmental agency. In that case, no direct property taxes related to the land are paid by the unit owners. Rather, the property tax is considered to be a component of the land lease, or a PILOT (Payment In Lieu Of Tax). Unit owners are allowed a property tax deduction, and the association is responsible for advising the member of the amount of their prorate share of deduction.

Members of homeowners' associations may feel that they should be allowed to deduct as property taxes that portion of their annual assessments that is used to pay property taxes on the common areas. Revenue Ruling 76-495 held that those assessments are not deductible by the members because they are imposed by the association and not by the government.

### **Unincorporated Neighborhood Associations**

Residents of some housing developments may participate in voluntary membership associations that provide security or other services to their members. They are not considered to be CIRAs subject to the AICPA guide if membership is voluntary rather than passing with the title to the property. However, if it is determined that the unincorporated neighborhood association is subject to federal income taxation, it may be classified as either a partnership or a corporation. Under Treasury Regulations Section 301.7701-3, the so-called “check-the-box” regulations allow the association to elect to be treated as one or the other. Existing associations will continue to be classified as they had been prior to January 1, 1997, unless they elect the other classification under the “check-the-box” rules. If no election is made for new associations, a partnership default classification will apply.

### **Environmental Cleanup Costs**

For both tax and financial reporting, environmental cleanup costs incurred generally should be capitalized if they improve the condition of the property and meet other specific conditions. For tax purposes, however, the costs generally cannot be deducted until they are paid because of the economic performance rules of IRC Section 461(h). GAAP requires a liability to be recognized if the criteria under FASB ASC 450 are met. Further discussion of environmental cleanup costs is beyond the scope of this course, but more information is available in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

### **Committees and Clubs**

Many larger associations have groups of members that form clubs or committees for their recreational and other activities. Some of these organizations conduct financial transactions and others do not. The majority of these organizations do not formally organize for tax purposes. Many of these organizations have the associations handle their financial transactions. Others opt for opening a separate bank account. In order to open a separate bank account, many of these organizations will use the association's federal ID number.

Accounting rules generally require the association to combine committee and club transactions into the association's financial statements for financial reporting purposes where it is considered that the association exerts significant control over the committee or club. The IRS requires that all financial transactions be reported, the only question is, “Who is the taxpayer?”

If the association combines or consolidates the financial transactions of the committees or clubs for accounting purposes, it is natural to also report those transactions as part of the association's financial transactions for tax

purposes. The tax preparer must consider the nature of the income and expenses in determining if the income and expenses are exempt or nonexempt on Form 1120-H or member or nonmember on Form 1120.

If committee and club financial transactions are not included on the association's tax return, the tax preparer must consider who is responsible for filing the tax returns and should advise the associations and appropriate representatives of the committees and clubs of their obligation to file tax returns.

It is possible that the committees and clubs could be formally formed into one or more 501(c)(7) recreational organizations. Unless there are significant financial transactions it is unlikely that the cost of preparing an exemption application could be justified.

The IRS stated in Revenue Ruling 75-370 that reserve funds created a relationship of agent and principal between the association and its members. Revenue Ruling 74-321 was cited as the precedent for this reasoning. That ruling further referenced Revenue Ruling 74-319 regarding an organization that collected and disbursed monies for a dealer advertising fund. Revenue Ruling 74-319 held that such monies were not income or deductions to the company, but belonged to the dealers as an unincorporated organization.

Applying that same reasoning here, the committees and clubs each represent an unincorporated organization as defined in IRC Section 7701(a)(3). Since these committee and clubs have members, and are not exempt under any section of the Code, they automatically fall under the provisions of IRC Section 277 and would be required to file Form 1120.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

20. Under which of the following circumstances would a CIRA be considered to serve the community?
  - a. Allowing the public free use of its common areas on weekends.
  - b. Occupying a geographic area that entails a large enough square mileage.
  - c. It must contribute to the exterior maintenance of all units to prevent eye sores.
  - d. Being considered a community in and of itself.
21. What is the most important benefit of an IRC Section 501(c)(7) exemption?
  - a. The CIRA qualifies for tax exemption for purchasing supplies and equipment for members.
  - b. The CIRA can prove its exemption based on its service to the community.
  - c. The CIRA's net membership income will not be subject to taxation.
  - d. The CIRA's interest income will not be subject to taxation.
22. The Hampstead Association is a master association. All of its members are other homeowners' associations. The CIRA is not considered tax exempt, and it meets appropriate qualifying tests under IRC Section 528. Which tax return should this association file?
  - a. Form 1120-H.
  - b. Form 14449.
  - c. Form 990-T [Under 501(c)(7)].
  - d. Form 990-T [Under 501(c)(4)].
23. Which of the following statements best describes a specialized tax situation that a CIRA may encounter?
  - a. Proceeds from the sale of common area assets are treated the same whether they are sold to a member or a nonmember.
  - b. When an association runs a rental pool for its members, related income will be shared amongst the group of participating owners.
  - c. Associations are required to report rebates from utility companies for energy-saving devices as income.
  - d. Timeshare associations are exempt from collecting and remitting the Transient Occupancy Tax (TOT).
24. The Desert Valley Neighborhood Association has recreational facilities that can be used by nonmembers. It has 21 full-time employees, and its annual gross receipts were \$750,000. During the current tax year, it spends \$9,000 making upgrades to these facilities to provide better access to disabled persons. How much can the association claim under the disabled access tax credit?
  - a. \$9,000.
  - b. \$5,000.
  - c. \$4,500.
  - d. \$0.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

20. Under which of the following circumstances would a CIRA be considered to serve the community? **(Page 398)**

- a. Allowing the public free use of its common areas on weekends. [This answer is incorrect. According to Revenue Rulings 74-99 and 80-63, an organization can serve the community by offering to the general public, i.e., "the community," (relatively) unrestricted access to its facilities (its common areas). A CIRA that limits such use by the public to weekends would not be considered to serve the community.]
- b. Occupying a geographic area that entails a large enough square mileage. [This answer is incorrect. Based on the guidance in Revenue Rulings 74-99 and 80-63, an organization can serve the community if it occupies a geographic area "which bears a reasonable relationship to an area ordinarily identified as governmental." However, this would be judged more by the lines of the governmental area, not by the number of square miles included.]
- c. It must contribute to the exterior maintenance of all units to prevent eye sores. [This answer is incorrect. To qualify for a 501(c)(4) exemption, a CIRA must *not* conduct activities directed to the exterior maintenance of any private residence. Therefore, doing so would not count as service to the community in order to attain tax exempt status.]
- d. **Being considered a community in and of itself. [This answer is correct. Section 501(c)(4) requires that the exempt organization serve a "community," but does not define "community." Revenue Rulings 74-99 and 80-63 reinforce the concept of service to a single community. One of the three criteria by which an organization can serve a community is when the organization itself constitutes a "community."]**

21. What is the most important benefit of an IRC Section 501(c)(7) exemption? **(Page 405)**

- a. The CIRA qualifies for tax exemption for purchasing supplies and equipment for members. [This answer is incorrect. Associations operated on a cooperative basis for the purpose of purchasing supplies and equipment for members or other persons at cost plus expenses may qualify for tax-exempt status under IRC Section 521. Therefore, this consideration is not part of IRC Section 501(c)(7). Also, Revenue Ruling 90-36 states that "there is no provision exempting cooperative housing corporations described in IRC Section 216(b)(1) from federal taxation," which makes this exemption problematic for such CIRAs.]
- b. The CIRA can prove its exemption based on its service to the community. [This answer is incorrect. IRC Section 501(c)(7) applies to "social" or "recreational" organizations. That section and its related regulations require that an organization be operated *exclusively* for "pleasure, recreation, and other nonprofitable purposes" to qualify under IRC Section 501(c)(7). Section 501(c)(4) is the one that requires an exempt organization to serve the community.]
- c. **The CIRA's net membership income will not be subject to taxation. [This answer is correct. The major benefit of an IRC Section 501(c)(7) exemption is that an association's *net membership income* is not subject to taxation. Thus, associations that are exempt under IRC Section 501(c)(7) automatically avoid having to deal with the complexities of Revenue Ruling 70-604's "excess membership income" provisions.]**
- d. The CIRA's interest income will not be subject to taxation. [This answer is incorrect. One disadvantage to the Section 501(c)(7) exemption, as compared to the Section 501(c)(4) exemption, is that associations must pay taxes on interest income. Interest income is not taxable for associations that are exempt under IRC Section 501(c)(4).]

22. The Hampstead Association is a master association. All of its members are other homeowners' associations. The CIRA is not considered tax exempt, and it meets appropriate qualifying tests under IRC Section 528. Which tax return should this association file? **(Page 411)**
- a. **Form 1120-H.** [This answer is correct. IRS Regulation 1.528-1 states, “. . . if the membership of an organization consists of other homeowners associations, the owners of units, residences, or lots who are members of such homeowners associations will be treated as the members of the organization for the purposes of the regulations under Section 528.” Thus, so long as a master association (such as Hampstead) meets the qualifying tests under IRC Section 528, it may file its income tax return on Form 1120-H.]
  - b. Form 14449. [This answer is incorrect. Form 14449 (Self-Declarers Questionnaire) is only filed by tax-exempt organizations. Therefore, Hampstead does not qualify to file this form.]
  - c. Form 990-T [Under 501(c)(7)]. [This answer is incorrect. Hampstead is not tax exempt, so it would not file this tax return.]
  - d. Form 990-T [Under 501(c)(4)]. [This answer is incorrect. Form 990-T relates to tax-exempt organizations, and Hampstead does not qualify for this status. Therefore, Hampstead will fill a different tax return.]
23. Which of the following statements best describes a specialized tax situation that a CIRA may encounter? **(Page 415)**
- a. Proceeds from the sale of common area assets are treated the same whether they are sold to a member or a nonmember. [This answer is incorrect. Proceeds from the sale of common area assets generally are received from nonmembers of the associations and, therefore, usually constitute nonmembership income on Form 1120. In the event that a sale of common area assets is made to a member of the association, the tax treatment may be different. If the association files Form 1120-H, it will still be classified as nonexempt function income and will not be distinguishable from a sale to a nonmember. However, if the associations files Form 1120, this sale will be classified as member income, as opposed to nonmember income.]
  - b. When an association runs a rental pool for its members, related income will be shared amongst the group of participating owners. [This answer is incorrect. There are two types of rental pooling arrangements. In one of them, when the association rents the units like a hotel, income is shared, but in the other type of rental pool arrangement the unit owner receives rental income only when the unit is rented and remains responsible for the unit's direct expenses.]
  - c. **Associations are required to report rebates from utility companies for energy-saving devices as income.** [This answer is correct. Many associations have reported receiving rebates from utility companies for installing energy-saving devices. Along with the rebates, however, the associations are receiving Form 1099s reporting the rebate amounts as income. While it seems illogical to report income for expending funds that do not generate a tax deduction, that is the net result. Failure to report the income virtually guarantees a tax adjustment under the IRS Form 1099 matching program. There is no apparent relief under tax law.]
  - d. Timeshare associations are exempt from collecting and remitting the Transient Occupancy Tax (TOT). [This answer is incorrect. The TOT is a tax assessed by local governments on hotels based on occupied room nights. TOT is the charge added to hotel bills. Most local governmental agencies have adopted the policy that TOT may not be assessed on owners or timeshare members that are staying in *their* rooms, as those individuals' full or fractional ownership privileges keep them from being considered *transients*. But, nonmembers staying in those same rooms are truly *transients* and are subject to the TOT. Consequently, timeshares or associations operating rental pools are obligated under local law to account for, collect, and remit the TOT to the local governmental agency.]

24. The Desert Valley Neighborhood Association has recreational facilities that can be used by nonmembers. It has 21 full-time employees, and its annual gross receipts were \$750,000. During the current tax year, it spends \$9,000 making upgrades to these facilities to provide better access to disabled persons. How much can the association claim under the disabled access tax credit? **(Page 418)**
- a. \$9,000. [This answer is incorrect. There is a cap on the disabled access tax credit; therefore, Desert Valley will not be able to claim the full \$9,000 that it spent making these upgrades.]
  - b. \$5,000. [This answer is incorrect. The disabled access credit is 50% of eligible access expenses for the year that are more than \$250 but not more than \$10,000. Therefore, the maximum credit allowed in any one year is \$5,000. Desert Valley did not spend \$10,000; therefore, it cannot claim the maximum credit amount.]
  - c. **\$4,500. [This answer is correct. The disabled access credit is 50% of eligible access expenses for the year that are more than \$250 but not more than \$10,000. Therefore, the maximum credit allowed in any one year is \$5,000. Assuming all of Desert Valley's expenditures qualify, it should be able to deduct half of the \$9,000 spent. Therefore, the association will claim a credit of \$4,500.]**
  - d. \$0. [This answer is incorrect. The association would not qualify for this tax credit if it had more than 30 full-time employees or more than \$1 million in gross receipts; however, as described in this scenario, Desert Valley does not exceed these limitations. Therefore, this association will qualify for the disabled access tax credit.]

## EXAMINATION FOR CPE CREDIT

### Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 3—Financial Statement Presentation and Income Taxes (HOATG173)

#### Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

**ONLINE GRADING.** Log onto our Online Grading Center at [cl.thomsonreuters.com/ogs](http://cl.thomsonreuters.com/ogs) to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of \$89 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

**PRINT GRADING.** If you prefer, you may email, mail, or fax your completed answer sheet, as described below (\$89 for email or fax; \$99 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation**, and payment via one of the following methods:

- Email to: [CPLGrading@thomsonreuters.com](mailto:CPLGrading@thomsonreuters.com)
- Fax to: **(888) 286-9070**
- Mail to:

**Thomson Reuters**  
**Tax & Accounting—Checkpoint Learning**  
**HOATG173 Self-study CPE**  
**36786 Treasury Center**  
**Chicago, IL 60694-6700**

**Note:** The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
3. Each answer sheet sent for print grading must be accompanied by the appropriate payment (\$89 for answer sheets sent by email or fax; \$99 for answer sheets sent by regular mail). Discounts apply for three or more

courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is \$254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The \$10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **September 30, 2018**. CPE credit will be given for examination scores of 70% or higher.
5. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS**. Be sure to keep a completed copy for your records.
6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.



**EXAMINATION FOR CPE CREDIT****Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 3—Financial Statement Presentation and Income Taxes (HOATG173)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. A common interest realty association (CIRA) should present its financial statements using what basis of accounting to be conformity with generally accepted accounting principles (GAAP)?
  - a. Accrual.
  - b. Cash.
  - c. Modified cash.
  - d. Whatever method the CIRA uses to maintain its accounting records during the year.
2. The Woodview Homeowners' Association uses fund accounting. How could this affect presentation of its balance sheet?
  - a. The difference between Woodview's assets and liabilities should be called "members' equity."
  - b. Woodview should eliminate interfund transactions so they are not reflected in the "total" column.
  - c. Woodview should aggregate funds designated for future repairs and replacements with cash it has available for current operations.
  - d. Woodview should always present its assets in order of maturity and its liabilities in order of liquidity.
3. Which of the following may be the only reconciling item on a CIRA's statement of changes in fund balance?
  - a. Contributions of capital.
  - b. Error corrections.
  - c. Excess of the period's revenues over expenses.
  - d. Unrealized gains and losses on securities classified as available for sale.
4. Which of the following CIRAs needs to report comprehensive income?
  - a. The Abbey Run Association presents changes in shareholders' equity on the face of its balance sheet.
  - b. The Barrow Hills Association has a discrepancy between the fund balance account on its balance sheet and supplementary information about a major repair.
  - c. The Centerpointe Association includes a reconciliation of beginning and ending fund balances with its financial statements.
  - d. The Dawn Vista Association has investments in marketable securities that are available for sale.

5. The Lunar Heights Homeowners' Association includes a statement of revenues and expenses and a balance sheet in its GAAP financial statements. Because both of these things are included in the association's financial statement presentation, it will also need to include which of the following?
- a. A statement of cash flows.
  - b. A statement of changes in shareholders' equity.
  - c. A statement of comprehensive income.
  - d. Notes to the financial statements.
6. Which of the following are the five principle elements of a typical statement of cash flows?
- |  |   |
|--|---|
| i. Cash flows from operations.             | v. Net change in cash during the period.  |
| ii. Cash flows from financing activities.  | vi. Excess of revenues over expenses for the period.  |
| iii. Cash flows from investing activities. | vii. Differences between the cash balance for future repairs/replacements and the fund balance for future repairs/replacements. |
| iv. Interfund transactions.                | viii. Supplemental disclosure of any non-cash financing and investment activities.  |
- a. i., ii., iii., iv., and v.
  - b. i., ii., iii., v., and vii.
  - c. i., ii., iii., v., and viii.
  - d. i., ii., iii., vi., and viii.
7. Which of the following pieces of supplementary information is a CIRA required to present with its financial statements?
- a. Additional details about the CIRA's revenues and expenses.
  - b. A comparison of actual operating results to budgeted amounts.
  - c. Details of expenditures the CIRA made from its replacement fund.
  - d. Estimates of future major repairs or replacements of existing components.
8. What type of CIRA files Form 1120-C and is subject to subchapter T of the Internal Revenue Code?
- a. A commercial condominium association.
  - b. A cooperative housing corporation.
  - c. A homeowner's association.
  - d. A timeshare association.

9. Which of the following is excluded from a CIRA's gross income for tax purposes?
- a. Operating assessments paid by CIRA members.
  - b. Fees paid by nonmembers for CIRA services.
  - c. Interest income and other passive income.
  - d. Litigation proceeds received by the CIRA.
10. The Patterson Homeowners' Association assesses funds from its members for a painting reserve fund. This money will be used to paint the association's common areas. Based on tax law, can the CIRA treat these funds as a capital contribution?
- a. Yes, because painting is a reserve item.
  - b. Yes, because painting is a high-dollar expenditure.
  - c. No, because the funds are for common areas.
  - d. No, because the nature of the activity is noncapital.
11. Which of the following can a CIRA distribute to provide members advance notice of a special assessment for replacements or repairs?
- a. A copy of the CIRA's annual budget.
  - b. Copies of the budget and a replacement fund reserve study.
  - c. Copies of a replacement fund reserve study and Form 1120-H.
  - d. Copies of Form 1120-H and Form 990.
12. If a CIRA plans to classify some member assessments as contributions of capital, having how many bank accounts would prove the most beneficial?
- a. One bank account—an operating account.
  - b. Two bank accounts—an operating account and a reserve account.
  - c. Three bank accounts—an operating account, a noncapital replacement fund account, and a capital replacement fund account.
  - d. Multiple bank accounts—an operating account and a separate account for every component of the reserve fund.
13. After the Hollowland Neighborhood Association files its Form 1120 for the current year, it determines that an impermissible accounting method was used. How should the association proceed?
- a. If its return is selected by the IRS for audit, the association should file an amended return.
  - b. If the association files an amended return, it must do so within 12 months.
  - c. The association must request permission from the Commissioner to file an amended return and provide the reason why.
  - d. The CIRA should avoid filing an amended return because it will prejudice the IRS against them.

14. The Glendale Homeowners' Association has a deficit in its operating fund so it transfers in funds from its reserve fund. Which of the following actions would help the association nullify any tax consequences of this transfer?
- a. Members could vote to refund an amount equal to the deficit from the reserves to themselves then vote to contribute it as operating assessments.
  - b. Association management can make the transfer of funds without involving a vote of the membership.
  - c. The association can treat the transfer of funds as a permanent transfer so it will not be considered a loan.
  - d. Association members should document the fact that the transfer was made with no evil motives and for no bad purposes.
15. Under what circumstances would a CIRA be considered the taxpayer in relation to a lawsuit?
- a. CIRA members individually or collectively file a lawsuit.
  - b. The CIRA files a lawsuit as an agent for the members.
  - c. The CIRA files the lawsuit on behalf of itself.
  - d. A designated settlement fund is established.
16. Carlos, a construction contractor, receives membership shares in the Shady Elm Homeowners' Association when he turns common property (a swimming complex and an activities room) over to the association. What basis will the association have in the property?
- a. The association will have the same basis that Carlos had when he turned over the property.
  - b. The association will have a basis in the property equal to fair market value at the time of transfer.
  - c. The association will have a basis in the property worth the same amount as the membership shares.
  - d. The association will have no basis in the property since it did not purchase the property outright.
17. Which of the following statements best describes an aspect of tax law common to all CIRAs?
- a. Investment income from settlement proceeds from a construction claim are typically insignificant and unlikely to be considered taxable income.
  - b. Under GAAP and tax law, CIRAs must treat transactions the same way for income tax purposes as they do for financial reporting.
  - c. Assets purchased by a CIRA from operating funds generally will have a tax basis, while assets purchased from reserves likely will not.
  - d. Cooperative associations follow the same types of tax law as condominium and homeowners' associations because they have the same structure.

18. Which of the following are included in a *homeowner's association* according to IRC Section 528?
- a. Cooperative housing corporations and timeshare associations.
  - b. Nonresidential condominium associations and homeowners' associations.
  - c. Residential condominium associations, homeowners' associations, and timeshare associations.
  - d. Residential condominium associations, homeowners' associations, and timeshare associations and cooperative housing corporations.
19. Assuming they meet all additional qualifications, which of the following homeowners' associations can file its taxes on Form 1120-H?
- a. The Manchester Building Association holds 90% of its square footage for residential purposes.
  - b. The Valleyview Association's gross income for the tax year is 45% exempt function income.
  - c. The Cloverbrook Association classified 50% of its expenses for the tax year as related to its exempt functions.
  - d. The founding member of the Havisham Association profits from the association's net earnings.
20. The total amount of which of the following is considered a qualifying expense when applying the 90% expenditures test?
- a. Expenditures for member recreational facilities guests can use for a fee.
  - b. Excess assessments that the association refunds to its members.
  - c. Transfers of funds the association holds to use for next year's roof replacement.
  - d. Expenditures that related to an association's investments.
21. The Residential Bowers Association has income from the following sources. Which would be considered nonexempt function income?
- a. Member operating assessments.
  - b. Fees paid by members to use laundry facilities.
  - c. Interest on delinquent member assessments.
  - d. Fees paid by members for moving in or moving out.
22. Which of the following might disqualify a homeowners' association from filing Form 1120-H?
- a. Reducing nonexempt function income by expenses that are directly connected to nonexempt function income.
  - b. Allocating janitorial costs to multiple income categories, such as both rentals and community rooms.
  - c. Borrowing money for repairs if the association is unable to raise enough with regular or special assessments.
  - d. Increasing monthly member assessment enough that utility costs will not be passed through.

23. Which of the following pieces of advice applies when an association is deciding whether to file Form 1120-H?
- a. If the tax is only marginally different, the higher risk of filing Form 1120 is worth it.
  - b. If the association's taxable income is less than \$100, Form 1120-H yields lower taxes.
  - c. When filing Form 1120-H, the association will be liable for any state income taxes.
  - d. When strictly considering the cost-benefit ratio, filing Form 1120 makes more sense.
24. According to the IRS, once an association makes an 1120-H election for a tax year, can it be revoked?
- a. Yes, the association can revoke the election any time by filing Form 1120.
  - b. Yes, as long as the association makes the revocation within 12 months.
  - c. Yes, but only if consent of the IRS Commissioner is obtained.
  - d. No, the election is binding since the association filed Form 1120-H for that tax year.
25. Subchapter T cooperative housing corporations should file which of the following?
- a. Form 1120.
  - b. Form 1120-C.
  - c. Form 1120-H.
  - d. They can elect to file the form that is most advantageous.
26. A CIRA's *nonmembership income* is defined as which of the following?
- a. Gross income minus its membership income.
  - b. Income from investments and membership assessments.
  - c. Income from nonassociation property, revenue from the use of association property by nonmembers, and amounts charged to members for specific services.
  - d. Reclassification of reserves to exempt function income.
27. According to IRC Section 277, how should a CIRA address net nonmembership loss?
- a. Pay taxes on it at the regular corporate rate.
  - b. Treat it as net operating losses under IRC Section 172.
  - c. Defer tax on it using the 70-604 election.
  - d. Carry it forward to future years.

28. Revenue Ruling 70-604 allows a CIRA to do which of the following?
- a. Allocate expenses to investment income.
  - b. Apply excess membership income to replacement funds.
  - c. Remove excess membership assessments from taxable income.
  - d. Carry back net operating losses.
29. The Gardenvue Circle Neighborhood Association has not made a 70-604 election and files Form 1120. In the current year, it has taxable income of \$200,000. Assuming no other credits or deductions, what is Gardenvue's total income tax?
- a. \$30,000.
  - b. \$45,000.
  - c. \$61,250.
  - d. \$70,000.
30. It would be the most advantageous tax-wise for which of the following CIRAs to switch from filing Form 1120-H to Form 1120?
- a. CIRA 1 was created last year and has low balances in its reserves.
  - b. CIRA 2 has material cash balances and excess membership deductions.
  - c. CIRA 3 is accumulating reserves for a painting initiative in two years.
  - d. CIRA 4 revises its budget to eliminate excess membership income.
31. What type of CIRA can use patronage dividends to accumulate working capital without paying income on that reserve?
- a. A homeowners' association.
  - b. A timeshare association.
  - c. A cooperative condominium association.
  - d. A residential condominium association.
32. Eighteen months after filing its Form 1120, the Collinwood Homeowners' Association determines that it should have filed Form 1120-H instead. How should the CIRA proceed?
- a. It can file an amended return by replacing Form 1120 with Form 1120-H.
  - b. It must request an extension of time to make an election under IRC Section 528.
  - c. It must pay a penalty to the IRS before it can amend its return.
  - d. It is prohibited from amending the return because more than 12 months have passed.

33. Which of the following statements describes an aspect of tax exemption as it relates to CIRAs?
- a. Typically, if a CIRA is tax exempt it will qualify as an IRC Section 501(c)(3) organization.
  - b. A formal application process is required before a CIRA can begin filing Form 990 as an exempt organization.
  - c. Because they focus on members rather than the community, CIRAs seldom qualify as tax exempt.
  - d. CIRAs with gross receipts under \$25,000 currently are not required to file tax returns.
34. Which of the following would disqualify a CIRA from tax exemption under IRC Section 501(c)(7)?
- a. Providing trash collection or police and fire protection.
  - b. Being organized for pleasure or recreation.
  - c. Having no net earnings that benefit private shareholders.
  - d. Allowing members to choose their own architectural styles.
35. Form 1024 allows a CIRA to do which of the following?
- a. Retain basis in purchased common area property.
  - b. Deduct environmental cleanup costs.
  - c. Revoke its tax-exempt status.
  - d. Request IRS recognition of tax-exempt status.
36. The Ketter Fields Homeowners' Association qualifies as tax exempt. It earns income on several activities. Assuming all other qualifications are met, which of the CIRA's activities would be considered an unrelated trade or business?
- a. Activity 1 is considered to be a business.
  - b. Activity 2 is carried on only twice per year.
  - c. Activity 3 is related to the CIRA's exempt purpose.
  - d. Activity 4 is performed by full-time CIRA employees.
37. A CIRA for an industrial park or a professional building would be considered which of the following?
- a. A timeshare development.
  - b. A commercial association.
  - c. A master association.
  - d. A cooperative housing corporation.



38. How are a CIRA's ancillary operations, such as user fees, treated if the organization files Form 1120-H?
- a. They are classified as nonexempt function income.
  - b. They must be separated between members and nonmembers.
  - c. They will be considered unrelated business taxable income.
  - d. They will be exempt from items such as tax credits and sales taxes.
39. After losing his job, Michael has to abandon his home. How will this affect the homeowners' association?
- a. It will receive ownership shares from Michael.
  - b. It will foreclose on his unit for nonpayment.
  - c. Receipt of the unit will be treated as the sale of property.
  - d. Its basis in the unit will be the same for tax and financial statement purposes.
40. Under what circumstances would a neighborhood association **not** be considered a CIRA?
- a. If the association is structured as a cooperative housing corporation.
  - b. If the association is considered a master association.
  - c. If the association is part of a "gated community."
  - d. If membership is voluntary as opposed to passing with the title of the property.



## GLOSSARY

**12-month rule:** A tax position taken by CIRAs in which any asset purchases from reserve funds are deferred for 12 months. After that period has passed, funds from the reserve fund can be used to purchase assets.

**60% income test:** To qualify to file Form 1120-H, at least 60% of an association's gross income for the tax year must consist of exempt function income.

**90% expenditure test:** To qualify to file Form 1120-H, at least 90% of an association's expenses for the tax year must be for the purpose of carrying on one or more of the exempt functions of a condominium or homeowners association. Timeshare associations must spend at least 90% during the taxable year for activities provided to or on behalf of their members.

**Commercial association:** These provide nonresidential facilities and generally are either condominiums or planned developments (e.g., office parks, professional buildings, shopping centers, and docks). They perform the same functions for their owners as typical residential CIRA management corporations perform for their owners (e.g., management, maintenance, and care of common elements).

**Comprehensive income:** All changes in equity during a period *except* those resulting from investments by owners and distributions to owners.

**Condominium management associations:** These are organized and operated to acquire, build, manage, and care for the property in a condominium project substantially all of whose units are homes for individuals.

**Earmarking:** Segregating funds for future major repairs and replacements from operating funds.

**Exempt function income:** Associations determine this type of income based on the source test, the nature test, the purpose test, and the gross income test.

**Fund:** An accounting entity established to account for resources used for specific activities or objectives in accordance with special regulations, restrictions, or limitations.

**Fund accounting:** A type of accounting that segregates the financial statement amounts into groupings based on the entity's specific activities.

**Gross income:** All income from whatever source derived, except as otherwise provided by IRC Section 61.

**Homeowners' associations:** According to the IRS, these include residential condominium associations, homeowners' associations, and timeshare associations, but exclude cooperative housing corporations.

**Homeowners' association taxable income:** An association's net nonexempt function income.

**Lack of private benefit test:** To qualify to file Form 1120-H, no member of an association may profit from the association's net earnings.

**Membership income:** Gross income received by a membership organization from its members in consideration for membership activities. Similar to *exempt function income*.

**Nonmembership income:** Defined by exception, this is a membership organization's gross income exclusive of *membership income*.

**Other comprehensive bases of accounting (OCBOAs):** The cash, tax, and regulatory bases of accounting, as well as other bases of accounting that use a definite set of logical and reasonable criteria applied to all material items within the financial statements.

**Other comprehensive income:** Revenues, expenses, gains, and losses that, under GAAP, are included in *comprehensive income* but excluded from the excess of revenues over expenses.

**Qualified settlement fund:** According to IRC Section 468B, this is a fund, account, or trust established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event that has occurred and that has given rise to at least one claim asserting liability arising out of a tort, breach of contract, or violation of law.

**Qualifying expenditures:** When applying the *90% expenditure test*, qualifying expenditures are either current operating expenditures or capital expenditures that are made for the acquisition, construction, management, maintenance, and care of association property.

**Qualifying expenses:** When applying the *90% expenditure test*, the term qualifying expenses refers to actual expenditures made. Holding funds in reserve to meet future expenditures does not count.

**Residential real estate management associations:** These are organized and operated to acquire, build, manage, and care for a subdivision, development, or similar area substantially all of whose lots or buildings are homes for individuals.

**Structured settlements:** These are a concept sometimes applied to CIRAs in cases of construction defects litigation. The payout of the construction defects settlement is *structured* to help reduce the tax burden of the association while at the same time making it less expensive for the developer to settle the claim.

**Substantially residential test:** To qualify to file Form 1120-H, substantially all of the association's units must be held for residential purposes.

**Timeshare developments:** A specific form of CIRA that entitles the owner to the right to use a unit for a specified period of time each year (usually at weekly intervals) or a fee simple ownership interest in a unit.

**Unrelated business income:** Income that comes from an activity not related to a tax-exempt organization's exempt purpose. Unrelated business income comes from an *unrelated trade or business*.

**Unrelated trade or business:** Any trade or business, the conduct of which is not substantially related to the exercise or performance of a tax-exempt organization's exempt purpose.

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**EXAMINATION FOR CPE CREDIT ANSWER SHEET****Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 1—Performing Substantive Procedures and Concluding the Audit (HOATG171)**

Name: \_\_\_\_\_

Firm Name: \_\_\_\_\_

Firm Address: \_\_\_\_\_

City: \_\_\_\_\_ State /ZIP: \_\_\_\_\_

Firm Phone: \_\_\_\_\_ Firm Fax No.: \_\_\_\_\_

Firm Email: \_\_\_\_\_

Signature: \_\_\_\_\_

Credit Card Number: \_\_\_\_\_ Expiration Date: \_\_\_\_\_

Birth Month: \_\_\_\_\_ Licensing State: \_\_\_\_\_

**ANSWERS:**

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ☒ not like this ☐ ☐ ☒.

**You must complete the entire course to be eligible for credit.**

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8. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	18. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	28. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	38. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	19. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	29. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	39. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	20. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	30. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	40. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

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**Expiration Date: September 30, 2018**

## Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 1—Performing Substantive Procedures and Concluding the Audit

Course Acronym: HOATG171

Your Name (optional): \_\_\_\_\_ Date: \_\_\_\_\_

Email: \_\_\_\_\_

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ☒ not like this ☐ ☐ ☐.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please enter the number of hours it took to complete this course. \_\_\_\_\_

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

### Additional Comments:

- What did you find **most** helpful? \_\_\_\_\_
- What did you find **least** helpful? \_\_\_\_\_
- What other courses or subject areas would you like for us to offer? \_\_\_\_\_
- Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? \_\_\_\_\_
- How many employees are in your company? \_\_\_\_\_
- May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No** ☐ ☐

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**EXAMINATION FOR CPE CREDIT ANSWER SHEET****Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 2—Common Interest Realty Associations and Applicable Accounting Principles and Practices (HOATG172)**

Name: \_\_\_\_\_

Firm Name: \_\_\_\_\_

Firm Address: \_\_\_\_\_

City: \_\_\_\_\_ State /ZIP: \_\_\_\_\_

Firm Phone: \_\_\_\_\_ Firm Fax No.: \_\_\_\_\_

Firm Email: \_\_\_\_\_

Signature: \_\_\_\_\_

Credit Card Number: \_\_\_\_\_ Expiration Date: \_\_\_\_\_

Birth Month: \_\_\_\_\_ Licensing State: \_\_\_\_\_

**ANSWERS:**

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ☒ not like this ☐ ☐ ☒.

**You must complete the entire course to be eligible for credit.**

a	b	c	d	a	b	c	d	a	b	c	d	a	b	c	d
1. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	11. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	21. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	31. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	12. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	22. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	32. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	13. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	23. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	33. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	14. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	24. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	34. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	15. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	25. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	35. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	16. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	26. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	36. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	17. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	27. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	37. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	18. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	28. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	38. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	19. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	29. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	39. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	20. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	30. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	40. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

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**Expiration Date: September 30, 2018**

## Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 2—Common Interest Realty Associations and Applicable Accounting Principles and Practices (HOATG172)

Course Acronym: HOATG172

Your Name (optional): \_\_\_\_\_ Date: \_\_\_\_\_

Email: \_\_\_\_\_

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ☒ not like this ☐ ☐ ☒.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please enter the number of hours it took to complete this course. \_\_\_\_\_

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

### Additional Comments:

- What did you find **most** helpful? \_\_\_\_\_
- What did you find **least** helpful? \_\_\_\_\_
- What other courses or subject areas would you like for us to offer? \_\_\_\_\_
- Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? \_\_\_\_\_
- How many employees are in your company? \_\_\_\_\_
- May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No** ☐ ☐

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**EXAMINATION FOR CPE CREDIT ANSWER SHEET****Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 3—Financial Statement Presentation and Income Taxes (HOATG173)****CTEC Course No. 3039-CE-2148**

Name: \_\_\_\_\_

Firm Name: \_\_\_\_\_

Firm Address: \_\_\_\_\_

City: \_\_\_\_\_ State /ZIP: \_\_\_\_\_

Firm Phone: \_\_\_\_\_ Firm Fax No.: \_\_\_\_\_

Firm Email: \_\_\_\_\_

CTEC No.: \_\_\_\_\_ PTIN: \_\_\_\_\_

Signature: \_\_\_\_\_

Credit Card Number: \_\_\_\_\_ Expiration Date: \_\_\_\_\_

Birth Month: \_\_\_\_\_ Licensing State: \_\_\_\_\_

**ANSWERS:**

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ☒ not like this ☐ ☐ ☒.

**You must complete the entire course to be eligible for credit.**

a	b	c	d	a	b	c	d	a	b	c	d	a	b	c	d
1. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	11. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	21. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	31. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	12. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	22. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	32. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	13. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	23. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	33. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	14. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	24. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	34. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	15. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	25. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	35. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	16. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	26. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	36. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	17. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	27. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	37. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	18. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	28. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	38. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	19. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	29. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	39. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	20. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	30. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	40. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

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**Expiration Date: September 30, 2018**

## Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 3—Financial Statement Presentation and Income Taxes

Course Acronym: HOATG173

Your Name (optional): \_\_\_\_\_

Date: \_\_\_\_\_

CTEC Number: 3039-CE-2148

Email: \_\_\_\_\_

IRS Program Number(s): OYC0C-T-00887-17-S

CE Provider: Checkpoint Learning

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ☒ not like this ☐ ☐ ☐.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please enter the number of hours it took to complete this course. \_\_\_\_\_

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

### Additional Comments:

- What did you find **most** helpful? \_\_\_\_\_
- What did you find **least** helpful? \_\_\_\_\_
- What other courses or subject areas would you like for us to offer? \_\_\_\_\_
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- How many employees are in your company? \_\_\_\_\_
- May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No** ☐ ☐

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