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By Veeraraghavaraju at 11:36 am, Aug 28, 2018

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Companion to PPC's Guide to

Homeowners' Associations and Other Common Interest Realty Associations

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Interactive Self-study CPE

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. *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* and other PPC products are available for purchase at **tax.tr.com**/**ppcguidance**.

To obtain credit for this course, you must complete the learning process by logging on to our Online Grading System at **cl.tr.com**/**ogs** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **September 30, 2019**. 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 engagements CPAs may perform for homeowners' associations or 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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The requirements for NASBA Registry membership include conformance with 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. Each course is designed to comply with the *Standards*. 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** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the **Overview** page before each course.

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*. 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

PRE-ENGAGEMENT ACTIVITIES AND AUDIT PLANNING (HOATG181)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses pre-engagement activities and audit planning in a homeowners' association or common interest realty association (CIRA) audit. Lesson 1 looks at client acceptance/continuance, establishing the terms of the engagement, and audit planning. Lesson 2 examines how a CPA obtains an understanding of the CIRA, its environment, and internal control. Lesson 3 concludes the course with discussions of audit planning decisions and judgments, sampling, detailed audit plans and workpapers, and planning for initial engagements.

PUBLICATION/REVISION DATE: September 2018

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** 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, 2019**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Client Acceptance and Continuance, Terms of the Engagement, and Audit Planning

Completion of this lesson will enable you to:

- Identify appropriate strategies for making client acceptance and continuance decisions and establishing the terms of the engagement in a CIRA audit.
- Recognize the types of audit planning that are needed in a CIRA audit, such as risk assessment, management inquiries, and the engagement team discussion.

Lesson 2—Understanding the CIRA, Its Environment, and Its Internal Control

Completion of this lesson will enable you to:

- Determine how an auditor obtains an understanding of the CIRA and its environment.
- Identify the components necessary for an understanding of a CIRA's internal control.

Lesson 3—Audit Planning Decisions and Judgments, Sampling, Detailed Audit Plans and Workpapers, and Initial Engagements

Completion of this lesson will enable you to:

- Identify the audit planning decisions and judgments that may be needed in a CIRA audit.
- Determine the best way to address sampling, detailed audit plans and workpapers, and initial engagements when performing a CIRA audit.

TO COMPLETE THIS LEARNING PROCESS:

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See the test instructions included with the course materials for additional instructions and payment information.

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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: Client Acceptance and Continuance, Terms of the Engagement, and Audit Planning

INTRODUCTION

Most audits are performed as part of a continuing engagement with a client. This course explains the activities that take place (a) before an engagement is accepted and (b) in the early planning stages of an engagement. Many of these matters receive attention annually before the start of a continuing engagement. However, they are particularly important and more extensive in the first audit of a new client. In addition to allowing the auditor to make a decision about the acceptance or continuance of a client relationship, pre-engagement activities also provide the auditor with important information that directly contributes to the assessment of risks and development of an audit strategy and detailed audit plan.

At the beginning of an audit, an auditor should perform engagement acceptance and continuance procedures, evaluate compliance with applicable ethics requirements, and establish an understanding with the client about the services to be performed. (AU-C 300.06)

Learning Objectives:

Completion of this lesson will enable you to:

- Identify appropriate strategies for making client acceptance and continuance decisions and establishing the terms of the engagement in a CIRA audit.
- Recognize the types of audit planning that are needed in a CIRA audit, such as risk assessment, management inquiries, and the engagement team discussion.

Authoritative Literature

The authoritative pronouncements that establish requirements or provide guidance about the activities and audit considerations that occur in the pre-engagement and planning stages of an engagement are as follows:

a. AU-C 210, *Terms of Engagement*, establishes the auditor's responsibilities in agreeing on the terms of the audit engagement with management and, when appropriate, those charged with governance. This includes determining that certain preconditions for an audit, for which management and, when appropriate, those charged with governance are responsible, are present.

b. AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, addresses the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements.

c. AU-C 230, *Audit Documentation*, addresses the auditor's responsibilities to prepare audit documentation for an audit of financial statements. These requirements apply to documentation of risk assessment procedures as well as all other audit procedures.

d. AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, establishes requirements for identifying and assessing the risks of material misstatement due to fraud and determining the overall and specific responses to those risks.

e. AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, establishes requirements for obtaining an understanding of the legal and regulatory framework relevant to the industry or sector in which the entity operates and how the entity complies with that framework.

f. AU-C 260, *The Auditor's Communication With Those Charged With Governance*, establishes requirements for the auditor to communicate with those charged with governance.

g. AU-C 300, *Planning an Audit*, addresses the auditor's responsibility to plan an audit of financial statements.

h. AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, establishes requirements for performing risk assessment procedures to provide a basis for identifying and assessing risks of material misstatement and requires obtaining an understanding of various specific matters, including the aspects of internal control relevant to the audit.

i. AU-C 320, *Materiality in Planning and Performing an Audit*, establishes requirements for determining materiality for the financial statements as a whole and performance materiality for assessing the risks of material misstatement at the assertion level, and determining the nature, timing, and extent of further audit procedures.

j. AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, establishes requirements for determining the nature, timing, and extent of further audit procedures (both tests of controls and substantive procedures) in response to the assessed risks of material misstatement.

k. AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, provides guidance on obtaining an understanding of internal control of a client that uses a service organization.

l. AU-C 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*, establishes the auditor's responsibilities relating to opening balances in an initial audit engagement, including a reaudit engagement.

m. AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, establishes requirements relating to auditing accounting estimates.

n. AU-C 550, *Related Parties*, establishes specific additional audit requirements regarding related party relationships and transactions.

o. AU-C 570 and AU-C 570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, establishes requirements for considering whether conditions or events exist that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time.

p. Statement on Quality Control Standards No. 8*, A Firm's System of Quality Control* (QC 10), describes the quality control policies and procedures, including those that pertain to client acceptance and continuance, that a member firm's quality control system should encompass.

q. ET 1.295 of the AICPA *Code of Professional Conduct*, provides guidance regarding an auditor's independence in relationship to an attest client when performing nonattest services.

In addition, auditors need to comply with other ethical requirements of the AICPA's *Code of Professional Conduct* when considering whether an engagement can be accepted or continued. These authoritative pronouncements are explained further at the relevant points in the following discussion.

CLIENT ACCEPTANCE AND CONTINUANCE

The auditor's broad responsibilities under professional standards regarding client acceptance and continuance decisions are as follows:

- *Establishing Policies and Procedures.* Quality control standards require CPA firms to establish policies and procedures for accepting and continuing of client relationships and specific engagements. Engagements should only be continued or accepted when the firm—

  a. Has the necessary competencies to perform the engagement and has the capabilities, including time and resources, to do so;

  b. Can comply with legal and relevant ethical requirements; and

c. Has considered the integrity of the client (including the identity and business reputation of the client's principal owners, key management, and those charged with governance) and does not have information that would lead it to conclude that the client lacks integrity.

- *Timing of Procedures.* AU-C 300.6 and AU-C 300.A8 indicate that auditors should perform client acceptance and continuance procedures, including evaluating compliance with ethical requirements, prior to performing significant audit activities for the current engagement.

- *Establishing Preconditions for an Audit.* AU-C 210.06 addresses the auditor's responsibilities in agreeing on the terms of an audit, which includes establishing that certain preconditions are present. As a precondition for an audit, the auditor should determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable. Another precondition of an audit is to obtain the agreement of management and those charged with governance, as appropriate, that it acknowledges and understands its responsibilities. If the preconditions for an audit are not met, the auditor should discuss the matter with management. Unless the auditor is required by law or regulation to accept the engagement, the auditor should not accept the proposed audit engagement (AU-C 210.08).

- *Communicating with Previous Auditors.* AU-C 210.11 notes that the successor auditor should request permission from the prospective client to inquire of the predecessor auditor prior to final acceptance of the engagement about matters that would assist in making the acceptance decision. In determining whether to accept the engagement, the auditor should evaluate the predecessor auditor's response or consider the implications if the predecessor auditor provides no response or a limited response. Considerations when there is a predecessor auditor are discussed elsewhere in this course.

Client acceptance/continuance policies and procedures provide reasonable assurance that:

- Engagements that are accepted can reasonably be expected to be completed with professional competence.

- The risks associated with providing professional services in the particular circumstances are appropriately considered.

Many auditors have traditionally viewed the client acceptance/continuance process as a means of gathering information that will allow a decision about whether to accept or continue a client relationship or a specific engagement, but the information gathered also generally affects later steps in the audit process for those clients or engagements that are accepted. For example, acceptance/continuance procedures often provide critical information that can be used by the auditor when establishing an audit strategy, identifying and assessing risks, and developing a detailed audit plan, as well as for other audit purposes. AU-C 500.A27 specifically notes that audit evidence includes information obtained from client acceptance and continuance procedures.

If issues involving the acceptance or continuance of a client relationship or a specific engagement are identified and the firm decides to accept or continue the client relationship or the specific engagement, QC 10.28 requires the firm to consider whether any ethical requirements under ET 1.110.010 of the AICPA *Code of Professional Conduct*, apply and to document how the issues were resolved.

Preconditions for an Audit

Financial Reporting Framework. As a precondition for an audit, the auditor should determine whether the financial reporting framework (for example, GAAP or a special purpose framework) to be applied in the preparation of the financial statements is acceptable. According to AU-C 210.A4, factors to consider to determine if the financial reporting framework is acceptable include—

- The nature of the entity (for example a business entity, governmental entity, or a nonprofit organization).

- The purpose of the financial statements (for example whether they meet the common financial information needs of a wide range of users).

- The nature of the financial statements (for example, whether they are a complete set of financial statements or a single financial statement).

- Whether law or regulation prescribes the applicable financial reporting framework.

That determination generally is made during the acceptance and continuance procedures. For many clients, AU-C 210.A3 notes that the auditor may presume the applicable reporting framework is acceptable, and the authors believe that will be the case for most CIRA engagements.

Agreement of Management. Another precondition of an audit is to obtain the agreement of management that it acknowledges and understands its responsibilities. That agreement generally is obtained through the use of an engagement letter. Engagements letters are discussed later in this lesson.

Management-imposed Limitation on Scope. AU-C 210.07 notes that there may be circumstances when management or those charged with governance may impose a limitation on the scope of the auditor's work. If the auditor believes that the scope limitation would result in a disclaimer of opinion on the financial statements as a whole, the auditor should not accept the engagement. (However, if the entity is required by law or regulation to have an audit and the scope limitation and disclaimer of opinion is acceptable under the applicable law or regulation, the auditor may, but is not required, to accept the engagement.)

Risk-based Perspective

When deciding whether to accept or continue a client, the auditor considers the risks related to the engagement. This is a very high-level consideration of whether the risk level related to the engagement and the overall financial statements is greater than normal. For situations that pose greater than normal risk, firm policies determine when a new engagement is declined and when the relationship with a continuing client is terminated. If a client with greater than normal risk is accepted or continued, there has to be an appropriate audit response to the risk level in the audit plan. A client with greater than normal risk poses a greater risk to the auditor from a business risk perspective (the auditor's own business risk) and also involves a greater risk of material misstatement of the financial statements. Both AU-C 240.A27 and AU-C 315.07 note that the auditor considers whether procedures relating to the acceptance and continuance of clients and engagements may be relevant in the identification of risks of material misstatement.

For a new CIRA audit engagement, the auditor obtains a general understanding of management's reputation and integrity and of the CIRA industry, and the CIRA's operations and financial condition through discussions with management and the CIRA's board of directors, predecessor auditors, and other knowledgeable parties. For a continuing engagement, the auditor considers the same factors, but also considers whether there have been changes that affect the auditor's continuance decision.

The engagement acceptance or continuance decision will normally focus on factors that increase overall financial statement risk. What is the intended use of the financial statements? For example, does the CIRA need audited financial statements to comply with the requirements of the CIRA's governing documents, state statutes, regulatory agencies, or bank loan agreements? Will the CIRA's financial statements be distributed to the CIRA's members, developers, or financial institutions? Do discussions with the predecessor auditor, bankers, insurance carriers, attorneys, or others raise any concerns about management integrity? Are there increased risks due to indications of pressures, opportunities, or incentives for fraudulent financial reporting on the part of management? Is the CIRA in a precarious financial position that raises going concern issues? Consideration of this information might cause the auditor to decline to accept the engagement or to terminate the client relationship, or might cause the auditor to plan and perform the audit in a different manner.

The early identification of higher risk engagements can help ensure that audit personnel with adequate CIRA and overall audit experience are assigned to the engagement and that sufficient involvement of the partner and manager occur at all stages of the audit, but particularly during the risk assessment process. (This early identification of risks and the associated assignment of appropriate engagement team members helps meet the requirement in AU-C 220.16 that the audit partner needs to be satisfied that the engagement team and any auditor's external specialists have the appropriate competencies for the engagement. Competency in the CIRA industry is discussed later in this lesson.) Also, the preliminary scheduling of audit work and estimates of audit time (and often, fee

estimates) will be affected by any risks that have been identified through client acceptance or continuance; thus, the reporting deadlines established need to allow sufficient time for dealing with the anticipated risk level. In some cases, greater than normal involvement of a second partner in the engagement may be advisable. Many of these matters are audit strategy issues.

Ability to Accept the Engagement

Before deciding to propose for or accept a new CIRA audit engagement, the auditor needs to consider the auditor's ability to accept the engagement, management's integrity, and the scope of the proposed audit. (These considerations are also made annually in deciding whether to retain an existing client.) To propose for, or accept, an audit, the auditor needs to be able to meet the responsibilities and requirements related to the engagement. Factors the auditor considers include the following:

a. Whether there are any professional reasons not to provide services to the client.

b. What services are to be provided.

c. Whether the firm meets ethical requirements, including independence.

d. Whether professional standards and other relevant requirements can be met in providing those services.

After accepting a new client, auditors should consider whether their engagement acceptance procedures provide information that may be relevant in identifying risks of material misstatement due to error or fraud. The annual evaluation for continuing engagements is discussed further later in this lesson.

Assessment of Services. A preliminary discussion with the client is usually necessary to become familiar with the services that will be provided. That allows the auditor to consider whether the firm's resources are adequate to provide those services. It also provides an opportunity to make sure the client understands the nature of the services to be provided. Subsequent fee disputes can be avoided if the client clearly understands that additional fees will be charged for additional services that are later requested.

Level of Service. Information about the CIRA and the level of service being requested is vital in deciding whether to propose for the engagement, in preparing the proposal and reasonable fee estimate once a decision is made to do so, and in planning the engagement once it is obtained. The level of service that accountants will be engaged to provide on the CIRA's financial statements generally is specified by the state statutes that govern the CIRA or its governing documents. Often, an audit is required, but a review is also common for some CIRAs, especially smaller CIRAs. (Usually size is based on gross revenues from assessments.) Generally accountants will be engaged to perform the highest level of service called for by any of the requirements. For example, state law may require the CIRA's financial statements to be reviewed if they report gross revenue from assessments in excess of $75,000, but the CIRA's bylaws require an annual audit. Usually, accountants will be engaged to perform an audit in those circumstances, and, since it is a higher level of service than a review, the audit will be considered as evidence of compliance with state law.

Even if audited financial statements are not required to comply with state statutes or the CIRA's governing documents, other regulators, such as HUD, may require annual audited financial statements. Banks, creditors, and other external parties also may request them. When audited or reviewed financial statements are required, those statements generally satisfy the needs of other financial statement users.

Management is responsible for determining what level of service is required and engaging the accountants to perform that service. The auditor must meet certain responsibilities when a CIRA requests a level of service lower than required by the CIRA's governing documents or state statutes. Changes in the terms of an engagement, including changes in the level of service requested, are discussed later in this lesson.

Independence. The AICPA, state boards, the Securities and Exchange Commission, and the PCAOB each have their own independence rules. (The SEC and PCAOB rules generally would not affect CIRAs.) AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, requires the auditor to be independent, unless GAAS or law or regulation specifies otherwise. AICPA

independence rules apply to attest clients, which are persons or entities with respect to which an attest engagement is performed. Some of the AICPA independence rules apply a team approach, which narrows the pool of those members of a firm who are subject to certain independence requirements by focusing on *covered members*. Covered members include those who are (a) members of an attest engagement team or (b) able to influence the engagement or attest engagement team. By carefully considering the definition of a covered member, auditors may be able to structure the engagement team so that independence is not impaired. An in-depth discussion of those and other independence rules is beyond the scope of this course, but more information can be found in *PPC's Guide to GAAS*. Conclusions on compliance with independence requirements applicable to the engagement, including the identification of any threats to independence and safeguards that were applied should be documented. Some specific considerations in applying independence rules in audit engagements for nonpublic entities are discussed in the following paragraphs.

Nonattest Services. For many small CIRA engagements, a frequent concern about meeting independence requirements is the effect of providing nonattest services, such as bookkeeping services. An auditor may be asked to provide those services to clients who are too small to employ an adequate accounting staff or management. Concerns may arise that an auditor's independence has been impaired in those circumstances.

According to ET 1.295 of the Code, before auditors perform nonattest services, they should determine that the requirements of ET 1.295 have been met. ET 1.295.040 requires the following with respect to the performance of nonattest services:

- The auditor should not assume management responsibilities of the attest client.
- The client must agree to perform certain specific functions in connection with the nonattest services.
- The auditor should establish and document in writing the understanding with the client regarding the nonattest services.

Those requirements are discussed below.

If the requirements of ET 1.295 have not been met during the period of the audit engagement or the period covered by the financial statements, independence is considered impaired *unless, for nonattest services performed during the period covered by the financial statements*—

a. the nonattest services were provided before the period of the professional engagement (which begins when a member either signs an engagement letter or other agreement to perform attest services or begins to perform an attest engagement for a client, whichever is earlier),

b. the nonattest services related to periods before the period covered by the financial statements, and

c. another firm audited the financial statements for the period to which the nonattest services relate.

Although performing an individual nonattest service might not impair independence, the cumulative effect of multiple nonattest services can increase the significance of threats to independence. As discussed in ET 1.295.020, before agreeing to perform the services, the member should evaluate whether the aggregate effect of performing multiple nonattest services results in a significant threat to independence that cannot be reduced to an acceptable level by the application of safeguards. If there are no safeguards that eliminate the threat or reduce it to an acceptable level, the member's independence would be impaired.

During an audit engagement, the auditor will often communicate with management about issues related to the engagement. The following discussions are considered a normal part of an audit engagement and would not be subject to the ET 1.295:

- The client's selection and application of accounting standards or policies and financial statement disclosure requirements.
- Whether the client's accounting and financial reporting methods are appropriate.

- Adjusting journal entries proposed by the auditor.
- The form or content of the financial statements.

The auditor is cautioned to consider whether the level of involvement constitutes a separate nonattest service. For example, activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations are considered outside the scope of an attest engagement and are, instead, nonattest services. However, such activities would not impair independence provided the requirements of ET 1.295 are met.

Under ET 1.295.030, independence is considered to be impaired if an auditor (or his or her firm) assumes management responsibilities for an attest client. However, the auditor may assist management in those responsibilities. For the auditor to remain independent, before the start of the nonattest engagement, the attest client and its management should agree to perform all of the following functions in connection with the nonattest services (ET 1.295.040):

- Assume all management responsibilities.
- Oversee the services by designating an individual, preferably within senior management, who has suitable skill, knowledge, or experience.
- Evaluate the adequacy and results of the services performed.
- Accept responsibility for the results of the services.

The auditor should also assess and be satisfied that the designated individual who will oversee the services sufficiently understands the services to be performed by the auditor to ensure oversight. Also, the auditor ought to assess the suitability of their skills, knowledge, and/or experience. It is a best practice to document these matters.

In addition, the auditor should be satisfied that management will be able to meet all of the criteria listed above, make an informed judgment on the results of the nonattest services, and be responsible for making the significant judgments and decisions that are management's responsibility. In cases where the attest client is unable or unwilling to assume its responsibilities, the auditor's performance of the nonattest services would impair independence.

ET 1.295.040 also requires the auditor to *establish* and *document in writing* before performing the nonattest service, his or her understanding with the client regarding the following:

- Objectives of the engagement (i.e., the nonattest services).
- Services to be performed.
- Client's acceptance of its responsibilities.
- Auditor's responsibilities.
- Any limitations of the engagement.

ET 1.295 does not specify how the understanding is to be documented, so the auditor has flexibility. For example, the understanding might be documented in a separate engagement letter, in a separate form in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with an audit engagement. The authors believe it is common in many small CIRA engagements for auditors to also provide nonattest services, such as tax return preparation or bookkeeping services. It would be a best practice for the firm to document its compliance with the requirements of ET 1.295, including the assessment that the designated individual who will oversee the services sufficiently understands the services to be performed by the auditor to ensure oversight along with the suitability of their skills, knowledge, and/or experience. The AICPA's Professional Ethics Division has issued *Frequently Asked Questions: Nonattest Services Questions*, which provides additional guidance on documentation of the understanding with the attest client, as well as the suitable skill, knowledge, and/or experience of the designated

individual overseeing the nonattest service. The document can be found at **www.aicpa.org**/**interestareas**/**professionalethics**/**resources**/**tools**/**downloadabledocuments**/**nonattestservicesfaqs.pdf**. Furthermore, the AICPA has issued a Nonattest Services Toolkit that auditors may find useful when considering the performance of nonattest services. The Toolkit can be found at **www.aicpa.org**/**InterestAreas**/**ProfessionalEthics**/**Resources**/**DownloadableDocuments**/**ToolkitsandAids**/**Nonattest-Services-Toolkit.pdf**. The authors believe that many auditors will document the understanding with the client in the audit engagement letter.

Certain activities performed as part of a nonattest service are considered to be management responsibilities and, therefore, impair independence regardless of whether the auditor complies with the other requirements of ET 1.295. In addition, if an auditor assumes a management responsibility for an attest client, the management participation threat created would be so significant that no safeguards could reduce the threat to an acceptable level. ET 1.295 identifies common nonattest service activities and provides guidance on considerations as to whether they impair independence.

ET 1.295 also addresses tax compliance services. Preparing a tax return and transmitting the tax return and related payment, either electronically or in paper form, to a taxing authority does not impair independence as long as the auditor does not have custody or control of the CIRA's funds and the individual overseeing the tax services (a) reviews and approves the return and payment and (b) signs the return prior to transmittal, if required for the filing. Signing and filing a tax return impairs independence unless the auditor has legal authority to do so and—

- the taxing authority has prescribed procedures allowing the taxpayer to permit the auditor to sign and file a return on their behalf that meet the standards for electronic return originators and officers outlined in IRS Form 8879, or

- an individual in CIRA management who is authorized to sign and file the tax return provides the auditor with a signed statement that indicates—

  a. The return being filed.

  b. That the individual is authorized to sign and file the return.

  c. That the individual has reviewed the return, including accompanying schedules, and it is true, correct, and complete to the best of their knowledge and belief.

  d. That the individual authorizes the member to sign and file the return on the CIRA's behalf.

ET 1.295 also indicates that the auditor's representation of the client in an administrative proceeding before a taxing authority does not impair independence providing that auditor obtains the client's agreement prior to committing the client to a specific resolution with the taxing authority. Independence is impaired if the auditor represents the client in court to resolve a tax dispute.

For a comprehensive list of the types of services that an accountant may and may not perform for an attest client and maintain independence, see the AICPA *Code of Professional Conduct* at **www.aicpa.org**/**Research**/**Standards**/**CodeofConduct**/**Pages**/**default.aspx**.

Competency in the CIRA Industry. ET 1.300.001 of the AICPA *Code of Professional Conduct* indicates that a firm should only undertake an engagement that can reasonably be expected to be completed with professional competence. SQCS No. 8 (QC 10), *A Firm's System of Quality Control*, requires firms to adopt quality control policies and procedures that provide reasonable assurance that the engagement partner (or other individual responsible for supervising the engagement and signing or authorizing someone else to sign the auditor's report) has the necessary competencies for the engagement. The necessary competencies may vary depending on the client, type of CIRA, or type of service being provided. Although the CIRA is not specifically mentioned in the standard, specific competencies may be necessary when supervising the audit of a CIRA.

The auditor contemplating a CIRA engagement needs to consider whether the auditor has the necessary experience in the area or can obtain sufficient knowledge and understanding to perform the services requested through continuing education courses; attendance at relevant conferences; discussions with knowledgeable persons; etc.

The AICPA and most state licensing authorities have continuing education requirements for CPAs. In fulfilling these requirements, particular attention can be given to accounting, auditing, and tax matters relevant to CIRAs.

According to QC 10.33, a CPA firm's quality control policies and procedures should also require that the engagement partner have the appropriate competence capabilities, authority, and time to perform the role. Policies and procedures may include systems to monitor the workload and availability of engagement partners so as to allow these individuals sufficient time to adequately perform their responsibilities. AU-C 220.16 requires the engagement partner to be satisfied that the engagement team has the appropriate competence and capabilities to (a) perform the audit in accordance with professional standards and relevant legal and regulatory requirements and (b) enable the issuance of an auditor's report that is appropriate in the circumstances. The engagement team's competencies should be evaluated and documented.

Management Integrity

An auditor considers the reputation and integrity of a prospective or continuing client, its management, and those charged with governance, and evaluates any adverse information about management in considering whether the CPA firm would want to be associated with the CIRA's financial statements. The auditor's concern is with the client's general honesty, good faith, and forthrightness in its operations, administration, and financial reporting and in providing information, responses, and representations for the audit. If the CIRA engages the services of a managing agent, auditors will need to consider the reputation and integrity of the management of the managing agent as part of the engagement acceptance and continuance process.

Quality control standards require CPA firms to establish policies and procedures to minimize the likelihood of accepting or continuing association with a client whose management lacks integrity. There are no specific quality control standards or GAAS requirements, however, concerning the depth of an investigation of a prospective client, except the requirement in AU-C 300.13 to communicate with a predecessor auditor. Communication about management integrity and the other matters noted below should be made of all predecessor auditors. The precise form of the communication with a predecessor is not specified by professional standards. For example, a written communication is not required; simply talking with the predecessor is enough. The essential aspects of the communication are as follows:

a. Information that might bear on management's integrity.

b. Disagreements with management on accounting principles, auditing procedures, or similar matters.

c. Communications to those charged with governance, such as the audit committee (or others with equivalent authority and responsibility such as the board of directors or trustees) regarding fraud and noncompliance with laws and regulations by the entity.

d. Communications with management and those charged with governance regarding internal control matters.

e. The predecessor's understanding of reasons for the change in auditors.

In addition, successor auditors may also consider it helpful to obtain information about areas that required a significant amount of audit time or audit problems that arose from the condition of the accounting system or records. Successor auditors typically review or request copies of the prior-year accountants' report on the financial statements, management letter (if one was issued), tax returns, trial balance, and journal entries. Depending on the circumstances, the successor may consider it necessary to review other workpapers or tax information. Some predecessor auditors prefer to provide detailed information on what workpapers will be available to the successor.

In addition to communicating with the predecessor auditor, the AICPA's Audit and Accounting Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, suggests obtaining and evaluating information such as the following (as they might apply to a CIRA):

a. Available financial information about the prospective client, such as the CIRA's most recent interim or annual financial statements, income tax returns, and reports to regulatory agencies.

b. Responses to inquiries of management about the nature and purpose of services to be provided.

c. Responses to inquiries of the prospective client's lawyer, banker, and others having business relationships with the entity.

Other sources of information may include:

- Discussions with other CPAs in the community and other professionals, such as lawyers, bankers, etc.
- Inquiry of commercial credit agencies and business groups or associations, such as the Better Business Bureau.

CIRA engagements tend to have frequent changes of auditors, in part because of fees and changes in board composition. In addition, CIRA officers may be uninterested in financial and accounting matters. Furthermore, the investigation of the prospective client may indicate frequent changes in bankers or lawyers or reveal questionable responses to the auditor's inquiries. In those cases, the CPA firm may consider a background check performed by an investigative firm. In addition to the CIRA itself, subjects of background checks might include officers, board members, managing agents, developers, and other related entities or affiliated parties. Caution is advisable to help ensure a solid, long-lasting relationship.

Unless the client gives authorization, the predecessor cannot ethically respond to the successor's inquiries because of the ethical requirement for confidentiality. If the potential client refuses to give authorization, the auditor should determine why. Such a refusal is considered by many auditors to be sufficient reason to decline the engagement because it may signal a lack of future cooperation and may deprive the auditor of useful information only the predecessor can provide.

Use of Third-party Service Providers

ET 1.150.040 requires that clients be informed, preferably in writing, if the audit firm will outsource professional services to a third-party service provider. If the audit firm intends to use a third-party service provider (that is, an entity not controlled by the audit firm or an individual not employed by the audit firm), to perform portions of the audit, the client should be informed before confidential information is shared with the service provider. If the client objects, the auditor should perform the services without using the third party or should decline the engagement. ET 1.150.040 applies when another party is used, for example, to audit an element, account, or item of the financial statements, or to act as a specialist. The authors believe the ruling does not apply when another audit firm performs a separate engagement, the results of which will be used by the auditor, for example, when another firm audits a master association to which the CIRA belongs. In addition, the client is not required to be informed when a third party is used only for the auditor's administrative support services, such as for record storage, software application hosting, or authorized e-file tax transmittal services. One option is to inform the client in the engagement letter. ET 1.700.040 requires a contractual agreement between the audit firm and the service provider to maintain the confidentiality of client information. This rule also requires members to be reasonably assured that the service provider has procedures in place to prevent the unauthorized release of confidential information.

DOCUMENTING THE ENGAGEMENT ACCEPTANCE OR RETENTION DECISION

The authors recommend that the auditor document the considerations discussed in the preceding section as they are made during the proposal, pre-engagement, or early planning stages. AU-C 220.25 requires the auditor to document (a) issues identified concerning compliance with relevant ethical requirements and how they were resolved, (b) conclusions on compliance with applicable independence requirements and any relevant discussions with the firm supporting those conclusions, and (c) conclusions reached about the acceptance and continuance of the client relationship and engagement. The documented information about independence, ability to provide the requested service, and management integrity will provide a basis for the auditor's decision about whether to accept or retain the client. Other information on the type of CIRA, common properties managed, managing agent, etc., will be useful in later stages of the audit and will serve as a basis for review and update in future years. Information gathered in the client acceptance process is considered when identifying risks that could result in material

misstatement of the financial statements. Therefore, when performing client acceptance (and continuance) procedures, the auditor needs to be alert for risks that could result in misstatements at the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures.

Annual Evaluation for Continuing Engagement

An annual evaluation of clients and engagements generally is performed as part of the planning process for those engagements. QC 10 and AU-C 220.14 require the firm to assess its continuing association with a client and the engagement. The continuing auditor may consider the topics discussed in this course when reassessing the desire and ability to retain the engagement. This reassessment is especially important if there has been a high degree of turnover in key management positions. Other reasons to reevaluate whether to continue serving the client include significant changes in financial position, litigation status, general economic conditions, scope of the engagement, auditor independence, or other considerations that would have caused the auditor to reject the client had the conditions existed at the time of the original acceptance. Moreover, industry risk factors and other considerations may have changed since the initial client acceptance decision. The assessment also considers matters such as (a) being aware of potential legal liability risks, (b) avoiding conflict of interest problems, and (c) monitoring compliance with independence rules. For example, the continuance decision of a CIRA's auditor may be affected when the association's management company changes. Such a situation may occur when the management company moves outside of the auditor's geographic area, the auditor is unfamiliar with the new management company, or the auditor has worked unsuccessfully with the particular management company in the past.

If the firm obtains information that would have caused it to decline an engagement had that information been previously available, QC 10.30 requires that policies and procedures on continuance of the engagement and the client relationship include consideration of (a) professional and legal responsibilities that apply to the circumstances and (b) the possibility of withdrawing from the engagement or from both the engagement and the client relationship. In addition, AU-C 220.15 requires the engagement partner to notify other members of the firm promptly whenever information is obtained that would have caused the firm to decline the engagement, so appropriate action can be taken. As part of making a withdrawal decision, the firm considers whether there is a requirement to report the withdrawal decision to regulatory authorities. For those engagements that will be continued, auditors consider whether their engagement continuance procedures provide information that may be relevant in identifying risks of material misstatement due to error or fraud. Such information may also affect the nature, timing, and extent of procedures to be performed and auditor's fee estimate.

Once a client relationship has been established, the firm has more objective information to use in evaluating and reassessing the conclusions reached for each factor considered when the initial client acceptance decision was made. The review of factors affecting the continuance decision is made in light of the increased knowledge about the client obtained from the prior audit(s) and consideration of changes that have occurred since the prior audit. This review is generally performed at the beginning of an engagement to ensure that no circumstances have occurred since the last engagement that would cause the firm to discontinue providing services to the client. A decision to discontinue services to a client generally is made before work commences on the engagement.

The continuance decision should be documented. If the firm uses practices aids such as those in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations,* this can be done by signing off the appropriate program step during the planning stage of the current year engagement.

ESTABLISHING THE TERMS OF THE ENGAGEMENT

After a new or continuing engagement has been accepted, AU-C 210.09–.10 state that the auditor should agree upon the terms of the audit engagement with management or those charged with governance, as appropriate, and document that agreement in an audit engagement letter or another form of written communication. The process in this course assumes the use of an engagement letter (rather than another form of agreement). The issuance of an engagement letter may reduce the business risk to the auditor by clarifying the responsibilities of each party and the objectives and limitations of the engagement.

AU-C 210.10 indicates that the engagement letter should include (a) the objective and scope of the engagement; (b) management's responsibilities; (c) the auditor's responsibilities; (d) a statement that due to the inherent

limitations of an audit, combined with the inherent limitations of internal control, there is a risk that a material misstatement may not be detected; (e) identification of the applicable financial reporting framework; and (f) reference to the expected form and content of reports to be issued by the auditor and a statement that circumstances may occur in which a report may differ from its expected form and content. The understanding also may include whether the auditor will make use of a specialist or another auditor's report on the information system and other controls placed in operation by a managing agent. However, determining the need to obtain a service auditor's report involves considerations that may have to wait until the audit planning stage when the auditor has more information about the significance of the service organization's controls to the CIRA's controls. Thus, it may not be possible to reach a definitive understanding about these matters with the client at the pre-engagement stage, and the auditor may need to alert the client of this.

The understanding of the engagement terms may also include any other services to be rendered, for example, preparation of the tax return.

Engagement letters are most effective when the client signs them before any services are rendered. (Even though not specifically required by AU-C 210, the authors believe it is best practice to have management sign the engagement letter to document that they acknowledge and understand their responsibilities.) AU-C 210.09 states that the auditor should agree upon the terms of the engagement with the management or with those charged with governance, which encompasses the board of directors, as appropriate. However, because one of the preconditions for an audit is to obtain agreement from management that it acknowledges and understands its responsibilities, the authors believe management should always be included. In addition, AU-C 260 states the auditor should communicate with those charged with governance the auditor's responsibilities with regard to the financial statement audit and the planned scope and timing of the audit. Those items can be communicated through an engagement letter or separate communication. In most cases, the authors believe the items are communicated through an engagement letter. Therefore, to accomplish all of the previously discussed objectives, the authors recommend that the engagement letter be addressed to, and signed by, both management (including the managing agent, if applicable) and those charged with governance. If there is no separate group charged with governance, the letter would only be addressed to, and signed by, management. Because a CIRA's board of directors may be inexperienced in dealing with auditors, the board might expect the managing agent to deal with the auditors and not understand the need for the CIRA's management to also sign an engagement letter. If a CIRA officer does not sign the engagement letter, the auditor should consider reviewing the board minutes to determine whether the governing board has approved the selection of the audit firm.

Documenting the Terms of the Engagement

In addition to documenting the required matters mentioned in the preceding paragraphs, an engagement letter can be used to document the fee estimate, expected timing of fieldwork and the report delivery date, expected client clerical assistance during the audit, and arrangements with predecessor auditors, if applicable. Documenting such matters can help prevent misunderstandings. Also, an engagement letter can be an efficient way to provide audit staff with an understanding of the engagement arrangements.

CIRAs are required to disclose certain information about future major repairs and replacements as supplementary information outside of the basic financial statements. Accordingly, the authors recommend that the engagement letter describe the auditor's responsibilities for that information (for example, they will compile the information and not audit or review it). The authors also recommend that the engagement letter illustrate how the auditors will report on the required supplementary information.

Multi-year Engagement Letters

AU-C 210.10 requires the auditor to establish an understanding with the client for each engagement and to document that agreement in an audit engagement letter. The authors recommend obtaining a new engagement letter each year. Obtaining a new letter forces the auditor to focus on the scope of services that it will be providing, and helps to ensure that the letter reflects recent developments that are required by professional standards. However, AU-C 210 does not preclude the use of engagement letters that cover more than one year of services. For example, some auditors include provisions in their engagement letters that cover each annual engagement unless subsequently modified. Accordingly, they would obtain an engagement letter in the first year of a client relationship and would not require a new letter in subsequent years unless circumstances change. Auditors should assess each

year whether circumstances require the terms of the engagement letter to be revised. If the auditor does not issue a new engagement letter, the auditor should remind management of the terms of the engagement letter. That reminder, which may be written or oral, should be documented (AU-C 210.13).

Change in Terms of an Audit Engagement

AU-C 210.14 states that an auditor should not agree to a change in the terms of an engagement unless there is a reasonable justification for doing so. The authors believe that a change in circumstances affecting the entity's requirement for an audit or a misunderstanding as to the nature of an audit may be acceptable reasons for a change in the level of service and are considered to be a change in the terms of an engagement.

Unacceptable Change in the Level of Service. A restriction on the scope of the audit, whether imposed by the client or caused by circumstances, generally is an unacceptable reason for a change in the level of service. Unless a reasonable justification for a change in the terms of the engagement exists, the auditor should not agree to the change (AU-C 210.14). A change may not be considered acceptable if it relates to information that is incorrect, incomplete, or otherwise unsatisfactory. Examples where a change in the terms of the engagement may not be reasonable include when the auditor has been prohibited from corresponding with the CIRA's legal counsel for purposes of obtaining evidence on litigation, claims, and assessments; management has refused to sign a client representation letter in connection with the audit; or the auditor is unable to obtain sufficient, appropriate audit evidence and management asks for the change in terms of the engagement to avoid a qualified opinion on the financial statements.

If the auditor concludes that there is not a reasonable justification for the change and management of the CIRA will not permit the audit to continue, the auditor should withdraw from the engagement, communicate the circumstances to those charged with governance, and determine whether or not to report the circumstances to other parties, such as regulators (AU-C 210.17).

Document Change in the Terms of an Engagement. If there is a reasonable justification for a change in the terms of the engagement, the auditor and management should agree on and document that agreement in an engagement letter or another form of written communication (AU-C 210.16).

Early Communication with Those Charged with Governance

Auditors are required to communicate certain matters about the audit to those charged with governance, including the auditor's responsibilities under GAAS and an overview of the planned scope and timing of the audit, which needs to be sufficiently timely to enable those charged with governance to take appropriate action. One option is to include those matters in the engagement letter and send it to those charged with governance. Another option is to send a separate letter to those charged with governance.

SELF-STUDY QUIZ

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

1. A firm's client acceptance and continuance policies and procedures should provide reasonable assurance of what?

    a. That the risks of providing the professional services have been fully mitigated.

    b. That accepted engagements are expected to be completed with professional competence.

    c. That the successor auditor will contact the predecessor auditor with or without the client's permission.

    d. The information gathered during this phase of the engagement will not be used for any other purpose.

2. Which of the following would be subject to ET 1.295 if performed for an attest client?

    a. Communicating with management about financial statement disclosure requirements.

    b. Assisting management with its responsibilities.

    c. Communicating with management about the form and content of the financial statements.

    d. Performing nonattest services, such as bookkeeping.

3. Which of the following statements best describes the use of an engagement letter to establish the terms of an audit engagement?

    a. The engagement letter should be limited to information about the audit engagement.

    b. The client must sign the engagement letter before the auditor's report is released.

    c. A breakdown of responsibilities should be included in the engagement letter.

    d. Engagement letters are prohibited from covering more than a single year's engagement.

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. A firm's client acceptance and continuance policies and procedures should provide reasonable assurance of what? **(Page 5)**

   a. That the risks of providing the professional services have been fully mitigated. [This answer is incorrect. The acceptance/continuance procedures should provide reasonable assurance that the risks associated with providing professional services in the particular circumstances are appropriately considered, not fully mitigated.]

   b. That accepted engagements are expected to be completed with professional competence. [This answer is correct. Under the professional standards, a firm's client acceptance/continuance policies and procedures should provide reasonable assurance that, among other things, engagements the firm accepts can reasonably be completed with professional competence.]

   c. That the successor auditor will contact the predecessor auditor with or without the client's permission. [This answer is incorrect. AU-C 210.11 notes that the successor auditor should *request permission* from the prospective client to inquire of the predecessor auditor to final acceptance of the engagement about matters that would assist in making the acceptance decision.]

   d. The information gathered during this phase of the engagement will not be used for any other purpose. [This answer is incorrect. Many auditors have traditionally viewed the client acceptance/continuance process as a means of gathering information that will allow a decision about whether to accept or continue a client relationship or a specific engagement, but the information gathered also generally affects later steps in the audit process for those clients or engagements that are accepted. Such information is not disposed of, ignored, or discounted after the acceptance/continuance phase of the engagement.]

2. Which of the following would be subject to ET 1.295 if performed for an attest client? **(Page 8)**

   a. Communicating with management about financial statement disclosure requirements. [This answer is incorrect. Certain discussions are considered a normal part of an audit engagement and would not be subject to ET 1.295. One example of such a communication is the that regarding the client's selection and application of accounting standards or policies and financial statement disclosure requirements.]

   b. Assisting management with its responsibilities. [This answer is incorrect. Under ET 1.295.030, independence is considered to be impaired if an auditor (or his or her firm) assumes management responsibilities for an attest client. However, the auditor may assist management in those responsibilities. When merely assisting, management must meet appropriate conditions for ET 1.295 independence concerns not to apply.]

   c. Communicating with management about the form and content of the financial statements. [This answer is incorrect. ET 1.295 does not apply to communications such as this, as the discussions are considered a normal part of the audit engagement.]

   d. Performing nonattest services, such as bookkeeping. [This answer is correct. For many small CIRA engagements, a frequent concern about meeting independence requirements is the effect of providing nonattest services, such as bookkeeping services. When the auditor is asked to perform such services, concerns may arise that his or her independence has been impaired. According to ET 1.295 of the Code, before auditors perform nonattest services, they should determine if the requirements of ET 1.295 have been met.]

3. Which of the following statements best describes the use of an engagement letter to establish the terms of an audit engagement? **(Page 13)**

   a. The engagement letter should be limited to information about the audit engagement. [This answer is incorrect. The understanding of the engagement terms may also include any other services to be rendered, for example, preparation of the tax return.]

   b. The client must sign the engagement letter before the auditor's report is released. [This answer is incorrect. Engagement letters are most effective when the client signs them *before* any services are rendered.]

   c. A breakdown of responsibilities should be included in the engagement letter. [This answer is correct. AU-C 210 indicates that the engagement letter should include, among other things, the responsibilities of management and the responsibilities of the auditor.]

   d. Engagement letters are prohibited from covering more than a single year's engagement. [This answer is incorrect. Obtaining a new engagement letter each year is recommended; however, AU-C 210 does not preclude or prohibit the use of engagement letters that cover more than one year of services.]

AUDIT PLANNING

Objectives of Audit Planning

According to AU-C 300.02, audit planning involves developing an overall audit strategy for the engagement and developing an audit plan. Audit strategy is the auditor's operational approach to achieving the objectives of the audit. It is a high-level description of the audit scope, timing, and direction. It includes matters such as identifying material account balances, identifying audit areas with a higher risk of material misstatement, the overall responses to those higher risks, and the planned audit approach by area (for example, substantive procedures or a combined approach of substantive procedures and tests of controls).

Auditors generally establish a preliminary audit strategy before performing extensive risk assessment procedures based on knowledge from past experience with the client and the results of preliminary engagement activities. As auditors gather additional information through the performance of risk assessment procedures, they complete the overall audit strategy, including overall responses at the financial statement level.

An overriding objective throughout the planning process is the identification and assessment of risks that could result in material misstatement of the financial statements. Obtaining an understanding of the CIRA and its environment, including its internal control, is an essential part of planning the audit. An effectively planned audit is responsive to the assessment of the risk of material misstatement based on the auditors' understanding of the CIRA and its environment, including its internal control.

Audit planning also includes developing an audit plan (also called an audit program). The audit plan is more detailed than the audit strategy and documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence. The nature, timing and extent of audit planning varies with the size and complexity of the CIRA, and with the auditor's understanding of the CIRA and its environment, including internal control. However, audit planning always includes a risk assessment process.

If a CIRA engages a managing agent, the managing agent needs to be viewed as an extension of the CIRA client. That means that auditors should consider how the use of a managing agent will affect the planning and performance of the audit, including whether the managing agent's financial reporting system will allow the application of audit procedures sufficient to express an opinion. The CIRA's use of a managing agent will have a significant effect on the auditors' approach to understanding the CIRA and its environment, including the CIRA's internal control, as explained in Lesson 2.

Requesting Information from the CIRA

Before fieldwork begins, the authors recommend providing the CIRA's accounting personnel with a list of documents and records needed for the audit. Using a standardized list of documents and records ordinarily needed for a CIRA engagement can save time and ensure that important documents are not overlooked.

Risk Assessment Process

The risk assessment process involves performing procedures, obtaining an understanding of various matters about the CIRA and its environment, and making decisions and judgments about assessed risks and other matters based on that understanding.

Procedures Performed. Risk assessment procedures include inquiry, analytical procedures, inspection, and observation as well as related planning activities and procedures, such as preliminary engagement activities related to client acceptance and continuance, and holding a discussion among the engagement team. The auditor performs all of these procedures when planning the audit. Furthermore, the auditor's consideration of fraud in accordance with AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, is not separate from the consideration of audit risk but is integrated into the overall risk assessment process. That is, the assessment of risks due to error occurs simultaneously with the assessment of risks due to fraud. The key requirements of AU-C 240 are addressed at relevant points throughout this course. The evaluation of fraud risks occurs continuously throughout the audit.

Understanding Obtained. Risk assessment procedures are performed to obtain an understanding of the entity and its environment, including its internal control. The auditor obtains information about the following:

a. Industry, regulatory, and other external factors.

b. Nature of the entity, including—

   (1) Organizational structure and personnel.

   (2) Operating characteristics.

   (3) Governing documents and similar documents.

   (4) Related-party transactions.

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.

d. Measurement and review of the CIRA's financial performance.

e. Internal control, which includes the selection and application of accounting policies.

f. Fraud risk factors.

Decisions and Judgments Made. The information obtained by applying risk assessment procedures is used to make the important decisions and judgments that are part of audit planning. These decisions and judgments include determining materiality levels and assessing risks of material misstatement at the financial statement and relevant assertion levels.

Summary of Risk Assessment Process. Exhibit 1-1 summarizes the various elements in the risk assessment process in the categories of procedures performed, understanding obtained, and decisions and judgments made.

The Sequence of Audit Planning

Because an audit of financial statements is an iterative process, audit planning is not a discrete phase of the audit. Audit planning continues throughout the audit even though many of the planning steps and procedures necessarily are performed at the beginning of the audit process. Audit planning begins with engagement acceptance and continues throughout the remainder of the audit. Also, many of the audit planning steps and procedures can be performed simultaneously and tend to blend together. Nevertheless, having a logical sequence of steps and procedures provides a useful framework. The authors' approach is presented in Exhibit 1-2.

Exhibit 1-1

The Risk Assessment Process

Procedures Performed	Understanding Obtained	Decisions and Judgments Made
• Preliminary engagement activities. • Inquiries of management and others. • Preliminary analytical procedures. • Observation and inspection. • Discussion among the engagement team.	• Industry, regulatory, and other external factors. • Nature of the entity. • Objectives, strategies, and related business risks. • Measurement and review of the CIRA's financial performance. • Internal control. • Selection and application of accounting policies. • Fraud risk factors.	Decisions at the Financial Statement Level: • Materiality at the financial statement level. • Materiality for particular items of lesser amounts. • Risks of material misstatement at the financial statement level. • Overall audit strategy. Decisions at the Account Balance, Transaction Class, and Relevant Assertion Level: • Performance materiality. • Risks of material misstatement at the relevant assertion level, including identification of significant risks. • Nature, timing, and extent of further audit procedures (including tests of controls and substantive procedures).

* * *

Exhibit 1-2

Steps in the Audit Process Related to Planning

Preliminary Engagement Activities

1. Perform procedures regarding acceptance or continuance of the client relationship and the specific audit engagement.

2. Evaluate compliance with ethical requirements, including independence.

3. Establish an understanding with the client and communicate in an engagement letter.

General Audit Planning at the Financial Statement Level

4. Establish preliminary audit strategy.

5. Determine the nature, timing, and extent of risk assessment procedures and perform the procedures.

6. Determine the materiality level for the financial statements as a whole (preliminary planning materiality) and materiality for particular items of lesser amounts.

7. Perform preliminary analytical procedures (a risk assessment procedure).

8. Hold a discussion among the engagement team.

9. Identify fraud risk factors, areas where special audit consideration may be necessary, and other areas where there may be higher risks for material misstatement.

10. Assess audit risk at the overall financial statement level.

11. Complete the overall audit strategy, including overall responses at the financial statement level.

Detailed Audit Planning at the Relevant Assertion Level for Account Balances, Transaction Classes, and Disclosures

12. Determine performance materiality (often in conjunction with Step 6).

13. Assess audit risk in relation to relevant assertions for transaction classes, account balances, and disclosures.

14. Develop a detailed audit plan for the nature, timing, and extent of further audit procedures.

* * *

Depending on the auditor's knowledge and past experience with the client, as well as other factors, certain planning steps might be performed at differing stages or sequences from one engagement to the next. For example, the sixth step, determine the materiality level for the financial statements as a whole, and the twelfth step, determine performance materiality, are often performed concurrently. Also some auditors might choose to determine materiality (Step 6) before performing risk assessment procedures (Step 5) to help determine the areas of focus. For the eighth step, the discussion among the engagement team, the precise timing of this meeting can vary with the circumstances. It is usually more efficient and effective if it occurs relatively early in planning, but it need not occur in any particular sequence. Although planning steps may occur in a slightly different sequence than illustrated in Exhibit 1-2, it is important for the auditor to revisit judgments made earlier in planning as new information becomes available throughout the audit to determine the effect on risk identification, risk assessment, materiality, and further audit procedures.

As stated previously, an overriding objective throughout the planning process is identifying and assessing risks to determine whether they could result in material misstatement of the financial statements. AU-C 315.05 explains that the auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at both the financial statement and relevant assertion levels. Risk assessment procedures are focused toward gathering and evaluating information about the client and are not specifically designed as tests of controls or substantive procedures. Obtaining an understanding of the entity and its environment, including its internal control, is an essential aspect of the consideration of risk. Thus, audit procedures performed to obtain that understanding are referred to as *risk assessment procedures* because the information obtained by performing those procedures may be used to support the auditor's assessment of the risk of material misstatement. Auditors normally consider the effectiveness of various types of risk assessment procedures that are used in identifying risks during the planning process. A variety of risk assessment procedures are used when obtaining an understanding of the entity and its environment. For example, an auditor cannot limit risk assessment procedures to only inquiry.

In addition to providing information about the entity and its environment, including its internal control, performing risk assessment procedures may provide audit evidence about relevant assertions related to account balances, transaction classes, or disclosures, or about the operating effectiveness of controls. Therefore, risk assessment procedures may also serve as tests of controls or substantive procedures, or may be performed concurrently with those procedures. However, risk assessment procedures by themselves do not provide sufficient appropriate audit evidence to express an opinion on financial statements.

Types of Risk Assessment Procedures

AU-C 300 and 315 specifically identify the following audit procedures and related activities as necessary risk assessment and other planning procedures:

a. Preliminary engagement activities, including establishing an understanding with the client.

b. Inquiries of management, internal audit (if applicable), and others within the entity and those charged with governance.

c. Analytical procedures.

d. Observation and inspection. Examples include visits to the HOA development and tracing transactions through the information system; that is, walkthroughs.

e. Discussion among the engagement team.

All of the risk assessment procedures are performed when obtaining an understanding of the entity and its environment. There is no requirement that each of those procedures be performed for every component of the required understanding. Nevertheless, the standards are explicit in indicating that inquiry alone is not sufficient to evaluate the design and implementation of internal control. Therefore, observation and inspection will most likely be coupled with inquiry procedures when obtaining the understanding of internal control. The discussion among the engagement team about the susceptibility of the CIRA's financial statements to material misstatement is required by AU-C 315.11, and AU-C 240.15 expands on the discussion as it relates to brainstorming about susceptibility to material misstatement due to fraud.

Nature, Timing, and Extent—General Considerations. The nature, timing, and extent of some risk assessment procedures may be relatively consistent across audit engagements, but some procedures will require tailoring in response to the information gathered. For example, in all audits the auditor will make inquiries of management responsible for financial reporting about accounting policies and other aspects of the financial reporting process. However, determining others within the CIRA to whom related questions may be directed will depend on the circumstances and the specific information gathered about the CIRA. For example, if initial inquiries reveal that the CIRA has investments in debt securities, the auditor will likely make further inquiries of personnel involved in the valuation of those investments. Thus, performing risk assessment procedures often can begin without extended consideration of their nature, timing, and extent, but other aspects of the risk assessment procedures can only be determined after some information is gathered about the entity and its environment.

Gathering Other Information Needed to Identify Fraud Risks. In connection with obtaining an understanding of the client's operations and the CIRA industry, auditors may become aware of information that is relevant to identifying fraud risks. AU-C 240.17–.24 explain that auditors should perform the following procedures to obtain information that is used to identify fraud risks:

- Inquire of management (including the managing agent, if applicable) and others in the CIRA about the risks of fraud and how they are addressed.
- Consider the results of preliminary analytical procedures.
- Consider the existence of fraud risk factors.
- Consider certain other information.

Using the Results of Risk Assessment Procedures Performed in Prior Periods. Because professional standards require the performance of risk assessment procedures to obtain an understanding of the CIRA and provide a basis for the assessment of risks, can the auditor use information gathered from procedures performed in a prior period and limit the extent of current year procedures? Similarly, can information obtained from the auditor's previous experience with the client (for example, a review engagement performed in the previous year) be used in identifying risks of material misstatement? The answer to both questions is a qualified "yes."

The process of understanding the CIRA's operations and the CIRA industry is continual. For a new engagement, a basic level of knowledge is needed to begin preliminary planning. However, a significant amount of knowledge is gained during the audit. The auditor's previous experience with the entity also contributes to the understanding of the entity and its environment. Audit procedures performed in previous audits ordinarily provide useful audit evidence about the following:

- The CIRA's organizational structure, operations, and controls.
- Past misstatements and whether they were corrected on a timely basis.
- Significant changes from the prior period.

Information about past misstatements assists the auditor in assessing risks of material misstatement in the current audit. Before using information obtained in prior periods, however, AU-C 315.10 requires the auditor to determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. The auditor is interested in identifying changes in personnel; procedures; processes; contracts; services; contingencies; facilities; nature of the operations; management; financial condition; pressures to meet budgets; conditions and events or operating results that are relevant to the going concern assumption; loan covenant compliance; litigation status; control environment or activities; fraud risks; management attitude toward, or pressures on, the auditors; scope of the engagement; and any other internal or external conditions that might be of audit significance. These changes may change the CIRA's business risk or the auditor's assessment of risks of material misstatement. Therefore, the auditor performs risk assessment procedures in the current audit to determine whether changes have occurred that impact the relevance of information gathered in previous audits. For example, auditors might perform inquiries of key client personnel, supplemented by observation and inspection (for example, review of budgets and walkthroughs) to determine if changes have occurred.

Paragraph 3.132 of the AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit* (the AICPA Risk Assessment Audit Guide), specifically notes that the nature, timing, and extent of procedures performed to update the understanding of the client obtained in prior periods may depend on matters such as the following:

- Significance of the changes to the entity or its environment that have occurred from the prior period.
- Relative significance of the risks of material misstatement that may be affected by changes.
- Reliability of evidence available to support conclusions about any changes from the prior period.

Although the nature of the auditor's procedures always includes inquiries, observation, and inspection, the authors believe the extent of risk assessment procedures will often be considerably less in continuing audit engagements than in initial engagements, consisting primarily of sufficient procedures to identify and evaluate changes. The extent of current period risk assessment procedures may need to be increased, however, in response to the following:

- The information relates directly to a past misstatement or risk of material misstatement identified in the prior year.
- Other information obtained through risk assessment procedures indicates a possible significant change in the current year.
- There is a greater likelihood that significant changes will occur given the nature of the information.

The following paragraphs address the risk assessment procedures listed previously in the "Types of Risk Assessment Procedures" paragraph and their role in identifying and assessing risk.

Inquiries of Management and Others

Inquiry of management and others is used extensively throughout the audit planning process. AU-C 315.06 specifically requires the auditor to make inquiries of management, internal audit (if such function exists), and others

within the entity who may have information that is likely to help in the identification of risks of material misstatement whether due to error or fraud. In many cases, inquiry serves as a foundation for the performance of other risk assessment procedures in that the responses obtained drive the need for additional or corroborating procedures. Inquiry consists of several elements—posing a question or requesting information on a matter, evaluating the response, and following up to obtain additional information as needed. As such, inquiry can be an extremely effective procedure in identifying risks. For example, an auditor might ask management about delinquent assessments. The auditor would then evaluate the response obtained and determine if a potential risk exists. In this case, the auditor is concerned about potential inappropriate valuation of assessments receivable. If the auditor deems that there is an indication of this risk, additional inquiries might be posed to further identify the risk and determine whether other risk assessment procedures are necessary.

Although inquiry is a critical risk assessment procedure, inquiry cannot be used alone when identifying and assessing risks. Auditors use a combination of inquiry, analytical procedures, and observation and inspection during the risk assessment process. Furthermore, auditors are prohibited from only using inquiry when evaluating the design and implementation of internal control.

Matters and Parties of Inquiry. The auditor should inquire of management (including the managing agent, if applicable) and others in the CIRA about the following matters relevant to audit planning:

a. The entity and its environment as enumerated in AU-C 315.

b. Fraud-related matters as enumerated in AU-C 240.

c. Related parties and related party transactions as enumerated in AU-C 550.

d. Accounting estimates as enumerated in AU-C 540.

e. Compliance with laws and regulations as enumerated in AU-C 250.

f. Communications from service organizations about fraud, noncompliance with laws or regulations, or uncorrected misstatements at the service organization that affect the entity's financial statements, as enumerated in AU-C 402.19.

g. Management's preliminary evaluation of whether 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 as enumerated in AU-C 570 and discussed later in this lesson.

Items a. through e. are all discussed later in this course.

In addition to inquiries of management and those charged with governance, inquiries of others within and outside the entity are either required or can provide useful information. Examples of inquiries of others that might be made include the following:

a. *Those Charged with Governance.* Their involvement in the financial reporting process and how financial statements are used. AU-C 240.21 requires the auditor to inquire directly of those charged with governance (or the audit committee or at least its chair) about the risks of fraud and their knowledge of actual, suspected, or alleged fraud.

b. *Internal Audit.* Activities concerning the design and effectiveness of internal control and management's responses to any findings by the internal audit function, if the CIRA has an internal audit function. AU-C 315.06 requires inquiries of appropriate internal audit personnel who may have information on risks of material misstatement due to fraud or error or who can assist in identifying such risks. AU-C 240.19 requires inquiry of internal audit personnel about risks of fraud, knowledge of actual, suspected, or alleged fraud, and activities concerning fraud detection, and whether management satisfactorily responded to any findings.

c. *Other Employees.* Their role in the financial reporting process and additional or corroborating information to support management's responses. AU-C 240.A18–.A19 and AU-C 315.A7 discuss the benefits of inquiry

and provide examples of others within the CIRA to whom the auditor may direct inquiries about the existence or suspicion of fraud. Auditors may consider obtaining the perspective of employees from different functional areas and at varying levels of authority when identifying risks of material misstatement.

d. *Parties Outside the CIRA.* Inquiries of parties outside the CIRA are not required but are procedures that might be helpful. For example, the auditor might find it useful to make inquiries of external legal counsel or of valuation experts that management has engaged. The auditor might also find it useful to make inquiries of developers/sponsors, members, suppliers, or regulators to better understand the nature of the CIRA and its operations.

Fraud-related Inquiries. The auditor should integrate the requirements of AU-C 240 into the risk assessment process. As part of gathering the information needed to identify fraud risks, AU-C 240.A17–.18 require auditors to inquire of management personnel and others about the following:

- Whether they have knowledge of any actual, suspected, or alleged fraud.
- Management's process for identifying, responding to, and monitoring the risks of fraud in the entity.
- The nature, extent, and frequency of management's assessment of fraud risk and the results of those assessments.
- Any specific risks of fraud that management has identified or that have been brought to its attention.
- The classes of transactions, account balances, or disclosures for which a fraud risk is likely to exist.
- Management's communications, if any, to—
  - Those charged with governance on its process for identifying and responding to fraud risks.
  - Employees on their views about appropriate business practices and ethical behavior.

The areas of inquiry required by AU-C 240 include management's processes and assessment methods, as well as knowledge of identified risks or actual, suspected, or alleged fraud. Naturally, auditors give more weight to information about risks and knowledge of fraud if management has effective processes and assessment methods. However, AU-C 240.A20 also notes that management is often best situated to perpetrate fraud. Thus, the responses of members of senior management concerning the likelihood of perpetration of fraud by them are far less meaningful than responses with respect to perpetration by lower levels within the entity.

In addition, AU-C 240.21 requires the auditor to inquire directly of those charged with governance (or the audit committee, or at least its chair) about their views of the risks of fraud and whether they have knowledge of any actual, suspected, or alleged instances of fraud. Furthermore, where applicable, AU-C 240.20 requires the auditor to obtain an understanding of the role of those charged with governance in overseeing the CIRA's fraud risk assessment and monitoring process. Also, AU-C 315.06 and AU-C 240.19 require inquiries of appropriate individuals within the internal audit function (if such function exists) concerning risks of material misstatement due to fraud or error and other matters related to fraud. According to AU-C 315.A12, appropriate individuals are those whom the auditor concludes have appropriate knowledge, experience, and authority.

Management. Examples of management and others that auditors may consider interviewing include:

- The CIRA's president.
- The treasurer or other equivalent governing individual.
- Members of the board of directors.
- The managing agent, if any.
- The CIRA's bookkeeper.

Exhibit 1-3 presents a list of questions the auditor might consider asking management of a CIRA or managing agent, if applicable.

Exhibit 1-3

Inquiries about Fraud Risks for Management of a CIRA

Required Areas of Inquiry	Possible Questions
Knowledge of any actual fraud or suspicions of fraud affecting the CIRA.	• Are you aware of any actual instances of fraud within the association? • Do you have any suspicions that fraud may be occurring within the association? If so, where and how? • Have you seen any changes in employee behavior?
Awareness of any allegations of fraud or suspected fraud affecting the CIRA.	• Have you received any communications from employees, former employees, regulators, or others alleging fraud?
Frequency and ways they assess the risk that the CIRA's financial statements might be materially misstated due to fraud and the controls in place to prevent and detect it.	• What is your process (how, to what extent, and how often) for assessing the risk that the CIRA's financial statements might be materially misstated due to fraud? • What is your process (how, to what extent, and how often) for assessing the controls in place to prevent and detect fraud? • What incentives or pressures exist to commit fraud? • What opportunities are available for fraud to be carried out? • Are you aware of any attitudes (or potential rationalizations) on the part of employees that might enable them to justify fraud? • What would be the easiest way for someone to misstate the financial statements or steal assets without getting caught? • If someone were going to overstate or understate equity, how would they do it? • If someone were going to steal and cover it up, how would they do it? • Does the association use source documents that could be easily accessed and forged? • How could a false entry be made to the accounting system? • What departures from GAAP (or a special purpose framework) are most common for CIRAs? What departures from GAAP (or a special purpose framework) are most likely at your association? • Where are the weaknesses in the CIRA's internal controls? • Which controls can be bypassed or overridden? Are there instances where controls have been bypassed or overridden in the past? • Have there been any identified frauds that are common for CIRAs? • Have there been any changes within the CIRA industry or the association that have created or changed risks of fraud?
How they communicate to employees the importance of ethical behavior and appropriate business practices.	• What instructions do you give to employees about how they are expected to behave when conducting business? • How do you make it clear to employees that fraudulent or unethical behavior will not be tolerated?

Required Areas of Inquiry	Possible Questions
Their processes (programs and controls) for identifying, responding to, and monitoring fraud risks, including any (1) specific fraud risks they have identified or that have been brought to their attention, or (2) classes of transactions, account balances, or disclosures for which a fraud risk is likely to exist.	• What measures have you taken to address specific risks of fraud within the association? • What controls have been implemented to prevent one person from perpetrating and concealing a fraud when segregation of duties is not possible? • What procedures are in place for initiating, approving, and processing nonroutine transactions? • How have employees who suspect fraud been told to communicate their suspicions? • Are there any other programs and controls in place to help prevent, deter, or detect fraud? • How do you monitor the association's antifraud programs and controls to make sure they are working as intended? • Which types of transactions, account balances, financial statement classifications, or association locations are most at risk for intentional misstatement or theft? • Have you identified any specific risks of fraud within the association?
The nature and extent of monitoring affiliated CIRA locations and whether any of them have a higher level of fraud risk.	• Do fraud risks exist or are they more likely to exist in particular locations or components? • How do you monitor the affiliated association's locations to reduce the likelihood of fraud occurring and going undetected?
Whether they have reported to those charged with governance about the CIRA's processes for identifying and responding to fraud risks.	• Have you reported to the board of directors or audit committee about how the association's internal control serves to prevent, deter, and detect material misstatements due to fraud?

* * *

Other Employees. When deciding which individuals within the CIRA to make inquiries of, it may be helpful to consider—

- Employees who may have additional knowledge of matters identified in discussions with management or those charged with governance, or during the engagement team discussion.
- Employees who may be able to corroborate information received from management or others.
- Employees who may offer a unique or different perspective about the risks of material misstatement due to their background, tenure, etc.
- Employees who might provide information about the possibility of management override of controls.

In addition to the members of management and other employees identified earlier in this section, examples of the types of individuals within the CIRA that auditors may consider interviewing include—

- Employees at varying levels of authority within the CIRA, from low-level clerical employees to senior management, including employees the auditor comes in contact with while obtaining an understanding of internal control, or obtaining explanations for significant differences or fluctuations arising from analytical procedures.
- Employees outside the accounting department.

- Operating personnel.
- Employees involved in recording or processing journal entries.
- Employees involved in initiating, recording, or processing complex or unusual transactions.
- Employees in areas identified as vulnerable to the risk of fraud or error during the engagement team discussion.
- Employees with key roles in internal control.
- Employees referred by other interviewees.
- In-house legal counsel.

See Exhibit 1-4 for illustrative inquiries that might be appropriate for employees of different levels and departments.

Going Concern Uncertainties Inquiries. AU-C 570.12 requires that the auditor consider, when performing risk assessment procedures, 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 should 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 auditor is required to discuss with management the intended use of the going concern basis 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.

Related Party Inquiries. Although many related party transactions occur in the ordinary course of business, some related party relationships and transactions may give rise to higher risks of material misstatement than transactions with unrelated parties. As a result, AU-C 550, *Related Parties*, at AU-C 550.14, requires the auditor to make specific inquiries of management and others regarding related parties. In addition, auditors are required by AU-C 550.15 to inquire of management and others within the entity and perform other risk assessment procedures as needed to understand the controls over related party relationships and transactions.

Inquiries about Accounting Estimates. Because of the nature of accounting estimates, there can be a high degree of estimation uncertainty. AU-C 540, *Auditing Accounting Estimates, Including Fair Value Estimates, and Related Disclosures*, at AU-C 540.08, indicates that, when obtaining an understanding of how management identifies transactions, events, and conditions requiring accounting estimates, the auditor should make inquiries of management about whether any changes in circumstances have occurred that may give rise to new accounting estimates or the need to revise existing estimates.

Inquiries about Compliance with Laws and Regulations. AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, at AU-C 250.14, requires the auditor to inquire of management and those charged with governance about whether the entity is in compliance with laws and regulations that may have a material indirect effect on the financial statements and to inspect relevant correspondence with licensing and regulatory authorities. The focus of the auditor's inquiries is on laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements. However, compliance with those laws and regulations may be fundamental to the operating aspects of the entity, fundamental to an entity's ability to continue as a going concern, or necessary for the entity to avoid material penalties. Examples relevant to CIRAs include state statutes and local ordinances directed toward CIRAs, a CIRA's governing documents, federal and state environmental laws, and compliance with laws or regulations related to occupational safety and health. The auditor may also inquire about the entity's policies and procedures regarding compliance with laws and regulations (including the prevention of noncompliance); the policies or procedures adopted for identifying, evaluating, and accounting for litigation claims; and the use of directives and periodic representations obtained from management at appropriate levels of authority concerning compliance with laws and regulations.

Exhibit 1-4

Possible Inquiries about Fraud Risk for CIRA Employees

Suggested Questions	Direct Inquiries to
• Do you understand what fraud is and can you provide an example or a definition of fraud? • Does management make you aware of the importance of ethical behavior and appropriate business practices? If so, how? • Are you aware of any allegations of fraud or suspected fraud affecting the association? If so, please describe. • Are you aware of any programs in place to help employees learn to identify fraud and report it? If so, please describe the programs and comment on their effectiveness. • Is the CIRA's property and equipment physically secured to prevent fraud or misuse of the CIRA's assets? If not, how do you believe the CIRA is susceptible to fraud or misuse of assets as a result? • Are you aware of any areas where the association is not in compliance with laws and regulations? If so, please describe. • Do you know of anyone who is stealing from the association? • Do you suspect that anyone is stealing from the association? • Do you know of anyone in the association who is manipulating the accounts or records? • How could someone steal from the association without getting caught? • How would you describe the association's (and/or management's) values and ethics? • Are you upset with the association for any reason? Do you know of anyone who is? • Have you ever been asked to ignore or override a policy or procedure that is part of your job? Who asked you? • Have you ever seen another employee circumventing association policies, procedures, or controls? What explanation did they give? • Have you noticed any unusual changes in the behavior or lifestyle of management or any other employees? • Do you know of any employees who are under pressure to make ends meet financially? • How do you think this association compares with others in terms of the honesty of its employees? • Do you think your co-workers are honest? • Has anyone you work with ever asked you to do anything you thought was illegal or unethical? What would you do if someone asked you? • Have you ever been asked to enter false information in the (accounting/personnel) system or records? • Has anyone you work with ever asked you to withhold information from the auditors or alter documents or records? • Has management communicated how to report suspected fraud? If so, would you feel comfortable reporting suspected fraud in that manner? Do you believe that reporting suspected fraud would not be held against you by management or others? • Is there anything else you would like to add, or anyone else we should talk to? • I have one last question. Have you yourself done anything against the association that was illegal or unethical?	All employees selected

Suggested Questions	Direct Inquiries to
• What factors (such as economic conditions or changes in technology) may threaten the association's ability to continue to operate? • How would reporting improved financial results help the association? • What pressure is put on employees to achieve the association's financial goals, and by whom? • Have there been any recent changes in assessment billing or collection policies or terms offered to members? • Were any large or unusual revenue transactions entered into at or near the end of the year? • What types of member complaints do you typically receive?	CIRA officer responsible for assessments and revenue
• How is management and/or the board compensated? • How are financial targets used to determine employees' pay or benefits? • Has there been any significant turnover in personnel? In what departments? • Are there any recent or planned layoffs or changes in pay rates or benefit plans that have or could upset the employees? • Have recent bonuses, raises, and promotions met employee expectations? Is there anything planned in those areas that could cause resentment among employees? • Have employees complained about work conditions, management demands or style, or other matters that could lead to pressures or incentives to commit fraud? • Have employees been punished or terminated for whistle-blowing or otherwise bringing unethical or fraudulent practices to the appropriate internal or external parties?	Human resources (or CIRA employee responsible for compensation)

Suggested Questions	Direct Inquiries to
• How active is management in supervising the accounting department? • What are the weaknesses in the association's internal controls? • Do any of the association's accounting policies seem inappropriate or overly aggressive? • Does management always tend to favor amounts that are on the high (low) side when developing accounting estimates, such as estimated liabilities and valuation accounts? • Does management often use materiality to justify questionable accounting practices? • Does it ever seem like the method of accounting for a transaction is more important than the transaction itself? Can you give me an example? • Does management or employees run personal expenses through the association? • What aspect of the association's operating results is management most concerned about? • Are there any changes in procedures or improvements in controls that could easily be made, but management has chosen not to? • Have there been any unusual changes in the way transactions are processed? • Are there any third parties that have expectations about (or a stake in) the association's operating results? What are their needs or expectations? • Have you ever been asked to record any journal entries that seemed unusual or lacked support? • Have you ever been asked to make false entries in the accounting records?	Accounting and finance
• Has the association's relationship with particular suppliers significantly changed (improved or deteriorated) in the past year? • What types of vendor complaints do you typically receive? • Do any vendors have a close or unusual relationship with management?	Purchasing

* * *

Documentation. There are no specific documentation requirements for inquiries made as risk assessment procedures, but AU-C 230, *Audit Documentation*, at AU-C 230.09, states that in documenting the nature, timing, and extent of audit procedures, the auditor should record the identifying characteristics of the items or matters tested. AU-C 230.A14 suggests that, for a procedure involving inquiries of entity personnel, the auditor records the inquiries made, the dates of inquiries, and the names and job designations of the personnel. The authors recommend documenting such matters when performing risk assessments inquiry procedures.

Analytical Procedures

AU-C 315.06 specifies that risk assessment procedures should include analytical procedures, and AU-C 315.14 notes that analytical procedures performed as risk assessment procedures may encompass both financial and nonfinancial information. AU-C 315.A15–.A16 explains that unusual or unexpected relationships identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud, but when analytical procedures use data aggregated at a high level, the results provide only a broad initial indication about whether a material misstatement may exist. Other than the analytical procedures related to revenue that are required by AU-C 240, analytical procedures used in the planning stage only need to be designed to point out audit areas that may be indicative of potential risks and, thus, need special emphasis.

Knowledge of the CIRA and its environment is interrelated with the use of analytical procedures in audit planning. Performing effective preliminary analytical procedures requires the auditor to know what relationships would be

expected to exist, what relationships would be considered unusual or unlikely, and what plausible explanations might exist for observed relationships. That knowledge is also important in assessing the significance of differences from expected relationships. For that reason, the auditor generally needs an understanding of the CIRA and its environment before performing preliminary analytical procedures. The auditor's knowledge and understanding of the CIRA can also be improved by applying preliminary analytical procedures in audit planning. The use of any particular analytical procedures is not required. The sophistication, extent, and timing of analytical procedures may vary widely, depending on the size and complexity of the client. In the audit of a small CIRA, simple comparisons and ratios, combined with inquiries of financial and operating management, are ordinarily effective, and the auditor normally need not make use of complex mathematical or statistical models. Depending on the facts and circumstances, analytical procedures may be limited to comparing the major account balances shown in the unadjusted general ledger with the financial statements for the prior year. A comparison of significant account balances with prior period amounts can improve the auditor's understanding of the entity and its operations. For example, are there significant fluctuations in assessment revenue and receivables? Do changes in laundry revenue make sense in relation to changes in water and gas usage? When the results of preliminary analytical procedures indicate the existence of unusual or unexpected relationships, the auditor considers those results in identifying risks of material misstatement of the financial statements due to fraud.

Analytical Procedures Related to Revenue. In addition to the requirement in AU-C 315 to perform analytical procedures as part of risk assessment procedures, AU-C 240.22 requires that, to the extent they are not already included, analytical procedures should include procedures related to revenue. Auditors perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. Ordinarily, comparison of current and prior-period account balances for revenue accounts will not be sufficient to achieve that objective, and other types of analytical procedures are used. Analytical procedures that may be useful in identifying unusual or unexpected relationships related to revenue include the following:

- *Analysis of Relationships Between Financial and Nonfinancial Amounts.* When comparing financial and nonfinancial amounts, it may be most effective to use a base that (a) would be expected to have a reasonable relationship to revenue, and (b) could not easily be manipulated by management. For example, auditors may compare assessments revenue, as determined from recorded revenue amounts, with units in the CIRA development. Assessment revenue in excess of projected estimates may indicate the recording of fictitious revenue.

- *Trend Analysis.* Auditors may analyze trends in the components of revenue or transaction types. It may be helpful to look at several trends or relationships to identify inconsistencies or unusual patterns. For example, the auditor might perform a trend analysis of assessment revenue by month.

- *Ratio Analysis.* Ratio analysis is the analysis of relationships between financial statement items by computing the ratio of one financial statement item to another. The ratio may be compared to the same ratio for a prior period (or several prior periods) to identify unusual or significant variations. For example, receivables turnover, the allowance for uncollectible accounts as a percentage of receivables, and bad debt expense as a percentage of revenues are activity ratios related to assessments receivable that may be useful. However, many other common ratios, such as the current ratio or debt to equity ratio, are less meaningful because of a CIRA's simple financial structure. Ratios that use information that management generally is unable to manipulate, such as cash flows, may be most effective in revealing indications of fraudulent financial reporting.

- *Budgetary Comparison.* Comparison of actual amounts with budgets may also indicate unusual variations. For example, revenue might significantly exceed budget because of improper revenue recognition.

As indicated in AU-C 240.34, the analytical procedures related to revenue should be updated in the final review stage of the audit.

Documentation. Documentation of preliminary analytical procedures can be limited, but it needs to be sufficient to provide support for the auditor's risk assessment. The results of the preliminary analytical review ordinarily are documented using a narrative memorandum, comparative carryforward schedule, or other form of workpaper. Documentation may also include the effect on the audit plan or indicate that the results have been considered when identifying fraud risks.

Observation and Inspection

According to AU-C 315.06, risk assessment procedures should include observation and inspection. There are a number of ways to use observation and inspection when assessing risk. When obtaining an understanding of the CIRA and its environment, observation or inspection might be the key procedure that enables the auditor to fully obtain pertinent information and identify related risks. For example, in order to gain an understanding of the CIRA's financing arrangements and underlying covenants, the auditor might decide to review the CIRA's loan agreements and other related documents. That procedure, coupled with a review of the CIRA's financial statements, might be the key procedure that helps the auditor identify risks related to potential noncompliance with loan covenants.

More frequently, observation and inspection are used to corroborate or follow-up on the results of inquiries made of management and others. For example, when evaluating the design and implementation of the CIRA's system of internal control, members of management might tell the auditor that they communicate the importance of ethical values to employees through a written code of conduct and by example. The auditor might wish to corroborate this response by examining the written code. In addition, the auditor may determine that a risk exists based on observation of management's current and past interactions with employees that contradict the behavior standards in the written code.

Other than the requirement to perform some observation and inspection procedures related to internal control, determining when to use observation and inspection, as opposed to other risk assessment procedures, is generally a matter that is left to the auditor's judgment. The authors believe that observation and inspection procedures are ordinarily effective in the following situations when obtaining an understanding of the entity:

- To understand the design of internal controls related to the audit.
- To verify that controls have been implemented, for example, as part of a walkthrough.
- When responses to inquiries indicate a potential risk for a significant account.
- When responses to inquiries are inconclusive, conflicting, or prove to be incorrect.
- In combination with inquiry to fully understand a matter.
- When necessary information can only or best be obtained through observation or inspection.
- When the evidence gathered through observation and inspection can also be used for a substantive procedure.
- In recurring engagements, to determine whether changes have occurred that affect the continued relevance of the information gathered in a prior period.

Documentation. AU-C 230.09 requires documentation of the identifying characteristics of specific items tested and AU-C 230.A14 provides examples of how that might be accomplished. Based on that guidance, the authors recommend documenting the following:

- For an inspection of documents, identify the item inspected, for example, by indicating the title and date of the report or the document name and number. (To facilitate inquiring about or requesting copies of the report or document at a later time, the author's recommend referring to the report or document by the same name that the client uses to refer to it.)
- For an observation procedure, document the process or subject matter observed, individuals involved and their titles, and where and when the observation was carried out.

Discussion among the Engagement Team

AU-C 315.11 requires the key members of the audit team (including the engagement partner) to discuss the susceptibility of the CIRA's financial statements to material misstatements and the application of GAAP to the

CIRA's facts and circumstances. AU-C 240.15 requires an exchange of ideas, or "brainstorming" among audit team members about how and where they believe the CIRA's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the CIRA could be misappropriated. These discussions can be held concurrently, that is, one meeting can cover the susceptibility of the financial statements to material misstatements from both error and fraud. However, it is important that the auditor consider the susceptibility to fraud as a distinct part of this combined discussion to avoid the potential dilution of this critical consideration.

The focus of the audit team discussion is on the individual members gaining a better understanding of the potential for material misstatements resulting from error or fraud in the specific areas assigned to them, and understanding how the results of audit procedures they perform affect other aspects of the audit. In this discussion, the partner and more experienced members of the audit team can share their insights based on their cumulative knowledge of the CIRA, its industry, and the environment. AU-C 315.11 states that the engagement partner and key engagement members should take part in the team discussion, and the engagement partner should determine what matters are to be communicated to team members who are not involved in the team discussion.

Matters to be Discussed. The engagement team discussion is aimed at the susceptibility of the financial statements to material misstatement (including the application of GAAP), that is, the areas of vulnerability. The discussion is one of the sources of information used to assess the risks of material misstatement. Thus, the discussion ought to open the minds of members of the audit team to potential material misstatements from error and, particularly, from fraud. Any high risk areas that have already been identified, however, also need to be communicated to the team members. The following matters are specifically required to be discussed during the engagement team discussion:

- The susceptibility of the entity's financial statements to material misstatement.
- The application of GAAP to the entity's facts and circumstances in light of its accounting policies.
- The susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.
- Fraud-related matters.

In addition, focusing on the areas of vulnerability, the engagement team discussion might include the following topics:

a. Critical issues and areas of significant audit risk.

b. Areas susceptible to management override of controls.

c. Unusual accounting practices used by the CIRA.

d. Implementation of new accounting standards.

e. Important control systems.

f. Significant IT applications and how the use of IT may affect the audit.

g. Areas susceptible to cyber attacks or intrusion that may affect the audit.

h. Materiality levels and how materiality will be used to determine the extent of testing.

i. The need to exercise professional skepticism throughout the engagement, to be alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred, and to be rigorous in following up on such indications.

The authors believe the discussion also needs to address how the risks facing the CIRA could result in a material misstatement of the financial statements, focusing especially on changes from the prior year and new

developments. Examples of factors that affect the likelihood of material misstatements caused by error that the engagement team might discuss include the following:

- Past experience with the client (including areas with audit difficulty and misstatements encountered).
- Changes in the CIRA's organization (for example, changes in managing agent, personnel, or accounting systems).
- The nature and complexity of transactions.
- Known accounting and auditing issues.

In addition to discussing important control systems, it may be appropriate to discuss potential risks that may exist due to limitations in the CIRA's personnel and assignment of responsibilities. For some smaller CIRAs, the engagement team might consider issues regarding the background and competence of individuals in key processing and financial decision-making roles, especially if concerns have been noted in previous audits.

Related Parties. As part of the engagement team discussion, AU-C 550.13 specifically requires auditors to consider how related party relationships and transactions could affect the susceptibility of the financial statements to material misstatement. AU-C 550.A7–.A8 indicates that the team discussion might include the following related party matters:

- Nature and extent of the CIRA's relationships and transactions with related parties.
- Importance of maintaining professional skepticism regarding related parties throughout the audit.
- Circumstances or conditions that may indicate the existence of unidentified related party relationships or transactions.
- Types of records or documents that might indicate the existence of related party relationships or transactions.
- Importance that management and those charged with governance attach to the identification of, accounting for, and disclosure of related party relationships and transactions and the related risk of management override.
- How related parties might be involved in fraud.

The authors recommend that the discussion include reminding the engagement team that if related parties or significant related party transactions are identified by the auditor that were not previously identified and disclosed by management, the engagement team is required by AU-C 550.23 to promptly communicate such information to other team members. Also, AU-C 550.23 requires the auditor to inquire of management about why applicable controls over related party relationships and transactions failed to identify and disclose such information.

Fraud-related Matters. AU-C 240.15 indicates that the discussion should also include the following fraud-related matters:

- How and where the CIRA's financial statements (for example, which account balances or transaction classes) might be susceptible to material misstatement due to fraud.
- How the CIRA's assets could be stolen.
- External and internal factors that might create incentives/pressures, provide opportunities, or enable rationalization of fraud.
- Risk of management override of controls.

- Circumstances that might be indicative of earnings management or manipulation of other financial measures.
- Practices management might use to manage earnings or other financial measures that could lead to fraudulent financial reporting.
- How the auditor might respond to the susceptibility of the financial statements to material misstatement due to fraud.
- Importance of maintaining professional skepticism regarding potential for material misstatement due to fraud.

The fraud aspect of the discussion ought to give appropriate consideration to financial statement misstatement from both fraudulent financial reporting (i.e., "cooking the books") and stealing. A key consideration when assessing fraud risk is what motivations may exist for management to intentionally misstate the financial statements or what controls may be lacking that could result in theft. By identifying the motives and opportunities for fraud, the auditor should be able to assess the direction of the risk.

AU-C 240.15 requires the discussion to also include the appropriate audit response to the areas identified as susceptible to material misstatement due to error or fraud (for example, by identifying the accounts that would be affected and the nature of procedures that could be performed to address the risks). The discussion should include an open exchange of ideas (that is, *brainstorming*). AU-C 240.15 indicates that participants should set aside their beliefs that management and others are honest and have integrity and maintain an attitude of professional skepticism throughout the discussion. AU-C 315 and AU-C 240 refer to a discussion; therefore, one-sided communication, such as a memo from the engagement partner, is not appropriate. (However, when the entire engagement is performed by a single auditor, the auditor might simply consider and document the susceptibility of the CIRA's financial statements to material misstatements.) The medium for discussion (for example, a meeting or a conference call) ought to encourage interaction and an appropriate exchange of ideas. AU-C 240.15 indicates that communication about the risks of material misstatement is not limited to that discussion, but should occur throughout the audit.

AU-C 240.12 indicates that, in accordance with AU-C 200, the auditor should exercise skepticism throughout the audit and recognize the possibility of a material misstatement due to fraud regardless of any beliefs about the honesty and integrity of management and those charged with governance gained from past experience. AU-C 200.14 defines *professional skepticism* as "an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence." Thus, auditors ought to actively consider how management could perpetrate and conceal fraudulent financial reporting. For example, auditors may use "what if" scenarios that focus on the financial statement areas vulnerable to fraud with the presumption that management or employees are inclined (either because of incentives/pressures or attitudes/rationalizations) to perpetrate fraud. According to AU-C 200.A26, the auditor's belief that management and those charged with governance are honest and have integrity does not mean that the auditor is allowed to be satisfied with less than persuasive audit evidence.

Effect on Significant Audit Areas. After discussing the risks that could result in a material misstatement of the financial statements and determining how those risks affect specific audit areas, the authors recommend that the engagement team then discuss each significant audit area. The team ought to focus on the real risks affecting each area and determine the most effective and efficient audit procedures that address those risks. Members of the audit team need to avoid relying on what procedures were performed during the prior year audit when discussing what procedures to perform in the current year. In fact, it may be best to ignore the prior year workpapers when initially discussing each significant area. That way, the audit team starts with a clean slate when developing the audit approach and avoids the temptation to just rely on "what we did last year." The result is usually a more effective and efficient audit approach. However, after the team has discussed each significant area, the prior year workpapers can be reviewed to make sure there are not any issues that were overlooked.

Who Attends the Discussion? As previously discussed, key members of the engagement team need to participate in a single discussion, and the engagement partner determines what matters will be communicated to other team members. It may be appropriate to include specialists, such as IT specialists, assigned to the engagement

team. Executive level team members generally are aware of significant accounting and auditing issues that could affect the audit, while staff members or specialists may be more familiar with the client's accounting systems and controls. Both perspectives are important in considering the susceptibility of the financial statement to material misstatements from error or fraud. The authors recommend that all members of the engagement team, including specialists with an ongoing role in the engagement, participate in the discussion. Also, the discussion may include component auditors and consideration of how the matters discussed apply to components. The engagement team, however, does not include external specialists engaged by the auditor or individuals within the internal audit function who provide direct assistance to the auditor on the audit engagement.

When Does the Discussion Occur? Before holding the discussion with the engagement team, the authors recommend that the engagement partner have preliminary planning discussions with the client. Issues to discuss with the client include the services to be provided, scheduling, and other administrative matters. In addition, the auditor can discuss the CIRA's operating environment (particularly changes from the prior year), the client's view of the risks that the client is addressing, and other specific issues facing the client. The auditor can also obtain additional information to be used in the planning process prior to meeting with the engagement team. Specific information to obtain includes the following:

a. Interim financial information.

b. Client budgets and any related operating and strategic planning documents.

c. Minutes of board of directors meetings.

d. Copies of new debt or other significant agreements or contracts.

e. Significant internal audit reports.

Also, if an engagement summary memo was prepared for the prior year audit, it can be reviewed before the engagement team discussion to identify risk areas identified in the prior audit.

AU-C 240 and AU-C 315 make it clear that the discussion among the engagement team is expected to occur during the performance of risk assessment procedures as part of audit planning, but the exact timing is not specified. The authors recommend holding the discussion prior to performing the information-gathering procedures discussed in Lesson 2. The authors believe it is important to set the proper tone of professional skepticism and to inform less experienced staff members about the risks of material misstatement before performing those procedures. However, nothing prevents the firm from holding discussions both before and during the information-gathering process. These decisions are normally made by engagement partners, and auditors need to exercise professional judgment to determine what works best in the particular circumstances. In any case, engagement team members communicate and share information obtained throughout the audit about the risks of material misstatement due to error or fraud.

Other Matters That May Be Discussed. The engagement team discussion also provides an opportunity for the engagement partner to remind the audit team members of the audit documentation requirements of AU-C 230. Among the matters that might be covered are the following:

a. Inclusion of abstracts or copies of significant contracts or agreements examined to evaluate the accounting for significant transactions.

b. Identification of items tested in tests of operating effectiveness of controls.

c. Identification of documents inspected or items confirmed in substantive tests of details.

d. Documentation relating to substantive analytical procedures.

e. Documentation relating to consideration of the CIRA's ability to continue as a going concern.

f. Documentation of the nature and effect of aggregated misstatements and the conclusion as to whether they cause material misstatement of the financial statements.

g. Documentation of who performed and reviewed the audit work and the date the work was performed and reviewed.

Discussion of Revenue under the New Accounting Standard. FASB ASC 606, *Revenue from Contracts with Customers* (effective for nonpublic entities for years beginning after December 15, 2018, and interim periods beginning after December 15, 2019), may change the revenue recognition model to recognize revenue in the financial statements and to make appropriate related disclosures. To enhance the auditor's understanding of the entity and develop an appropriate risk assessment, the AICPA Audit and Accounting Guide, *Revenue Recognition,* indicates that the engagement team discussion may include an exchange of the following:

- Knowledge of the different revenue streams, including controls that pertain to revenue transactions, and any changes to the revenue streams as a result of FASB ASC 606 or new performance obligations.
- Information about the business risks related to revenue transactions.
- Ideas about how revenue may be susceptible to material misstatement due to fraud or error.

Auditors will need to exercise professional skepticism when auditing implementation of the new revenue related accounting policies. Also, the transition process could create new opportunities to perpetrate or conceal fraud. Implementation of the new revenue recognition guidance may also present opportunities for fraud in the development of new significant accounting estimates, such as estimates for variable consideration and standalone selling prices. The additional stress and workload for auditors during the implementation period may also create incentives and pressure that act as a constraint on professional skepticism. The discussion among the engagement team members should caution auditors against allowing feeling rushed and accepting audit evidence that is insufficient in the interest of saving time.

Documentation. AU-C 315.33 requires that the following items be documented regarding the discussion among the audit team:

- How and when the discussion occurred.
- Participating audit team members.
- Significant decisions reached concerning planned responses at the financial statement and relevant assertion levels.

AU-C 240 imposes similar documentation requirements related to fraud aspects of the discussion.

SELF-STUDY QUIZ

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

4. Which of the following audit planning activities is generally considered a preliminary engagement activity?

    a. Establishing the preliminary audit strategy.

    b. Making sure the firm meets relevant ethical requirements.

    c. Developing a detailed audit plan for further audit procedures.

    d. Performing preliminary analytical procedures.

5. John is performing an annual audit of a homeowners' association. He has audited this CIRA for the past five years. John can use information he obtained from procedures performed in one of the prior audits to provide useful audit evidence about which of the following?

    a. The CIRA's organizational structure.

    b. The CIRA's risks related to fraud.

    c. The nature, timing, and extent of risk assessment procedures he will need.

    d. Current misstatements in the financial statements.

6. Observation and inspection procedures are particularly helpful when an auditor seeks to understand which of the following?

    a. A specific class of accounts.

    b. Management's evaluation about its ability to continue as a going concern.

    c. Whether controls have been implemented.

    d. Related-party transactions.

7. Which of the following matters is a required part of the engagement team discussion?

    a. Areas susceptible to management override of controls.

    b. Past experience with the audit client.

    c. Materiality levels and how those levels will affect the extent of testing.

    d. How susceptible the financial statements are to material 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.)**

4. Which of the following audit planning activities is generally considered a preliminary engagement activity? **(Page 22)**

   a. Establishing the preliminary audit strategy. [This answer is incorrect. This is generally considered to be part of general audit planning at the financial statement level. It is not considered a preliminary engagement activitiy.]

   b. Making sure the firm meets relevant ethical requirements. [This answer is correct. The audit planning activities that are generally considered preliminary engagement activities include (1) performing procedures regarding acceptance or continuance of the client relationship and the specific audit engagement; (2) evaluating compliance with ethical requirements, including independence; and (3) establishing an understanding with the client and communicating that understanding in an engagement letter.]

   c. Developing a detailed audit plan for further audit procedures. [This answer is incorrect. Developing a detailed audit plan that covers the nature, timing, and extent of further audit procedures is considered detailed audit planning at the relevant assertion level for account balances, transaction classes, and disclosures. Preliminary engagement activities include other activities.]

   d. Performing preliminary analytical procedures. [This answer is incorrect. Performing preliminary analytical procedures (which is a risk assessment procedure) is considered general audit planning at the financial statement level, not a preliminary engagement activity.]

5. John is performing an annual audit of a homeowners' association. He has audited this CIRA for the past five years. John can use information he obtained from procedures performed in one of the prior audits to provide useful audit evidence about which of the following? **(Page 25)**

   a. The CIRA's organizational structure. [This answer is correct. An auditor's previous experience with an entity contributes to his or her understanding of the entity and its environment. Audit procedures performed in previous audits ordinarily provide useful information about the CIRA's organizational structure, operations, and controls, among other things. Thus, John's prior-year information will be helpful in this area.]

   b. The CIRA's risks related to fraud. [This answer is incorrect. According to AU-C 240.17–.24, auditors should perform certain procedures to obtain information used to identify fraud risks, such as making inquiries of management and others in the CIRA about the risks of fraud and how they are addressed. This is not one of the areas, however, in which prior-year information is typically used; therefore, John should gather new information in the current year.]

   c. The nature, timing, and extent of risk assessment procedures he will need. [This answer is incorrect. The nature, timing, and extent of some risk assessment procedures may be relatively consistent across audit engagements, but some procedures will require tailoring in response to the information gathered. Therefore, John would not want to base the nature, timing, and extent of his risk assessment procedures solely on prior-year information.]

   d. Current misstatements in the financial statements. [This answer is incorrect. Prior-year information may provide information on past misstatements and whether they were corrected on a timely basis, but John should not limit his procedures in relation to current-year misstatements based on the prior-year information.]

6. Observation and inspection procedures are particularly helpful when an auditor seeks to understand which of the following? **(Page 35)**

   a. A specific class of accounts. [This answer is incorrect. One situation in which observation and inspection is effective is when responses to inquiries indicate a potential risk for a significant account (not the whole class of accounts).]

   b. Management's evaluation about its ability to continue as a going concern. [This answer is incorrect. Typically, inquiry (not observation and inspection) will help the auditor understand management's preliminary evaluation of whether 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.]

   c. Whether controls have been implemented. [This answer is correct. Other than the requirement to perform some observation and inspection procedures related to internal control, determining when to use observation and inspection, as opposed to other risk assessment procedures, is generally a matter that is left to the auditor's judgment. Two situations in which they may ordinarily be effective include understanding the design of internal controls related to an audit and verifying that controls have been implemented.]

   d. Related-party transactions. [This answer is incorrect. AU-C 550 requires the auditor to make specific inquires of management and other regarding related parties. While some such transactions might be observed, the inquiries are more important.]

7. Which of the following matters is a required part of the engagement team discussion? **(Page 36)**

   a. Areas susceptible to management override of controls. [This answer is incorrect. The engagement team discussion might include discussion of this topic; however, this is not one of the required topics.]

   b. Past experience with the audit client. [This answer is incorrect. This might affect the likelihood of material misstatements caused by error, so the engagement team may want to discuss it; however, it is not on the list of topics that are required to be discussed.]

   c. Materiality levels and how those levels will affect the extent of testing. [This answer is incorrect. This topic might be included in the engagement team discussion, but it is not required to be included.]

   d. How susceptible the financial statements are to material misstatement. [This answer is correct. Certain matters are specifically required to be discussed during the engagement team discussion. Examples include the susceptibility of the entity's financial statements to material misstatement and the application of GAAP to the entity's facts and circumstances in light of its accounting policies.]

Lesson 2: Understanding the CIRA, Its Environment, and Its Internal Control

INTRODUCTION

This lesson discusses two issues important to early planning stages of an audit engagement. It begins with a discussion of how the auditor obtains an understanding of the CIRA and its environment. This includes topics such as the industry, the nature of the entity, measuring the CIRA's financial performance, and fraud risk.

After that, Lesson 2 examines the auditor's understanding of a CIRA's internal control, which also must be obtained early in the engagement. This discussion covers the components of internal control—control environment, risk assessment, information and communication, monitoring, and control activities—as well as IT concerns and other issues.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine how an auditor obtains an understanding of the CIRA and its environment.
- Identify the components necessary for an understanding of a CIRA's internal control.

UNDERSTANDING THE CIRA AND ITS ENVIRONMENT

The auditor, according to AU-C 315.05, should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion level. AU-C 315.03 explains that the objective of the auditor is to make this assessment through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks. The auditor's focus in obtaining the understanding is on attaining a knowledge level sufficient to identify the risks of material misstatement of the financial statements and to design the nature, timing, and extent of further audit procedures. The understanding is a purpose-driven audit focus and not a general knowledge level that might be appropriate for some other purpose such as managing the entity.

Obtaining a solid in-depth understanding of the client's business and how it operates is fundamental to both audit efficiency and effectiveness. This understanding is the key to knowing what the risks are and where to look to see if the risks have resulted in a material misstatement of the financial statements. It includes not only understanding the risks the client faces in operating, but ideally, understanding what management's response is to those risks, and, consequently, what residual risk of material misstatement of the financial statements remains. The auditor's process in obtaining this understanding is focused on those matters that could cause material misstatements in the financial statements, including potential fraud risk factors, undisclosed related-party transactions, violations of laws and regulations, uncertainties, or going-concern problems.

The auditor's understanding of the entity also assists in:

- Establishing planning materiality and evaluating whether such judgments remain appropriate throughout the audit.

- Evaluating whether certain observed conditions, such as unusual or unexpected relationships from preliminary analytical procedures, do not make sense and indicate possible risk considerations.

- Considering fraud risk factors, for example, the existence of significant or complex related-party transactions. Knowledge of key personnel might help the auditor identify employees who could provide relevant information in response to fraud risk inquiries.

- Evaluating the appropriateness and sufficiency of audit evidence.

The audit personnel working on the engagement need to sufficiently understand the client's business and industry to effectively analyze the risks and plan and perform an efficient and effective audit in response to those risks. The level of understanding that is attainable by individual members of the audit team will vary with the experience, training, and assigned engagement duties of the personnel, but the partner and manager need to spend sufficient time in audit team meetings or on-the-job supervision to convey to the assigned staff the insight needed for effective performance of the audit.

The process of understanding the client's business and industry is continual. For a new engagement, a basic level of knowledge is needed to begin preliminary planning. However, a significant amount of knowledge is gained during the audit. Also, there are always important new developments with the client and within the industry. For this reason, each member of the audit team should continually try to improve client and industry knowledge by such measures as reading industry publications, taking self-study courses, and above all, talking to CIRA personnel, including personnel outside the accounting department.

In a continuing engagement, the auditor should update knowledge of the CIRA and its environment by focusing on identifying changes from the prior year in internal or external conditions that might be of audit significance and affect the CIRA's business risk or the auditor's assessment of audit risk. (Lesson 1 addresses the auditor's use of the results of risk assessment procedures performed in prior periods.)

Components of the Understanding

AU-C 315.12 indicates that the auditor's understanding of the entity and its environment consists of an understanding of the following items:

a. Industry, regulatory, and other external factors.

b. Nature of the entity.

c. Objectives, strategies, and related business risks.

d. Measurement and review of the entity's financial performance.

e. Selection and application of accounting policies.

In addition, the consideration of fraud risk factors is an important objective of performing risk assessment procedures. Although considering the presence of fraud risk factors occurs simultaneously with obtaining information about the entity and its environment, it merits separate and focused attention. The authors believe that the response to fraud risk may differ significantly for risks of fraudulent financial reporting versus misappropriation of assets. Accordingly, the authors suggest that auditors assess these risks separately and develop an overall or specific response tailored to those differing fraud risks.

Documentation. In addition to the documentation of the discussion among the engagement team explained in Lesson 1, AU-C 315.33 indicates that auditors should document:

- Key elements of the understanding obtained for each of the aspects of the entity and its environment.
- Sources of the information from which the understanding was obtained.
- Risk assessment procedures that were performed.

Purpose of This Section. The following paragraphs provide a detailed discussion of each of the aspects of the entity and its environment that the auditor is required to understand, procedures the auditor may perform to gain that understanding, and the types of risks the auditor may identify throughout that process.

Industry, Regulatory, and Other External Factors

AU-C 315.12 indicates that the auditor should obtain an understanding of industry, regulatory, and other external factors relevant to the audit. The objective of the auditor's understanding is to evaluate whether the entity is subject

to specific risks of material misstatement arising from the nature of the industry, the degree of regulation, or other external forces, such as political, economic, social, technological, or competitive forces.

AU-C 315.A25–.A29 indicates that the auditor might consider factors such as the following when obtaining an understanding of industry, regulatory, or other external factors:

a. Industry conditions, including market and competition, cyclical or seasonal activity, and availability and cost of materials and supplies.

b. Regulatory environment, including relevant legislation and regulation, environmental requirements, specific regulatory requirements, direct supervisory activities, and taxation.

c. Government policies, including monetary, fiscal, and financial incentives.

d. Other external factors, including the general level of economic activity, interest rates, availability of credit, energy and insurance risks, and inflation.

The Economic Environment. Financial and economic conditions may affect the CIRA's operations, risks, and financial reporting. That in turn, may affect the auditor's responsibilities in providing auditing services. The AICPA issued an Audit Risk Alert, *General Accounting and Auditing Developments—2017/18* (AICPA Risk Alert), to help identify and respond to accounting and auditing issues related to economic developments. (That AICPA Risk Alert replaces the 2016/17 alert of the same name.)

The AICPA Risk Alert emphasizes the importance of understanding economic conditions facing the industry and the entity. The Alert notes that in a changing economic environment, auditors need to evaluate how changes that have occurred since the previous audit affect their reliance on information obtained from prior experience with the client. For example, changed conditions may require auditors to reconsider their understanding about how the economic environment affects the entity, reassess risks, and modify planned audit procedures as the audit progresses, including risk assessment procedures.

The AICPA Risk Alert also addresses the following topics that may assist auditors when addressing risks and considering the impact of the current economic climate on their audit clients:

- Economic, legislative, and regulatory developments.
- Accounting, auditing, and attestation issues and developments, including the enhancing audit quality initiative.
- Recent accounting, audit and attest, independence, and ethics developments.
- The status of outstanding accounting, auditing, and attest projects.
- Various resources auditors may find useful.

The Regulatory Environment. AU-C 250.12 states that when obtaining an understanding of the entity and its environment, the auditor should obtain a general understanding of the laws and regulations to which an entity is subject, the industry or sector in which the entity operates, and how the entity complies with laws and regulations. The auditor may consider knowledge of any history of noncompliance.

Possible Risk Assessment Procedures and Factors to Consider. The authors believe, in most situations, auditors will initially gather information and identify risks related to industry, regulations, and other external factors through inquiry procedures. Many of the matters to be addressed are best approached through inquiry of appropriate client management and other employees. The auditor may need to expand inquiries based on the client's responses to more fully understand the area and follow up on information that may be indicative of a potential risk.

As discussed in Lesson 1, the auditor might supplement inquiry procedures with inspection or other risk assessment procedures. For example, when obtaining an understanding of the industry and environment, the auditor

might read *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*, which is updated annually; the AICPA Audit and Accounting Guide, *Common Interest Realty Associations*; industry publications of CIRA membership organizations; financial statements of other CIRAs; textbooks; or trade journals, or the auditor might subscribe to services that provide an in-depth analysis of the CIRA's industry. The auditor might also read articles of incorporation, minutes of meetings of directors, and important contract agreements; review several prior years' financial statements, income tax returns, and IRS agents' reports; have discussions with individuals knowledgeable about the CIRA industry; participate in relevant internet discussions; or tour the CIRA's facilities. Regarding the regulatory environment, the auditor might read correspondence from taxing or other regulatory authorities, applicable regulations that were recently enacted, or proposed legislation that may affect the industry. The use of other risk assessment procedures, in addition to inquiry, may be influenced by the matters discussed in Lesson 1.

Nature of the Entity

AU-C 315.12 indicates that the auditor should obtain an understanding of the nature of the entity relevant to the audit. The nature of the entity includes its operations, its ownership and governance, the types of its investments, and its structure and financing. Among other things, the understanding of the nature of the entity helps the auditor to understand the classes of transactions, account balances, and disclosures that would be expected in the financial statements. The auditor also learns about the characteristics of the entity's structure and associated risks. For example, a CIRA may have a complex structure that includes various commercial activities. Complex structures often give rise to risks of material misstatement, such as whether appropriate accounting principles have been appropriately applied, and also often have special audit implications. Furthermore, by understanding the nature of the entity, the auditor learns of the relationship between the CIRA and its management and other related parties. As noted in AU-C 550, *Related Parties*, the nature of related parties and transactions may, in some circumstances, give rise to higher risks of material misstatements. Matters that the auditor might consider about the entity's operations and its structure, ownership, and governance include the following:

- Revenue sources.
- Number of residential and commercial units in the CIRA development.
- Involvement in e-commerce.
- Conduct of operations.
- Important suppliers.
- Major assets, including types of common property, and liabilities.
- Major operating expenses and expenditures from replacement and capital improvement funds.
- Policy, statutory requirements, and methods for funding major repairs and replacements.
- Policy and methods for funding capital improvements.
- Employment and human resource matters, including compensation methods and employee benefits.
- Tax status.
- Related parties and transactions with them.
- Location of facilities.
- Types of investments.
- Financing activities.

Matters that the auditor might consider about investments and financing depend on the relative importance of those activities.

Organizational Structure and Personnel. Auditors need to obtain an understanding of the CIRA's legal structure, including the CIRA's legal form (corporation or unincorporated association) and the legal form of the entity for which it provides services (condominium, HOA, or cooperative housing corporation). Copies of the declaration (for a condominium or homeowners' association), the corporate charter (for a cooperative housing corporation), articles of incorporation, and bylaws generally are retained in the permanent file. Auditors identify the key management members and whether there is an audit committee or an equivalent group. A CIRA normally has a volunteer governing board with board members simultaneously serving as officers. For example, the president is usually the chairman of the board, another board member serves as treasurer, and other board members have designated duties for the CIRA's operations. It is unusual for a CIRA to have an audit committee or other individual or group formally designated with responsibility for oversight of the financial reporting process.

A CIRA may be internally managed, but it is relatively common for a CIRA to use a managing agent or property management company for various operational and financial functions. Auditors need to obtain an understanding of the extent of the managing agent's responsibilities and the degree of control that the CIRA's board of directors exercises over the managing agent's activities. Some CIRAs may have employees, and, in those cases, the auditors need to obtain an understanding of the nature and size of the work force and the compensation methods.

Operating Characteristics. Auditors need to obtain an understanding of the areas the CIRA controls and the size of the CIRA (number of units, shares, or weeks), location and types of common properties, and funding policies and methods (for example, policy and methods for funding current operations and for funding future major repairs and replacements). Auditors also consider the importance of budgets in the CIRA's operations. Some of the CIRA's operating characteristics can impact its ability to obtain financing and may even impact the ability of unit owners to obtain financing.

Most CIRAs have common operating characteristics. Documenting those characteristics in a permanent file has the practical advantage of giving new staff a convenient means of obtaining knowledge without having client personnel answer questions already asked in prior years.

Governing Documents and Similar Documents. The governing documents are the legal documents that created the CIRA. Normally, those documents will describe the board of directors' responsibility to unit owners, including responsibilities for maintaining common property and funding future major repairs and replacements. Auditors need to review the governing documents as well as relevant state statutes or local ordinances. They need to have an understanding of the effects of noncompliance on the financial statements. Auditors also review the governing documents for items such as the CIRA being set up with a limited life rather than a perpetual life or accounting or financial reporting matters that are contrary to current practices or regulations. Any such defects in the governing documents can be discussed with management of the CIRA.

Either obtaining copies of key agreements or preparing memoranda summarizing their key provisions provides helpful information.

Additionally, auditors need to review the minutes of meetings of the board of directors and appropriate committees and consider matters that may affect the CIRA's operations. Reviewing the minutes of the association can reveal to the auditor how involved the board of directors is in the association's financial decisions. The minutes normally include matters such as the status of conversions from developer/sponsor control to owner control, approvals of budgets and assessments, authorizations for capital expenditures, bank and investment accounts, approvals of contracts for services to be performed, changes in board members, related party transactions, and authorization for engaging a managing agent and paying the agent's fees.

Related-party Transactions. In a CIRA, related parties may include members of the CIRA's governing board, management, and their immediate families and the developer/sponsor. It is not uncommon for CIRAs to deal with related parties. (As previously discussed, a CIRA's board members typically serve simultaneously as officers of the CIRA.) Examples of related-party transactions with board members are as follows:

- Directors' fees.

- Board member is an insurance agent, CIRA broker, or on the board of a bank or other company that services the association.
- A member, or his or her relative, provides maintenance, professional, or other services to the CIRA on a nonemployee basis.
- Board member loans money to the CIRA.
- Member is materially delinquent in paying CIRA assessments.

It is not uncommon for a developer or sponsor, or entities controlled by them, to provide services to CIRAs, such as insurance, equipment leasing, or managerial or maintenance services. Also, a developer/sponsor may be paying assessments on unsold units or may have guaranteed interest rates or total maintenance expenses resulting in related party receivables and revenue. (If 10% or more of a CIRA's revenues are derived from any one source, FASB 972-605-50-2 requires that fact and the amounts of revenue from each source to be disclosed.) In addition, the auditors need to consider whether the managing agent or one of its affiliates provides additional services (especially without going through the bid or approval process), such as maintenance or landscaping, engineering, special project administration, etc., to the CIRA. Such transactions could represent related party transactions that should be disclosed in the financial statements.

Auditors review documents in the permanent file, inquire of management, and review board minutes to identify transactions with related parties. Also, auditors need to consider whether such transactions are occurring but not being recognized in the accounting records. The names of known related parties should be communicated to the audit staff at the start of the audit so they can identify and examine related-party transactions in applicable audit areas, such as receivables and payables.

Often the best way to become aware of related party transactions is through inquiry of management or review of board minutes.

Risk Assessment Procedures and Factors to Consider. Similar to the understanding of industry, regulatory and other external factors, the auditor often initially makes inquiries of appropriate client personnel about matters pertaining to the nature of the entity. To make effective risk-based inquiries, it is critical that the auditor identify the right person within the CIRA who possesses not only the requisite knowledge about the matter queried, but also about the nature of risks, how the CIRA has addressed them, and what the remaining risk is to the CIRA. For example, in many CIRAs, the auditor may be able to confine all inquiries about the nature of the business to the CIRA's president. As the size, complexity, and management structure expands within a CIRA, the auditor might need to direct questions, for example, about operational matters for investments and financing, to the treasurer or managing agent.

The auditor's inquiries may be supplemented by additional inquiries and other risk assessment procedures as deemed necessary to fully understand the entity, its operations, structure, ownership, governance, related parties, investments, and financing so that related risks can be identified. The understanding also provides the auditor with an expectation of what classes of transactions, account balances, and disclosures will be present in the financial statements. The auditor may need to expand inquiries based on the client's responses to more fully understand the area and follow up on information that may be indicative of a potential risk.

Objectives, Strategies, and Related Business Risks

AU-C 315.12 indicates that the auditor should obtain an understanding of the CIRA's objectives, strategies, and related business risks. The basic concept here is that most business risks eventually have financial consequences and, thus, an effect on the financial statements. Not all business risks create risks of material misstatement, so the auditor needs to focus on those risks that have financial reporting implications in the CIRA's particular circumstances.

The auditor obtains an understanding of management's objectives and strategies to identify the related business risks. Management determines the CIRA's objectives, which are the overall plans of the CIRA. Management's strategies are the operational approaches adopted to achieve the objectives. The related business risks are the

significant conditions, events, circumstances, actions, or inactions that could adversely affect the CIRA's ability to achieve its objectives or implement its strategies. When obtaining an understanding of the CIRA's objectives and strategies, it is often helpful to consider whether strategies align with objectives and whether the strategies have been implemented. By doing so, the auditor may become aware of heightened or additional business risks and potential risks of material misstatement.

Risk Assessment Procedures and Factors to Consider. When obtaining an understanding of management's objectives and strategies to identify the related business risks, the risk assessment procedures employed by the auditor may be influenced by the size and sophistication of the CIRA. Smaller CIRAs generally do not have formal plans or processes that are documented, which forces the auditor to rely primarily on inquiries. In contrast, some larger or more sophisticated CIRAs may have written strategic plans that provide a road map for the objectives, strategies, and associated business risks that have been selected and identified by the management team. When making inquiries, the auditor will generally restrict questioning to the CIRA's board of directors and officers given the subject matter and the level of knowledge that is needed to sufficiently address it. These inquiries would prompt management to describe the CIRA's future trends, expectations, objectives, and strategies in areas such as the following:

- Industry or regulatory developments.
- Products and services for members.
- Regular and special assessments.
- Technology.
- Business expansion or restructuring.
- Major repairs and replacements and capital improvements.
- Financing requirements.
- Employment or compensation.

Measurement and Review of the Entity's Financial Performance

AU-C 315.12 indicates that the auditor should obtain an understanding of the measurement and review of the entity's financial performance made by management and external parties. Information used for measurement and review might include the following:

a. Key performance indicators (KPI), both financial and nonfinancial.

b. Trends.

c. Key ratios and other operating and financial statistics.

d. Forecasts, budgets, and variance analyses.

e. Period-on-period financial performance.

f. Employee performance measures.

g. Performance reports for affiliated locations.

h. Comparisons to performance of comparable CIRAs (i.e., benchmarking).

Information prepared by external parties might include lender analyses and credit-rating agency reports.

Performance measures can affect the audit and the auditor's assessment of the risks of material misstatement in several ways, including the following:

a. The pressure to meet performance targets could motivate management actions, including intentional misstatements, and, thus, affect the auditor's risk assessment.

b. Use of performance measures might highlight unexpected results or trends such as an unusually rapid growth, which upon investigation result in detection of misstatements.

c. The auditor might be able to use key performance indicators or other measures used by management when performing analytical procedures. However, the auditor should consider whether the information used by management is reliable and provides the degree of precision that is needed for the analytical procedures.

A small CIRA might not have a formal process to measure and review financial performance, but management will still likely be aware of key performance indicators that it uses and that can be helpful to the auditor.

Risk Assessment Procedures and Factors to Consider. The procedures used by the auditor for understanding the measurement and review of the CIRA's financial performance will often be driven by the size and sophistication of the CIRA. For example, a sophisticated CIRA may have developed a "dashboard" reporting system that incorporates carefully selected key performance indicators that management has deemed to be the primary metrics in achieving its goals and objectives. In that case, the auditor could inspect and review these measures along with any accompanying analyses in order to identify risks that may be indicative of material misstatement.

In a smaller CIRA, management may have identified key financial performance indicators that it uses when managing the business, but it prepares no formal reporting or analyses. Instead, as management reviews financial or other operating reports, a determination is made whether the business has achieved the targets that management has established for these indicators. For those situations, the auditor would likely use inquiry to determine what indicators management believes are important in managing and measuring the CIRA's results and inspect the reports that are used to monitor performance.

For all situations, the auditor should consider inquiring whether there is any external measurement of the CIRA's financial performance such as by credit agencies, analysts, or the CIRA's creditors. If so, the auditor may review available reports to identify potential risks.

Selection and Application of Accounting Policies

AU-C 315.12 indicates that the auditor should obtain an understanding of management's selection and application of accounting policies and evaluate whether the policies are appropriate for the CIRA and consistent with policies used in the CIRA industry. Furthermore, AU-C 540.08 indicates that the auditor should obtain an understanding of the following regarding accounting estimates:

- Requirements of GAAP relevant to the accounting estimates, including those related to disclosures.
- How management identifies transactions, events, and conditions that may give rise to accounting estimates.
- How management makes accounting estimates and the data on which estimates are based, including—
  - Methods used, including models if applicable.
  - Relevant controls.
  - Whether a specialist was used.
  - Assumptions underlying accounting estimates.

- Any changes in methods or assumptions made, or ought to have been made, from the prior period and reasons for those changes.

- Whether and how management has assessed the effect of estimation uncertainty.

Gaining an understanding of the selection and application of accounting policies and accounting estimates is important for considering the risks of material misstatement at both the financial statement and relevant assertion levels, including both misstatements due to fraud and those due to error. The auditor's assessment of the appropriateness of the accounting policies that management has selected and applied is an important element in determining what can go wrong in the preparation of financial statements and, hence, in assessing risks of material misstatement. For CIRAs, significant accounting policies include those for allocating assessments to replacement funds; accounting for common property, including capitalization policies; funding for future major repairs and replacements; and revenue recognition for special assessments.

The auditor's understanding of management's selection and application of accounting policies includes the following:

a. Relevant accounting standards and industry specific practices.

b. The methods the CIRA uses to account for significant and unusual transactions.

c. The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

d. Changes in the CIRA's policies, including the reasons for the change and whether the change is appropriate and consistent with GAAP (or a special purpose framework).

e. Financial reporting standards and regulations that are new to the CIRA and management's plans to adopt such requirements, including new accounting standards.

f. The process used by management in formulating particularly sensitive accounting estimates.

g. The methods used to identify matters for disclosure and how the CIRA achieves clarity in disclosure.

The auditor uses the understanding of these aspects of management's selection and application of accounting policies to identify audit areas of higher risk and to identify what could go wrong at the relevant assertion level. For example, because accounting for special assessments revenue or deferred revenue involves judgment, there ordinarily is a higher risk of material misstatement for the valuation of those assets. For items of disclosure, many auditors of smaller CIRAs assist management in preparing the financial statements. In those cases, identification and clarity of required disclosures are often heavily influenced by the auditor. Therefore, the potential for risk may be mitigated with respect to disclosure.

The auditor uses the understanding of management's selection and application of accounting policies along with the identification of fraud risk factors to evaluate whether an overall response is necessary. AU-C 240.29 indicates that in determining overall responses to fraud risk, the auditor should evaluate whether the selection and application of accounting policies, particularly policies related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting to manage earnings or management bias that may create a material misstatement. In establishing the overall audit strategy, the auditor focuses on whether the accounting principles selected and policies adopted are being applied in an inappropriate manner. If the auditor identifies a risk in this area, it is often addressed by an overall response, such as the assignment of more experienced personnel and a higher level of supervision, as well as by the selection of specific further audit procedures.

Risk Assessment Procedures. The nature and extent of the risk assessment procedures to obtain an understanding of the selection and application of accounting policies normally depend on factors such as:

- The auditor's knowledge and experience with the CIRA's business and industry.

- The auditor's knowledge and past experience with the client.

- The degree of financial reporting sophistication of the client.
- The extent of new accounting standards that are recently effective for the client.
- The auditor's participation in assisting the client with the selection of accounting policies and the preparation of the financial statements.

For many small CIRA clients, the auditor is instrumental in assisting with the selection of accounting principles and choosing the methods by which they are applied. Consideration of accounting policies for those clients ordinarily will not be a time-consuming process since the auditor already possesses much of the requisite knowledge. The auditor in those cases can generally confine inquiries of the client to matters such as the manner and consistency of application. For other situations in which the auditor is not involved in the selection of accounting policies or has limited experience with the client, the auditor may inquire about the matters discussed earlier in the "Risk Assessment Procedures and Factors to Consider"paragraph. Also, the auditor may supplement inquiries with a review of prior year financial statements and supporting disclosures (for initial audits) coupled with a thorough review and understanding of relevant accounting standards that are either new or specifically applicable to CIRAs or the client's transactions.

Fraud Risk Factors

Fraud risk factors are conditions or events that indicate incentives/pressure to perpetuate fraud, opportunities to commit fraud, or indicate attitudes/rationalizations to justify a fraudulent action. AU-C 240.24 states that the auditor should evaluate whether the information obtained from risk assessment procedures indicates that one or more fraud risk factors are present.

The identification of fraud risk factors is a natural by-product of performing risk assessment procedures. Along with the other information obtained about the CIRA and its environment, the fraud risk factors are an important component in identifying the risks of material misstatement at the financial statement and relevant assertion levels. The auditor's primary concern in considering fraud risk factors is to identify whether a risk factor is present and needs to be considered in identifying and assessing risks of material misstatement due to fraud. The presence of a particular fraud risk factor does not necessarily indicate the existence of fraud. Whether a risk factor is present and needs to be considered in identifying and assessing the risks of material misstatement due to fraud is a matter of professional judgment.

Examples of Fraud Risk Factors. AU-C 240.A75 provides examples of fraud risk factors that may be considered when identifying and assessing the risks of material misstatement due to fraud. The risk factors are classified into factors related to fraudulent financial reporting and factors related to misappropriation of assets. Because it may be helpful to consider fraud risk factors in the context of the conditions generally present when fraud occurs, the standard further classifies the illustrative risk factors into conditions relating to incentives/pressures, opportunities, and attitudes/rationalizations. It is important to note that these are only examples and the auditor also may consider other risk factors not specifically listed. In fact, AU-C 240.A75 states:

> Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances.

One example of a risk factor related to fraudulent financial reporting is, "CIRA management is dominated by a single individual or a small group without compensating controls." (This is one of the risk factors provided in the practice aids in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations.*) Is that circumstance always a fraud risk factor? The authors believe that domination of management by a single individual or a small group does not, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In fact, in many small CIRAs, strong management involvement actually can be a control strength in that there is a great deal of oversight of employees throughout the process. The effect of management dominance is discussed further in the next section. In addition, AU-C 550.20 indicates that a fraud risk factor may exist when an entity has related parties who have the ability to exert control over, or significantly influence, management or the entity.

If the CIRA has a managing agent, fraud risk factors related to a CIRA's management also need to be considered from the perspective of the CIRA's managing agent. Another example of a fraud risk factor related to fraudulent financial reporting is, "When those charged with governance include nonmanagement personnel, there is ineffective oversight over the financial reporting process and internal control by those charged with governance." If the CIRA engages the service of a managing agent, auditors should consider whether the CIRA's board of directors understands the extent of managing agent responsibilities and if it exercises sufficient control over the managing agent's activities. Without effective oversight, a managing agent may have the ability to dominate activities or override controls.

Auditors need to focus on the choice of modifying words in the risk factors (such as *inappropriate* means, *unduly* aggressive, etc.). For example, a fraud risk factor might be, "Management feels significant pressure to avoid budget overruns." Many CIRAs have an interest in avoiding budget overruns. The primary consideration, however, is whether management has shown an interest in avoiding budget overruns through inappropriate means. If so, the situation would likely be considered a fraud risk factor. However, if management indicates interest in avoiding budget overruns through legitimate means, then the auditor would not consider the situation to be a fraud risk factor.

For misappropriation of assets, the consideration of fraud risk factors is influenced by the degree to which assets susceptible to misappropriation are present. However, some consideration is given to risk factors related to incentives/pressures, opportunities arising from control deficiencies, and attitudes/rationalizations for misappropriation, even if assets susceptible to misappropriation are not material. In small to mid-sized CIRAs, there is always an asset subject to misappropriation. Similarly, securities in the custody of a broker may be susceptible to misappropriation through unauthorized trading. Therefore, some consideration of fraud risk factors related to misappropriation is needed. In addition, when considering risk factors for misappropriation, the auditor may identify risk factors related to inadequate monitoring and weaknesses in internal control that could also be present when fraudulent financial reporting occurs.

The presence of risk factors related to financial stress or dissatisfaction among employees is particularly important when considering the risk of misappropriation of assets because those conditions often provide both incentive and rationalization for theft. The auditor, during the course of the audit, may become aware of information that indicates potential financial stress or dissatisfaction of employees with access to assets susceptible to misappropriation. Examples include:

- Anticipated layoffs that are known to employees.
- Unfavorable changes in employee compensation or benefit plans.
- Failure to receive promotions or other expected rewards.
- Known unusual changes in behavior or lifestyle.
- Employees who are known to be experiencing significant personal financial obligations.
- Behavior indicating dissatisfaction with the entity, including disregard for the entity's policies and procedures.

If the auditor becomes aware of the presence of these or similar risk factors, the auditor considers them when identifying the risks of material misstatement due to fraud.

If fraud risk factors are present, in accordance with AU-C 330, AU-C 240.28, and AU-C 240.30, the auditor considers whether the assessment of the risk of material misstatement due to fraud calls for an overall response, one that is specific to a particular account balance, class of transactions, or disclosures at the relevant assertion level, or both. An overall response is considered in establishing the overall audit strategy and a specific response is considered in developing the detailed audit plan.

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 statements best describes the auditor's understanding of the CIRA and its environment?

    a. The auditor's focus is how to mitigate risks of material misstatement.

    b. The auditor's understanding will be on a general knowledge level.

    c. The understanding includes operating risks and management's responses.

    d. Procedures for obtaining this understanding all performed early in the engagement.

9. Trends, key ratios, forecasts, and budgets are used to help an auditor obtain an understanding of what?

    a. The measurement and review of the entity's financial performance.

    b. Fraud risk factors that may affect the entity.

    c. The nature of the entity.

    d. The entity's related-party transactions.

10. Which of the following is a risk factor for possible misappropriation of the client's assets?

    a. Employees feel that their jobs are most likely secure.

    b. Employees are promoted on a specific cycle.

    c. Employees who are known to have large personal financial obligations.

    d. High employee morale and support of company policies.

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 statements best describes the auditor's understanding of the CIRA and its environment? **(Page 45)**

   a. The auditor's focus is how to mitigate risks of material misstatement. [This answer is incorrect. The auditor's focus in obtaining the understanding is on attaining a knowledge level sufficient to identify, not mitigate, the risks of material misstatement of the financial statements and to design the nature, timing, and extent of further audit procedures.]

   b. The auditor's understanding will be on a general knowledge level. [This answer is incorrect. The understanding is a purpose-driven audit focus and not a general knowledge level that might be appropriate for some other purpose such as managing the entity.]

   c. The understanding includes operating risks and management's responses. [This answer is correct. This understanding is the key to knowing what risks are and where to look to see if the risks have resulted in a material misstatement of the financial statements. It includes not only understanding the risks the client faces in operating, but, ideally, understanding what management's response is to those risks, and, consequently, what residual risk of material misstatement of the financial statements remains.]

   d. Procedures for obtaining this understanding all performed early in the engagement. [This answer is incorrect. The process of understanding the client's business and industry is continual. For a new engagement, a basic level of knowledge is needed to begin preliminary planning. However, a significant amount of knowledge is gained during the audit.]

9. Trends, key ratios, forecasts, and budgets are used to help an auditor obtain an understanding of what? **(Page 51)**

   a. The measurement and review of the entity's financial performance. [This answer is correct. AU-C 315.12 indicates that the auditor should obtain an understanding of the measurement and review of the entity's financial performance made by management and external parties. Information used for measurement and review may include (among other things) (1) key performance indicators, both financial and nonfinancial; (2) trends; (3) key ratios and other operating and financial statistics; and (4) forecasts, budgets, and variance analyses.]

   b. Fraud risk factors that may affect the entity. [This answer is incorrect. Fraud risk factors are conditions or events that indicate incentives/pressure to perpetuate fraud, opportunities to commit fraud, or indicate attitudes/rationalizations to justify a fraudulent action. Understanding such risk factors requires different considerations than those listed above.]

   c. The nature of the entity. [This answer is incorrect. Matters that the auditor might consider about the entity's operations and its structure, ownership and governance include items such as revenue sources, involvement in e-commerce, and conduct of operations, among other things. These considerations lead to a different understanding than those described above.]

   d. The entity's related-party transactions. [This answer is incorrect. To understand an entity's related-party transactions, the auditor will need to look at who its related parties are, not the items listed above.]

10. Which of the following is a risk factor for possible misappropriation of the client's assets? **(Page 55)**

    a. Employees feel that their jobs are most likely secure. [This answer is incorrect. An example of such a risk factor would be if layoffs are anticipated and known to employees. Employees whose jobs are secure are less likely to commit fraud.]

    b. Employees are promoted on a specific cycle. [This answer is incorrect. Failure to receive promotions or other expected rewards is an example of this type of risk factor. Employees who are receiving such rewards would be less likely to commit fraud.]

    c. Employees who are known to have large personal financial obligations. [This answer is correct. The presence of risk factors related to financial stress or dissatisfaction among employees is particularly important when considering the risk of misappropriation of assets because those conditions often provide both incentive and rationalization for theft. Employees who are known to be experiencing significant personal financial obligations are more a risk factor for this type of fraud and may require more attention in the audit.]

    d. High employee morale and support of company policies. [This answer is incorrect. A fraud risk factor would be behavior indicating dissatisfaction with the entity, including disregard for the entity's policies and procedures. Employees that are favorable to the entity are less likely to commit fraud.]

THE UNDERSTANDING OF INTERNAL CONTROL

AU-C 315.13–.25 establish requirements for auditors related to consideration of internal control as part of an audit. It also provides guidance about how the entity's use of information technology (IT) affects the auditor's consideration of internal control in planning the audit. Auditors should obtain an understanding of internal control that is sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures.

Components of Internal Control

AU-C 315.15–.25 require an understanding of the five interrelated components of internal control defined and described in COSO's *Internal Control—Integrated Framework*. Those components are as follows:

a. Control environment.

b. Risk assessment.

c. Information and communication.

d. Monitoring.

e. Control activities.

Each of these components is discussed further later in this lesson.

AICPA Technical Question and Answer, *Obtaining an Understanding of Internal Control Relevant to the Audit* (Q&A 8200.18), points out that the AU-C 315 requirement to obtain an understanding of internal control relevant to the audit applies to each of the five components of internal control. In other words, each of the five components is relevant in all audits and is required to be understood, and that understanding of each component is required to be documented in every audit engagement.

AU-C 315.A57 notes that the five components discussed above provide a useful framework for auditors when considering different aspects of internal control, and AU-C 315.A58 indicates auditors may use different terminology or frameworks to describe various aspects of internal control providing that the five components are addressed. AU-C 315.A52 recognizes that the five components may not be clearly distinguished in smaller, less complex entities. Those entities might not have extensive or formal descriptions of internal controls, descriptions of accounting procedures, or detailed policies. Furthermore, in very small entities, management may perform functions that cover several different components of internal control.

Although small nonpublic entities may not have formally adopted, or even be familiar with, the COSO framework, the authors believe that auditors turn to the COSO framework as a reference and guide for understanding and evaluating internal control as it relates to their clients. Given the widespread usage of COSO, this course makes reference to certain of the COSO principles that are associated with the five components of internal control discussed above. Those principles are provided as considerations for the auditor when obtaining an understanding of the CIRA's internal control.

The AICPA Risk Assessment Audit Guide discusses various aspects of the COSO Framework. For example, observations and suggestions are included, when relevant, that discuss the 17 principles associated with the five components of internal control. Furthermore, Appendix C of that guide explains how the concepts in AU-C 315 correspond to the COSO Framework and its 17 principles to help auditors relate the framework to the auditing standards. The audit guide also reminds auditors that while GAAS does not require the use of a specific framework, the COSO internal control framework is widely used by entities in connection with their internal control systems.

Nature of the Auditor's Understanding

AU-C 315.13–.14 require auditors to obtain an understanding of internal control relevant to the audit. As noted in a nonauthoritative AICPA Technical Question and Answer, *Ineffective Controls* (Q&A8200.11), auditors obtain a

sufficient understanding of the five components of internal control to evaluate the design of controls and determine whether they have been implemented, even if the auditor believes, prior to performing risk assessment procedures, that controls are nonexistent or ineffective. AICPA Technical Question and Answer, *Obtaining an Understanding of the Controls Relevant to the Audit* (Q&A 8200.19), also notes that the requirement to evaluate design and determine whether the controls have been implemented applies to each of the five components and is required every year. A key consideration is whether and how the entity's internal control prevents, or detects and corrects, material misstatements in relevant assertions related to transaction classes, account balances, or disclosures.

Evaluation of design considers whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. In other words, the auditor considers the effectiveness of the control in achieving its objective. If a control is improperly designed, a control deficiency may exist that needs to be communicated to management and those charged with governance.

The documentation of a control procedure, however, does not demonstrate that the control is actually operating as intended. The auditor, therefore, should also determine if the control, as documented or described, actually exists and the CIRA is using it. In other words, the auditor uses risk assessment procedures to obtain audit evidence that the control has actually been implemented. Determining whether a control has been implemented confirms the auditor's understanding of control design and helps ensure that the risk assessment is based on accurate information. Generally, the auditor uses procedures such as observation or inspection, combined with inquiries, to verify implementation. Inquiry alone is not sufficient to evaluate the design of a control and determine if it has been implemented.

Normally, the auditor's understanding of internal control design and implementation is not sufficient to reach a conclusion about the operating effectiveness of controls. The same types of procedures performed to determine if a control has been implemented (e.g., observation, inspection of documents, reperformance, and walkthroughs) are also used when testing controls for operating effectiveness. However, the extent of the procedures to determine implementation may fall short of what is needed to determine operating effectiveness because tests of operating effectiveness need to provide audit evidence about how controls were applied throughout the period under audit and the consistency with which they were applied. However, in some cases, the auditor's procedures may serve both purposes. For example, a walkthrough can serve as a test of controls for operating effectiveness and in some cases, along with other procedures that test operating effectiveness, can provide a valid basis for assessing control risk at less than high. In addition, for an automated control where consistency of application would normally occur assuming the existence of effective IT general controls, the auditor may be able to determine operating effectiveness based on procedures performed to establish that the control has been implemented and the auditor's assessment and testing of the related general controls.

Extent of the Auditor's Understanding

The overriding requirement regarding the understanding of internal control is that it should be *sufficient* to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures. Obtaining an understanding that is sufficient to assess the risks of material misstatement necessitates that the auditor develop a fairly thorough and robust knowledge of all five of the components of internal control. AU-C 315.26–.27 indicate that to provide a basis for designing and performing audit procedures, the auditor should identify and assess the risks of material misstatement throughout the process of obtaining an understanding of the entity and its environment, including the relevant controls that relate to the risks. The auditor is not permitted to simply default to high control risk. In most situations, the auditor's understanding of internal control will be more comprehensive than the understanding of the other aspects of the CIRA and its environment discussed earlier in this lesson, and obtaining it will require more time. In addition, for initial audit engagements, the effort and time to gather information on the components of internal control that is sufficient to assess risk will most likely exceed that necessary for engagements in following years. However, the auditor is not required to obtain an understanding and evaluate all of the controls at the client. The use of the auditor's professional judgment is paramount in determining which controls are relevant to the audit and, thus, require an understanding and evaluation.

In general terms, the extent of the understanding, along with the nature, timing, and extent of the associated risk assessment procedures performed to obtain the understanding, are affected by factors such as the following:

- The auditor's prior experience with the client.
- Materiality.
- Significance of the related risk.
- Size of the CIRA.
- Nature of the client's business, for example, the type of legal entity (corporation, association, etc.) and development (condominium, planned unit development, etc.).
- Diversity and complexity of operations.
- Nature and complexity of systems within the CIRA, including the use of service organizations.
- Applicable legal and regulatory requirements.
- Level of business and financial sophistication of the client.
- The facts and circumstances relevant to the applicable control components.
- Whether and how a specific control, individually or in combination with other controls, prevents, or detects and corrects, material misstatements.

The auditor's understanding of the CIRA and its environment other than internal control as discussed earlier in this lesson (as well as preliminary engagement activities discussed in Lesson 1) will generally influence the extent of the understanding of internal control components. Most of the factors noted in the previous paragraph are determined to a major degree when the auditor performs risk assessment procedures to understand the entity and its environment. Furthermore, that understanding often results in the identification of risks of material misstatement that further shape the direction, extent, and depth of the auditor's understanding of internal control. (However, the auditor needs to be aware that additional risks of material misstatement may be identified when obtaining an understanding of internal control and by performing further audit procedures.) The authors recommend that the auditor perform risk assessment procedures related to the understanding of the CIRA and its environment discussed in the previous section before obtaining an understanding of internal control.

How Are the Results of the Understanding Used? The understanding of internal control needs to be sufficient to assess the risks of material misstatement and to design the nature, timing, and extent of further audit procedures. Specifically, the understanding is used to:

- Identify types of potential material misstatements.
- Consider factors that affect the risks of material misstatement.
- Design tests of controls, when applicable, and substantive procedures.

In addition, the auditor needs to remain alert for risks that may be identified during the process of obtaining an understanding of internal controls. Identified risks should be documented.

Effect of Information Technology (IT) on Internal Control

Information that may be useful in understanding the effect of IT in internal control includes understanding the role of IT in initiating, authorizing, recording, processing, and reporting transactions. While information systems may use packaged software or custom developed applications, the auditor would also consider spreadsheets developed by end users that are used for accounting functions. How the client manages IT includes understanding the

persons and third parties who support the IT infrastructure, along with those parties responsible for managing the deployment and integrity of the infrastructure.

AU-C 315.22 indicates that in understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks that arise from IT. Relevant controls include both properly designed and implemented application controls and general controls upon which application controls depend. The AICPA Risk Assessment Guide (paragraph 4.63) notes that the auditor evaluates the design of IT general controls and determines whether they have been implemented when assessing the risks of material misstatement. Auditors test general controls when they plan to rely on IT application controls to modify the nature, timing, and extent of substantive procedures. The auditor also ought to be aware that the use of IT may affect the availability of information needed for the audit. Furthermore, in certain situations the auditor may be precluded from using only substantive procedures when the role of IT is significant to the processing of transactions. For example, in highly automated processing with little or no manual intervention where transactions are initiated, authorized, recorded, processed, or reported, the auditor may determine that detection risk cannot be adequately reduced without testing the operating effectiveness of controls.

Considering Whether Specialized IT Skills Are Needed to Understand Internal Control. Auditors need to consider whether specialized IT skills are needed to determine the effect of IT on the audit, identify and assess IT risks, understand IT controls, design and perform tests of IT controls or substantive procedures, or identify IT control deficiencies. That determination ought to be made relatively early in the planning process to assure that the necessary resources are available on a timely basis. AU-C 300.A18 states that auditors may consider the following factors in determining whether the audit team should include individuals who possess specialized IT skills:

- Complexity of the CIRA's systems and IT controls and the manner in which they are used in the CIRA's business conduct.
- Significance of changes to existing systems or the implementation of new systems.
- Extent to which systems share data.
- CIRA's use of emerging technologies.
- Significance of audit evidence available in electronic form only.
- Extent of the CIRA's participation in e-commerce.

An IT specialist may be either a member of the auditor's firm or an outside professional. When an IT specialist is used in the engagement, it may be advisable to include the specialist in the audit team discussions to help design relevant elements of the audit strategy and audit plan, including IT audit objectives, resource needs, and timing.

However, an IT specialist might not be needed, even for complex computer systems, if one or more of the following conditions exist:

a. The CIRA uses only purchased software and has no access to the source code.

b. The CIRA uses a service organization for its computer services and there is a recent service auditor's report on the service organization's internal control.

c. The auditors believe they can identify types of potential misstatements. This will normally be the case when manual control procedures are adequate to prevent or detect material misstatements in computer-processed information.

If a CIRA's systems are complex, such as when a significant amount of information is electronically initiated, recorded, processed, or reported, or when evidence is available only in electronic form, specialized skills may be needed. In those cases, either a professional on the audit staff who possesses IT skills or an outside professional may be needed. An IT specialist may help the auditor by—

- Inquiring of a CIRA's IT personnel about how data and transactions are initiated, authorized, recorded, processed, and reported and how IT controls are designed.

- Inspecting systems documentation.
- Observing the operation of IT controls.
- Planning and performing tests of IT controls.

If the auditor uses an IT specialist on the engagement team, AU-C 300.12 indicates that the auditor should be knowledgeable enough to communicate the audit objectives to the specialist, evaluate whether the procedures performed by the specialist meet the auditor's objectives, and determine the results of the procedures on the nature, timing, and extent of other planned procedures. That does not mean auditors have to be experts in information technology. The AICPA Risk Assessment Guide at paragraph 3.73 indicates that typically the auditor's responsibility when using an IT specialist is the same as for other members of the engagement team. To effectively supervise an IT specialist, auditors need a basic understanding of IT applications and controls, especially those most relevant to particular client systems. That understanding can be gained from experience with the client or from attending training classes or seminars. The extent of the understanding will vary with the nature of the entity's IT environment.

Cybersecurity

Cybersecurity risks have increased as entities have increasingly migrated to use of digital technologies in business and financial operations. Cybersecurity encompasses all IT-related controls in an entity's IT platform that guard against unauthorized access. Cybersecurity risk is the risk that an attack or intrusion of the IT platform will be successful and that there will be a breach in these controls and a cyber incident.

General Effects of Cybersecurity Issues on the Audit. Cybersecurity risks and controls affect the audit of financial statements primarily with respect to the auditor's assessment of the risks of material misstatement of the financial statements, obtaining an understanding of IT controls and their effect on financial reporting, and assessing the effect on the financial statements of known cyber incidents. The auditor's concern about cybersecurity relates to data, systems that process that financial-statement-related data, and controls over those systems that could affect the financial statements and the safeguarding of assets in a material way. If certain control deficiencies are identified during the review of the entity's controls relevant to cybersecurity, the auditor should follow the requirements of AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.

Inquiries of Management about Cybersecurity Risks and Controls. The auditors' inquiries of management need to include identification of the primary types of sensitive information the entity creates, uses, or stores that are susceptible to cybersecurity risk and management's process for dealing with these risks. Examples of inquiries that may be made include the following:

- The steps management has taken in designing and implementing controls at both the entity and activity level to assess and respond to the risks.
- The steps management has taken to monitor the effectiveness of those controls.
- The internal processes management has designed and implemented for identifying and communicating security events and/or security incidents.
- How management has responded to any security events and/or security incidents.

Engagement Team Discussion on Cybersecurity. In connection with the engagement team discussion, the engagement team needs to discuss the areas in the IT platform relevant to financial reporting that are vulnerable to cyber attacks or intrusion. The discussion could include the following matters:

- What are the primary types of sensitive information that the entity creates, uses, and stores?
- Are the control policies and procedures at both the entity and activity level sufficient to safeguard the integrity of this data?

- How would a cyber attack affect the reliability of the entity's financial reporting or result in a material loss or impairment of the entity's assets?

Documentation

AU-C 315.33 requires documentation of the understanding of the CIRA and its environment, including internal control. For internal control, the auditor is required to document the understanding obtained for the five components of internal control. The auditor should also document the sources of the information used and risk assessment procedures that were performed to obtain the understanding.

AU-C 315 permits auditors flexibility in the manner of documentation. The form and extent of documentation is influenced by factors such as the complexity, size, and nature of the CIRA and the use of technology. Where applicable, some auditors have supplemented their documented understanding with existing documentation of control systems prepared by the client. Due to the increasing visibility of the importance of controls, some CIRAs have developed or enhanced their internal documentation and evaluation of internal controls. Auditors may consider inquiring of the client about the existence of such documentation along with any supporting evaluation of the effectiveness of controls. In those cases, the auditor may gain additional audit efficiencies and a better understanding of the CIRA's internal control.

Control Environment

The control environment sets the tone of the CIRA and influences the control consciousness of its people. The control environment is the foundation for all other components of internal control and provides structure and discipline. Among the important elements of the control environment are the attitude, awareness, and actions of management, as well as those charged with governance, concerning internal control. Control environment considerations as discussed in this and the following paragraphs generally are relevant, regardless of whether the CIRA has a managing agent.

According to AU-C 315.A79, the elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- Communication and enforcement of integrity and ethical values.
- Commitment to competence.
- Participation of those charged with governance.
- Management's philosophy and operating style.
- Organizational structure.
- Assignment of authority and responsibility.
- Human resource policies and practices.

A CIRA's control environment is a significant factor when considering the risks of material misstatement due to error or fraud. The integrity of the CIRA's management, including managing agent, if any, often plays a significant role in establishing a strong control environment. Accordingly, when obtaining an understanding of the control environment, AU-C 315.15 requires the auditor to evaluate whether management and those charged with governance have created and maintained a culture of honesty and ethical behavior. For example, although a CIRA might not have a written code of conduct, it might still have a culture that emphasizes the importance of integrity and ethical behavior. That culture will be instilled through the visibility and direct involvement of the CIRA's management. Obtaining an understanding of the control environment of a small or midsize CIRA need not be a complex process. The term is more formal and imposing than the idea behind it. The control environment is simply the conditions and circumstances that exist within the entity that demonstrate management's attitude about controls and other indicators of management's integrity and motivation.

The auditor generally obtains a sufficient knowledge of the control environment as a result of performing risk assessment procedures to understand the attitudes, awareness, and actions of management and those charged with governance concerning internal control and its importance in achieving reliable financial reporting. The auditor should evaluate whether the control environment elements collectively provide support for the other components of internal control and whether those other components are undermined by deficiencies in the control environment. The responsibilities assumed by management and those charged with governance related to financial reporting are particularly important. For example, the auditor might identify the members of management, and directors if any, who are expected to understand the CIRA's business transactions and to evaluate whether they are appropriately reflected in the financial statements. The auditor considers both (a) the aspects of the control environment that help ensure the integrity of financial reporting (that is, the key control environment controls) and (b) any control environment weaknesses that could have a pervasive effect on the financial statements.

The audit evidence for the control environment is often not available in documentary form. When it is available, the auditor may inspect documents, for example, a written code of conduct, as evidence of how management communicates its views of business practices and ethical behavior. While formal documentation may be preferable, it is not always necessary in order for a policy to be in place and operating effectively. This is emphasized in a nonauthoritative AICPA Technical Question and Answer, *Obtaining an Understanding of the Control Environment*, at Q&A 8200.08, which notes that if an auditor decides to rely on these controls (whether documented or not), they are required to test the controls. For example, in a small CIRA, human resource policies may not be formally documented as they would in a larger CIRA. Even so, policies and practices can still exist and be communicated orally. When documentary evidence is not available, the auditor might observe management's and directors' actions and attitudes. When the client's documentation is minimal, the auditor may need to provide more robust documentation of the auditor's understanding of the control environment to serve as a basis for determining the nature, timing, and extent of further audit procedures.

Owner/managers are common in small commercial businesses, and comparable situations exist in many small CIRAs. For example, a small association may, in effect, be controlled by a president or chairman of the board who operates much like an owner/manager in that he or she is heavily involved in daily operations and designing accounting controls. Consideration of management integrity (or of the integrity of the management of the managing agent) is an important factor in deciding whether to accept a CIRA engagement, as explained in Lesson 1. Factors such as management's tendency to take unusual or unnecessary business risks may increase audit risk. In preliminary planning, an auditor needs to reconsider the background information on management integrity along with the knowledge that has been obtained about the client's business, its operations, and its industry.

The purpose of the auditor's reconsideration is to assess whether the attitude of management or the managing agent, if applicable, in the particular circumstances might create an increased risk of material misstatement of the financial statements. Because of the ability to dominate activities or override controls, CIRA management that is dominated by a single individual or small group without compensating controls, is in a position to execute and conceal improper transactions. (A managing agent may have similar opportunities if the CIRA board of directors does not exercise sufficient control over the managing agent's activities.) Even basically honest management may be motivated in some cases to materially misstate the financial statements, and an auditor needs to recognize those circumstances and consider them in planning, especially when identifying risks of material misstatement of the financial statements due to fraud.

Some of the circumstances that increase the risk of material misstatement of the financial statements of a small CIRA because of their effect on management's (or the managing agent's) attitude are as follows:

a. A threat to management's personal net worth when management has a significant interest in the CIRA.

b. A significant portion of management's compensation depends on incentives, the value of which is dependent on the CIRA meeting performance targets (for example budget, cash flow, or other financial or operating goals, such as a percentage of delinquent dues collected).

c. Managing agents feel they deserve perks such as free landscaping, etc. for the time they have invested in the CIRA.

In a smaller CIRA, a strong control environment can partially compensate for control deficiencies in other areas, including inadequate segregation of duties. The control environment is often viewed synonymously with "tone at the top." Employees of smaller CIRAs often interact with management and typically are influenced by the tone at the top. Consequently, smaller CIRAs often develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. The authors believe that in many recurring audits of small CIRAs, the auditor will have often developed an understanding of that culture and, thus, the control environment, through the collective interaction with management and employees. Therefore, many auditors of smaller CIRAs are able to articulate the control environment without exhaustive testing.

Due to the role of the control environment, the auditor's understanding of this area may influence how the auditor approaches obtaining an understanding of other areas of internal control, as well as the ultimate assessment of risk at the overall financial statement level. Risk at the overall financial statement level is discussed in Lesson 3.

Documentation of the Control Environment. The auditor's understanding of the CIRA's control environment, along with sources of information and procedures performed to obtain or update the understanding, should be documented. One method for doing so is using practice aids such as those provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

Risk Assessment

Risk assessment for financial reporting purposes refers to the CIRA's identification, analysis, and management of the risks of material misstatement of the financial statements. The risk assessment process includes financial reporting objectives, management of financial reporting risks, and consideration of fraud risk.

A key step in the risk assessment process is identifying changed conditions (for example, adding ancillary operations) and taking necessary actions. This involves identifying and communicating both external and internal events or activities that may affect the CIRA's financial reporting objectives and analyzing the associated risks. Risks relevant to the financial reporting process are affected by events and circumstances such as the following:

- Changes in operations.
- New personnel.
- New or revised information systems.
- Rapid growth.
- New technology.
- New programs or services to members.
- New accounting standards.

The earlier those risks are identified, the more effectively they can be dealt with.

The auditor needs to gain an understanding of how management identifies and takes action to address risks relevant to the CIRA's financial reporting objectives. This includes gaining an understanding of how management estimates the significance of those risks and assesses the likelihood of their occurrence. For example, if the CIRA is adding recreational activities, the auditor needs to gain an understanding of management's assessment of the effect of expanding the CIRA's operations on internal control and the steps taken to address that impact. For risks related to fraud, the auditor needs to gain an understanding of whether the CIRA has assessed its vulnerabilities to fraudulent activity (including determining whether those exposures could result in material misstatement of the financial statements) and whether the CIRA has identified and implemented the processes, controls, and other procedures needed to mitigate identified fraud risks. Gaining an understanding of management's risk assessment is not a complex process. Normally, the auditor can gain this understanding based on the auditor's experience with the CIRA, general observations of its operations, and discussions with management. For CIRAs with a managing agent, auditors will need to understand how the managing agent identifies and manages risks associated with the CIRA's financial reporting.

AU-C 315.17–.18 require the auditor to obtain an understanding of both the CIRA's risk assessment process and the results of that process. If the auditor identifies risks of material misstatement that the CIRA did not identify, the auditor should evaluate whether the CIRA's risk assessment process failed and, if so, why the process failed and whether the process is appropriate in the circumstances or contains a significant deficiency or material weakness. If the CIRA lacks a formal risk assessment process, the auditor should discuss with management whether risks relevant to financial reporting have been identified and how they were addressed. The auditor should also evaluate whether the lack of a documented process is appropriate for the CIRA or represents an internal control deficiency that needs to be evaluated to determine whether it is a significant deficiency or material weakness.

The CIRA's Fraud Risk Assessment and Monitoring. All CIRAs ought to be proactive in reducing fraud opportunities by identifying and measuring fraud risks, taking steps to mitigate identified risks, and implementing and monitoring appropriate preventive and detective controls and other antifraud measures. However, the nature and extent of these risk assessment and monitoring activities need to be commensurate with the size and complexity of the CIRA. It is important for management to understand its responsibility for establishing and monitoring the CIRA's fraud risk assessment process. That process is likely to be less formal and structured in a smaller CIRA than in a larger CIRA, but ought to include a sufficient degree of fraud awareness on the part of the CIRA's president and board of directors and appropriate fraud risk management activities with oversight from those charged with governance. The fraud risk assessment and monitoring process for a typical small to midsize CIRA may include:

a. Communicating to employees the management's views on business practices and ethical behavior, either orally or by example.

b. Thoroughly investigating any incidents of alleged fraud, taking appropriate and consistent actions against violators, assessing how relevant controls could be improved, correcting any effects on the financial statements, and reinforcing the CIRA's values and expectations through appropriate communication.

c. Considering standards of ethical behavior and appropriate business practices in the CIRA's employee training and evaluation procedures.

d. Identifying and assessing fraud risks and taking appropriate action to reduce or eliminate the risks.

e. Exercising appropriate oversight of the CIRA's fraud risk assessment and monitoring activities by the board of directors or audit committee (if the CIRA has one).

Documentation of the CIRA's Risk Assessment Process. The auditor's understanding of the CIRA's risk assessment process, along with the sources of information and procedures performed to update the understanding, should be documented. One method for doing so is by using the practice aids provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

Information and Communication

Information refers to the financial reporting system, which includes the accounting system and encompasses the procedures and records established to initiate, authorize, record, process, and report the CIRA's transactions. It also includes the accountability over the assets, liabilities, and equity. An information system may be automated, manual, or a combination of the two depending on the size and complexity of the CIRA. Communication is the process of providing an understanding of roles and responsibilities to individuals within the CIRA regarding internal control over financial reporting. Although part of the same internal control component, the authors discuss the financial reporting system and communication process separately in the following paragraphs.

Auditors are typically very familiar with the process of understanding the financial reporting system. When obtaining an understanding of the CIRA's internal control, auditors often spend most of their time in this area since it provides the auditor with other key information regarding the audit. For example, the understanding of the financial reporting system contributes to the auditor's ability to design and conduct efficient and effective substantive procedures since the auditor gains knowledge of the types, sources, and locations of documents and other evidence along with the individuals who are responsible for processing them. However, auditors ought not lose sight of the importance of the communication of accounting and financial reporting roles within the CIRA. Achievement of the objectives of a well-designed financial reporting system can easily fail if accounting personnel do not fully understand their roles and how proper performance mitigates the risks of material misstatement.

During the process of obtaining an understanding about the financial reporting system, auditors typically gain some knowledge about various monitoring controls or control activities that relate to the processing of transactions and the financial reporting process. In other words, as the auditor learns about how transactions flow through the accounting system and how those transactions are reported in the financial statements, a by-product of that knowledge is an understanding of how management monitors internal control and how certain control activities are applied to achieve accuracy, completeness, cutoff, and other relevant assertions. As a result, many auditors find that it is efficient to gain an understanding of the financial reporting system, internal control monitoring, and control activities components of internal control at the same time. In fact, after the auditor obtains an understanding of the control environment, risk assessment, information and communication (including the financial reporting system), and monitoring, it may not be necessary to devote additional attention to obtaining an understanding of control activities.

Financial Reporting System. AU-C 315.19 states that the auditor should obtain sufficient knowledge of the financial reporting system, including related processes, as a result of applying risk assessment procedures to understand the following:

a. *Classes of Transactions.* The classes of transactions in the CIRA's operations that are significant to the financial statements.

b. *Accounting Procedures.* The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements.

c. *Accounting Records.* The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, authorizing, recording, processing, and reporting transactions.

d. *Other Events and Conditions.* The methods used to capture events and conditions, other than classes of transactions, that are significant to the financial statements. Examples include asset impairment, commitments and contingencies, concentrations, subsequent events, compliance with debt covenants, related-party transactions, going concern uncertainties, and fair values of financial instruments.

e. *Financial Reporting Process.* The financial reporting process (including the closing process) used to prepare the CIRA's financial statements, including significant accounting estimates and disclosures.

f. *Journal Entries.* The controls over standard and nonstandard journal entries.

A financial reporting system includes methods and records that:

- Identify and record all valid transactions.
- Resolve incorrect processing of transactions.
- Provide, on a timely basis, sufficient detailed information about transactions to permit proper classification for financial reporting.
- Allow for the recording of transactions at their proper monetary value in the financial statements.
- Provide sufficient information to permit recording of transactions in the proper accounting period.
- Properly present the transactions and related disclosures in the financial statements.

The auditor's understanding is at a high level but sufficiently detailed to identify the significant accounting applications, how the computer is used in those applications, and the relative complexity and importance of use of the computer. The auditor also considers the qualifications of accounting personnel and the time pressure they face. Inexperienced or harried accounting personnel make more errors.

Auditors need to be satisfied that they have a sufficient understanding of the CIRA's financial reporting system to understand how misstatements might occur anywhere in the cycle from the occurrence of transactions to the final presentation of the financial statements. As required by AU-C 315.22, when understanding control activities, auditors also should obtain an understanding of how the entity has responded to risks arising from IT. That typically means that, when obtaining an understanding of the financial reporting system, auditors obtain knowledge of relevant IT application controls. In a simple financial reporting system the authors believe understanding the financial reporting system generally will involve:

- Understanding the financial close and reporting process.
- Identifying the CIRA's significant transaction classes.
- Understanding the flow of information through the financial reporting system for significant transaction classes.

For CIRAs with a managing agent, auditors will need to understand the interaction between the CIRA's and the managing agent's records, as well as the managing agent's financial reporting system.

Understanding the Financial Close and Reporting Process. Events and conditions other than transaction classes (that is, other than items processed through the entity's significant transaction processing systems) are often material to the preparation of financial statements. Examples include the fair value of financial instruments, accruals for contingencies, commitments, and related party transactions. Therefore, it is not enough for the auditor to understand the flow of transactions through the financial reporting system for significant transaction classes. The auditor also needs to understand how information about other significant events and conditions is captured. Therefore, for any accounts where material amounts enter the general ledger or financial statements from sources other than the entity's significant transaction processing systems, the auditor needs to understand how information about those events and conditions is captured for inclusion in the general ledger and financial statements. Also, for audit areas that require significant disclosure of information that is not available from the entity's general ledger or related supporting documents and records, the auditor needs an understanding of how information for disclosures is captured for inclusion in the financial statements. For most CIRAs, the authors believe that understanding is generally obtained as part of the financial close and reporting process.

The financial close and reporting process is particularly important to achieving reliable financial reporting. Weaknesses in the financial reporting process can create risks of material misstatement. The auditor obtains an understanding of how automated and manual procedures are used to accomplish the following:

a. Document and communicate the financial close and reporting process to appropriate departments and individuals.

b. Authorize and approve related-party transactions and identify, account for, and disclose related-party relationships and transactions.

c. Authorize and approve significant transactions outside the normal course of business.

d. Develop and evaluate significant accounting estimates (for example, the allowance for uncollectible assessments and accrued loss contingencies).

e. Initiate, authorize, record, and process journal entries.

f. Initiate, authorize, and record recurring and nonrecurring adjustments to the financial statements that are not reflected in formal journal entries.

g. Perform and review key analyses during the period-end close process.

h. If there are components, ensure that reporting instructions issued to them are clear and that they (1) adequately describe the accounting policies to be followed, (2) address disclosures needed to comply with GAAP, (3) provide a means of identifying intercompany balances and transactions, and (4) require approval of financial information by component management.

i. Combine and consolidate general ledger data.

j. Prepare, review and approve financial statements and disclosures.

The auditor needs to be aware that nonstandard journal entries and other adjustments made directly to the financial statements have been used in numerous instances of fraudulent financial reporting.

Identifying Significant Transaction Classes. The auditor identifies significant classes of transactions and obtains an understanding of the flow of information (including electronic information) through the CIRA's financial reporting system for each of those classes. *Significant transaction classes* are those classes of transactions in the CIRA's operations that are significant to the financial statements, generally because of the volume or risk characteristics of transactions processed. Exhibit 2-1 provides examples of transaction classes for specified audit areas and identifies the transaction classes that will be considered significant for many CIRAs.

Exhibit 2-1

Examples of Transaction Classes for Specified Audit Areas

Cash

Processing cash receipts[a]
Processing disbursements[a]

Receivables/Revenue

Processing billings for member assessments and ancillary operations[a]
Processing adjustments for assessments and ancillary operations
Processing cash receipts[a]
Estimating the allowance for doubtful accounts and bad debt expense[a]
Recording deferred revenue for special assessments
Maintaining member master file

Property and Equipment

Acquiring and safeguarding property and equipment
Depreciating property and equipment for capitalized assets
Disposing of property and equipment (sales and retirements)
Maintaining the property and equipment subledger
Assessing assets for impairment

Investments and Derivatives

Managing investments[a]
Managing derivatives
Assessing assets for impairment

Other Assets

Recording purchases of other assets
Assessing assets for impairment
Amortizing assets

Accounts Payable and Other Liabilities

Recording purchases[a]
Processing accounts payables and accruals[a]
Processing disbursements[a]
Maintaining the vendor master file

Notes Payable and Long-term Debt

Managing borrowings

Income Taxes

Calculating and reporting income taxes

Equity

Recording equity transactions

Income/Expenditures/Major Repairs and Replacements

Recording repair and replacement expenditures and expenditures for capital improvements[a]
Processing payroll
Maintaining the employee database master file

Note:

[a] For many CIRA audits, this will be considered a significant transaction class.

* * *

Risk Assessment Procedures. Risk assessment procedures that are ordinarily performed to understand the financial reporting system include inquiries of management and others, observation of procedures and controls, inspection of documents and records, and tracing transactions through the system (i.e., walkthroughs). The nature and extent of the procedures performed are affected by factors such as the size of the CIRA, its complexity, and most certainly, the number of significant transaction classes that exist within the CIRA.

The existence of any internal documentation that describes classes of transactions and the transaction flow in the accounting system is a key factor that may influence the risk assessment procedures used when obtaining an understanding of the financial reporting system. Typically, such documentation exists for larger and more complex CIRAs and may consist of the following:

- Training manuals for employees.
- Policy and procedure manuals.
- Formal memoranda and flowcharts.
- Internal audit analyses.

When such documentation exists, the auditor's risk assessment procedures typically include inspection and review of the documentation, corroborated by inquiries of various personnel to determine if the information is current, observation, and walk-throughs to verify that procedures are being followed. While the client's internal control information is an excellent source for understanding and evaluating the design of the financial reporting system, risk assessment procedures, consisting of inquiry, observation, and inspection, are necessary to ensure that the system has been implemented as designed.

However, for many small CIRAs, the range of control and day-to-day involvement of management frequently makes written documentation of the processing systems unnecessary. For those CIRAs, the auditor often relies on inquiries of management and accounting personnel to understand the design of the financial reporting system. The auditor determines that the system as described has been implemented by performing observation and inspection procedures, such as walkthroughs.

Walkthroughs. A common method of obtaining an understanding of the design and implementation of the financial reporting system for a significant transaction class is to trace a transaction through the various processing steps and related controls from initiation to inclusion in the general ledger and the financial statements. This is commonly referred to as a "walkthrough" or "cradle-to-grave" procedure. Walkthroughs may be used to confirm information obtained by inquiry or obtained in prior years' audits. Walkthroughs are also commonly used in gaining an

understanding of related control activities. Paragraph 3.123 of the AICPA Risk Assessment Audit Guide and paragraph 3.25 of the AICPA Audit and Accounting Guide, *Audit Sampling*, note that a walkthrough may be designed to include procedures that are also tests of the operating effectiveness of controls.

Walkthroughs of transactions often involve document inspection, inquiry, and observation. The auditor judgmentally selects one or a few transactions from each of the major classes of transactions and walks those transactions through the system from cradle to grave, that is, from initial creation of a source document to final posting in the general ledger and inclusion in the financial statements. The auditor inspects the documents and accounting records used in processing, talks to the personnel involved, and observes the handling of records and related assets. At each step, the auditor does the following:

- Observes the demonstration of, or reperforms, the prescribed manual and automated processing procedure or control.
- Identifies and examines the documents and IT involved.
- Identifies the name and position of the person who performs the procedure or control and considers the competence and understanding of the person performing the procedure or control.
- Determines whether the procedure is performed as prescribed and on a timely basis.
- Identifies the kinds of errors found by the client and the client's responses to correct them.
- Determines whether the person has been asked to override the procedures or controls.
- Identifies exceptions to the prescribed procedure or control.

Some auditors query individuals about the preceding or succeeding processing step or control activity as a means of obtaining corroborating information about each step in the process. In performing a walkthrough, the auditor follows the transaction through all of the processing steps in the system. A walkthrough may not be effective if a different transaction is used to test each control separately rather than walking a single transaction through the entire process or if the auditor does not use the same documents and IT that client personnel use. However, it may be necessary to select additional transactions to verify certain processing steps that may apply for some transactions but not for others. For example, some of the processing steps and control activities might be different for assessments collected by electronic transfer than for assessments received by mail.

Communication. The auditor needs to obtain a sufficient understanding of how management communicates financial reporting roles and responsibilities and other significant matters. The communication process includes both internal and external elements. For example, it includes communications between management and employees, those charged with governance, and regulatory authorities. Communication may take the form of policy manuals, memorandums, oral or electronic communications, etc. This will depend on the size and organizational structure of the CIRA. Auditors consider both:

- The aspects of the communication process that help to ensure employees and those charged with governance understand their jobs and responsibilities within the financial reporting system and are encouraged to report any exceptions.
- Any areas where communication does not occur.

Communication is another way that management conveys the tone at the top. Management ought to communicate the information necessary for employees to perform their assigned tasks, for managers to supervise, and for responsible parties to make key operating and financial decisions. Communication also relates to the flow of information upstream in an CIRA. For upstream communication to occur, there needs to be open channels of communication and a willingness on the part of management to deal with problems. For control activities to be effective, individuals need to be able to report exceptions or fraud to the appropriate levels of management.

When considering whether a CIRA has communication controls in place, auditors consider whether management has clearly communicated the following:

- That internal control responsibilities are a critical part of employee job duties.
- The role and responsibilities that each employee has in the internal control system.
- That unexpected events are to be investigated, including determining the cause of the event.
- How job activities relate to the work of others.
- That communication from employees or participants to management concerning exceptions, problems, controls, potential fraud, or other issues is both welcomed and expected.
- That alternative channels of communication are available if an employee or participant feels that taking an issue through the normal upstream communication methods would not be effective (such as a direct communication to senior management).

For CIRAs with a managing agent, auditors will need to understand how the managing agent internally communicates the internal control responsibilities of its employees, and also how communications occur between the CIRA and the managing agent.

Communication may be written, electronic, oral, or through the direct actions and involvement of management. As a result, auditors often use a combination of risk assessment procedures to understand the communication process. In addition to inquiries of management, the auditor may consider the following types of procedures to corroborate management's responses and determine if the communication process as designed has been implemented:

- Inquire of employees regarding the communication that they have received regarding their duties and management's expectations as they relate to financial reporting.
- Review policy and procedures manuals or similar documents that have been provided to employees regarding their duties.
- Review for the existence of training materials or programs on job functions and responsibilities.
- Discuss with human resources personnel the evaluation process and how job knowledge and the performance of responsibilities are incorporated into personnel reviews.
- Inquire of the audit committee and review minutes of meetings regarding the communication between management and those charged with governance.
- Inquire of employees regarding how upstream financial communication is received and implemented by management.
- Review of whistleblower policies, if any, and inspection of documentation regarding reported instances of suspected financial improprieties.
- Inquiry and review of related documentation of how communication from external parties is processed.

Monitoring

Monitoring is a process by which a CIRA assesses the quality of its internal control over time. Monitoring involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary. Monitoring activities can also reveal evidence or symptoms of fraud. Effective monitoring ensures that internal controls are modified as changes in conditions occur in the CIRA. As a result, poor monitoring controls can allow error or fraud to remain undetected. The elements of a CIRA's monitoring

process include (a) ongoing and/or separate evaluations and (b) evaluation and reporting of internal control deficiencies.

Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring includes management and supervisory activities and other actions that personnel take in performing their duties, such as performing comparisons, reconciliations, and other routine activities. For example in a small CIRA, the president may question reports that differ significantly from the president's knowledge of operations. Because these activities are performed in the normal course of business, ongoing monitoring procedures usually adapt to changing conditions and may be timely in detecting problems. Separate evaluations may involve any aspect of the CIRA's system of internal control such as management's review of a component (e.g., the control environment), an element within a component, or the control activities associated with a specific class of transactions or processing function. Regardless of the manner in which monitoring is accomplished, identified deficiencies ought to be reported to the individuals responsible for taking corrective action and to management and those charged with governance, as appropriate.

According to AU-C 315.23, the auditor should obtain an understanding of the major types of activities that management uses to monitor internal control over financial reporting, including control activities relevant to the audit. In addition, AU-C 315.25 indicates that the auditor's understanding should include the sources of information related to monitoring and the basis on which management considers information to be sufficiently reliable for that purpose. The auditor considers both (a) the aspects of the monitoring process that enable management to appropriately identify and correct control procedures that are not operating as intended and (b) any circumstances that indicate management has failed to appropriately identify and correct such deficiencies.

Monitoring can be virtually any activity that ensures that controls are operating as intended and continue to be properly designed. Monitoring may include activities such as the following:

- Review of whether bank reconciliations are prepared on a timely basis.
- Review of member complaints regarding the assessment process.
- Review of a reporting system that tracks timely collection efforts.
- Analysis of reported disbursement errors.
- Legal department review of compliance with ethics policies.
- Separate evaluation by internal audit regarding revenue recognition.

For CIRAs with a managing agent, auditors will need to understand how the managing agent assesses the quality of its own internal controls, as well as how the CIRA's board of directors assesses the effectiveness of the managing agent's internal controls.

For audits of small and midsize CIRAs, the auditor generally does not have to spend a great deal of time gaining an understanding of the CIRA's monitoring process. Normally, the auditor can gain this understanding based on the auditor's experience with the client, general observations of CIRA operations, and discussions with management or the managing agent.

Consideration of Internal Audit Function. One method some entities use to monitor internal control is through separate evaluations by the internal audit function. Most small and midsize CIRAs do not have internal auditors. However, if there is a designated internal audit function, the auditor obtains an understanding of that function during audit planning. AU-C 315.24 indicates that the auditor should obtain an understanding of the nature of the function's responsibilities, how the function fits into the organizational structure, and the activities performed or to be performed by the function.

In addition, AU-C 240 and AU-C 315, require auditors to inquire of appropriate individuals in the internal audit function about their understanding of the risks of error and fraud within the entity, and AU-C 240.19 requires inquiry about whether the internal audit function has performed any procedures to identify or detect fraud during the year,

whether management has satisfactorily responded to any findings resulting from their procedures, and whether they have knowledge of any actual, suspected, or alleged fraud. (The auditor ought to explain that fraud includes both misappropriation of assets and fraudulent financial reporting.) The results of those inquiries should be considered when identifying risks of material misstatement due to fraud. The auditor's inquiries should be documented.

Documentation of the CIRA's Monitoring Process. The auditor's understanding of the CIRA's monitoring process, along with the sources of information and procedures performed to obtain or update the understanding should be documented. The auditor should also document an overall conclusion regarding whether the monitoring process is properly designed and implemented considering the overall size and complexity of the CIRA.

IT Environment and General IT Controls

IT Environment. IT systems may include packaged applications provided by vendors; custom-developed applications; or end-user computing, such as spreadsheets, that provide accounting data used to generate financial reporting. Many small associations have simple IT operations, typically they use PCs, which may be linked in a local area network (LAN) and off-the-shelf software packages for specific applications such as assessments receivable. However, some small associations may have internal controls that depend heavily on IT. AU-C 315 indicates that auditors should consider how IT affects a CIRA's control activities. The effect on the client's internal control is related more to the nature and complexity of the system than to the client's size. Use of the Internet or any other information technology does not necessarily mean that a CIRA's internal control is heavily dependent on IT.

For example, a CIRA with a simple IT system may use primarily paper-based manual procedures to enter member assessments and other types of income and maintain assessments receivable. The CIRA may also use manual controls, such as approvals, reconciliations, reviews, and follow-up of exceptions. In a system that uses automated procedures to initiate, record, process, and report transactions, electronic records replace many of the paper forms. Controls in that environment generally consist of a combination of automated and manual controls. Automated controls include processes such as edit and validation routines embedded in software. In addition, the nature of the manual controls may be different. Manual controls in an automated system may be independent of the IT system, may use information produced by the system, or may be limited to monitoring the automated controls and handling exceptions. The mix of manual and automated controls varies with the nature and complexity of the CIRA's system.

The use of manual controls is often more effective when judgment and discretion are needed. For example, manual controls would generally be more appropriate in the following situations:

- Large, unusual, or nonrecurring transactions.
- When monitoring the effectiveness of automated controls.
- In changing circumstances in which a control response may be needed outside of the scope of an automated control.
- Circumstances where misstatements are difficult to anticipate, define, or predict.

However, automated controls may be more effective than manual controls in other circumstances. Since manual controls are performed by humans, they may be subject to override, misinterpretation, errors, or bypass. As a result, automated controls may be more suitable in the following circumstances:

- Recurring transactions or high volume.
- Situations in which errors can be anticipated or predicted and prevented or detected by control parameters subject to automation.
- Control activities where their nature allows the use of properly designed automated control processes.

The use of IT may enhance the effectiveness and efficiency of the CIRA's internal control because of the consistency, timeliness, and accuracy inherent in automated systems. Use of IT also offers benefits in terms of data

analysis, monitoring of the CIRA's performance, reduced risk of override, and systems and data security. For example, in an IT system, security controls can help achieve segregation of duties. However, the use of IT also poses certain risks to a CIRA's internal control, such as:

- Reliance on systems or programs that are inaccurately processing data or processing inaccurate data.
- Unauthorized access to data that may result in destruction of data or improper changes to data.
- Unauthorized changes to master file data.
- Unauthorized changes to systems or programs.
- Failure to change systems or programs when necessary.
- Inappropriate manual intervention.
- Loss or inability to access data.

The extent and nature of those risks depends on the nature and characteristics of the CIRA's system. For example, in a system in which users can access a common database of information that affects financial reporting, a lack of control at a single user entry point could compromise the security of the database and result in improper changes to or destruction of data.

Control Activities

Control activities are the policies and procedures that help ensure that management directives are carried out. That is, control activities are those actions that are taken to address risks that threaten the CIRA's ability to achieve its objectives, one of which is reliable financial reporting. Control activities usually involve two elements: (a) a policy that establishes what ought to be done and (b) the procedure that implements the policy. AU-C 315.21 requires the auditor to obtain an understanding of those control activities relevant to the audit and focus on identifying and obtaining an understanding of control activities that address areas in which the auditor considers material misstatements more likely to occur. The auditor concentrates on whether and how a specific control activity, individually or in combination with others, prevents, or detects and corrects, material misstatements in the classes of transactions, account balances, or disclosures that are significant to the financial statements. Specifically, the auditor needs to understand the entity's controls related to fraud risks and other significant risks and also the controls related to risks for which substantive procedures alone will not be sufficient. Also, as required by AU-C 315.22, the auditor should understand how the CIRA has responded to risks arising from IT when considering control activities.

AU-C 315.A157 provides examples of categories of control activities that are relevant to the audit are as follows:

- *Performance Reviews.* Comparisons of current financial reports to other information.
- *Information Processing.* Controls that are performed to check accuracy, completeness, and authorization of transactions. For information processing systems, there are two broad categories of control activities—application controls and general controls.
- *Physical Controls.* Controls that pertain to the physical security of assets, including adequate safeguards to limit access to assets, authorization safeguards for access to software, including coding and files, and periodic counting and comparison to control records.
- *Segregation of Duties.* The assignment of different people to authorize transactions, record transactions, and maintain custody of assets.
- *Accountability.* Controls relating to reconciliations of the detailed records to the general ledger. (Such controls are generally necessary to design and perform audit procedures for material classes of transactions and account balances.)

Examples of control activities unique to CIRAs are as follows:

- Reconciliations of—
  - Assessments billed with the control schedule of the CIRA's members.
  - Common property with general ledger control accounts.
- Board of director approval of annual assessments.
- A member of the board of directors or an officer of the CIRA serves as one of the dual signatories on checks if the managing agent can sign checks.

The AICPA has issued Technical Questions and Answers that provide nonauthoritative guidance on those control activities (Q&A 8200.20 and Q&A 8200.21) that are always relevant to the audit and those that may be relevant to the audit based on auditors' evaluation of all the particular facts and circumstances of the engagement.

The auditor may also learn of control activities while performing risk assessment procedures to obtain the understanding of the CIRA and its environment. Most frequently, however, the auditor learns of control activities while obtaining an understanding of the financial reporting process as discussed earlier in this lesson. A natural by-product of the understanding of how transactions are initiated, authorized, processed, corrected, transferred to the general ledger, and recorded is knowledge of how control activities ensure that relevant assertions are achieved.

For CIRAs with a managing agent, the extent of knowledge of control activities necessary in the circumstances depends on several factors, including the complexity and sophistication of the managing agent's financial reporting system. Generally, auditors will need to have an understanding of billing and collection procedures and disbursement procedures.

Auditing standards do not require an understanding of all of the control activities related to each class of transactions, account balance, and disclosure in the financial statements or to every assertion. The auditor's emphasis is on understanding control activities that allow the auditor to assess risks of *material* misstatement at the *relevant* assertion level and to design and perform further audit procedures that are responsive to those risks. Thus, after considering the control activities previously identified, the auditor evaluates whether a sufficient understanding of control activities has been obtained for those areas for which the auditor considers that material misstatements are more likely to occur. The auditor's evaluation will generally be focused on significant transaction classes and accounts. The auditor may need to devote additional attention to obtaining an understanding of control activities in certain circumstances. For example, it is necessary to obtain an additional understanding if:

- The auditor does not understand what controls, if any, the CIRA has implemented to prevent, or detect and correct, material misstatements in specific assertions related to fraud risks or other significant risks.
- The auditor plans or is required to test controls for one or more assertions but has not identified which controls to test (that is, which manual or automated controls are most likely to prevent, or detect and correct, material misstatements in that assertion).

Even if the auditor concludes additional attention to control activities is necessary, the auditor can focus on controls related to specific transactions, account balances, or assertions. The practical implication of this selective approach is that it is not necessary to complete an internal control questionnaire or prepare additional documentation to describe the control activities for all material account balances and transaction classes. The auditor may identify key balances, classes, or assertions and conclude that a further understanding of control activities is necessary only for those selected areas.

Understanding Controls Related to Significant Risks

AU-C 315.30 indicates that the auditor's understanding of internal control should include the CIRA's programs and controls that address risks of material misstatement that are considered significant risks. Fraud risks are always considered to be significant risks. Significant risks also often relate to nonroutine transactions, for example,

transactions with related parties and judgmental matters, such as estimates. In addition, revenue recognition issues often pose significant risks. Programs and controls addressing significant or fraud risks may relate to any of the five components of internal control; thus, the auditor needs to use care not to isolate the understanding to only the control activities component. The auditor ought to be alert to the fact that significant or fraud risks may not be subject to routine controls given the nature of the risks. Also, the auditor's understanding should extend to whether and how management responds to those risks. Controls that address fraud risks frequently relate to the following:

a. *Control Environment.* Fraud programs designed to prevent, deter, and detect fraud. For example, programs to promote a culture of honesty and ethical behavior.

b. *Control Activities.* Specific controls designed to mitigate specific risks of fraud. For example, controls to address specific assets susceptible to misappropriation.

As with other controls, the auditor evaluates whether the programs and controls that relate to significant risks are suitably designed and implemented and assesses the risks of material misstatement due to error or fraud in light of this evaluation. The existence (or lack) of these programs and controls might either mitigate or increase the risks of material misstatement. The auditor needs to consider the control activities that are relevant to account balances with a significant inherent risk of misappropriation to assets. The risk of misstatement due to fraud for misappropriation of assets always depends on whether there are controls to prevent or detect concealment of theft in the accounting records.

Documentation

Control activities should be documented. One method for doing so is using the "Financial Reporting System Documentation Form—Financial Close and Reporting/Significant Transaction Classes" provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*. The form allows the auditor to describe the sources of information used and the procedures performed, as well as to conclude whether the controls over the significant transaction classes in the audit area are properly designed and implemented.

The auditor should identify and describe the CIRA's controls and obtain a further understanding of control activities. The forms provided by *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* present detailed lists of controls for significant transaction classes that are applicable to an audit area. The relevant assertions that the control addresses are also listed. If desired, the appropriate "Control Activities Form" may be completed to further document the understanding of controls. The forms allow the auditor to document whether the control (a) addresses a fraud or significant risk, (b) is effectively designed and implemented, (c) is automated, and (d) is tested.

In addition, when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate evidence at the relevant assertion level, the auditor should perform tests of controls. The performance of tests of controls and the results of those tests should be documented.

Internal Control and Service Organizations

If the CIRA uses a service organization (such as a payroll processing company or, more commonly, a managing agent that provides bookkeeping and accounting services), AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, applies and requires auditors to obtain an understanding of the nature and significance of the services provided by the service organization and their effect on the CIRA's internal control sufficient to identify and assess the risks of material misstatement and to design and perform audit procedures that are responsive to those risks. The auditor may obtain the requisite understanding by (a) obtaining an understanding of how the CIRA uses the service organization in its operations when the auditor obtains an understanding of the CIRA as previously discussed and (b) evaluating the design and implementation of relevant controls at the CIRA that relate to the services provided by the service organization, including controls applied to transactions processed by the service organization, when the auditor obtains an understanding of CIRA's internal control.

AU-C 402.11 requires the auditor to ensure that the auditor's understanding of the service organization is sufficient to provide a basis for identifying and assessing the risks of material misstatement. In some cases, the

understanding obtained at the CIRA, as discussed in the previous paragraph, may be sufficient for that purpose. For example, if the CIRA authorizes and verifies all transactions (all cash collections and disbursements, etc.) and related information produced by the managing agent, the auditor would likely be able to obtain the necessary understanding by understanding and evaluating the CIRA's controls over the information produced by the managing agent. Generally, if the CIRA has effective controls, the service organization's controls over its services is not a significant part of the controls over the initiating, processing, recording, and reporting of transactions. An auditor also may be more likely to be able to obtain the necessary understanding of the service organization based on information about the CIRA and its controls if the services provided by the service organization are limited to processing and recording transactions (as contrasted to transaction initiation and authorization).

In other cases, if the understanding obtained at the CIRA is not sufficient, the auditor is required to obtain the necessary understanding by (a) obtaining and reading a service auditor's report on the service organization, (b) obtaining specific information by contacting the service organization through the CIRA, (c) visiting the service organization and performing procedures to obtain the necessary information, or (d) using another auditor to perform procedures to obtain the necessary information.

Many CIRAs do not have effective controls over the information produced by the managing agent. If the CIRA does not have effective controls, the auditor may be able to obtain a sufficient understanding about the managing agent's controls from a variety of sources, such as:

a. Available documentation about the managing agent's operating processes.

b. The contract between the CIRA and the managing agent.

c. Reports by service auditors on the information system and other controls placed in operation by the managing agent.

d. Inquiry or observation of personnel at the CIRA or at the managing agent.

In addition, if the services and the managing agent's controls over those services are highly standardized, information obtained through the auditor's prior experience with the managing agent may be helpful in obtaining the necessary understanding. (The lack of controls by the CIRA may indicate that a significant deficiency exists that should be communicated to the client.)

If the CIRA uses service organizations other than managing agents, the auditor may be able to obtain information similar to that described above.

Fraud, Noncompliance with Laws and Regulations, and Uncorrected Misstatements Related to Activities at Service Organizations. Whenever the CIRA uses the services of a service organization that are part of its information system relevant to financial reporting, AU-C 402.19 requires the auditor to inquire of CIRA management whether they are aware of any fraud, noncompliance with laws and regulations, or uncorrected misstatements at the service organization that affect the financial statements of the CIRA, either reported by the service organization or otherwise known by the CIRA. If such matters exist, the auditor should evaluate their impact on the nature, timing, and extent of the auditor's procedures, and on the auditor's conclusions and report. If additional information from the service organization is needed to make the evaluation, the client can be asked to coordinate obtaining the necessary information from the service organization.

Detailed guidance on the auditor's responsibilities when clients use service organizations is provided in *PPC's Guide to Audits of Nonpublic Companies*. The *Guide* can be ordered online at **tax.thomsonreuters.com**.

SELF-STUDY QUIZ

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

11. The following auditors have all accepted CIRA audit engagements. Which one is most likely to need an IT specialist?

    a. Mark's CIRA client uses purchased computer software and does not have access to the software's source code.

    b. Sue's CIRA client processes a lot of information electronically and stores most of its information in electronic formats.

    c. David's CIRA client uses a service organization for its computer service. The organization has a recent service auditor's report.

    d. Julie believes that the manual control procedures will be able to prevent or detect material misstatements in her CIRA client's computer-processed data.

12. Obtaining an understanding of a CIRA's commitment to competence, its organizational structure, and the philosophy and operating style of its management will help an auditor understand what element of internal control?

    a. Control activities.

    b. Control environment.

    c. Information and communication.

    d. Risk assessment.

13. Analyzing reported disbursement errors and reviewing whether bank reconciliations are prepared on a timely basis are examples of what element of internal control?

    a. Control activities.

    b. Control environment.

    c. Information and communication.

    d. Monitoring.

14. What is one risk that the use of IT poses to a CIRA's internal control?

    a. Frequent changes in systems or programs.

    b. Lack of manual intervention.

    c. The loss of data or the inability to access it.

    d. Too few changes to master file data.

15. Which of the following is likely when a CIRA uses a managing agent?

    a. The CIRA will have effective controls over the information the agent produces.

    b. Information from prior years can sometimes be used to obtain an understanding of the managing agent's controls.

    c. Auditors will need to obtain an understanding of the managing agent separately from the CIRA even if the CIRA has effective controls.

    d. Auditors are not required to gain an understanding of a managing agent's controls as they are not part of the 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.)**

11. The following auditors have all accepted CIRA audit engagements. Which one is most likely to need an IT specialist? **(Page 63)**

    a. Mark's CIRA client uses purchased computer software and does not have access to the software's source code. [This answer is incorrect. When the CIRA uses only purchased software and has no access to the source could, it is likely that an IT specialist will *not* be needed.]

    b. Sue's CIRA client processes a lot of information electronically and stores most of its information in electronic formats. [This answer is correct. If a CIRA's systems are complex, such as when a significant amount of information is electronically initiated, recorded, processed, or reported, or when evidence is available only in electronic form, specialized skills may be needed. In those cases, either a professional on the audit staff who possesses IT skills or an outside professional may be needed. Compared to the other CIRA audits in this question, Sue is the most likely auditor to need an IT specialist.]

    c. David's CIRA client uses a service organization for its computer service. The organization has a recent service auditor's report. [This answer is incorrect. Because the service organization used by David's client has a recent services auditor's report on its internal control, David is *less* likely to need to consult an IT specialist.]

    d. Julie believes that the manual control procedures will be able to prevent or detect material misstatements in her CIRA client's computer-processed data. [This answer is incorrect. When auditors believe they can identify types of potential misstatements, they are *less* likely to need to engage an IT specialist. This will normally be the case when manual control procedures are adequate to prevent or detect material misstatements in computer-processed information.]

12. Obtaining an understanding of a CIRA's commitment to competence, its organizational structure, and the philosophy and operating style of its management will help an auditor understand what element of internal control? **(Page 65)**

    a. Control activities. [This answer is incorrect. Control activities usually involve two elements: (1) a policy that establishes what ought to be done and (2) the procedure that implements the policy. The items above are more overarching than control activities typically are, so they apply to a different element of internal control.]

    b. Control environment. [This answer is correct. According to AU-C 315.A79, the elements of the control environment that may be relevant when obtaining an understanding of the control environment include (1) communication and enforcement of integrity and ethical values, (2) commitment to competence, (3) participation of those charged with governance, (4) management's philosophy and operating style, (5) organizational structure, (6) assignment of authority and responsibility, and (7) human resource policies and practices.]

    c. Information and communication. [This answer is incorrect. This element of quality control focuses on the communication of information, particularly related to the financial system. The items described above do not fit into this area.]

    d. Risk assessment. [This answer is incorrect. Risk assessment for financial reporting purposes refers to the CIRA's identification, analysis, and management of the risks of material misstatement of the financial statements. The risk assessment process includes financial reporting objectives, management of financial reporting risks, and consideration of fraud risk. It does not include obtaining an understanding of the items described above.]

13. Analyzing reported disbursement errors and reviewing whether bank reconciliations are prepared on a timely basis are examples of what element of internal control? **(Page 75)**

    a. Control activities. [This answer is incorrect. These are the actions taken to address risks that threaten the CIRA's ability to achieve its objectives. Examples of control activities, per AU-C 315.A157, include performance reviews and information processing, but not the activities described above.]

    b. Control environment. [This answer is incorrect. Important elements of the control environment are the attitude, awareness, and actions of management, as well as those charged with governance, concerning internal control. The examples described above, however, are related to a different component of internal control.]

    c. Information and communication. [This answer is incorrect. Information refers to the financial reporting system, and communication is the process of providing an understanding of roles and responsibilities to individuals within the CIRA regarding internal control over financial reporting. This is a different element of control than the one indicated by the examples above.]

    d. Monitoring. [This answer is correct. Monitoring can be virtually any activity that ensures that controls are operating as intended and continue to be properly designed. In addition to the activities described above, other examples of monitoring include reviewing member complaints regarding the assessment process and having the internal audit function evaluate revenue recognition.]

14. What is one risk that the use of IT poses to a CIRA's internal control? **(Page 76)**

    a. Frequent changes in systems or programs. [This answer is incorrect. One such risk of using IT is the failure to change systems or programs when necessary.]

    b. Lack of manual intervention. [This answer is incorrect. Inappropriate manual intervention (not the lack thereof) is a risk that the use of IT poses to a CIRA's internal control.]

    c. The loss of data or the inability to access it. [This answer is correct. The use of IT may enhance the effectiveness and efficiency of the CIRA's internal control because of the consistency, timeliness, and accuracy inherent in automated systems; however, the use of IT also poses certain risks to a CIRA's internal control. One of those risks is the loss or inability to access data.]

    d. Too few changes to master file data. [This answer is incorrect. When using IT, one risk is that there will be unauthorized changes to master file data.]

15. Which of the following is likely when a CIRA uses a managing agent? **(Page 80)**

    a. The CIRA will have effective controls over the information the agent produces. [This answer is incorrect. Many CIRAs do not have effective controls over the information produced by the managing agent. In those cases, the auditor will have to obtain a sufficient understanding about the managing agent's controls from other sources.]

    b. Information from prior years can sometimes be used to obtain an understanding of the managing agent's controls. [This answer is correct. If the services and the managing agent's controls over those services are highly standardized, information obtained through the auditor's prior experience with the managing agent may be helpful in obtaining the necessary understanding.]

c. Auditors will need to obtain an understanding of the managing agent separately from the CIRA even if the CIRA has effective controls. [This answer is incorrect. The auditor is only required to go outside the CIRA if the understanding obtained at the CIRA is not sufficient.]

d. Auditors are not required to gain an understanding of a managing agent's controls as they are not part of the CIRA. [This answer is incorrect. If the CIRA uses a service organization (such as a managing agent that provides bookkeeping and accounting services), AU-C 402 applies and requires auditors to obtain an understanding of the nature and significance of the services provided by the service organization and their effect on the CIRA's internal control sufficient to identify and assess the risks of material misstatement and to design and perform audit procedures that are responsive to those risks.]

Lesson 3: Audit Planning Decisions and Judgments, Sampling, Detailed Audit Plans and Workpapers, and Initial Engagements

INTRODUCTION

Lesson 3 looks at a variety of topics related to pre-engagement activities and audit planning. It begins with a discussion of audit planning decisions and judgments that must be made in a CIRA audit. Topics include materiality, the risk of material misstatement, and establishing an overall audit strategy.

Next, this lesson talks about audit sampling, followed by a discussion of the organization and structure of audit plans and workpapers (determining the audit approach, audit documentation, etc.).

Finally, Lesson 3 concludes with an examination of the special planning considerations that may need to be taken into account if the CIRA audit is an initial engagement. Topics include the reasonableness of opening balances and the differences between auditing a CIRA that has been previously audited and one that is previously unaudited.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify the audit planning decisions and judgments that may be needed in a CIRA audit.
- Determine the best way to address sampling, detailed audit plans and workpapers, and initial engagements when performing a CIRA audit.

AUDIT PLANNING DECISIONS AND JUDGMENTS

The information the auditor obtains about the entity and its environment by performing risk assessment procedures is used to make several important planning decisions and judgments. The primary planning decisions and judgments based on this information are as follows:

a. The materiality level for the financial statements taken as a whole (preliminary planning materiality).

b. Materiality for particular items of lesser amounts than planning materiality.

c. The risks of material misstatement at the financial statement level.

d. The overall audit strategy (a collective group of judgments about the audit approach, including overall responses to risks).

e. Performance materiality at the individual class of transactions, account balance, or disclosure level.

f. Risks of material misstatement at the relevant assertion level related to classes of transactions, account balances, and disclosures.

g. The specific nature, timing, and extent of further audit procedures.

The audit planning process is iterative and continuous. Some risk assessment procedures are performed to consider audit risk and materiality at the financial statement level and the judgments about those matters in turn affect the considerations at the relevant assertion level for account balances, transaction classes, and disclosures.

Determining Materiality at the Financial Statement Level

According to AU-C 320.10, the auditor should determine a materiality level for the financial statements as a whole when establishing the overall strategy for the audit. The preliminary judgment about materiality at the financial

statement level is generally referred to as *planning materiality*. The need to establish planning materiality is directly related to the auditor's objective of obtaining reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be material to the financial statements.

The auditor uses the concept of materiality both in (a) planning and performing the audit and (b) evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements on the financial statements. These two perspectives of the concept are usually referred to in practice as (a) *planning materiality* and (b) *evaluation materiality*. AU-C 320.06 explains that planning materiality is not necessarily the amount below which uncorrected misstatements, individually or in the aggregate, will be evaluated as immaterial. Because of surrounding circumstances, the auditor may evaluate an amount as material even if it is below planning materiality. AU-C 320.06 observes that it is not practical to design audit procedures to detect misstatements that could be material solely because of their nature (qualitative considerations), but when evaluating the effect of uncorrected misstatements on the financial statements, the auditor considers not only the size but also the nature of uncorrected misstatements and the particular circumstances of their occurrence. The implication of these matters explained in AU-C 320 is that determination of planning materiality is primarily a quantitative consideration, even though qualitative considerations influence evaluation decisions and judgments significantly.

Establishing Planning Materiality. The auditor's determination of materiality, according to AU-C 320.04, is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of the financial statements, but that is a conceptual view. AU-C 200.07 observes that, generally, misstatements or omissions are viewed as material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions made by users that are based on the financial statements, and that materiality decisions involve both quantitative and qualitative considerations. AU-C 320 does not adopt or provide a specific definition of materiality, but refers the auditor to the discussion of materiality in the financial reporting framework applicable to the preparation and fair presentation of the financial statements under audit. In determining *planning* materiality, the focus is generally on quantitative factors. Thus, auditors have historically used some common rules of thumb in establishing planning materiality.

If the financial reporting framework is GAAP, for example, then the pronouncements of the FASB would provide a frame of reference for making materiality decisions and judgments. For GAAP, the conceptual touchstone for determining materiality is the following definition from the nonauthoritative FASB Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting—Chapter 3, "Qualitative Characteristics of Useful Financial Information"*:

> Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report.

The reference to "based on the nature or magnitude or both" in that definition recognizes that qualitative as well as quantitative factors influence materiality judgments. As previously mentioned, however, in determining *planning* materiality the focus is generally on quantitative factors. For this reason, auditors have historically used some common rules of thumb in establishing planning materiality.

These rules of thumb generally apply a percentage to a benchmark amount from the financial statements. AU-C 320.A5 suggests the following factors that may affect the identification of an appropriate benchmark:

- Elements of financial statements (for example, assets, liabilities, revenue, and expenses).
- Nature of the entity, where it is in its life cycle, and the industry and economic environment in which it operates.
- Ownership structure of the entity and the way it is financed.
- Focus of financial statement users' attention on particular financial statement items.
- Relative volatility of the benchmark.

The appropriateness of a benchmark and the related appropriate percentage vary with the circumstances. In addition to assessing what the users of the financial statements are likely to regard as important, the following factors underlying the circumstances of a particular benchmark may be necessary to consider:

- Significant changes in the economy or industry in the current period.
- Significant revisions in the entity's budgets or forecasts.
- Significant changes in financial position or operating results between the prior period and the period to date.
- Significant changes in the entity's conditions.

If the auditor is using total revenue as a benchmark, for example, the cause of an increase in revenue may influence whether to use the current period amount or normalized revenue for a few prior periods. An unusual or nonrecurring increase may point toward using a normalized amount.

Desirability of a Single Benchmark. The desirability of a single benchmark arises from the practical requirements of audit planning. To understand the use of materiality in planning, it is helpful to contrast planning with evaluation. When the auditor is evaluating the materiality of misstatements at the conclusion of the audit, different materiality levels may be used for different financial statements. In planning, however, the auditor does not know in advance whether the misstatements that will be detected by a particular audit procedure will affect the balance sheet only, the statement of revenues and expenses only, or both statements. Thus, using several levels of materiality is impractical in planning. Also, the auditor needs to use a specific amount in making decisions about the scope of a test; for example, examine all cash disbursements in the subsequent period above a specific dollar amount. A range is not useful for making scope decisions but may be helpful in evaluation; for example, deciding that in particular circumstances an error over $10,000 is material, an error under $5,000 is immaterial, and an error between $5,000 and $10,000 may be material. That type of guide can be useful in evaluation, but it does not work well in planning. The auditor decides whether an audit test needs to be extensive enough to detect misstatements over $5,000 or over $10,000.

Recommended Benchmark. For many nonpublic companies, including CIRAs, total assets or revenue often provides a sound benchmark. Using either total assets or total revenue as a benchmark has the advantages of relative stability, predictability, and representativeness of entity size. Nevertheless, because it is unlikely that such benchmarks will adequately address user needs for all CIRAs and circumstances, the auditor needs to identify whether there are financial statement items on which, for the particular CIRA, users' attention tends to be focused. The auditor uses professional judgment considering the relevant factors when determining planning materiality for a specific CIRA. If a financial statement item is more important to users than the larger of total assets or revenue, then the auditor needs to estimate the planning materiality amount using that financial statement element as the benchmark.

Some auditors have questioned whether a different base, such as the larger of total assets or gross profit, should be used for CIRAs because many CIRAs have high revenues but a low dollar amount of assets if they do not capitalize common real property. In such situations, using total revenue as the base will result in a larger planning materiality amount than using total assets or the excess of revenues over expenses, which may seem high to some auditors. However, as explained below, a lower planning materiality amount will have implications for the efficiency of audit testing. Auditors need to apply their professional judgment when determining materiality limits so the desired level of comfort with coverage is attained. If the amount using the larger of total assets or total revenue is too high to give auditors that level of comfort, the base may be adjusted downward on an individual basis.

Regardless of the benchmark used for planning the extent of audit testing, the auditor needs to be satisfied that the combined effects of the nature, timing, and extent of planned procedures will be adequate to provide reasonable assurance that the financial statements are free from material misstatement, even if a different materiality benchmark is used for evaluation of audit differences.

A planning materiality benchmark is used primarily to plan the extent of audit testing, but does not purport to provide a basis for determining the adequacy of other aspects of audit planning; namely, the nature and timing of

procedures. Also, the choice of a benchmark for planning purposes does not predetermine what will be relevant in evaluating detected misstatements at the conclusion of the audit.

Selecting a Percentage. There are no authoritative percentage guides for materiality. AU-C 320 contains no guidance on selecting a percentage. Using total assets or total revenue as a benchmark means the audit scope will be driven by the size of the entity. Many auditors believe intuitively that this is appropriate because it agrees with their own past experience in making judgments about audit scope. Also, for intuitive reasons, many auditors believe that the materiality percentage ought to be adjusted in relation to the size of an entity. They believe the percentage can be larger for a very small entity to recognize the practical limits on the effectiveness of audit procedures and smaller for a very large entity to recognize the increased risks that usually accompany bigness and the fact that a large enough absolute amount is often considered material. Though outside of the scope of this course, *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* provides a sliding scale percentage that can be applied to the larger of total assets or total revenue, might be suitable for the circumstances of the typical CIRA.

This rule of thumb may produce a realistic amount for the preliminary judgment about materiality. The reduction of the percentages as the benchmark amount increases serves to prevent the planning materiality amount from becoming disproportionately large in relation to the statement of revenues and expenses. The auditor exercises judgment, however, and uses the recommended rule of thumb as a tool rather than a rigid requirement. The auditor's judgment about the client and its circumstances and uses of financial statements may in some cases result in modification of the planning materiality amount calculated by a rule of thumb.

Planning materiality decisions need to be reconsidered as the audit progresses. AU-C 320.12 states that the auditor should revise materiality levels if the auditor becomes aware of information during the audit that would have caused the auditor to determine a different amount(s) initially. Because the calculation made during initial planning often uses unadjusted financial information, the amounts in the annual audited financial statements might differ. If the auditor becomes aware of changes that would have affected the determination of planning materiality, adjustments are made. AU-C 320.13 indicates that if the auditor concludes a lower materiality than initially determined is appropriate, the auditor should determine whether performance materiality has to be revised and whether the nature, timing, and extent of further audit procedures remain appropriate. If planning materiality based on unadjusted amounts is too large, for example, then audit scope might not have been sufficient. If planning materiality based on unadjusted amounts was too small, then the audit would be less efficient than would have been possible because the auditor will have done more audit work than was necessary.

Determining Materiality for Particular Items of Lesser Amounts

AU-C 320.10 indicates that in addition to determining a planning materiality amount for the financial statements as a whole, the auditor should consider whether, in the specific circumstances of the CIRA, misstatements of particular classes of transactions, account balances, or disclosures of lesser amounts than planning materiality could be expected to influence economic decisions of users. Any such amounts determined represent lower materiality levels to be considered in relation to the particular classes of transactions, account balances, or disclosures in the financial statements for audit planning purposes. In other words, in addition to determining materiality at the financial statement level, the auditor should determine whether there are particular classes of transactions, account balances, or disclosures for which a lower planning materiality amount is appropriate based on user perceptions of the particular items. Many auditors believe, for example, that a lower materiality threshold is appropriate for related party transactions and balances.

The auditor generally consults with management and those charged with governance about whether there are particular financial statement items of lesser amounts than planning materiality that users would regard as material. However, the determination of such items is a decision based on the consideration of qualitative factors. (AU-C 320.A12 lists other factors to consider.) Lower levels of materiality for particular items in the financial statements should be documented.

Determining Performance Materiality

The auditor's objective is to perform 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. For this purpose, the auditor needs to establish a performance materiality amount(s) at the individual account balance, class of transaction, or disclosure level.

Performance materiality is a planning concept; it is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements will exceed materiality for the financial statements as a whole. When applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level(s) for particular classes of transactions, account balances, or disclosures. AU-C 320.11 states that the auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures. The term replaces *tolerable misstatement*, which now is used only to describe the application of performance materiality to a particular audit sampling procedure.

Professional standards do not discuss precisely how performance materiality is to be determined. The approach suggested by the authors is to determine performance materiality as a percentage of the auditor's judgment about the amount material to the financial statements taken as a whole. The percentage used is based on the auditor's expectation of uncorrected and undetected misstatements. Using this approach, a common rule of thumb is to calculate performance materiality as a fraction between 50% and 75% of materiality at the financial statement level (and materiality for items of lesser amounts, if applicable) with the percentage being increased from 50% as the likelihood of uncorrected and undetected misstatements decreases. Typically, for most CIRAs, the authors believe that the larger adjustment of 75% will be satisfactory.

Determining Individually Significant Dollar Items. The term *individually significant items* (ISI) encompasses two types of items in a financial statement component, both of which may be considered high risk. These include:

a. Unusual items (that is, items that have audit significance by their nature).

b. Individually significant dollar items.

The appropriate cutoff dollar amount for individually significant items depends on the distribution by size of the individual items comprising the balance. Many auditors find it convenient to determine the amount for which all items of that amount or larger that will be selected by using tolerable misstatement or a fraction thereof. A rule of thumb that typically minimizes the need to use audit sampling (or the total number of items tested from both ISIs and sample size when sampling is used) is to select all items that are one-third of tolerable misstatement or larger. However, the auditor may choose any amount less than tolerable misstatement to limit the remaining balance to an amount that reduces the risk of material misstatement to an acceptable level. The fraction of tolerable misstatement used for individually significant items may be reduced from one-third as the risk of material misstatement for the assertion being tested increases. One method for calculating individually significant dollar items is using the rule of thumb of one-third of tolerable misstatement. Auditors could also use another amount, not to exceed tolerable misstatement. Individually significant items often are used for making scope decisions in CIRA engagements in the following areas:

- *Accounts Payable*—determining the size of cash disbursements to be examined in the subsequent period in the search for unrecorded liabilities.

- *Expenditures*—determining the size of cash disbursements to be examined for significant expenditure classifications, such as major repair and replacement expenditures.

- *Litigation, Claims, and Assessments*—specifying materiality levels for an attorney to use in responding to an audit inquiry letter.

The possibility of using total assets or the excess of the revenues over expenses, rather than revenues, as the base for planning materiality for a CIRA that has high revenues but a low dollar amount of assets was discussed earlier in this section. Doing this can have implications for the efficiency of audit testing. Assume, for example, that a CIRA has revenue of $7 million and total assets of $200,000. Using Table 1 provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* and the $7 million revenue figure as the base would result in the following amounts: planning materiality of $72,000 and tolerable misstatement of $54,000. If one-third

of tolerable misstatement was selected to determine individually significant items, the resulting scope of $18,000 may seem high to some auditors. However, if those auditors use total assets or the excess of revenues over expenses as the base for determining planning materiality, resulting in a much lower individually significant item limit, they may not be conducting their audits efficiently. The authors believe auditors can use the larger of total revenue or total assets as the base, even if the result is a relatively high individually significant item limit. As previously mentioned, if the amount using the larger of total assets or total revenue are too high to give auditors their desired level of coverage, the base may be adjusted downward on an individual basis.

Documentation Requirements—Materiality

AU-C 320.14 requires the auditor to document the following relating to materiality, including factors considered in their determination:

- Materiality at the financial statement level.
- If applicable, materiality level(s) for particular transaction classes, account balances, or disclosures.
- Performance materiality.
- Revisions, if any, as the audit progressed from items a. through c. above.

In addition, AU-C 450.12 requires the auditor to document the amount below which misstatements would be considered clearly trivial. Although the documentation requirements related to materiality are limited to the preceding matters, the authors recommend more extensive documentation of the auditor's reasoning process in making these materiality-related determinations. The auditor may wish to document, among other matters, the expected users, or categories of users, of the audited financial statements; the key factors that affect the choice of the benchmark and, if applicable, the point within the range of percentages applied to the benchmark; the reasons for any adjustment of the benchmark; and the calculation of the ratio of the planning materiality amount to important totals and subtotals in the financial statements.

Assessing Risks of Material Misstatement at the Financial Statement Level

Audit risk is the risk that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materially misstated. It is a function of the risk that the financial statements are materially misstated and the risk that the auditor will not detect such material misstatement. In this sense, audit risk is the risk of material misstatement remaining in the financial statements after the audit. Audit risk cannot be precisely measured as a percentage; thus, consideration of audit risk is necessarily judgmental, not mathematical.

AU-C 315.03 states that "the objective of the auditor is to identify and assess the risks of material misstatement, whether due to error or fraud, at the financial statement and relevant assertion levels." These risks are identified and assessed by obtaining an understanding of the entity and its environment including its internal control, and this understanding provides a basis for designing and implementing responses to the assessed risks of material misstatement.

Risks of material misstatement at the financial statement level often relate to the CIRA's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. These overall risks are often especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control. Risks at the financial statement level might also relate to the process of preparing financial statements, the selection and application of significant accounting policies, entity-level control other than the control environment, and IT general controls. As with risks at the assertion level, the auditor needs to relate identified risks at the financial statement level to what can go wrong in the financial statements.

At the individual account balance, class of transaction, or disclosure level, the risk of material misstatement consists of inherent risk and control risk. Some auditors have questioned whether these risk model components also need to be considered at the financial statement level. The answer is, "No." The authors believe the risk assessment at the financial statement level is directed to an overall or combined assessment of the risk of material

misstatement. There is no requirement to separately assess inherent risk and control risk at the financial statement level. The overall assessment of risk of material misstatement at the financial statement level is made relatively early in audit planning, based on information such as the effectiveness of the CIRA's control environment and identification of fraud risk factors.

AU-C 330.A1 provides guidance to auditors when determining overall responses to address risks of material misstatement at the financial statement level. These responses may include:

- Emphasis to the audit team to use professional skepticism.
- Assigning staff with higher experience levels or specialized skills or using specialists.
- Increasing the level of supervision.
- Using a greater degree of unpredictability in selecting audit procedures.
- Changing the nature, timing, and extent of substantive procedures (e.g., instead of interim testing shift testing to period end or modify the nature of audit procedures to obtain more persuasive evidence).

In addition, the auditor should consider any specific relevant assertions that might be affected by the overall risks and develop responses at that level when designing the nature, timing, and extent of further audit procedures.

Because there is always a risk of management override of controls, AU-C 240.29 states that certain overall responses are required in every audit, as follows:

- Auditors should consider the knowledge, skill, and ability of individual team members when assigning and supervising personnel.
- Auditors should evaluate the client's selection and application of accounting principles, especially in subjective areas.
- Auditors should incorporate an element of unpredictability in the selection of audit procedures from year to year.

Other overall responses may also be appropriate to address identified fraud risks.

There is a presumption of revenue recognition as a fraud risk. Material misstatement of the financial statements due to fraudulent financial reporting often results from improper revenue recognition. Revenue may be overstated, such as by recording fictitious assessments or recognizing revenue before the performance obligation is satisfied, or understated, such as by shifting revenue to a later period. AU-C 240.26 requires auditors to make the rebuttable presumption that improper revenue recognition is a risk of 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. Risks of material misstatement due to fraud are always significant risks. The Observations and Suggestions at paragraph 5.31 of the AICPA Risk Assessment Audit Guide state that significant risks are those with inherent risk that is "higher than the usual high," thus requiring special attention in the audit. The author's believe that the presence of fraud risk qualifies revenue as significant audit area, as described later in this lesson.

The presumption that improper revenue recognition is a fraud risk is rebuttable, and the accompanying designation of revenue as a significant audit risk, may be overcome. The authors believe affirmative reasoning and an evaluation of observed fraud conditions, rather than negative reasoning (such as "nothing came to our attention") ordinarily are needed to overcome the presumption. Affirmative reasons may include, for example, (a) revenue recognition does not involve complex accounting for CIRAs, (b) the owner/manager or other senior management is not involved in recording assessments, or (c) all assessments are paid using an online portal connected to the CIRA's bank account. If the auditor lacks an affirmative reason to overcome the presumption that revenue recognition is a fraud risk, or if the auditor has observed the presence of fraud conditions related to improper revenue recognition, he or she evaluates that information with a heightened awareness of the need to identify improper revenue recognition as a fraud risk. Because revenue is generally material to the financial statements, if there are

one or more indications of potential improper revenue recognition gathered during the risk assessment process, the authors believe the auditor ordinarily will not be able to overcome the presumption. If improper revenue recognition is not identified as a risk of material misstatement of the financial statements due to fraud, the auditor is required by AU-C 240.46 to document the reasons supporting his or her conclusion. Revenue recognition as a fraud risk is discussed later in this lesson.

AU-C 315.33 requires the auditor to document the identified and assessed risks of material misstatement at the financial statement level. AU-C 330.30 requires the auditor to document the overall responses to address the assessed risks of material misstatement at the financial statement level. Thus, the auditor needs to include in audit documentation both the identified and assessed risks at the financial statement level and the overall responses to them.

Revenue-related Fraud Risk under the New Accounting Standard (FASB ASC 606). The AICPA Audit and Accounting Guide, *Revenue Recognition* (the Revenue Recognition Guide), observes that revenue recognition will continue to be a rebuttable presumed fraud and significant risk under the new accounting guidance. The Revenue Recognition Guide explains both general audit considerations for revenue recognition in Chapter 2 and provides helpful information specifically on risk assessment and fraud risk under FASB ASC 606. It also provides information on accounting and audit considerations applicable to the new five-step framework for revenue recognition under the new accounting guidance.

The auditor needs to understand the following basic concepts to perform the assessment of risks of material misstatement at the assertion level:

- The audit risk model.
- The risk of material misstatement.
- Financial statement assertions.

These concepts are all discussed further below.

The Audit Risk Model. AU-C 200.14 defines *audit risk* as "the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated." Audit risk is a function of the risks of material misstatement and detection risk. AU-C 200.14 defines these terms as follows:

- *Risk of Material Misstatement*—The risk that the financial statements are materially misstated prior to the audit. This consists of two components, described as follows at the assertion level:
  - *Inherent Risk*—The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
  - *Control Risk*—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- *Detection Risk*—The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Detection risk is a function of the effectiveness of the nature, timing, and extent of further audit procedures applied by the auditor and can be viewed as being a function of test of details risk (TD) and substantive analytical procedures risk (AP).

Risk of Material Misstatement. The risk of material misstatement is a function of inherent risk and control risk. The auditor assesses those two risks and then designs audit procedures to reduce detection risk to an appropriately

low level. Fraud risks encompass both inherent and control risk attributes. Therefore, the auditor's separate assessments of inherent and control risk should include consideration of the risk of material misstatement due to fraud. The combined effect of inherent risk (IR) and control risk (CR) is the risk of material misstatement (RMM). In other words, the aggregate risk of material misstatement in the risk model is expressed as follows:

$$RMM = IR \times CR$$

Inherent risk and control risk are the entity's risks and exist independently of the audit. The risk of material misstatement (RMM), the product of IR and CR, is the auditor's combined assessment of the two risks. The auditor may make an overall, or combined, assessment of the risk of material misstatement at the relevant assertion level or make separate assessments of inherent risk and control risk and then combine them. Thus, at the relevant assertion level, the audit risk model is as follows:

$$AR = RMM \times DR, \text{ where } DR = TD \times AP$$

The greater the risks of material misstatement, the less detection risk can be accepted. As a result, auditors would need to obtain more persuasive audit evidence.

In planning a particular test of details, the detection risk is established by the following relationship:

$$TD = \frac{AR}{RMM \times AP}$$

This model is not intended to be a mathematical formula including all factors that influence the assessment of audit risk, but some auditors find such a model in its formula form to be useful.

Relevant Assertions. AU-C 315.04 defines a *relevant assertion* as one "that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated." For example, the valuation assertion for cash is ordinarily not relevant unless foreign currency translation is involved. Relevant assertions are identified by evaluating the following:

- The source of likely potential misstatement in each significant class of transactions, account balance, and disclosure.
- The nature of the assertion.
- The volume of transactions or data related to the assertion.
- The nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertions.

Determination of whether an assertion is relevant is made without regard to the effect of internal controls.

Assessing the Risks of Material Misstatement at the Relevant Assertion Level

The assessment of the risks of material misstatement at the relevant assertion level, whether made in quantitative terms or nonquantitative terms (such as high, moderate, or low), is a judgment rather than a precise measurement of risk. The auditor needs to have an appropriate basis for the judgment about risk at the relevant assertion level. This basis is obtained through the risk assessment procedures performed to obtain an understanding of the entity and its environment, as described earlier in this lesson.

The only time that use of the formula and specific percentages are necessary is when statistical sampling is used, but the formula can be useful in other circumstances as well. The auditor can determine an acceptable audit risk and subjectively quantify the judgment of the risk of material misstatement (consisting of inherent risk and control risk), and the risk that substantive analytical procedures and other relevant substantive procedures would fail to detect misstatements that could occur in an assertion. In other words, the auditor's quantification of the components of the risk model is always made subjectively. Even when the auditor quantifies the components as a

percentage, the judgment is subjective and not a mathematical calculation. Whichever method is used, the auditor's assessment of audit risk at the relevant assertion level is a judgment rather than a precise measurement of risk.

Special Considerations—Accounting Estimates. AU-C 540.10–.11 indicates that as part of risk assessment, the auditor should evaluate the degree of estimation uncertainty of accounting estimates and determine whether any having a high degree of estimation uncertainty represents significant risks. The degree of estimation uncertainty associated with a particular accounting estimate may be influenced by a number of factors, as described in AU-C 540.A45–.A46. Furthermore, AU-C 540.12 indicates that the auditor is required to determine, based on the risk assessment, whether (a) management has appropriately applied GAAP to the accounting estimate, (b) the method for making the estimate is appropriate and applied consistently, and (c) any change in the estimate or method from the prior period is appropriate.

Special Considerations—Related Parties. AU-C 550.19 states that the auditor should identify and assess the risks of material misstatement associated with related party relationships and transactions to determine whether they represent significant risks. In addition, AU-C 550.20 indicates that if related party fraud risk factors are identified, the auditor should consider them in identifying and assessing risks of material misstatement due to fraud.

Determining Significant Audit Areas. The next step is to identify those audit areas that are significant. (An audit area encompasses the related account balances, transaction classes, and disclosures.) The following factors need to be considered in determining which audit areas are significant:

- Relative materiality of the account balance to the overall financial statements.
- Relative significance of the transaction class to the CIRA's operations or the overall financial statements (for example, because of either the materiality or volume of transactions flowing through the account during the period).
- The susceptibility of the account balance or transaction class to fraud, including both theft and similar loss of related assets and intentional misstatement by management.
- Audit areas that for other reasons (such as complex calculations, difficult or contentious accounting issues, new accounting standards, need for judgment, unusual nature of transactions, past history of significant adjustments, or other engagement risk factors) have a high assessed level of inherent risk or contain significant risks.
- Disclosures that require additional effort at the account balance level in individual audit areas to ensure their accuracy and completeness.

The authors believe that due to its materiality, complexity, and need for judgment, the implementation of FASB ASC 606, *Revenue from Contracts with Customers,* may present a significant risk and revenue would be a significant audit area.

Materiality of the Account Balance to the Financial Statements. One element of significance is the dollar amount of an account balance in relation to the auditor's judgment of the amount material to the financial statements as a whole. Judgment is needed even in making these quantitative comparisons because account balances are usually not completely misstated. Account balances other than liabilities and valuation allowances with an ending balance below performance materiality would generally be regarded as quantitatively immaterial and not significant. Account balances that are some multiple of performance materiality are generally quantitatively significant. Account balances that are approximately equal to performance materiality require careful consideration as to the nature of the account balance and prior experience with the client in evaluating significance.

Describing Specific Risks of Material Misstatement. As indicated in AU-C 315.28–.31, the auditor's risk assessment should include an evaluation of whether the following risks are present:

- Significant risks that require special audit consideration.
- Risks for which substantive procedures alone do not provide sufficient appropriate evidence.

Those risks are discussed in the following two subsections.

Significant Risks Requiring Special Audit Consideration. AU-C 315.28 indicates, as part of the auditor's risk assessment, that in most audits, the auditor should determine whether any of the risks identified by risk assessment procedures are significant risks. The AICPA Risk Assessment Audit Guide indicates that one or more significant risks normally arise on most audits. The AICPA Risk Assessment Audit Guide notes in paragraph 5.31 that in most audits one or more significant risks normally arise. It observes with respect to the determination of significant risk that in a situation in which the auditor assesses inherent risk as high, moderate, or low, a significant risk may be one that is higher than high and, thus, requires special audit consideration. The auditor's determination of significant risks is based solely on the consideration of inherent risk, that is, before consideration of the effect of identified controls related to the risk. The auditor determines whether the risk is such that it requires special audit consideration by focusing on the following:

- The nature of the risk.
- The likely magnitude of the potential misstatement, including the possibility of multiple misstatements.
- The likelihood of the misstatement occurring.

Each of these aspects of the auditor's consideration needs attention in determining whether special audit consideration is required, but the nature of the risk is particularly important.

According to AU-C 315.29, the nature of the risk should be evaluated by considering the following:

- Is the risk a risk of fraud or theft?
- Is the risk related to recent significant economic, accounting, or other developments?
- Are the transactions complex?
- Does the risk involve significant transactions with related parties?
- Is there a relatively large degree of subjectivity in the measurement of the financial information related to the risk?
- Does the risk involve significant transactions outside the normal course of business or that otherwise appear unusual?

An affirmative answer to any of these questions is likely to indicate the need for a specific audit response and, thus, a determination that the risk is a significant risk because it requires special audit consideration. Risks of material misstatement due to fraud are always significant risks. Risks of material misstatement due to error also may be deemed significant risks depending on their nature.

Risks for Which Substantive Procedures Alone Are Not Sufficient. As part of the auditor's risk assessment, the auditor might identify risks for which it is not possible or practicable to reduce detection risk at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures. That is, substantive procedures alone will not be sufficient. Such risks often occur in audit areas in which there is highly automated processing with little or no manual intervention, that is, situations in which a significant amount of the CIRA's information is initiated, authorized, recorded, processed, or reported electronically. Accordingly, auditors are required by AU-C 315.31 to understand and evaluate controls related to risks for which substantive procedures alone are not sufficient. For those risks, the auditor would ordinarily do the following:

- Evaluate the design and determine the implementation of mitigating controls, including control activities, over those risks (required by AU-C 315.31).
- Perform tests of controls to obtain evidence about their operating effectiveness.
- Document the risks identified and related controls evaluated (required by AU-C 315.33).

Documenting Audit Risk Considerations. Auditors are required to document any fraud risks or other significant risks they identify.

Establishing an Overall Audit Strategy

AU-C 300.07 states that the auditor should establish an overall strategy for the audit. The audit strategy is the auditor's operational approach to achieving the objectives of the audit. It is a high level determination of the audit approach and includes the identification of overall risks, overall responses to those risks, and the general approach to each audit area as being substantive procedures or a combination of substantive procedures and tests of controls. Determination of audit strategy would normally be the responsibility of more senior and experienced members of the audit team, including the audit partner, given the judgments that are required. AU-C 300.08 provides that in establishing the overall audit strategy the auditor should do the following:

a. Determine the key characteristics of the engagement that define its scope.

b. Determine the reporting objectives of the engagement to plan the timing of the audit and the nature of communications required.

c. Consider the significant factors that will determine the focus of the engagement team's efforts.

d. Consider the results of preliminary engagement activities.

e. Consider, if applicable, the knowledge from other engagements performed for the entity.

f. Determine the nature, timing, and extent of resources needed to perform the audit.

Steps a. and b. are relatively straightforward factual determinations of the information to be audited, reporting objectives, the overall timing of the audit, and the written and other communications that will be needed. Step c. is the heart of determining the nature, timing, and extent of audit procedures that will be necessary. In establishing audit strategy, these matters are dealt with at a high level rather than at the detailed audit plan level, which describes the nature, timing, and extent of procedures at the relevant assertion level. Steps d. and e. concern additional information that also may affect the focus of the engagement team's efforts. Finally, step f. concerns the personnel resources that will be necessary to accomplish audit objectives, including the need for the involvement of specialists and other experts.

Important aspects of overall audit strategy that determine the focus of the engagement team's efforts generally include the following:

- Materiality considerations, including:
  - Planning materiality.
  - Preliminary identification of material classes of transactions, account balances, and disclosures.
- Preliminary identification of areas where there may be higher risks of material misstatement, including those due to fraud.
- Effect of assessed risks of material misstatement at the overall financial statement level.
- Results of previous audits that involved tests of controls, including the nature of identified deficiencies and action taken to address them.
- Discussion of matters with firm personnel responsible for performing other engagements for the entity.
- Evidence of management's commitment to sound internal control and the importance attached to internal control, including appropriate documentation.

- Volume of transactions.
- Significant changes in accounting standards.
- Evaluation by audit area of whether the auditor plans to obtain evidence regarding the operating effectiveness of internal control, i.e., whether the auditor plans to use substantive procedures alone or a combination of substantive procedures and tests of controls.
- Manner of emphasizing the use of professional skepticism.
- Determination of general aspects of the nature, timing, and extent of further audit procedures, such as performing testing at the balance sheet date rather than at an interim date.
- Identification of recent significant developments affecting the entity, its industry, its financial reporting, or its legal or economic environment.
- Determination of areas for which client assistance is expected to be minimal.
- Determination of whether the work of the internal audit function will be used to obtain audit evidence or whether internal auditors will be used to provide direct assistance.

Considerations for Small CIRAs. One of the primary characteristics of a small CIRA is concentration of operational control in a president or chairman of the board who operates much like an owner/manager in a small commercial business. This characteristic has important influences on preliminary planning, particularly the audit strategy that is most effective for a small CIRA engagement. The authors have long maintained that an audit strategy that is efficient and effective for a large entity is not usually so for a small CIRA client and that ignoring the unique characteristics of a small CIRA usually leads to overauditing. The primary characteristics of a small CIRA that should influence audit strategy are as follows:

a. Concentration of operational control in the president or chairman of the board.

b. Limited segregation of duties and functions within the accounting system.

These characteristics generally mean that the most efficient and effective audit strategy for a small CIRA engagement is to take a primarily substantive approach to the audit. Under a substantive approach, the basis for an auditor's opinion on the financial statements is evidence obtained from substantive procedures, rather than a combination of tests of controls and substantive procedures. Also, the authors have maintained that if the characteristics of the small CIRA are ignored, the auditor will spend more time and effort documenting control activities than is really necessary and will usually be both ineffective and inefficient. Substantive procedures will not be properly designed, with the result that key procedures may be omitted and unnecessary procedures will almost always be included.

As explained in Lesson 2, auditors are required to understand the design and implementation of internal controls and to document the understanding of the five components of internal control and the sources of information used and procedures performed to obtain that understanding, even if the audit strategy will be a primarily substantive approach. However, before deciding not to test controls, auditors need to be satisfied that performing only substantive procedures will be effective in reducing detection risk to an acceptable level. IT may affect an auditor's decision to adopt an audit strategy that is a primarily substantive approach.

Timing of Developing the Audit Strategy. In some cases, the auditor may have sufficient information to establish a preliminary audit strategy prior to performing extensive risk assessment procedures based on knowledge from past experience with the CIRA and the results of preliminary engagement activities. For example, in a continuing engagement, the auditor may be able to establish a preliminary audit strategy after completing the client continuance procedures based on knowledge from the previous engagements and discussions with the client regarding any new issues or changes in circumstances.

For new engagements, the auditor may have gained sufficient information while performing client acceptance procedures and gathering information for the fee proposal that would allow the development of a preliminary audit

strategy. In fact, many auditors collect enough information during this process to make preliminary decisions on the assessment of overall risks, the determination of personnel requirements, use of specialists or component auditors, and other overall strategy matters. In these situations, the auditor simply needs to gather additional information throughout the performance of the risk assessment procedures to complete the overall audit strategy.

Revising the Initial Audit Strategy. It is not uncommon for auditors, after developing the initial audit strategy, to obtain information indicating that the audit strategy needs to be revised. AU-C 300.10 states that the auditor should update and modify the audit strategy as necessary throughout the engagement. Changes should be documented.

Communicating with Those Charged with Governance. The auditor may discuss elements of the overall audit strategy with those charged with governance. AU-C 260.11 requires the auditor to communicate with those charged with governance about the planned scope and timing of the audit. When these discussions occur, the auditor should be careful not to compromise the effectiveness of the audit, for example, by discussing the detailed nature and timing of audit procedures.

Documentation. Establishing the overall audit strategy need not be complex or time consuming. AU-C 300.14 requires that the auditor document the overall audit strategy, the audit plan, and any significant changes made to them during the audit and the reasons. Professional standards do not necessarily require that a separate audit strategy memorandum be prepared to document all matters that affect audit strategy. Many of the matters that relate to the overall audit strategy would be documented in the normal course of gathering information about the CIRA and its environment.

An efficient approach to documenting the audit strategy and any changes to it in the audit of a small, noncomplex, nonpublic CIRA is to prepare a brief memorandum at the conclusion of the previous audit, based on a review of audit documentation and highlighting issues identified in the audit just completed, and update and change it in the current period to provide a basis for planning the current audit. The update can be based on discussions with CIRA management.

USE OF A SPECIALIST

During planning, AU-C 300.12 requires the auditor to determine whether it will be necessary to use the work of a specialist. The use of a specialist may not be a common occurrence in a CIRA audit. When it is necessary to use the work of a specialist, however, AU-C 620 applies when the auditor uses the work of individuals or organizations that possess expertise in an area other than accounting and auditing. An auditor's specialist can either be an internal specialist within the auditor's firm or a network firm or an external specialist. AU-C 620.09 requires the auditor to evaluate the specialist's competence, capabilities, and objectivity for the auditor's purposes. The auditor is not only concerned with whether the specialist has the necessary expertise, but also whether the specialist has the available time and resources to achieve the auditor's objective. In evaluating the specialist's competence, capabilities, and objectivity, the auditor might consider matters such as the following:

- Previous experience with the work of the specialist.
- Experience of others with the work of the specialist.
- Discussions with the specialist.
- Professional certifications, memberships in professional bodies or industry associations, licensing, or other external recognition of competence.
- Published papers or books written by the specialist.
- Technical performance standards and industry or licensing requirements related to the specialist's field of expertise.
- Relevance of the specialist's field or experience to the matter for which the specialist's work will be used.
- Competence of the specialist with respect to accounting and auditing requirements that relate to the matter for which the specialist's work will be used.

- Unexpected events, changes in conditions, or audit evidence obtained that indicate it may be necessary to reconsider the initial evaluation of the specialist's competence, capabilities, and objectivity.

- Circumstances that threaten objectivity, such as self-interests, advocacy, familiarity, self-review, or intimidation.

In addition, AU-C 620 requires the auditor to—

- Obtain a sufficient understanding of the specialist's field of expertise to (a) determine the nature, scope, and objectives of the specialist's work and (b) evaluate the adequacy of that work for the auditor's purposes. The auditor might gain the understanding through discussions with the specialist, experience in auditing other entities that required such expertise, and education or professional development in the field of expertise (AU-C 620.10).

- Reach agreement with the auditor's specialist regarding (a) nature, scope, and objectives of the specialist's work; (b) roles and responsibilities of the auditor and the auditor's specialists; (c) nature, timing, and extent of communication between the auditor and the specialist, including the form of any report to be provided by the specialist; and (d) need for the specialist to observe confidentiality requirements (AU-C 620.11).

- Evaluate the adequacy of the specialist's work for the auditor's purposes, including the (a) relevance and reasonableness of the specialist's findings and conclusions and their consistency with other audit evidence, (b) significant assumptions and methods used by the specialist, and (c) relevance, completeness, and accuracy of significant source data used by the specialist (AU-C 620.12).

When determining the nature, timing, and extent of the procedures discussed above, AU-C 620.08 requires the auditor to consider (a) the nature of the matter to which the specialist's work relates, (b) the risks of material misstatement of the matter, (c) the significance of the specialist's work in the context of the audit, (d) previous knowledge of, and experience with, work performed by the specialist, and (e) whether the specialist is subject to the audit firm's quality control policies and procedures (that is, for internal specialists and those in a network firm that shares common quality control procedures). For example, the auditor may consider it necessary to perform more extensive procedures or obtain additional or more reliable audit evidence if the work of the specialist relates to a significant finding or issue involving subjective and complex judgments; the specialist is new to the auditor and there is no prior knowledge of the competence, capabilities, and objectivity of the specialist; procedures performed by the specialist are integral to the audit versus limited to providing advice on an individual matter; or the specialist is an external specialist and not subject to the audit firm's quality control policies and procedures.

An auditor should not make reference to the work of a specialist in a report with an unmodified opinion. If the auditor issues a modified opinion, reference to the work of an external specialist may be necessary if relevant to understanding the modification. If reference is made in such situations, the auditor is required to indicate in the report that the reference does not reduce the auditor's responsibility for the opinion. When reference to the specialist is necessary, the auditor may need the specialist's permission before the reference is made. Auditors might consider detailing such potential communications in the agreement with the specialist discussed above.

AU-C 620 does not apply to the auditor's use of *management's specialists*, that is, individuals or organizations that have expertise in a field other than accounting or auditing who are used by the entity to assist in preparing the entity's financial statements. The auditor's responsibilities when using the work of management's specialists are primarily addressed in AU-C 500, *Audit Evidence*. In addition, AU-C 620 does not apply to the auditor's use of specialists on the engagement team or other individuals or organizations with whom the auditor consults who possess expertise in a specialized area of accounting or auditing. Situations involving those specialists are addressed in AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, and AU-C 300, *Planning an Audit*. *PPC's Guide to Audits of Nonpublic Companies* provides detailed guidance on using the work of an auditor's specialist and also discusses the auditor's responsibilities when using the work of a management's specialist or other specialists. The *Guide* can be ordered online at **tax.thomsonreuters.com**.

SELF-STUDY QUIZ

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

16. An auditor's preliminary judgment about materiality at the financial statement level is called what?

    a. Evaluation materiality.

    b. Performance materiality.

    c. Planning materiality.

    d. Tolerable misstatement.

17. Which of the following responses would help an auditor address risks of material misstatement at the financial statement level?

    a. Assigning additional lower-level staff members to the audit engagement.

    b. Choosing audit procedures with predictability so they will be quicker to perform.

    c. Documenting the misstatements that would be considered clearly trivial for this engagement.

    d. Emphasize the importance of professional skepticism to the engagement team.

18. What is *inherent risk*?

    a. How susceptible an assertion about a transaction class, account balance or disclosure is to being material, individually or when aggregated with others, before controls are considered.

    b. The risk that the auditor's procedures to reduce audit risk will not detect an existing misstatement that could be material, either individually or in aggregate.

    c. The risk that the auditor will express an inappropriate audit opinion on financial statements that are materially misstated.

    d. This risk that the client's financial statements are already misstated prior to the audit engagement.

19. The Elm Bend Homeowners' Association is considered a small CIRA. Ellen is engaged to perform the annual audit of the CIRA's financial statements. How will the size of this CIRA affect Ellen's audit strategy?

    a. Ellen should use the same strategy she would on a CIRA of any other size to maintain consistency.

    b. For this audit engagement, Ellen should take a primarily substantive approach.

    c. Ellen should spend extra time documenting her client's control activities.

    d. Ellen should decide on her audit approach irrespective of the CIRA's IT.

20. When using a specialist, an auditor must do which of the following?

    a. Obtain enough of an understanding in the field to perform the specialist's work, if needed.

    b. Reach an agreement with the specialist about roles and responsibilities and about the scope, nature, and objectives of the work.

    c. Accept the specialist's work since he or she is the expert in the subject matter.

    d. Refer to the specialist's work in the auditor's unmodified report at the conclusion of the engagement.

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.)**

16. An auditor's preliminary judgment about materiality at the financial statement level is called what? **(Page 87)**

    a. Evaluation materiality. [This answer is incorrect. Evaluation materiality, along with planning materiality, is one of the perspectives that make up the concept of materiality.]

    b. Performance materiality. [This answer is incorrect. *Performance materiality* is a planning concept; it is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate uncorrected and undetected misstatements will exceed materiality for the financial statements as a whole.]

    c. Planning materiality. [This answer is correct. According to AU-C 320.10, the auditor should determine a materiality level for the financial statements as a whole when establishing the overall strategy for the audit. The preliminary judgment about materiality at the financial statement level is generally referred to as *planning materiality.* The need to establish planning materiality is directly related to the auditor's objective of obtaining reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be material to the financial statements.]

    d. Tolerable misstatement. [This answer is incorrect. Today, this term is used only to describe the application of performance materiality to a particular audit sampling procedure.]

17. Which of the following responses would help an auditor address risks of material misstatement at the financial statement level? **(Page 93)**

    a. Assigning additional lower-level staff members to the audit engagement. [This answer is incorrect. According to AU-C 330.A1, one of the appropriate response would be to assign staff with *higher* experience levels or specialized skills to the engagement. Alternatively, the auditor could use a specialist.]

    b. Choosing audit procedures with predictability so they will be quicker to perform. [This answer is incorrect. Per the guidance in AU-C 330.A1, using a greater degree *unpredictability* in selecting audit procedures is a better way to respond to such risks.]

    c. Documenting the misstatements that would be considered clearly trivial for this engagement. [This answer is incorrect. AU-C 450.12 requires the auditor to document the amount below which misstatements would be considered clearly trivial. However, this is a separate consideration from the type of risk responses described above.]

    d. Emphasize the importance of professional skepticism to the engagement team. [This answer is correct. AU-C 330.A1 provides guidance to auditors when determining overall responses to address risks of material misstatement at the financial statement level. In addition to other things, these responses may include emphasizing to the audit team that they should use professional skepticism.]

18. What is *inherent risk*? **(Page 94)**

    a. How susceptible an assertion about a transaction class, account balance or disclosure is to being material, individually or when aggregated with others, before controls are considered. [This answer is correct. According to AU-C 200.14, *inherent risk* is defined as the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.]

    b. The risk that the auditor's procedures to reduce audit risk will not detect an existing misstatement that could be material, either individually or in aggregate. [This answer is incorrect. This is AU-C 200.14's definition of *detection risk,* not inherent risk.]

    c. The risk that the auditor will express an inappropriate audit opinion on financial statements that are materially misstated. [This answer is incorrect. Per AU-C 200.14, this is the definition of *audit risk.* Inherent risk is defined differently.]

    d. This risk that the client's financial statements are already misstated prior to the audit engagement. [This answer is incorrect. This is the *risk of material misstatement,* as defined in AU-C 200.14. The risk of material misstatement is made up of inherent risk and control risk; however, inherent risk is defined in a different way.]

19. The Elm Bend Homeowners' Association is considered a small CIRA. Ellen is engaged to perform the annual audit of the CIRA's financial statements. How will the size of this CIRA affect Ellen's audit strategy? **(Page 99)**

    a. Ellen should use the same strategy she would on a CIRA of any other size to maintain consistency. [This answer is incorrect. This course suggests that an audit strategy that is efficient and effective for a large CIRA is not usually so for a small CIRA client and that ignoring the unique characteristics of a small CIRA usually leads to overauditing. Therefore, Ellen needs to adapt a different audit strategy for this engagement.]

    b. For this audit engagement, Ellen should take a primarily substantive approach. [This answer is correct. The characteristics of a small CIRA generally mean that the most efficient and effective audit strategy is to take a primarily substantive approach to the audit. Under a substantive approach, the basis for Ellen's opinion on her client's financial statements is evidence obtained from substantive procedures, rather than a combination of tests of controls and substantive procedures.]

    c. Ellen should spend extra time documenting her client's control activities. [This answer is incorrect. If the characteristics of a small CIRA are ignored, this course suggests that the auditor will spend more time and effort documenting control activities than is really necessary and will usually be both ineffective and inefficient. Therefore, Ellen should not spend extra time in this area when auditing this small CIRA.]

    d. Ellen should decide on her audit approach irrespective of the CIRA's IT. [This answer is incorrect. IT may affect an auditor's decision to adopt the strategy that this course recommends for small CIRA audit engagements. Therefore, Ellen must consider Elm Bend's IT before finalizing her audit strategy.]

20. When using a specialist, an auditor must do which of the following? **(Page 101)**

    a. Obtain enough of an understanding in the field to perform the specialist's work, if needed. [This answer is incorrect. According to AU-C 620, the auditor is required to obtain a sufficient understanding of the specialist's field of expertise to (1) determine the nature, scope, and objectives of the specialist's work and (b) evaluate the adequacy of that work for the auditor's purposes.]

    b. Reach an agreement with the specialist about roles and responsibilities and about the scope, nature, and objectives of the work. [This answer is correct. As discussed in AU-C 620, when using a specialist, the auditor needs to reach an agreement with the specialist regarding (1) the nature, scope, and objectives of the specialist's work; (2) roles and responsibilities of the auditor and the auditor's specialists; (3) nature, timing, and extent of communication between the auditor and the specialist, including the form of any report to be provided by the specialist; and (4) need for the specialist to observe confidentiality requirements.]

    c. Accept the specialist's work since he or she is the expert in the subject matter. [This answer is incorrect. Per AU-C 620, the auditor must evaluate the adequacy of the specialist's work for the auditor's purposes, not accept it as it is.]

    d. Refer to the specialist's work in the auditor's unmodified report at the conclusion of the engagement. [This answer is incorrect. An auditor should *not* make reference to the work of a specialist in a report with an unmodified opinion. If the auditor issues a modified opinion, reference to the work of an external specialist may be necessary if relevant to understanding the modification.]

AUDIT SAMPLING

AU-C 330.25 requires that when the auditor designs tests of controls and tests of details, the auditor should determine the approach to selecting items for testing that is effective in meeting the purpose of the audit procedure. AU-C 330.A65 explains that the approaches to selecting items for testing are as follows:

- Selecting all items (100 percent examination).
- Selecting specific or individually significant items.
- Audit sampling.

The auditor may apply any one or a combination of these approaches to selection depending on the circumstances.

Authoritative Literature

The authoritative pronouncement that applies when the auditor has decided to use audit sampling in performing audit procedures is AU-C 530, *Audit Sampling*. AU-C 530 addresses the auditor's use of statistical and nonstatistical sampling when:

a. Designing and selecting the audit sample.

b. Performing tests of controls and tests of details.

c. Evaluating the results of the sample.

In addition, the AICPA Audit and Accounting Guide, *Audit Sampling*, provides interpretive guidance to apply the concepts in AU-C 530.

Audit Sampling. AU-C 530.05 defines *audit sampling* as "the selection and evaluation of less than 100 percent of the population of audit relevance such that the auditor expects the items selected (the sample) to be representative of the population and, thus, likely to provide a reasonable basis for conclusions about the population. In this context *representative* means that evaluation of the sample will result in conclusions that, subject to the limitations of sampling risk, are similar to those that would be drawn if the same procedures were applied to the entire population." The definition is important in the selection of audit procedures. Some audit procedures are *not* sampling by this definition, including the following:

a. Application of an audit procedure limited to a specific group of items within a balance or class of transactions that have a distinct characteristic, e.g., all property and equipment additions over $5,000.

b. Examining a few transactions within a balance or class of transactions to obtain an understanding of the nature of the client's operations.

c. Applying audit procedures to one or a few transactions of each type to clarify the auditor's understanding of the design of the CIRA's internal controls.

In each of these three examples, the auditor is not selecting items expected to be representative of the population to provide a reasonable basis for drawing conclusions about the population from which the items were selected. In item a, the auditor is dividing the account balance or transaction class into two populations and selecting 100 percent of one of those populations. In items b and c, the auditor is selecting items to obtain information that will increase the auditor's understanding rather than attempting to reach a conclusion about a population of items. In each of these cases, authoritative pronouncements on sampling would not apply to the test performed.

Uses of Audit Sampling

In a CIRA engagement, three distinct types of audit procedures may involve the use of audit sampling as follows:

a. Substantive tests of details of account balances.

b. Substantive tests of details of transactions.

c. Tests of controls directed toward operating effectiveness.

The auditor may also perform a dual-purpose test that applies both tests of details and tests of controls (b. and c.) to the same sample of items.

Substantive Tests of Account Balances. The auditor's objective in using a substantive test of a general ledger account balance is to decide whether the balance is materially misstated. Audit sampling is usually necessary in applying a substantive test of an account balance when the balance is composed of a large number of items and the remaining balance, after identifying individually significant items, exceeds tolerable misstatement. An audit sampling application for a substantive test of an account balance that may be used in certain CIRA engagements is confirmation of assessments receivable.

Substantive Tests of Transactions. The auditor's objective in using a substantive test of transactions is to decide whether the total of a transaction class is materially misstated. The auditor inspects documents supporting recorded transactions to determine whether transactions are valid, and valued and coded properly, i.e., recorded correctly as to account, amount, and period. Tests of transactions may not be necessary in CIRA audits if the statement of revenues and expenses does not present unnecessary detail, risks of material misstatement are low, and if alternatives such as effective analytical procedures can be applied to transaction classes. However, in some engagements, this type of test may be a common audit sampling application. It can be used for testing most types of expenditures, e.g., payroll, expenditures for goods and services, etc.

PPC's Guide to Audits of Nonpublic Companies explains an approach to avoid the use of sampling by determining the extent of testing using individually significant amounts. *PPC's Guide to Audits of Nonpublic Companies* also explains practical approaches that can be used in a CIRA audit for substantive tests of details using audit sampling. More information about this approach and the applicable forms are available in that guide and in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

Tests of Controls. Generally, audit sampling is used for tests of controls directed toward operating effectiveness where there is *documentation* of the operation of controls. Those tests normally include the audit procedures of inspecting documents and reperforming the application of the controls. In some cases, it may be efficient to perform a test of controls in combination with a substantive test of transactions. Both tests may be accomplished concurrently by performing a test of controls and a test of details on the same transaction. This approach is known as a *dual-purpose* test. One common example is examining an invoice to determine whether it has been approved and to provide evidence about the recorded amount of the transaction. AU-C 330.A24 points out that a dual-purpose test is designed and evaluated by considering each purpose of the test separately.

Generally, the use of audit sampling for tests of controls will be efficient and effective in the following circumstances:

- The control is applied on a transaction basis, for example, matching approved purchase orders to supplier invoices.

- The control operates frequently and the population is relatively large.

In these circumstances, the auditor can select a sample of transactions and reperform the related control activities to see whether compliance with the control procedures is acceptable. When the control operates infrequently or the population is not relatively large, additional consideration needs to be given to an approach other than audit sampling.

In a CIRA engagement, the need to test controls for operating effectiveness depends on whether (a) the auditor's risk assessment includes an expectation of the operating effectiveness of controls or (b) substantive procedures alone do not provide sufficient appropriate evidence at the relevant assertion level. However, not all tests of controls involve audit sampling.

Risk assessment procedures performed to obtain an understanding of internal control do not involve sampling. Also, sampling concepts might not apply to the following types of tests of controls:

- Tests of automated application controls when effective IT general controls are present.
- Analyses of controls for determining the appropriate segregation of duties or other analyses that do not examine documentary evidence of performance.
- Analyses of the effectiveness of security and access controls.
- Tests directed toward obtaining audit evidence about the operation of the control environment, for example, inquiry or observation of the explanation of variances from budgets when the auditor does not plan to estimate the rate of deviation from the prescribed control.
- Examining actions of those charged with governance for assessing their effectiveness, for example, evaluating whether the audit committee is appropriately involved in the financial reporting process.

CIRA Considerations

Generally, sampling will be more efficient in a CIRA engagement when the audit area is a critical area based on consideration of audit risk and materiality, the volume of transactions is relatively high, and individual items within the balance or class do not differ significantly in dollar amount or the details of processing. In many cases, one of these features will tip the scales for or against designing the procedure as a sampling application. Exhibit 3-1 lists some common sampling applications and their relative frequency for nonpublic CIRA audits.

Many CIRAs tend to have relatively small populations of accounting data in both account balances and classes of transactions, and also often have account balances for which a large portion of the balance is accounted for by only a few of the items making up the balance. As a result, sampling may not be as useful or appropriate in many CIRA engagements, and an auditor normally considers other methods of deciding the extent of testing. Only after other approaches to decide the extent of testing have been adequately considered does an auditor plan to use sampling.

The auditor is required by AU-C 315 to obtain an understanding of the entity and its environment, including the design and implementation of internal control. Based on that understanding, the auditor may often assess control risk as high for relevant assertions for significant audit areas in a typical CIRA due to the lack of effective controls. The auditor may also determine that performing only substantive procedures is effective and testing the operating effectiveness of controls would be inefficient. Accordingly, an auditor may be less likely to use audit sampling for tests of controls in many CIRA engagements.

Exhibit 3-1

Sampling Applications in CIRA Audits

Substantive Test Application	Frequency
1. *Receivables Confirmation.* This is the most common use of sampling in many industries, but not for CIRAs. Due to the relatively small number of accounts that exist and because receivables are normally collected shortly after assessment, sampling is not typically used to accomplish the objectives in this area.	Rare to Moderate
2. *Tests of Fixed Assets Additions.* Some CIRAs have a significant number of fixed assets additions. Although a few specific items normally may be examined to address a large portion of the additions, sampling may be used when the objectives cannot be satisfied efficiently by examining individual items.	Rare to Moderate
3. *Tests of Revenue Transactions.* The likelihood of using sampling to perform a test of revenue transactions depends on the assessment of the risks of material misstatement. For example, when there is a risk of material misstatement due to fraud and a possibility exists of fictitious revenue and receivables or when the accounting for revenue recognition is complex, use of sampling may be necessary. However, other substantive procedures may be used to effectively and more efficiently address the assessed risk.	Moderate
4. *Test of Disbursements.* Similar to tests of revenue transactions, a test of disbursements does not typically address the risks of material misstatement as efficiently as other audit procedures. Therefore, sampling disbursements may not be an effective and efficient approach. However, for some entities, classification of disbursements may be important for both operating decisions and presentation of operating results, e.g., the income statement presents general and administrative expenses in great detail.	Rare to Moderate

* * *

DETAILED AUDIT PLANS AND WORKPAPERS—ORGANIZATION AND STRUCTURE

AU-C 330.06 indicates that the further audit procedures the auditor designs and performs should be responsive to the assessed risks of material misstatement at the relevant assertion level. In designing further audit procedures, AU-C 330.07 indicates that the auditor should consider the reasons for the assessed risk of material misstatement, including the related inherent risk and control risk, and obtain more persuasive evidence in higher risk areas. AU-C 330.A8 notes that the design and performance of audit procedures that are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level provide a clear linkage between the assessment and further audit procedures. The observations and suggestions to paragraph 5.38 of the AICPA Risk Assessment Audit Guide note that *linkage* describes the relationship between the assessed risks and further audit procedures. *Clear linkage* implies that the further audit procedures are responsive to the assessments and that the assertions of the assessed risks are closely correlated to those addressed by the substantive procedures.

A description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level is a significant component of the audit plan. AU-C 300.09 indicates that the auditor should develop an audit plan that includes a description of the following:

a. The nature and extent of planned risk assessment procedures.

b. The nature, timing, and extent of planned further procedures at the relevant assertion level.

c. Other planned procedures required by GAAS.

AU-C 300.10 notes that the auditor should update and change the audit plan as needed during the audit.

As part of developing the overall audit strategy, the auditor will ordinarily have identified material account balances and audit areas where there may be higher risks of material misstatement. Once the audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The audit plan is commonly referred to as the audit program.

Determining the Audit Approach

The purpose of the risk assessment is to determine the nature, timing, and extent of further audit procedures to be performed. The auditor identifies risks (including risks of material misstatement due to fraud), considers management's responses to those risks through operating decisions and controls, and assesses the risk of material misstatement at the relevant assertion level. Based on that risk assessment, the auditor determines what audit procedures need to be performed. For simplicity in the discussions throughout this course, the authors refer to the overall decision of which further audit procedures will be performed as the selection of an audit "approach." In this course, the approach selected by the auditor to respond to the risk assessment for each audit area involves the following decisions:

- Performing only limited procedures and not developing a separate audit program.
- Choosing between core audit programs and specified risk audit programs.
- Performing basic procedures from the core audit programs or performing basic procedures plus certain extended procedures from the core audit programs.
- Performing procedures from the specified risk audit programs.

This audit approach should be documented, perhaps on a form such as the "Risk Assessment Summary Form" provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

Performing Only Limited Procedures. The auditor first considers whether the preliminary analytical procedures and other risk assessment procedures performed during initial planning and the final analytical procedures performed in the overall review stage of the audit provide enough assurance that no further audit procedures are considered necessary. In other words, no separate specific audit program is needed for the audit area because the procedures for performing preliminary analytics, other risk assessment procedures, and final analytics are included in the general programs. That approach is referred to as the Limited Procedures Approach and will generally be appropriate only for audit areas (or assertions) that are not significant and have a low combined risk of material misstatement. For audit areas that are not significant but have a risk of material misstatement other than low or require audit attention for other reasons such as client or regulatory expectations, an audit program might be needed. In addition, for significant audit areas, the auditor is required to perform some substantive procedures for each relevant assertion; therefore, an audit program is always needed for those areas.

Choosing between Core Audit Programs and Specified Risk Audit Programs. The next decision to be made by the auditor is whether to use the core audit programs or the specified risk audit programs for a particular audit area. Practitioners can build their own audit programs or use audit programs provided by a third party, such as those provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations.* Both sets of audit programs illustrated in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* (i.e., core and specified risk) provide a starting point for the auditor to use in developing an audit response and determining the nature, timing, and extent of further audit procedures that need to be performed to respond to the risk assessment. Both sets of audit programs need to be tailored to respond to the individual risk assessment. The individual audit programs document audit procedures and the assertions relevant to each procedure and provide linkage to the assessed risk of material misstatement. The assessment of the risk of material

misstatement by assertion assists the auditor when deciding on an appropriate audit response by providing linkage between the risks and related audit program procedures.

When deciding which approach is appropriate, it is important for the auditor to perform a careful review of the procedures in each program to ensure that the approach and the further audit procedures selected will appropriately respond to the assessed risk for his or her client. The key to audit effectiveness and efficiency is to choose an audit approach that adequately responds to the identified risks without requiring excessive time commitments.

Using the Core Audit Programs. The PPC core audit programs (such as those included in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*) include both general audit programs and audit programs for specific financial statement audit areas. To assist auditors in tailoring their audit procedures to appropriately respond to the risk assessment, the core audit programs for individual audit areas include the following sections:

- *Basic Procedures*, which include a combination of substantive analytical procedures and tests of details.
- *Extended Procedures (Procedures for Additional Assurance)*, which include procedures from which the auditor can choose one or more steps as necessary to supplement the basic procedures in response to the auditor's risk assessment at the relevant assertion level.
- *Other Audit Procedures*, which include procedures that may be warranted due to the specific circumstances of the engagement. (Other audit procedures are considered Extended Procedures when completing the "Risk Assessment Summary Form.")

Auditors using the core audit programs decide whether to apply basic or basic plus extended procedures based on the risk assessment at the relevant assertion level. However, the analysis is not a simple determination based on whether that risk is high, moderate, or low. Usually, a low or moderate risk of material misstatement in a significant audit area means that a Basic Procedures approach is appropriate for those assertions. However, the auditor also has to consider the expected cause and direction of potential misstatements, the relationships among audit areas, and whether the risks are fraud risks or other significant risks, as well as client expectations. The particular tests selected, whether they are in the Basic or Extended section of the audit programs, need to be tailored to the nature, cause, and direction of potential misstatements at the relevant assertion level. It may also be appropriate to alter the extent or timing of the procedures to adequately respond to the risk assessment.

As previously stated, the Basic Procedures section of the core audit programs contains certain tests of details, many of which are required by auditing standards. If applicable, the auditor performs those procedures. The performance of those procedures may also be a response to a higher assessed level of risk for the related assertions. In other words, those procedures may provide additional assurance even though they are included in the Basic Procedures section rather than in the Extended Procedures section.

The Extended Procedures section of the core audit programs, which includes procedures for additional assurance, is a source list of possible audit procedures. It is not an alternative audit program. It is arranged by topic and includes a column indicating the assertions that are primarily and secondarily addressed by the procedure. The auditor selects procedures from the list that are needed to respond to the risk assessment.

Using the Specified Risk Audit Program. The specified risk programs have been developed from the basic and extended procedures in the core audit programs. Generally, the audit procedures in the specified risk programs are more focused on substantive tests of details versus substantive analytics. The programs have been developed based on a predefined set of risk assumptions and include procedures that are typical in a CIRA engagement. The procedures provided in the specified risk audit programs are intended to apply to CIRA audit engagements that have the following general characteristics:

- The auditor does not intend to rely on the operating effectiveness of controls to reduce the control risk assessment. Substantive procedures alone are effective in responding to the risk assessment.
- Accounting personnel of the CIRA's management company are generally competent to process data and make decisions necessary to perform their assigned duties. The management company performs basic

recordkeeping functions based on information submitted from the CIRA, and it performs those functions for a large number of different CIRAs.

- In addition to the risks of improper revenue recognition related to nonassessment cash receipts and management override of controls, the risk of misappropriation of assets is present in the cash disbursement area.

- A lack of segregation of duties by onsite CIRA personnel is a known significant deficiency. The board of directors includes a volunteer treasurer who provides some oversight by reviewing the financial statements and asking questions when unusual items are noted. However, the board does not generally review detail transactions.

- Audit procedures are either performed entirely at year end or are applied to transactions through an interim date and completed as part of year-end procedures (that is, audit conclusions are not extended from an interim date to the balance sheet date).

If the preceding general characteristics do not apply to the engagement, the auditor needs to consider whether it is appropriate to use the specified risk approach or whether to use the core audit programs.

The audit programs for the individual audit areas in the specified risk programs section consist of one set of procedures, developed from the basic and extended procedures in the core audit programs. At the front of each specified risk audit program is a description of the underlying risk assumptions for that audit area. Before selecting the specified risk approach and using the related programs, the auditor ought to perform a careful review of the underlying risk assumptions and the procedures in each program to ensure that the audit procedures included in the program appropriately respond to the risk assessment for a particular client or audit area.

If the risk assessment for a particular audit area or assertion differs from the assumed underlying risk assumptions, the auditor ought to consider the need to modify the audit program for that audit area or assertion to adequately respond to the risk assessment. If additional procedures are needed, they can be selected from the basic, extended, and other procedures included within the core audit programs. (The core audit programs designate with an "S" those steps that have already been included in the specified risk audit programs.) In some cases, it may be possible to adequately respond to a particular risk assessment by altering the extent or timing of procedures rather than selecting additional procedures.

Documenting the Approach Selected. The auditor must document the level selected (Limited = "L", Basic = "B", Extended = "E", or Specified Risk="S"). He or she might also want to include comments that may be appropriate concerning the audit program, including the linkage between risks and responses. Comments may include the following:

- Information that clarifies how the audit programs/procedures have been tailored to respond to the risk assessment.

- Information about the nature, timing, or extent of further audit procedures in response to identified risks.

- Descriptions of the procedures that will be performed to specifically respond to fraud risks or other significant risks.

- Whether certain tests of details included in the Basic Procedure section will be performed to respond to an identified risk.

- A reference to audit areas for which tests of controls are performed.

- Documentation of the basis for your assessment of inherent risk for an assertion or account.

Audit Documentation (Workpapers)

The main purpose of workpapers, as identified in AU-C 230.02, is to provide the principal evidence for the auditor's report that includes the following:

- The representation that the audit was planned and performed in accordance with generally accepted auditing standards.
- The opinion expressed (or disclaimed) on the financial statements.

In addition to this primary purpose, audit documentation can be used for a variety of other purposes. These additional purposes are discussed below.

Support for Auditor's Report. Auditors should prepare audit documentation with an appropriate amount of detail that provides a clear understanding of the work performed, the evidence obtained along with its source, and the conclusions reached. AU-C 230.A3 notes that preparing sufficient and appropriate audit documentation on a timely basis throughout the audit helps to improve the audit quality. Also, sufficient and appropriate audit documentation assists in the effective review and evaluation of the audit evidence and conclusions reached before the auditor's report is finalized. An auditor's support for representations in the audit report is not strictly limited to what is in the workpapers. The primary need to support the representations in the audit report arises in internal and external quality control reviews. Another less frequent, but important, use arises if the quality of the audit is questioned in litigation, regulatory proceedings, or ethics disciplinary actions. The workpapers are the principal record of the work done and conclusions reached, but an auditor, in defending the quality of the audit, might supplement the audit documentation by other means. According to AU-C 230.A7, on their own, the auditor's oral explanations do not constitute adequate support for the work performed or conclusions reached, but may be used to clarify or explain information contained in the audit documentation. While an auditor will not document every consideration during the course of the audit, audit documentation needs to provide a clear understanding of what was done, the evidence gathered, and conclusions that were reached based on the procedures and evidence obtained.

Auditors need to be aware that certain states and regulatory agencies may have stringent requirements for audit documentation. For example, California has adopted rules applicable to both public and nonpublic company audits containing a rebuttable presumption that an audit procedure not documented was not performed. The burden of proof lies with the auditor. The presumption can be overcome by a preponderance of the evidence, which ordinarily needs to be more than just an oral explanation. The authors believe that workpapers need to be prepared with an awareness that someone external to the auditor's firm might review them, whether in a peer review or an adversarial proceeding.

Other Purposes of Workpapers. While audit workpapers need to achieve the primary purpose noted above, audit documentation that is thoroughly prepared with a sufficient amount of detail can be useful for a number of purposes. In fact, firms that adopt documentation policies that encourage well-designed and prepared workpapers will often achieve a higher degree of audit effectiveness and efficiency in their engagements. Some additional purposes of audit documentation include:

- Aids in the planning and performance of the current and future engagements.
- Provides guidance for newer engagement team members.
- Retains a record of matters of continuing significance to future audits.
- Reinforces and demonstrates accountability.
- Aids in internal supervision and review.
- Assists in the conduct of quality control reviews and inspections.
- Aids in external review.

Basic Requirements for Content. An auditor has some discretion in deciding on the specific workpapers to prepare; however, AU-C 230 provides criteria auditors should use in making documentation decisions and defines significant findings and other matters that should be documented in the workpapers. According to AU-C 230.08, workpapers should enable an *experienced auditor with no previous connection to the audit* to understand:

a. The nature, timing, and extent of auditing procedures performed to comply with professional standards and applicable legal or regulatory requirements.

b. The results of the audit procedures performed along with the evidence gathered.

c. The significant judgments made and conclusions reached on significant findings on issues.

The use of the term *experienced auditor with no previous connection with the audit* reinforces a documentation concept practiced by many auditors that indicates workpapers should "stand by themselves." That is, the documentation needs little or no oral explanation as to what was done, who performed the work, who reviewed the work, and the reasons for the conclusions. AU-C 230.06 considers an experienced auditor to be an individual with practical audit experience and the necessary competency and skill to perform the audit. Such skills and competencies would include an adequate knowledge of professional standards and applicable legal or regulatory requirements, the audit process, the client's business environment, and the audit and financial reporting issues that apply to the CIRA industry.

As discussed above, there are few stringent requirements as to what needs to be contained in the workpapers. Accordingly, the form, content, and extent of the workpapers will be dependent to some extent on factors that are unique to the engagement. In determining the documentation appropriate for a particular engagement, auditors may consider:

a. The size and complexity of the entity.

b. The audit methodology and tools used.

c. The identified risks of material misstatement.

d. The nature of the auditing procedures performed.

e. The amount of judgment involved in carrying out the procedure and evaluating the results.

f. The significance of the audit evidence obtained.

g. The nature and extent of exceptions.

h. The need to document or support a conclusion not readily apparent from the documentation of the work performed or evidence gathered.

AU-C 230 also provides certain specific audit documentation requirements as follows:

a. *Departures from the Requirements in the Auditing Standards.* In the rare instances in which an auditor deems it necessary to depart from a presumptively mandatory requirement of the auditing standards, documentation *must* be made of the justification for the departure and how alternative procedures performed were sufficient to achieve the objectives of the requirement (AU-C 230.13). This requirement is mandatory *unless* the related presumptively mandatory requirement is—

- Not relevant, for example, if the requirement relates to service organizations and the client does not use a service organization.

- Conditional, for example, if the requirement is to document the expectation if not readily determinable when performing substantive analytical procedures and the expectation is readily determinable.

b. *Abstracts or Copies of the Client's Records.* The workpapers should include copies of the client's records and abstracts or copies of significant contracts or agreements examined, if they are needed to allow an experienced auditor to understand the work performed and conclusions reached. (AU-C 230.10)

c. *Identification of Items Tested.* Documentation of procedures performed should identify the items tested. (AU-C 230.09)

d. *Individuals Performing and Reviewing the Work and Associated Dates.* When documenting the audit procedures performed, auditors should record who performed the work, the date of completion, who reviewed specific documentation, and the date and extent of the review. (AU-C 230.09)

e. *Significant Findings or Issues.* Auditors are required to document information related to significant audit findings or issues. (AU-C 230.11–.12)

f. *Revisions after the Date of the Auditor's Report.* Auditors are required to document certain items if revisions to the workpapers are necessary after the date of the auditor's report. Revisions may be attributable to:

- Omitted procedures that would have been considered necessary at the time of the audit. (AU-C 230.14)
- Subsequent discovery of facts that existed at the date of the report. (AU-C 230.14)
- Other reasons an auditor considers it necessary to make an addition or change to the workpapers after the documentation completion date. (AU-C 230.18)

g. *Report Release Date.* The report release date should be recorded in the audit documentation. (AU-C 230.15)

Documenting Specific Items Tested and Other Procedures. Audit documentation of the procedures performed should include identifying characteristics of the specific items that were tested. This requirement includes tests of the operating effectiveness of controls, substantive tests of details involving inspection of documents or confirmation, and inquiry and observation procedures. For inspection of documents and confirmation procedures, the authors believe items tested can be identified by listing the items; by including a detail schedule in the workpapers, such as an aged trial balance, on which the items are identified; or by documenting in the workpapers the source and selection criteria. For example:

- For tests of significant items, documentation may describe the auditor's scope and the source of the items (for example, all disbursements greater than $5,000 from the repairs and maintenance expense detail).
- For haphazard or random samples, documentation may identify the items by their dates and specific invoice numbers, check numbers, employee numbers, etc.
- For systematic samples, documentation may indicate the source, starting point, and sampling interval (for example, a selection of checks from the cash disbursements journal for the period 1/1/X2 to 12/31/X2, starting with check number 2150 and selecting every 100th check thereafter).

For inquiry and observation procedures, the identifying characteristics may be recorded as follows:

- For inquiries, document the dates of the inquiries, the names and job functions of client personnel queried, and the inquiry that was made.
- For observations, document the matter observed, the individuals involved and their responsibilities, and where and when the observation took place.

When analytical procedures have been performed, AU 520.08 states that the auditor should document (a) the expectation and the factors considered in its development (unless readily determinable from the work performed), (b) the results of the comparison between the expectation and recorded amounts, and (c) any additional proce-

dures performed to address unexplained differences and the results of those procedures. 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.

Documenting the Identification of Preparer and Reviewer. Auditors should record who performed the audit procedures and when such work was completed. (AU-C 230.09) In most situations, this is a simple process; normally the individual who performs the procedure initials and dates the specific workpaper, checklist, or program step that specifies the work performed.

AU-C 230.09 also requires documentation of who reviewed *specific* audit documentation and the *date* of the review. AU-C 230 does not indicate the manner or form of recording the evidence of these "who and when" components of the review. However, reviewers are *not* required to evidence their review on each working paper. For detailed reviewers, a practical and efficient way of indicating who reviewed the audit work and when is for the reviewer to initial and date the specific workpapers reviewed. However, auditors may adopt other documentation methods to evidence this review as long as it is clear who reviewed specified elements of the work and when the review occurred. Some auditors, especially those performing the partner level review, may prefer documenting the evidence of their review in a memo that indicates the workpaper sections reviewed and the date(s) of their review. Checklists such as those provided in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* may also be used.

Documenting Significant Findings or Issues. On some CIRA audits, the engagement team may be faced with difficult issues that need significant professional judgment to resolve. Examples of significant audit findings or issues include the following:

- Significant matters involving the appropriate selection, application, and consistency of accounting principles, such as:
  - The reasonableness of significant accounting estimates and underlying assumptions.
  - The likelihood of significant contingencies occurring.
  - Complex or unusual transactions and the application of GAAP to those transactions.
- Results of procedures that indicate the financial statements or disclosures could be materially misstated.
- Results of procedures that indicate a need to revise prior assessments of the risks of material misstatement and the auditor's responses to such risks.
- Circumstances that cause significant difficulty in applying procedures considered necessary.
- Other findings that could result in modification of the auditor's report.
- Audit adjustments identified by the auditor, whether or not recorded by the client, that could, either individually or when aggregated with others, have a material effect on the financial statements.

AU-C 230.08 requires auditors to document significant audit findings or issues such as those outlined in the previous paragraph, actions taken and evidence obtained in addressing them, and the significant professional judgments made in reaching conclusions. According to AU-C 230.A12, examples of situations when it is appropriate to prepare audit documentation related to the exercise of professional judgment when the findings, issues, and judgments are significant include the following:

- The basis for the auditor's conclusion when auditing standards require the auditor to consider certain information or factors, and the consideration is significant to the engagement.
- The basis for the auditor's conclusions on the reasonableness of subjective judgments (for example, significant accounting estimates).

- The basis for the auditor's revision of assessed risks of material misstatement (i.e., inherent and/or control risk).

- The basis for the auditor's conclusion about the authenticity of a document when conditions identified during the audit caused the auditor to believe that the document might not be authentic.

Discussions of significant findings or issues that occur between the auditor and management should also be documented in a timely manner, including the items discussed and when and with whom they were discussed. In addition, the auditor should document similar information regarding any discussions of significant findings or issues with internal or external parties other than management, including those charged with governance (such as board or audit committee members, if applicable); lower level employees; record keepers; or other third-party service providers. Auditors also are required to record any discussions of such matters with parties outside of the audit firm or the engagement team. Minutes of meetings attended by the auditor at which these matters were discussed can satisfy this documentation requirement.

Auditors should also document how they addressed information that was contradictory or inconsistent with their final conclusion on a significant finding or issue. Such documentation might include the auditor's procedures to address the information or consultations regarding, or resolutions of, differences in professional judgment among engagement team members or between the team and others consulted.

The matters discussed above can be documented in a memorandum. The authors recommend that such a memorandum begin with a description of the facts giving rise to the issue, followed with a discussion of the factors considered and evidence gathered in formulating the conclusion. The auditor's conclusion needs to be clearly stated, along with the auditor's reasoning process supporting the conclusion. Other items that should be documented include any discussions as noted above, the existence of conflicting evidence or guidance supporting contrary points of view, and any consultation that occurred in resolving the issue.

Assembling, Completing, and Making Changes to Audit Documentation. Timely completion of audit documentation is critical to assure audit quality. As a practical matter, the auditor needs to strive to prepare audit documentation as the audit progresses to avoid inadvertently omitting critical information or incorrectly recording aspects of the procedures that were completed or the evidence obtained. When concluding the audit, the auditor needs to ensure that the documentation meets the objective discussed earlier beginning at the "Audit Documentation (Workpapers)" paragraph. Professional standards also include requirements for (a) assembling and completing the workpapers at the conclusion of the audit and (b) making revisions to the documentation after the date of the auditor's report. These requirements are centered on the following key dates:

- The audit report date.

- The report release date.

- The documentation completion date.

Those dates, as well as the requirements for assembling and completing the audit file and making changes to the workpapers, are discussed in the following paragraphs.

The *audit report date* represents the date that the auditor has obtained sufficient appropriate audit evidence to support the auditor's opinion on the financial statements. Typically, such evidence includes evidence that (AU-C 700.41):

- The audit work has been reviewed.

- The financial statements, including disclosures, have been prepared.

- Management has taken responsibility for the financial statements.

This means that the auditor's report should be dated using a date that signifies the completion of workpaper review, the preparation of the financial statements, and the receipt of management's representation that it is responsible for

the financial statements (ordinarily in the management representation letter). The auditor cannot simply use the date that the audit team left the field unless the requirements of this paragraph have been satisfied at that date.

AU-C 220.19 requires that by the date of the audit report, the engagement partner be satisfied that sufficient appropriate evidence has been obtained to support audit conclusions and the audit report to be issued, by discussion with the engagement team and a review of audit documentation. The authors believe that it is implicit in this requirement that detailed and supervisory reviews need to be completed before the engagement partner's review. AU-C 220.A15 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.

According to AU-C 580.A27, the auditor does not need to be in receipt of the management representation letter on the date of the auditor's report, but needs to have the signed letter in hand prior to releasing the auditor's report. At the date of the report, management has to have reviewed the final representation letter and, at a minimum, orally confirmed that they will sign it without exception on or before the date of the representations. An in-depth discussion of management representation letters 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 *report release date* is the date that the auditor gives the client permission to use the auditor's report in connection with the financial statements. For most CIRA audits, this will be the date the auditor delivers the report to the client. AU-C 230.15 requires the auditor to document the report release date in the workpapers. In most cases, the report release date will be close to the date of the auditor's report. If there is a delay in releasing the report of more than two weeks after the report date, the authors recommend extending the subsequent events review to the later date and redating the report. (That matter may be covered in the firm's quality control policies and procedures.)

QC 10.49 states that firms "should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been released." Those policies and procedures need to comply with any time limits established by professional standards, laws, or regulations that address the assembly of final engagement files for specific types of engagements. AU-C 230.07 requires completing workpapers on a timely basis. However, the final assembly and completion of the audit file should occur within 60 days of the report release date. AU-C 230.06 refers to that date as the *documentation completion date*. After that date, the auditor should not delete or discard any documentation prior to the required five-year retention period. Auditors may adopt documentation completion periods that are shorter than 60 days, either on an engagement-by-engagement basis, or as part of the firm's system of quality control. In addition, the auditor needs to consider whether there are regulatory or state requirements that require a shorter documentation completion period.

AU-C 230.A26 indicates that at any time prior to the documentation completion date, the auditor is permitted to make changes to the workpapers that are administrative in nature, such as to:

- Finalize the documentation and assemble the evidence that was obtained, discussed, and agreed among the engagement team prior to the date of the auditor's report, including discarding to-do lists and superseded drafts, correcting typographical errors, and changing notes that reflect incomplete or preliminary thinking.
- Insert information that was received after the date of the auditor's report such as replacing faxed copies of confirmations with originals.
- Perform routine file assembly procedures that might include sorting, cross-referencing, collating, and deleting or discarding superseded documentation.
- Sign off on file completion checklists prior to completing and archiving the workpapers.

The examples provided in this paragraph emphasize that changes to the workpapers after the date of the auditor's report and prior to the documentation completion date constitute those that are part of the "wrap-up" or workpaper filing process. Making changes after the report date that affect the documentation of the work performed, the evidence obtained, the conclusions reached, or the review that was conducted prior to that date would not comply with the requirements for dating the auditor's report.

AU-C 230.14 provides requirements for audit documentation when the auditor determines that it is necessary to make additions or other changes to the audit workpapers after the date of the auditor's report other than those activities noted in the previous paragraph. Such changes may relate to the following:

a. *Omitted Procedures That Would Have Been Considered Necessary at the Time of the Audit.* In such cases, auditors should follow the guidance provided by AU-C 585, *Consideration of Omitted Procedures After the Report Release Date*.

b. *Subsequent Discovery of Facts That Existed at the Date of the Report.* If the auditor subsequently becomes aware of information that existed at the date of the report but was not previously known to the auditor, the provisions of AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, should be followed.

For changes such as those noted above, the auditor should make changes to the audit documentation to record:

- When and by whom the changes were made and reviewed.
- The specific reasons for making the changes.
- The procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report.

The auditor needs to also consider whether there are regulatory or state requirements that differ from GAAS.

There might be other reasons an auditor considers it necessary to make an addition or change to the workpapers after the documentation completion date. AU-C 230.A28 notes that an example would be the need to clarify existing audit documentation arising from comments received during monitoring inspections. If the auditor deems that additions or amendments are necessary for a particular reason, the authors believe that the auditor should carefully consider the affect on the conclusions previously reached at the date of the auditor's report and the opinion expressed in the report. According to AU-C 230.18, in those situations, the auditor should document—

- The specific reasons for the change.
- When and by whom the changes were made and reviewed.

Audit Documentation Recommendations. There are a number of practical workpaper documentation techniques that the authors recommend auditors follow, including the following:

- Always identify the individuals who performed and reviewed the audit work and the dates completed and reviewed.
- Clearly describe the purpose of the workpaper and the nature of the audit steps performed. For example, state "Examined vendor's invoice, purchase order, and receiving report to determine that item is a proper charge to repairs and maintenance," rather than simply "Vouched."
- Identify client prepared schedules, including, if applicable, the title of the report, the period covered, and the date prepared.
- Initial and cross-reference from the audit program to the documentation supporting the completion of the related program step.
- Document the resolution of all significant questions and issues raised during the audit, including discussions with management and others.
- When incoming or outgoing emails need to be preserved for engagement support, they ought to be transferred to the firm's electronic document management system so they can be labeled and indexed. The copy in the email system should then be deleted.

Considerations for Small CIRA Audits. The audit documentation for the audit of a smaller, less complex CIRA is generally less extensive than the documentation for the audit of a larger, more complex CIRA. In some cases, it may be efficient for the auditor of a smaller, less complex CIRA to record various aspects of the audit together in a single document or memorandum, with cross-references to supporting working papers as appropriate. For example, the understanding of the entity and its internal control, engagement team discussion, inquiries of management and others about fraud risks, performance of preliminary analytical procedures, overall audit strategy, materiality, identified risks, and the auditor's risk assessments may all be documented together in a single narrative.

In addition, for small firms, the engagement partner may perform all of the audit work. In that case, the documentation will not include certain matters related to communications with or among the engagement team or review of the workpapers by anyone other than the partner. Nevertheless, the engagement partner needs to comply with the requirement to prepare audit documentation that can be understood by an experienced auditor with no previous connection to the audit because the audit documentation may be subject to review by external parties for regulatory or other reasons.

In addition, in a small CIRA engagement, workpapers usually serve other purposes besides those explained in the preceding paragraphs. In particular, workpapers are often used as a basis to assist in drafting the financial statements, prepare tax returns, and draft other reports. For that reason, workpapers in a small CIRA engagement may contain more information than would otherwise be required to conform with professional standards. Since workpapers serve as a source of information, there may be more detailed schedules in support of specific financial statement components.

Workpaper Indexing. In practice, workpaper files normally fall into three categories (a) the general or administrative file, (b) the work or account balance file, and (c) the permanent file. There is a great deal of flexibility and individuality in the contents of files and the way they are indexed and cross-referenced. The most important consideration is to use some type of well-organized, but simple, system that can be uniformly adopted on all engagements. One simple scheme is to use one folder or binder for general file items, for example, the audit planning form, planning materiality worksheet, etc., with the individual items indexed alphabetically, and a series of binders or folders for the work file. The material for each audit program area can be indexed numerically with a prefix to indicate it is a work file; for example, receivables would be WF-1, and the workpapers within that file would be WF-1-1, WF-1-2, etc. Many auditors assign an alphabetic code to each account balance or audit program area, for example, A for cash, B for receivables, etc., and numerically index supporting schedules within each alpha code, for example, A-1, A-2, B-1, B-2, etc. These are just two possible approaches to workpaper indexing, but the authors encourage adoption of a simple indexing approach.

SPECIAL PLANNING CONSIDERATIONS IN INITIAL ENGAGEMENTS

Lesson 1 explains communicating with a predecessor auditor in an initial engagement concerning management integrity or disagreements with management on significant accounting or auditing matters. Other parts of this course explain risk assessment procedures and the development of audit plans for an initial or a continuing engagement. While out of the scope of this course, *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* discusses efficient and effective approaches to common audit areas that generally apply in a continuing CIRA audit engagement. In an initial engagement, additional procedures are necessary in most of those areas. This section focuses on the audit procedures in the initial audit of a CIRA that need to be added to the core procedures and explains the considerations involved in the selection of additional procedures in a variety of circumstances that may exist in an initial CIRA engagement. (The Initial Audit Programs (IA) may be used to assist in performing initial audit procedures.) This section also addresses the responsibilities of predecessor auditors in connection with the reissuance of their report in comparative financial statements. *PPC's Guide to Audits of Nonpublic Companies* includes more detailed guidance on initial audits.

The auditor's additional procedures in an initial engagement usually fall into one or more of the following categories:

a. To obtain preliminary knowledge of the client, its business, its operating characteristics, and its internal control, particularly its control environment and financial reporting system.

b. To assess the reasonableness of the opening balances of significant balance sheet accounts.

c. To obtain reasonable assurance of the accounting principles and their method of application in the prior year.

The auditor should always read the most recent financial statements and the predecessor auditor's report, if any, for information about opening balances, including disclosures, and about the consistency of application of accounting policies.

Preliminary Knowledge of Client

Pre-engagement activities and the risk assessment procedures necessary to obtain an understanding of the client and its environment are usually more extensive and time-consuming in an initial engagement. More knowledge must be obtained and documented in areas such as (1) acceptance/continuance, (2) understanding the entity and identifying risks, (3) understanding the design and implementation of internal control, and (4) documenting the financial reporting system.

Practice aids, audit programs, and other such tools may be helpful for obtaining this type of preliminary knowledge of a new client. *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations* includes such job aids, if they are so desired.

Reasonableness of Opening Balances

In an initial engagement, the auditor's objective is to obtain sufficient evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. Normally, in most engagements, there is no need for the auditor to express an opinion on the opening balances. Accordingly, the audit procedures applied to opening balances are usually more limited than the procedures applied to the closing balances of the current period.

Nature of Opening Balances. The auditor focuses on the opening balances that affect the current period's ending balances or that affect results of operations for the current period. The extent of additional procedures applied to the opening balance depends on the extent to which items in the opening balance are also in the closing balance and on the audit approach to the ending balance. This is especially true when the prior period financial statements were not audited or the auditor will not use information from the review of the predecessor's audit documentation as evidence. Generally, the account balances that the auditor is concerned with will fall into one of the following categories:

a. All, or a substantial portion, of the ending balance is accounted for by the opening balance, and the audit approach in a continuing engagement is to focus on the items that increase or decrease the opening balance to substantiate the ending balance (e.g., property and equipment).

b. All, or a substantial portion, of the ending balance is accounted for by the opening balance, and the audit approach in a continuing engagement is to substantiate directly all or most of the items in the ending balance (e.g., investments in marketable securities, notes receivable, and notes payable).

c. The account balance turns over at least once each accounting period, and none of the items in the opening balance are normally included in the ending balance (e.g., cash, receivables, and accounts payable).

Naturally, the auditor's additional procedures are most extensive for the first category and, if the auditor uses information from the review of the predecessor auditor's workpapers as evidence, the use of that information as evidence is normally considerable. The auditor's procedures are generally the least extensive for the second category because the audit procedures applied to the ending balance also support the opening balance. For the last category, the auditor's primary concern is the effect of misstatement of the opening balance on the current period's operating results.

Generally, the decision to use information from a review of the predecessor's workpapers is made by audit area (e.g., the auditor may decide to use information from a review of the predecessor's workpapers extensively in the receivables area, but not at all in the notes payable area).

Avoid Overauditing. One of the greatest sources of inefficiency in an initial engagement is a more extensive review of a predecessor's workpapers than is necessary to achieve the auditor's objectives. Simply because there are workpapers that can be reviewed, the auditor might do more work in an area than would be done if no reliance on a predecessor were possible.

Misstatements in Opening Balances. If the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor should perform additional procedures to determine the effect of the misstatements on the current period's financial statements. If the auditor determines that the current period's financial statements are materially misstated, the auditor should communicate the misstatements to the appropriate level of management and those charged with governance. If the prior period financial statements were audited, the auditor should ask management to inform the predecessor auditor and arrange for all three parties to discuss and attempt to resolve the matter. If management refuses to inform the predecessor that the prior period financial statements may require revision, or if not satisfied with the resolution of the matter, the auditor should evaluate the implications for the current audit and whether to withdraw from the engagement or disclaim an opinion. The auditor may need to seek legal advice when making that evaluation. The successor should also communicate information to the predecessor that the predecessor may need to consider to meet its responsibilities for subsequently discovered facts.

Consistency. The suggested additional audit procedures for an initial engagement include procedures designed to identify the accounting principles and methods of application followed in the prior period to permit the auditor to evaluate whether there has been a change in accounting principles. Usually, there is no problem in identifying significant accounting principles (e.g., depreciation methods). However, the auditor also is concerned with the methods of application (e.g., nature of expenditures recorded in the repair and replacement fund). Also, the auditor is concerned with the year-end closing routines followed at the end of the prior and current periods because of the effect on current operating results (e.g, the dates and methods of establishing cutoffs). If accounting policies changed in the current period, the auditor should determine that the changes are properly accounted for and adequately presented and disclosed in the financial statements.

Audit of a Previously Unaudited CIRA

Previous Accounting Services. A client may have obtained compiled or reviewed financial statements in prior periods. The accounting services may have been provided by the auditor's own firm or by another CPA firm. An auditor is not required to communicate with a predecessor accountant who provided accounting services before accepting an audit engagement. However, it is usually worthwhile to communicate with a predecessor accountant and obtain copies of detailed schedules for account balances.

The additional audit procedures that should be applied to opening balances are not reduced when there are previous accounting services. The same additional procedures for an initial engagement are appropriate when information from a review of the predecessor's audit documentation will not be used as audit evidence for opening balances and consistency. However, considerable time may be saved when detailed schedules are available.

No Previous Accounting or Auditing Services. Generally, the most time-consuming and difficult initial audit engagement is for an existing CIRA with no previous accounting or auditing services. The additional audit procedures that should be applied to opening balances are the same procedures for circumstances when information from a review of the predecessor's audit documentation will not be used as audit evidence for opening balances and consistency. However, there is an increased likelihood that the condition of the accounting records will not permit the application of necessary procedures.

In an initial engagement, the auditor's primary concern with significant current asset balance sheet accounts is the effect on current operating results. Unless the auditor can determine the reasonableness of the opening balances in these accounts, it will usually be necessary to disclaim an opinion on results of operations, cash flows, and consistency. Even though the auditor does not express an opinion on consistency, the inability to evaluate whether there has been an accounting change is also a scope limitation. Inventory is likely to present the greatest difficulty, but similar problems may arise with receivables and accounts payable. Even when a scope limitation will preclude expression of an unmodified opinion, the auditor does not ignore opening balances of current asset accounts as it may be possible to identify and correct a material distortion of operating results.

A New CIRA. The initial audit of a new CIRA does not usually have the difficulties associated with other initial engagements. Generally, the additional audit procedures for an initial engagement do not apply because those procedures are directed to opening balances. Nevertheless, some modifications of the procedures for a continuing engagement may be necessary. More attention is focused on equity accounts and the transactions involved in the creation of the CIRA. Also, long-term assets, such as property, require more attention in this type of engagement because more detailed work is necessary to establish ownership of common property and to initially create the detailed property records.

Replacing a Predecessor Auditor

AU-C 510 defines the term *predecessor auditor* as an auditor from a different firm who reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of the financial statements. That may include an auditor who was engaged to perform an initial audit but did not complete the audit. It may also include an auditor who was engaged subsequent to the most recent audited financial statements (that is, a successor auditor) who did not complete the audit. In the latter case, there may be two predecessor auditors—the auditor who reported on the most recent audited financial statements and the successor auditor who did not complete the audit. The communication required by AU-C 300.13 about management integrity and other matters should be made of all predecessor auditors. However, when a predecessor did not complete the audit, the successor is generally unable to use information from a review of the predecessor's audit documentation as audit evidence for opening balances or consistency. In addition, a predecessor who did not complete the audit may be unwilling to cooperate with the successor. The successor's primary concern in that situation should be determining the reason the audit could not be completed.

AU-C 510.07 requires the successor auditor to request management to authorize the predecessor auditor to allow a review of the predecessor's workpapers and to fully respond to the successor's inquiries. Generally, it is more efficient to make this request at the same time permission is requested concerning the inquiries to be made before acceptance.

The successor's review of the predecessor's workpapers has two aspects. The first is an overall review of the predecessor's workpapers, which provides information about the predecessor's professional competence by demonstrating an adequate understanding and application of auditing and other relevant professional standards and that the firm possessed the special skills (for example, industry-specific knowledge or knowledge of relevant financial reporting and accounting requirements) that were necessary to perform the audit. During the overall review of the predecessor's workpapers, the auditor needs to give particular attention to matters that would identify potential problem areas in the audit. In particular circumstances, some or all of the following procedures might be useful:

a. Read the predecessor's planning memo and other planning workpapers. (This may assist in identifying risks, significant audit areas, and the nature of the predecessor's procedures in those areas.)

b. Read the predecessor's management letter or communication of internal control related matters, and client and attorney representation letters. (This helps to assess the condition of the financial reporting system and to identify control deficiencies and unusual accounting or auditing risks.)

c. Scan the workpaper summary of adjusting journal entries. (This provides an indication of the client's expectations on accounting assistance and helps to identify potential risks that may result in time-consuming areas.)

d. Scan the summary and evaluation workpaper that accumulates uncorrected misstatements. (This helps to identify risk areas and identifies possible uncorrected misstatements in opening balances.)

e. Read the predecessor's engagement summary memo (if available). (This may identify potential risk areas of the engagement and how the predecessor addressed those risk areas.)

f. Scan the time budget—planned and actual. (This helps to identify areas that required more than the anticipated time and can identify risk areas.)

A predecessor may be sensitive about permitting review of the engagement summary memo and the planned and actual time budget. In that case, the auditor may merely inquire about areas that caused difficulty or problems.

If the overall review of the predecessor's workpapers indicates that the successor may be able to use information in the predecessor's audit documentation as audit evidence, the successor generally reviews the workpapers for specific asset and liability accounts and items from the permanent files such as contracts, carryforward schedules, and other workpapers in important audit areas. The amount of audit evidence to be obtained by the successor auditor relating to opening balances and consistency in application of accounting policies is a matter of professional judgment.

The predecessor's workpapers alone do not constitute sufficient evidence. The successor auditor's review of the predecessor auditor's workpapers may affect the nature, timing, and extent of the successor auditor's work relating to the opening balances and consistency; however, the audit work performed and the conclusions reached are solely the responsibility of the successor auditor. Generally, an auditor's own procedures on opening balances will include scanning, following up on unusual items, and evaluating whether the results of the audit tests in the current year indicate problems with opening balances.

When comparative financial statements are presented, the two following reporting options concerning the prior year's statements are acceptable:

a. The predecessor may reissue the report on the prior year's statements, or

b. The successor may refer to the predecessor's report in the successor's report or the current period financial statements.

Before reissuing the report on the on the prior period financial statements, AU-C 560.19 indicates that a predecessor auditor should (a) read the financial statements of the current period, (b) compare the prior-period financial statements the predecessor reported on with the financial statements to be presented for comparative purposes, and (c) obtain representation letters from management of the former client and from the successor auditor. The purpose of the representation letter from the successor is to determine whether the successor's audit revealed any matters that might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor. The representation letter from management addresses whether any prior management representations made have changed and whether any subsequent events have occurred which affect the prior period financial statements. If a subsequently discovered fact becomes known, the predecessor should apply procedures for subsequent discovery of facts after the report release date. Generally, it is simpler and less costly for the client for the successor to refer to the predecessor's report.

Audits of Financial Statements Previously Audited (Reaudits)

Occasionally, an auditor may be asked to audit and report on a CIRA's financial statements for a period that was previously audited and reported on by a predecessor auditor (a reaudit). This differs from the situation discussed previously in which the auditor is reporting on the financial statements for a period subsequent to the period audited and reported on by the predecessor auditor. The following paragraphs discuss issues when an auditor is performing a reaudit.

The following questions have arisen in practice about the responsibilities of the successor and predecessor auditor in a reaudit situation:

- What communications are required between the successor and predecessor auditors?
- How much reliance can be placed on the work of the predecessor auditor by the successor auditor?
- What is the impact on the successor auditor's report?

Communications with the Predecessor Auditor. As previously discussed, the successor auditor is required to ask management to authorize the predecessor to allow a review of the predecessor's workpapers and to respond fully to the successor's inquiries regarding matters that will assist in the engagement acceptance decision. If

management refuses, or limits the predecessor's response, the auditor should inquire about the reasons and consider their implications when deciding whether to accept the engagement. These communications should also be made when engaged to audit and report on financial statements previously audited and reported on by a predecessor auditor. When making the inquiries about the predecessor's understanding for the reasons for the change in auditors, the successor auditor should clearly communicate that the purpose of the communications is to obtain information about whether to accept an engagement to report on financial statements previously audited and reported on by the predecessor auditor.

When the auditor has been engaged to audit and report on financial statements for a period previously audited by a predecessor auditor, the successor would normally request access to and review the predecessor's workpapers for the period under audit (the reaudit period) and the period prior to the reaudit period. After accepting a new engagement, the successor auditor usually requests access to the predecessor's workpapers for the prior period to plan the audit, obtain evidence about beginning balances, and evaluate the consistency in application of accounting policies. In a reaudit situation, the auditor reviews the workpapers for the period to be reaudited for purposes of obtaining information to be used in planning the reaudit.

Using the Work of the Predecessor. When performing a reaudit, the successor auditor reviews the predecessor's workpapers for the reaudit period and the period prior to the reaudit period. However, the purpose of the successor's review of the predecessor's workpapers for the reaudit period cannot be to use the predecessor's workpapers as evidence. Instead, the purpose for reviewing the workpapers for the reaudit period is to obtain information that might be useful in planning the reaudit. Because the successor auditor has been engaged to perform a reaudit, the audit work performed and the conclusions reached are the responsibility of the successor auditor. If the successor relies on the predecessor's workpapers to support the successor's opinion, the successor has not obtained sufficient evidence for expressing an opinion. In addition, the work and report of the predecessor auditor cannot be treated as that of a specialist or as the work of an internal auditor.

In other words, the successor auditor should perform the procedures considered necessary to report on the financial statements as if they had not been audited by the predecessor auditor. For example, the successor auditor cannot use the confirmation procedures documented in the predecessor's workpapers as evidence to support the existence of investments. Additional procedures, such as sending additional confirmations, need to be performed by the successor auditor. The authors believe, however, that the review of the predecessor's workpapers may provide information that can be used as part of the auditor's risk assessment procedures relating to the reaudit period. The authors caution that such information would normally only supplement the auditor's risk assessment procedures performed for the reaudit period.

For purposes of substantiating the beginning balances of the reaudit period and evaluating the consistency in application of accounting principles, the successor may use information from the review of the predecessor's workpapers for the period prior to the reaudit period. The guidance provided earlier beginning at the "Replacing a Predecessor Auditor" paragraph would apply to the review of the workpapers for the period prior to the reaudit period.

Effect on the Successor's Audit Report. When an auditor is reporting on financial statements that have been previously audited and reported on by a predecessor auditor, the successor auditor cannot assume responsibility for the work of the predecessor or make reference to the report of the predecessor auditor. However, if the financial statements of the reaudit period and the period *prior to* the reaudit period (which were not reaudited by the successor auditor) are presented, the guidance provided earlier in relation to a presentation of comparative financial statements would apply. Additional guidance on reporting in these circumstances may be found in *PPC's Guide to Auditor's Reports*.

Providing Access to Workpapers in a Reaudit Situation. When the predecessor auditor is requested to provide access to workpapers in a reaudit situation, it is generally considered a professional courtesy to provide that access. However, there may be circumstances in which the request will not be accommodated. Valid business reasons may lead the predecessor auditor to decide not to allow a review of the predecessor's working papers. One solution may be for the predecessor to provide access only to workpapers for the period *prior* to the reaudit period. Another may be for the predecessor to obtain written confirmation from the successor that the successor

accepts sole responsibility for the nature, timing, and extent of audit work performed and conclusions reached as a basis for the successor's report on the reaudited periods.

Unique Considerations for CIRA Engagements. The following considerations may be needed when performing a CIRA engagement:

- Initial Audits—Transfer of CIRA Control to Property Owners.
- Initial Audits with a Predecessor Auditor.
- Management Company Transition Audit.
- Special Audits or Attest Engagements.

SELF-STUDY QUIZ

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

21. Audit sampling would be best used for which of the following?

    a. Testing automated application controls with effective IT general controls.

    b. Analyzing the effectiveness of the entity's security and access controls.

    c. Evaluating whether the audit committee is appropriately involved in financial reporting.

    d. Testing a control that is applied on a transaction basis.

22. What is the main purpose of an auditor's workpapers?

    a. Providing the principle evidence for the auditor's report.

    b. Aiding in the planning and performance of future engagements.

    c. Assisting in the firm's quality control reviews.

    d. Providing a record that can be used for issues that will continue in future audits.

23. Which of the following is a best practice concerning workpapers?

    a. Keep confidential who performed and reviewed the work.

    b. Make a note of any significant issues that were not resolved.

    c. Keep information about the audit steps brief to save space.

    d. Identify client prepared schedules.

24. Which of the following is a predecessor auditor required to do before reissuing his or her report on the prior-period financial statements?

    a. Reread the financial statements from the prior period.

    b. Compare the prior-year and current-year financial statements.

    c. Obtain a representation letter from those charged with governance of the client and any third-party users of the financial statements.

    d. List any facts that were subsequently discovered for the successor auditor's attention.

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.)**

21. Audit sampling would be best used for which of the following? **(Page 109)**

    a. Testing automated application controls with effective IT general controls. [This answer is incorrect. When effective IT general controls are present, audit sampling concepts may *not* apply to tests of automated application controls.]

    b. Analyzing the effectiveness of the entity's security and access controls. [This answer is incorrect. This type of tests of controls is one in which audit sampling concepts are *less* likely to apply.]

    c. Evaluating whether the audit committee is appropriately involved in financial reporting. [This answer is incorrect. Examining the effectiveness of those charged with governance for assessing their effectiveness, such as described here in relation to the audit committee, is one area in which the concepts of audit sampling may *not* apply.]

    d. Testing a control that is applied on a transaction basis. [This answer is correct. Generally, the use of audit sampling for test of controls will be efficient and effective when (1) the control is applied on a transaction basis, for example, matching approved purchase orders to supplier invoices, and (2) the control operates frequently and the population is relatively large.]

22. What is the main purpose of an auditor's workpapers? **(Page 115)**

    a. Providing the principle evidence for the auditor's report. [This answer is correct. The main purpose of workpapers, as identified in AU-C 230.02, is to provide the principal evidence for the auditor's report that includes (1) the representation that the audit was planned and performed in accordance with generally accepted auditing standards and (2) the opinion expressed (or disclaimed) on the financial statements.]

    b. Aiding in the planning and performance of future engagements. [This answer is incorrect. This is an additional purpose of workpapers, but not the primary purpose described in AU-C 230.]

    c. Assisting in the firm's quality control reviews. [This answer is incorrect. While workpapers can assist in the conduct of quality control reviews and inspections, this is ancillary to the main purpose outlined in AU-C 230.]

    d. Providing a record that can be used for issues that will continue in future audits. [This answer is incorrect. This is not the main purpose of workpapers discussed in AU-C 230; however, it is an additional purpose that workpapers may sometimes be used for.]

23. Which of the following is a best practice concerning workpapers? **(Page 121)**

    a. Keep confidential who performed and reviewed the work. [This answer is incorrect. It is a best practice to always identify the individuals who performed and reviewed the audit work and the dates completed and reviewed.]

    b. Make a note of any significant issues that were not resolved. [This answer is incorrect. It is a best practice to document the resolution of *all* significant questions and issues raised during the audit, including discussions with management and others.]

c. Keep information about the audit steps brief to save space. [This answer is incorrect. It is a best practice to clearly describe the purpose of the workpapers and the nature of the audit steps performed. For example, state "Examined vendor's invoice, purchase order, and receiving report to determine that item is a proper charge to repairs and maintenance," rather than simply "Vouched."]

d. Identify client prepared schedules. [This answer is correct. When preparing workpapers, it is a best practice to identify client prepared schedules, including, if applicable, the title of the report, the period covered, and the date prepared.]

24. Which of the following is a predecessor auditor required to do before reissuing his or her report on the prior-period financial statements? **(Page 126)**

a. Reread the financial statements from the prior period. [This answer is incorrect. According to AU-C 560.19, the predecessor auditor must read the financial statements of the *current* period before reissuing the report.]

b. Compare the prior-year and current-year financial statements. [This answer is correct. As discussed in AU-C 560.19, among other things, before reissuing the report, a predecessor auditor must compare the prior-period financial statements the predecessor reported on with the financial statements to be presented for comparative purposes.]

c. Obtain a representation letter from those charged with governance of the client and any third-party users of the financial statements. [This answer is incorrect. Per AU-C 560.19, one of the things that a predecessor auditor must do before reissuing the report is to obtain representation letters from management of the former client and from the successor auditor. Representations from others are not needed.]

d. List any facts that were subsequently discovered for the successor auditor's attention. [This answer is incorrect. Before reissuing the report, AU-C 560.19 requires that the predecessor himself (or herself) apply procedures for subsequent discovery of facts after the report release date on any subsequently discovered facts that have become known.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 1—Pre-engagement Activities and Audit Planning (HOATG181)

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.tr.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 $95 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 ($95 for email or fax; $105 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*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     HOATG181 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 ($95 for answer sheets sent by email or fax; $105 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 $271 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $342 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $404 (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, 2019**. CPE credit will be given for examination scores of 70% or higher.

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EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 1—Pre-engagement Activities and Audit Planning (HOATG181)

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 factors helps determine whether a potential audit client's financial reporting framework is acceptable?

    a. The amount of profit earned by the entity.

    b. The purpose of the financial statements.

    c. Management's opinion of the framework's acceptability.

    d. Whether the client has related-party transactions.

2. When performing acceptance and continuance procedures, an auditor's consideration of risk will be which of the following?

    a. A high-level consideration.

    b. Focused on individual financial transactions.

    c. Performed later in the process.

    d. Separate from the consideration of reporting deadlines.

3. What often determines the level of service needed for a CIRA engagement?

    a. State statutes.

    b. Federal law.

    c. Management.

    d. The auditor.

4. What do the quality controls standards require when audit firms examine the integrity of a potential client's management?

    a. An in-depth investigation with lengthy documentation.

    b. A surface-level investigation focusing on specific areas.

    c. Written communications with various individuals.

    d. Communication with the predecessor auditor.

5. Which of the following is the best method for establishing the terms of an audit engagement?

    a. A phone call with the client.

    b. A face-to-face meeting with the client.

    c. An engagement letter.

    d. Documentation in audit workpapers.

6. Which of the following CIRA audit clients has a sufficient reason for changing the terms of its audit engagement?
   a. The Northern Association misunderstood the costs associated with the audit.
   b. The Southern Association is no longer required to have an audit.
   c. The Eastern Association would like to restrict the scope of the audit.
   d. The Western Association's auditor does not have adequate time to perform an audit.
7. A high-level approach to meeting the objectives of an audit engagement is called what?
   a. Audit planning.
   b. The audit program.
   c. An audit strategy.
   d. The risk assessment process.
8. When do auditors generally do their audit planning?
   a. In the middle of the audit engagement.
   b. After the acceptance/continuance decision is made.
   c. After inquiries, inspections, and other fieldwork has commenced.
   d. Throughout the entire audit engagement.
9. Risk assessment procedures—
   a. are typically designed as either tests of controls or substantive procedures.
   b. are focused on gathering and evaluating information about the audit client.
   c. are limited to making inquiries of management, those charged with governance, and others.
   d. provide sufficient appropriate audit evidence on their own for the auditor to express an opinion on the financial statements.
10. How important is making inquiries of management and others to the audit planning process?
    a. Not very important, so making inquiries is rarely done at this stage of the engagement.
    b. Somewhat important as it can be used in the engagement, but only if the auditor deems inquiries necessary.
    c. Important as it is critical to the engagement, but other procedures must be used, as well.
    d. Extremely important as the information can stand on its own when identifying and assessing risks.
11. Which of the following statements best describes the use of analytical procedures as part of the auditor's risk assessment procedures during audit planning?
    a. Use of analytical procedures is a best practice but not required.
    b. They provide specific, detailed information about the existence of misstatements.
    c. They are designed to point out areas that need special emphasis in the audit.
    d. They can be performed before an understanding of the entity and its environment is obtained.

12. The CPA firm of Amsler & Juarez is engaged to audit the Oceanview Homeowners' Association's annual financial statements. Janice will be the engagement partner, and two staff accountants—Ross and Caroline—will assist on the engagement. Joe, the firm's IT specialist, is assigned to the team, as well. The firm hires Bob, an external specialist, to help with the audit. The engagement team requests that Oceanview's internal auditor, Rachel, provide assistance to the team, as well. Who should be invited to the engagement team discussion?

    a. Janice, Ross, and Caroline.

    b. Janice, Ross, Caroline, and Joe.

    c. Janice, Ross, Caroline, Joe, and Bob.

    d. Janice, Ross, Caroline, Joe, Bob, and Rachel.

13. When obtaining an understanding of the entity and its environment, which of the following should be given separate and focused attention?

    a. Industry, regulatory, and other external factors.

    b. The nature of the entity.

    c. Measurement and review of its financial performance.

    d. The consideration of fraud risk factors.

14. Which of the following might cause an auditor to reassess audit risks and modify planned audit procedures in a CIRA audit (including risk assessment procedures)?

    a. A changing economic environment.

    b. Common characteristics with other CIRAs.

    c. Appropriate selection and application of accounting policies.

    d. The absence of fraud risk factors related to financial stress or dissatisfaction of employees.

15. Which of the following is typical of a CIRA's organizational structure?

    a. Having an audit committee.

    b. Using a managing agent.

    c. Having a large number of employees.

    d. Having a president instead of a governing board.

16. What is usually the best way to determine whether a CIRA has any related-party transactions?

    a. Consulting the CIRA's governing documents.

    b. Reviewing the CIRA's budget.

    c. Making inquiries of management or reviewing board minutes.

    d. Obtaining an understanding of the CIRA's business objectives and strategies.

17. The Harvest Heights Homeowners' Association is a small, relatively unsophisticated CIRA. What source would the auditor most likely consult to obtain an understanding of Harvest Heights' objectives and strategies?

    a. Consult a written strategic plan.

    b. Make inquiries of management and others.

    c. Perform observation and inspection procedures.

    d. Made educated guesses based on the financial statements.

18. How might financial performance measures affect an audit?

    a. Reducing the need for analytical procedures.

    b. Providing an understanding of the selection and application of accounting policies and estimates.

    c. Identifying possible fraud risk factors that may lead to material misstatement.

    d. Highlighting unexpected results or trends that require investigation.

19. What are the components of internal control, as outlined in COSO's *Internal Control—Integrated Framework*?

    a. Control environment, fraud assessment, information and communication, monitoring, and analytical procedures.

    b. Control environment, risk assessment, information and communication, monitoring, and control activities.

    c. Audit strategy, control environment, fraud assessment, monitoring, and control activities.

    d. Audit strategy, risk assessment, information and communication, monitoring, and analytical procedures.

20. What should the auditor's understanding of internal control allow him or her to do?

    a. Evaluate the design of controls and whether they have been implemented.

    b. Determine whether controls that were evaluated last year can be skipped this year.

    c. Identify any material misstatements in the entity's financial statements.

    d. Focus on each control independently, not as part of a group.

21. The Windward Homeowners' Association has developed spreadsheets that it uses for some of its accounting functions. This is an example of which of the following?

    a. Control activities.

    b. Information technology (IT).

    c. Ongoing monitoring activities.

    d. Risk assessment procedures.

22. Which of the following statements best describes an aspect of the risk assessment element of internal control?

    a. Risk assessment is most concerned with conditions that stay the same from year to year.

    b. It is better to identify risks later in the audit process.

    c. Auditors need to understand how management identifies and responds to relevant risks.

    d. If the auditor finds a risk that the CIRA did not, it is the CIRA's responsibility to evaluate where the process failed.

23. Which of the following will help an auditor understand the design and implementation of a CIRA's financial reporting system for a significant transaction class?

    a. Document inspections, such as a code of conduct.

    b. The engagement letter.

    c. Monitoring evaluations.

    d. Walkthroughs.

24. Which of the following CIRAs should use manual controls instead of automated controls?

    a. The Blue Association typically processes small, recurring transactions.

    b. The circumstances around the Red Association's automated controls is stable and rarely changes.

    c. The Purple Association can generally predict or anticipate where misstatements are most likely to occur.

    d. The Green Association needs to monitor the effectiveness of its automated controls.

25. Controls that address the risk of fraud usually relate to what elements of internal control?

    a. Control activities and control environment.

    b. Control activities and monitoring.

    c. Control environment and information/communication.

    d. Information/communication and monitoring.

26. The understanding of a service organization must provide auditors a basis for what?

    a. Knowing whether management is aware of any fraud or uncorrected misstatements.

    b. Describing the sources of information used and procedures performed during the audit.

    c. Identifying and assessing the risks of material misstatement.

    d. Identifying control activities related to each class of the CIRA's transactions.

27. Which of the following statements best describes an aspect of the auditor's judgments about planning materiality?

    a. The auditor's determination of materiality is affected by his or her perception of the needs of the financial statement users.

    b. The auditor needs to determine planning materiality based on qualitative evidence, not quantitative.

    c. Whether or not the client produces GAAP financial statements, the auditor needs to use FASB pronouncements as a frame of reference.

    d. The percentage applied to an appropriate benchmark cannot vary or the resulting audit evidence will be inconclusive.

28. When determining planning materiality, it is most desirable to have how many benchmarks?

    a. One.

    b. Two.

    c. Three.

    d. It depends on the CIRA.

29. Which of the following will help an auditor mitigate the risk of management override of controls?

    a. Increasing the level of supervision over audit team members.

    b. Evaluating the audit client's selection and application of accounting principles.

    c. Presuming that there is fraud risk in relation to the audit client's revenue retention.

    d. Evaluating the audit client's individually significant and unusual dollar items.

30. To gather enough information to make a judgment about the risks of material misstatement at the relevant assertion level, the auditor needs to do which of the following?

    a. Determine the entity's inherent risk and its control risk.

    b. Establish an overall audit strategy to describe how the audit objectives will be achieved.

    c. Understand the entity's performance materiality as required in professional standards.

    d. Perform risk assessment procedures to understand the entity and its environment.

31. Audit areas in which substantive procedures alone will not be sufficient typically have which of the following characteristics?

    a. Processes that are highly automated.

    b. Processes that require a great deal of manual intervention.

    c. Areas in which there is a high volume of transactions.

    d. Areas in which there is a low volume of transaction.

32. Which of the following may occur in relation to the audit strategy?

    a. Once developed, the audit strategy will remain the same for the course of the audit.

    b. Those charged with governance must approve the audit strategy and the nature and timing of audit procedures.

    c. Auditors may be able to establish a preliminary audit strategy based on past experience with the client and preliminary procedures.

    d. The documentation requirements for the separate audit strategy memorandum are relatively complex as outlined in AU-C 300.14.

33. How does the use of a specialist typically affect CIRA audits?

    a. It is uncommon for CIRA audits to require the services of a specialist.

    b. CIRA audits often require internal specialists, but seldom external specialists.

    c. Specialists with the knowledge necessary for a CIRA audit are hard to find, so expertise is the only requirement to selecting one.

    d. If a CIRA audit requires a specialist, it is usual enough to be exempt from the requirements of AU-C 620.

34. When audit sampling is used, which of the following occurs?

    a. One hundred percent of the items in the population are tested.

    b. Specific or individually significant items in the population are tested.

    c. A representative number of the items in the population are tested.

    d. The auditor choses items from the population on a case-by-case basis.

35. In a CIRA engagement, audit sampling will be most efficient under which of the following circumstances?

    a. The volume of transactions is low.

    b. The processing of the population items differs.

    c. The dollar amounts of the population items varies.

    d. The audit area being sampled is material or high risk.

36. Which of the following statements best describes audit sampling in a CIRA engagement?

    a. Sampling is often neither appropriate nor useful in a CIRA engagement.

    b. Receivables confirmation is the most common use of sampling in a CIRA engagement.

    c. It is important for auditors to perform tests of disbursements in CIRA engagements.

    d. AU-C 315 prohibits auditors from performing only substantive procedures in a CIRA engagement.

37. An audit plan should include descriptions of all of the following **except**:

    a. The nature and extent of the risk assessment procedures planned.

    b. The nature, timing, and extend of any planned further procedures at the relevant assertion level.

    c. Any other planned procedures that the auditor is required to perform under GAAS.

    d. A description of how the audit plan and its documentation will not be changed.

38. The workpapers for the audit of a small CIRA may do what?

    a. Be more complex than the workpapers of a large CIRA.

    b. Include a detailed record of communications amongst the engagement team.

    c. Combine various aspects into one document.

    d. Eliminate the need for workpaper indexing.

39. Which of the following should an auditor do in relation to opening balances in an initial engagement?

    a. The auditor must express an opinion on the opening balances as part of the current-period audit.

    b. The auditor focuses on opening balances that affect current-period ending balances or affect current-period operation results.

    c. The auditor's decision to use information from a review of the predecessor's workpapers is made once for all audit areas.

    d. The auditor should note misstatements in opening balances, but no additional procedures need to be performed.

40. Which of the following could occur during a reaudit?

    a. The predecessor's workpapers are not consulted.

    b. Responsibility for the reaudit conclusions is the responsibility of the predecessor.

    c. The successor auditor must make reference to the predecessor's report.

    d. The successor cannot rely on the predecessor's workpapers to support his or her opinion.

GLOSSARY

Application controls: Controls that apply to a specific application, such as receivables, payroll, or the general accounting application. They apply to the processing of individual transactions and help ensure that the transactions occurred, are authorized, and are completely and accurately recorded and processed. Sometimes, such controls are part of a CIRA's IT system.

Audit report date: The date that the auditor has obtained sufficient appropriate audit evidence to support the auditor's opinion on the financial statements.

Audit risk: The risk that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materially misstated. It is a function of the risk that the financial statements are materially misstated and the risk that the auditor will not detect such material misstatement.

Audit sampling: Selecting and evaluating less than 100 percent of the population of audit relevance in such a way that the auditor expects the items selected to represent the whole population and, thus, be likely to provide a reasonable basis for conclusions about the population as a whole.

Audit strategy: The auditor's operational approach to achieving the objectives of the audit. A high-level description of the audit scope, timing, and direction, including matters such as identifying material account balances, identifying audit areas with a higher risk of material misstatement, the overall responses to those higher risks, and the planned audit approach by area.

Brainstorming: This type of open exchange of ideas should occur during the engagement team discussion at the beginning of the audit engagement.

Clear linkage: The implication that the further audit procedures are responsive to the assessments and that the assertions of the assessed risks are closely correlated to those addressed by the substantive procedures.

Communication: One of the components of internal control from the COSO Framework. It is the process of providing an understanding of the roles and responsibilities to individuals within the CIRA regarding internal control over financial reporting. It is part of the same internal control component as *information.*

Control activities: The policies and procedures that help ensure that management directives are carried out. The actions that are taken to address risks that threaten a CIRA's ability to achieve its objectives, one of which is reliable financial reporting. They usually involve (1) a policy that establishes what ought to be done and (2) the procedure that implements the policy.

Control environment: One of the components of internal control from the COSO Framework. It sets the tone of the CIRA and influences the control consciousness of its people. It is the foundation for all other components of internal control and provides structure and discipline. It includes the attitude, awareness, and actions of management, as well as those charged with governance, concerning internal control.

Control risk: The risk that a misstatement could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

COSO's *Internal Control—Integrated Framework* (COSO Framework): This framework discusses five components and seventeen principles of internal control. It is a good reference for all firms when obtaining an understanding of an audit client's internal control.

Cybersecurity risk: The risk that an attack or intrusion of the IT platform will be successful and that there will be a breach in these controls and a cyber incident.

Detection risk: The risk that procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Engagement letter: A letter that can be used to establish the terms of the engagement with the client. It should include (1) the objective and scope of the engagement; (2) management's responsibilities; (3) the auditor's responsibilities; (4) a statement that due to the inherent limitations of an audit, combined with the inherent limitations of internal control, there is a risk that material misstatement may not be detected; (5) identification of the applicable financial reporting framework; and (6) reference to the expected form and content of reports to be issued by the auditor and a statement that circumstances may occur in which a report may differ from its expected form and content.

Evaluation materiality: A concept of materiality in which the auditor evaluates the effect of identified misstatements on the audit and the effect of uncorrected misstatements on the financial statements.

Individually significant items (ISI): Two types of high-risk items in a financial statement component: (1) unusual items (items that are significant by their nature) and (2) individually significant dollar items.

Information: One of the components of internal control from the COSO Framework. It refers to the financial reporting system, which includes the accounting system and encompasses the procedures and records established to initiate, authorize, record, process, and report the CIRA's transactions. It also includes the accountability over the assets, liabilities, and equity. It is part of the same internal control component as *communication.*

Inherent risk: The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Monitoring: A process by when the CIRA assesses the quality of its internal control over time. It involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary. Such activities can also reveal evidence or symptoms of fraud.

Performance materiality: The amount(s) set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements will exceed materiality for the financial statements as a whole. It also refers to the amount(s) set by the auditor at less than the materiality level(s) for particular classes of transactions, account balances, or disclosures.

Planning materiality: The auditor's preliminary judgment about materiality at the financial statement level. This concept of materiality is used to plan and perform the audit.

Predecessor auditor: An auditor from another firm who reported on the most recent set of the client's audited financial statements or was engaged to perform but did not complete the audit of the financial statements. It may include an auditor who was engaged to perform an initial audit but did not complete that audit or an auditor who was engaged to subsequent to the most recent audited financial statements (that is, a successor auditor) who did not complete the audit.

Relevant assertions: One that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.

Report release date: The date that the auditor gives the client permission to use the auditor's report in connection with the financial statements. This is usually the date that the auditor delivers the report to the client.

Risk assessment: One of the components of internal control from the COSO Framework. It refers to a CIRA's identification, analysis, and management of the risks of material misstatement of the financial statements.

Risk assessment process: This involves performing procedures, obtaining an understanding of various matters about the CIRA and its environment, and making decisions and judgments about assessed risks and other matters based on that understanding.

Risk of material misstatement: The risk that the financial statements are materially misstated prior to the audit. *Inherent risk* and *control risk* are components of this risk.

Significant risk: An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration. The determination of significance is based on an assessment of inherent risk and does not include consideration of controls. Such risks often relate to significant nonroutine transactions and matters that require significant judgment.

Significant transaction classes: Classes of transactions in the CIRA's operations that are significant to the financial statements, generally because of the volume or risk characteristics of the transactions processed.

Tolerable misstatement: Some of this term's meaning has been replaced by *performance materiality.* Now this term is used only to describe the application of performance materiality to a particular audit sampling procedure.

Walkthroughs: An auditor judgmentally selects one or a few transactions from each of the major classes of transactions and walks those transactions through the system from initial creation of a source document to final posting in the general ledger and inclusion in the financial statements (a cradle-to-grave procedure). It is a common method used to obtain an understanding of the design and implementation of the financial reporting system for a *significant transaction class.*

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USE OF A SPECIALIST 100

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 (HOATG182)

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 2018

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** 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, 2019**

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; how a CIRA would report on members' equity and income taxes; and how to address revenue from contracts with customers.

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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

Characteristic	Condominium Association	Homeowners' Association	Cooperative
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 151)**

   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 152)**

   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**. 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 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 49.2 million persons in 2016. In 2016, almost one in every seven persons (or 15% 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 86 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**.

- *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**.

- *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**.

- *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**.

- *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**.

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
  - CCAL—College of Community Association Lawyers
- 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
  - CTS—Certified Timeshare Supervisor
- 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**.

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 or review 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 162)**

   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 166)**

   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 169)**

   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; how a CIRA would report on members' equity and income taxes; and how to address revenue from contracts with customers.

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 180)**

   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 182)**

   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	CASH EQUIVALENTS
Definition (FASB ASC 230-10-20)	*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 . . .	. . . 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:	*Examples:*
Certificates of deposit, money market accounts, and repurchase agreements that have the characteristics described above.	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
	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. However, in the statement of cash flows, restricted cash is grouped with cash, cash equivalents, and restricted cash equivalents to show a change in total cash. Separation by classification is not required for presentation.

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:

Debt Securities	Equity Securities
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[a]

Category	Type of Investment	Basis	Reporting Unrealized Gains and Losses
Held to maturity	Debt—entity has positive intent and ability to hold to maturity, and the security cannot be contractually prepaid or otherwise settled such that the security holder would not recover substantially all of its recorded investment	Amortized cost, reduced for nontemporary 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; report realized gains and losses and nontemporary losses in the statement of revenues and expenses

Note:

[a] 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 "accreted 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:

Maturity	Days to Maturity	Bid	Asked	Chg.	Yield
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 × .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 × $^{97}/_{365}$	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 × 3.245%)	418.60
Premium amortization	$ 250.15

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 %

		Investment Balance	Interest Income Using Yield	Premium Amortization	Principal Received
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	335.52	333.23	$ 10,000.00
			$ 3,787.50	$ 2,900.00	

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	$ 3,787.50

* * *

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 $13^3/_8$, 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 × $^{0.13375}/_2$) 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:

Rate	Maturity Mo/Yr	Bid	Asked	Chg.	Ask Yield
$6^{7}/_{8}$	July X9n	101:05	101:07	−7	6.43

The first column indicates the coupon rate—in this case, $6^{7}/_{8}$%. 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 $101^{5}/_{32}$ or $1,011.56, and the asked quote (the price at which an entity could purchase) translates to $101^{7}/_{32}$ 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**.

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 187)**

    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 188)**

    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 196)**

    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 202)**

    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 203)**

    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

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. 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). Additional guidance on ASU 2014-09 for CIRAs is provided at the end of this lesson.

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[a]

Note:

[a] 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:

	Condominium	HOA	Cooperative
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

Type of Common Property	Condominium	HOA Community	Cooperative
Real property directly associated with the unit			
Examples:			
Exterior wall Roofs Public hallways Underlying land Sidewalks Driveways Roads Parking spaces Greenbelts	Generally do not capitalize	Generally do not capitalize	Capitalize
Real property not directly associated with the unit			
Examples:			
Recreational facilities Managers' apartments Property used for commercial operations directed at nonunit owners or at unit owners for which they pay a fee	Capitalize if CIRA has title and (1) can sell and retain proceeds or (2) can use the property to generate significant cash flows from members on the basis of usage or from nonmembers[a]	Capitalize if CIRA has title and (1) can sell and 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.			
Personal property			
Examples:			
Furnishings Recreational equipment Maintenance equipment Work vehicles	Capitalize	Capitalize	Capitalize

Note:

[a] As noted previously, condominiums rarely have title to common real property.

* * *

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 210)**

    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 219)**

    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 226)**

    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 229)**

    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 231)**

    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 1/3 × $25,550)	8,517
Prepaid insurance at December 31	$ 4,133

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 1/3 × $25,550)	8,517
Balance	$ 17,033
Amount due under premium finance agreement at December 31 (total financed of $19,350 less three payments of $2,150)	$ 12,900

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:

Replacement Fund

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:

	Total	Undesignated	Designated for Future Repairs and Replacements
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	$ 4,721,000	$ 4,146,000	$ 575,000

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:

Replacement Fund

Transfer to Operating Fund	$ 32,000	
Cash		$ 32,000

Operating Fund

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**.

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
	$ 5,400	$ 27,000	$ 21,600			$ 1,332.43

* * *

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
	$ 5,400	$ 27,000	$ 21,600			$ 847,000

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 × 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. Additionally, associations may expend funds held for refundable security deposits for operating expenses to mitigate deficiencies in operating cash causing a shortfall in the cash available for the refund of these security deposits. Auditors need to review management's accounting policies and procedures over refundable security deposits for deficiencies in internal controls.

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).
- Property tax liabilities.
- 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. Some associations that provide a benefit to the community may qualify as a tax-exempt organization under Internal Revenue Code Section 501(c)(4). If an association has been determined by the Internal Revenue Service to qualify as a "social welfare organization" under the Code Section 501(c)(4), most or all of the activities performed by the association are considered exempt activities, including the interest earned on investments.

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 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 not 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.

On December 22, 2017, President Trump signed into law H.R. 1, *An Act to Provide for Reconciliation to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018,* commonly referred to as the Tax Cuts and Jobs Act of 2017. For tax years beginning after December 31, 2017, the Act reduces the corporate tax rate to 21% and repeals the alternative minimum tax. The Act also changes a number of other areas affecting the taxation of entities in years beginning after December 31, 2017. A detailed discussion of those changes is beyond the scope of this course. As discussed in FASB ASC 740-10-30-8, deferred tax liabilities or assets are measured using the applicable or enacted tax rates expected to apply to taxable income in those periods that the deferred tax liability or asset is expected to be settled or realized. Thus, auditors need to determine whether entities have appropriately considered the change in the tax rates in their measurements of deferred tax assets and liabilities.

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[a]

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:

[a] 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 20X2 are no longer subject to examination by the Internal Revenue Service.

REVENUE FROM CONTRACTS WITH CUSTOMERS

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The ASU introduces a comprehensive, principles-based framework for recognizing revenue. The new revenue guidance introduces FASB ASC 606 and supersedes the revenue recognition requirements in FASB ASC 605 and most industry-specific revenue guidance in the FASB ASC, including the accounting guidance that CIRAs currently follow. The ASU is intended to improve GAAP by providing a framework to address revenue recognition issues, creating more consistency and comparability of revenue recognition practices across entities and industries, and improving the usefulness of information provided to financial statement users through more robust disclosure requirements.

In August 2015, the original effective dates of ASU 2014-09 were deferred by one year by the issuance of ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*. ASU 2014-09 (as revised) is effective for entities other than public business entities for annual reporting periods beginning after December 15, 2018, and interim periods within annual reporting periods beginning after December 15, 2019. Early application is allowed.

The FASB also issued, subsequent to ASU 2014-09, a number of ASUs to address various implementation issues that were identified. The amendments do not change the core principle in FASB ASC 606. These ASUs, which have the same effective dates as ASU 2014-09 (as revised), are as follows:

- ASU 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)* (March 2016).
- ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing* (April 2016).
- ASU 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients* (May 2016).
- ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers* (December 2016).

Effect of FASB ASC 606 on this Course

This course has been updated to incorporate various aspects of the new revenue recognition guidance that will apply to engagements when FASB ASC 606 is adopted. As previously mentioned, unless adopted early, the new guidance will be effective for annual reporting periods beginning after December 15, 2018. For example, it will be effective for the 2019 annual financial statements of nonpublic companies with a calendar year end. As a result, practitioners should, if they have not already, begin preparing for the adoption of FASB ASC 606.

The following paragraphs in this section provide an overview of the accounting requirements in the new revenue recognition guidance.

CIRA-specific Information. Auditors need to discuss with management the various ways that a CIRA generates revenue and the applicability of FASB ASC 606 to each revenue source. Auditors also need to review each revenue source to identify the performance obligation(s) associated with a contract as well as to identify the transaction price associated with each performance obligation. A discussion of CIRA-specific revenue sources appears later in this lesson.

New Terms. Several new terms defined in FASB ASC 606-10-20 are important to understanding the new revenue recognition process, including—

- *Contract*—an agreement between two or more parties that creates enforceable rights and obligations.
- *Contract asset*—an entity's right to consideration in exchange for goods or services transferred to a customer when that right is conditioned on something other than the passage of time.

- *Contract liability*—an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

- *Customer*—a party that contracts with an entity to obtain goods or services in exchange for due consideration, where the goods or services are an output of the entity's normal activities.

- *Performance obligation*—a promise in a contract with the customer to transfer a good or service to the customer.

- *Revenue*—inflows or other enhancements of assets of an entity or settlements of its liabilities from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

- *Standalone selling price*—the price for which an entity would sell a promised good or service separately to a customer.

- *Transaction price*—the amount of consideration assigned to a performance obligation to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.

Criteria for Recognizing Revenue

FASB ASC 606 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. In applying the new guidance, the terms of each contract and all relevant facts and circumstances should be considered. Additionally, the guidance should be applied consistently to contracts with similar characteristics and in similar circumstances.

According to FASB ASC 606-10-25-1, the revenue recognition guidance only applies to contracts with customers that meet certain criteria. If the criteria are not met, it is questionable whether the contract creates enforceable rights and obligations. Therefore, to recognize revenue from a contract, the contract must meet the following conditions:

- The contract has been approved by the parties to the contract. The approval may be written, oral, or in another form that is a customary business practice.

- Each party is committed to perform its obligation(s) under the contract (such as an obligation to provide a good or service or an obligation to pay consideration). However, in the Basis for Conclusions, the FASB indicated that the parties do not necessarily have to be committed to fulfill *all* of their respective obligations, as long as they are substantially committed to the contract.

- Each party's rights to the goods or services to be transferred can be identified in the contract.

- The payment terms can be identified in the contract. However, the price does not have to be fixed or explicitly stated as long as the right to payment is enforceable and the transaction price can be estimated.

- The contract has commercial substance. To have commercial substance, the risk, timing, or amount of an entity's cash flows must be likely to change as a result of the contract.

- It is probable that all or substantially all of the consideration will be collected from the customer for the goods and services promised in the contract. To determine if this condition is met, the member's ability and intent to pay the consideration when it is due must be considered.

If a contract meets those conditions at contract inception, it is not necessary to reassess whether the contract continues to meet those conditions unless the entity becomes aware of a significant change in facts and circumstances.

FASB ASC 606 supersedes the revenue guidance for CIRAs in FASB ASC 972-605. The FASB applies ASU 2014-09 to most industries, including the CIRA industry. Some practitioners have not historically thought of CIRA members as customers or arrangements between the CIRA and its members as contracts. Additionally, some practitioners

believe that only the revenue generated from fees for activities other than those mandated by the CIRA's governing documents need to apply the guidance in FASB ASC 606; however, the authors believe that CIRAs are required to implement the guidance from ASU 2014-09. Additionally, the services provided by the CIRAs and their relationship with the members appear to meet the definitions of contracts and customers, respectively, as defined in FASB ASC 606.

A Five-step Approach

Under FASB ASC 606, the key principles applied when accounting for revenue are—

- Revenue should be recognized in a way that reflects the transfer of promised goods or services to customers, and
- The amount of revenue recognized should equal the consideration to which an entity expects to be entitled for those promised goods or services.

FASB ASC 606 establishes a five-step approach for recognizing and measuring revenue. The five steps are intended as guidelines to help adhere to the key principles established by the new guidance. Under FASB ASC 606, entities should recognize revenue from contracts by applying the following five-step process:

a. Identify the contract with the customer.

b. Identify the separate performance obligations in the contract.

c. Determine the transaction price.

d. Allocate the transaction price to the separate performance obligations.

e. Recognize revenue when (or as) each performance obligation is satisfied.

Step 1—Identify Customer Contracts. The determination of what is a "contract" is important because it affects subsequent decisions about the transaction price, costs to acquire or fulfill the contract, and contract modifications. A contract does not have to be in writing. It can be a verbal agreement or an arrangement implied by normal business practices. A contract must have commercial substance and identify the rights of the parties, the payment terms, and commitment of the parties. The scope of the revenue guidance does not apply to promises to provide goods and services that are not associated with a contract. A contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract (no goods or services have been transferred, and no consideration has been received) without compensation to the other party.

Customer credit risk should be considered as part of Step 1 because the revenue guidance cannot be applied to a contract unless it is probable that the entity will collect substantially all of the consideration to which it will be entitled. Therefore, CIRAs will need to assess whether it is probable that they will collect substantially all the transaction price. A CIRA should use its evaluation of members' creditworthiness and historical collection experience to assess whether collection is probable. This requirement is a change from the previous guidance on revenue recognition, where member credit is typically evaluated after the revenue is recorded, as part of assessing potential allowance for doubtful accounts on assessments receivable.

If applicable, CIRAs should combine two or more contracts that are entered into at or near the same time with the same customer (or related parties of the customer) and account for them as a single contract if the consideration to be paid in one contract depends on the price or performance of the other contract, and the goods and services promised are considered a single performance obligation.

FASB ASC 606-10-10-4 provides a practical expedient that permits a portfolio of contracts with similar characteristics to be combined and accounted for as a single contract if the result of applying the revenue guidance to the combined contract would not differ materially from applying the revenue guidance to the contracts individually. Different types of contracts with customers relevant to CIRAs that might be combined may include (a) maintenance of common property; (b) management of the CIRA; and (c) ancillary activities such as vending, food and beverage,

rental of recreational facilities, and golf course fees. Maintenance of common property and management of a CIRA are contracts that would normally be combined. These items are included in the annual budget and assessments billed to owners with a single commercial objective and generally will also be determined to be services bundled together as a single performance obligation as described in FASB ASC 606-10-25-22.

Step 2—Identify Performance Obligations. After identifying customer contracts, each distinct promise of goods and/or services within the contract should be identified. The concept of a *performance obligation* is similar to the concept of a *deliverable* in FASB ASC 605. However, determining distinct goods or services requires judgment.

FASB ASC 606-10-25-19 indicates that a good, service, or bundle is distinct, and should be treated as an individual performance obligation or unit of account, only if both of the following are true:

- The good, service, or bundle is capable of being distinct. In other words, the customer can benefit from the item alone, or together with other resources readily available to the customer.

- The promise to transfer the good, service, or bundle is distinct within the context of the particular contract; that is, the promise to transfer the good or service can be separately identified from the other promises in the contract.

Goods or services that are not distinct should be combined with other goods and services into a group, or bundle, that is distinct.

FASB ASC 606-10-25-21 provides the following factors that indicate a promise to transfer a good or service cannot be separately identified from the other promises in a contract:

- The good or service is an input used to create an end product (output) promised to the customer in the contract. That is, the good or service needs to be integrated with other goods or services promised in the contract to deliver the output(s) for which the customer contracted.

- One or more good or service substantially changes or customizes one or more other goods or services promised in the contract.

- The good or service is either highly interdependent on or highly interrelated with other goods or services promised in the contract. That is, each good or service is significantly affected by one or more of the other goods or services in the contract, and the promise may not be fulfilled by transferring each of the goods or services separately.

It is possible to conclude that all goods and services in a contract are part of one performance obligation. Before reaching that conclusion, however, the individual goods and services in the contract need to be evaluated to determine whether the contract contains multiple performance obligations. All contracts should be carefully considered to determine whether multiple performance obligations exist.

Step 3—Determine the Transaction Price. The third step of the five-step approach to recognizing revenue is to determine the total consideration the CIRA is entitled to receive under the contract. The revenue guidance refers to that amount as the *transaction price*, defined as the amount of consideration that an entity receives or expects to receive in exchange for the transfer of goods or services promised in a contract. The transaction price can be fixed, include variable consideration, and/or may be adjusted for the time value of money. In addition, the consideration can be cash or noncash. Any noncash consideration is generally measured at fair value.

Variable consideration includes discounts, rebates, incentives for completing a contract early or on time, penalties for not completing a contract on time, price concessions, and other contingencies. When determining the transaction price, a CIRA should consider the effects of variable consideration among other factors, including estimates of variable consideration. Since CIRAs usually do not accept an amount less than the budgeted and billed assessments and there are no products to be returned, there would not be any variable consideration adjustment to its assessment revenues. However, variability in consideration for other types of ancillary activities should be considered in calculating transaction price, if applicable. The amount of variable consideration should be estimated and included in the transaction price, but only to the extent that it is probable that the estimate would not result in the

reversal of a significant amount of the cumulative revenue recognized for the contract when the uncertainty related to the variable consideration is resolved.

Customer credit risk is not considered in determining the transaction price but is considered as part of Step 1 in determining whether a valid contract exists. If the customer pays either before or after given control of the good or service being purchased (as opposed to paying at the time control of the good or service is received), the revenue transaction may include a *financing component*. If the length of time between when the contract consideration must be paid and when the customer will obtain control of the good or service is more than one year, a financing component exists. If the financing component is significant, an adjustment to the transaction price is required to recognize the time value of money. When a significant financing component is determined to exist, interest is accounted for following the guidance in FASB ASC 835-30, *Interest—Imputation of Interest.* For CIRAs, payment of special assessments may occur over time and may include a financing component.

Step 4—Allocate the Transaction Price to the Performance Obligations. This step requires an allocation of the transaction price to the performance obligations based on the standalone selling prices of the goods or services. The standalone selling price of a good or service may be directly observed when that item is sold separately to similar customers in similar circumstances. This could be applicable to a CIRA should a member pay delinquent assessments on a payment plan and late fees are charged.

The transaction price is typically allocated to each performance obligation on the basis of the relative standalone selling prices of each good or service in the contract. To accomplish this, the standalone selling price of each performance obligation must be determined and then all the standalone selling prices should be aggregated. The ratio of the amount of each good's or service's standalone selling price to the aggregate is then calculated, and the total transaction price is multiplied by each ratio to allocate the transaction price to each performance obligation. This allocation includes considering whether any discount or variable consideration amount applies to one or some of the performance obligations, rather than to all performance obligations in the contract.

In the CIRA environment, the transaction price for each type of assessment revenue is detailed in the annual budget and is generally readily apparent. Other types of revenue are generally distinct and the stand-alone selling price basis is readily apparent based on the face amounts for these transactions. If there is only one performance obligation for a bundle of goods and services, the total transaction price is allocated to the single performance obligation and there is no need to determine standalone selling prices.

Step 5—Recognize Revenue When (or as) Performance Obligations Are Satisfied. In the final step of the five-step approach, revenue is recognized equal to the amount of the transaction price allocated to the performance obligations. Performance obligations are satisfied by transferring a promised good or service to a customer. The good or service is considered transferred when (or as) the customer obtains control. A performance obligation may be satisfied at a point in time or over time, and this determination must be made for each performance obligation at the inception of the contract. For those performance obligations satisfied over time, revenue is recognized at the end of each reporting period by selecting an appropriate method for measuring the progress toward complete satisfaction of that performance obligation.

Disclosures

FASB ASC 606-10-50 states broad objectives for disclosures and it also defines some detailed guidance toward fulfilling the broader objectives. The financial statement disclosures required under the new revenue recognition guidance include comprehensive information about the nature, amount, timing, and uncertainty of revenue and cash flows that result from contracts with customers. Both quantitative and qualitative information are required to be disclosed for contracts with customers, significant judgments made and any changes in those judgments, and any

assets recorded that are associated with the costs to obtain or fulfill a contract. Some of the disclosure requirements are optional for nonpublic entities. The disclosure requirements are summarized in Exhibit 2-9:

Exhibit 2-9

Disclosures for Nonpublic Entities

Category	Required Disclosure	Required for Non-public Entities?
Disaggregated revenue	Revenue disaggregated into categories that show how economic factors affect the nature, timing, amount, and uncertainty of revenue and cash flows	Minimum disclosures only[a]
	Relationship between the disaggregation of revenue and revenue for segments	No
Contract balances	Opening and closing balances of receivables, contract assets, and contract liabilities	Yes
	Amount of current period revenue included in the opening contract liability balance	No
	How the transfer of control relates to the timing of payment, and how both affect contract balances	No
	Significant changes in contract balances (qualitative and quantitative)	No
Performance obligations	Description of (a) the nature of goods and services, (b) significant payment terms, (c) when performance obligations are typically satisfied, (d) obligations for refunds and returns, and (e) warranties	Yes
	Amount of current period revenue from performance obligations wholly or partially satisfied in a prior period (often due to contract modifications made subsequent to year end)	Yes
Transaction price allocated to remaining performance obligations	Aggregate amount of transaction price allocated to remaining performance obligations at the end of the period	No
	Quantitative or qualitative explanation of when remaining amounts will be recognized as revenue	No
	Any consideration not included in the transaction price and, therefore, not included in the information disclosed	No
	If variable consideration is excluded from the information disclosed because it meets specified criteria, a description of the performance obligation, remaining duration, nature of the variability, and how it will be resolved	No
Significant judgments	For performance obligations satisfied over time: (a) the method used to measure progress, (b) how the method is applied, and (c) why the method faithfully depicts the transfer of control	Yes, but may omit disclosure of why the method faithfully depicts the transfer of control
	For performance obligations satisfied at a point in time, significant judgments made in evaluating when the customer gets control	No

Category	Required Disclosure	Required for Non-public Entities?
	Methods, inputs, and assumptions used to (a) estimate the transaction price including variable consideration, the time value of money, and noncash consideration, (b) assess whether variable consideration is constrained, (c) allocate the transaction price, and (d) measure related obligations	Only required to disclose the methods, inputs, and assumptions used to assess whether variable consideration is constrained
Practical expedients	The election to apply available practical expedients related to significant financing components and expensing of incremental costs to obtain a contract	No
Contract costs	Judgments to determine the amount of costs incurred to obtain or fulfill a contract	No
	The amortization method	No
	Balance of contract costs at the end of the period by asset category	No
	Amortization expense and impairment losses for the period	No

Note:

[a] If a nonpublic entity chooses not to disclose disaggregated revenue, at a minimum both of the following have to be disclosed: revenue broken down based on how control of goods and services transfers (over time or at a point in time), and qualitative information about how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows.

* * *

Additional Guidance

The AICPA has issued an Audit and Accounting Guide, *Revenue Recognition* (AICPA Revenue Guide), to assist entities and auditors with their implementation of ASU 2014-09 and the other related subsequently-issued ASUs. It explains the significant auditing considerations relevant to the new guidance, including an explanation of the audit approach and procedures for auditing the five steps for recognizing revenue, as well as auditing considerations for a client's adoption and transition to the new accounting standard. Implementation issues and guidance for timeshare entities can be found in the AICPA Revenue Guide. Implementation issues for CIRAs are expected to be addressed in a future edition. More information on the AICPA revenue recognition guide can be found at **www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition.html**. Also, the AICPA Audit Risk Alert, *General Accounting and Auditing Developments—2017/18*, includes a section on revenue recognition that provides an overview of the new guidance in ASU 2014-09 and catalogs the latest developments.

CIRA-specific Revenue Situations

The remaining discussion in this section focuses on how CIRAs account for revenue under FASB ASC 606 in certain situations. Future editions of this course will expand on this discussion.

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. (Timeshare developments typically bill their dues on a quarterly or annual basis.) In addition, member assessments may include the allocation of certain other expenses to owners, for example, utilities that are sub metered, expenses related to limited common areas, and common area expenses that benefit fewer than all the units. (Some CIRAs present additional assessments such as those separate from regular assessments.)

Under FASB ASC 606, an association recognizes revenue from member assessments as the members get control of the related services. The performance obligation is the maintenance and management of the common area property and is generally believed to be met on a periodic basis throughout the fiscal year. When control transfers depends on the facts. For example, the portion of the monthly fee that relates to monthly services (including general repairs and replacements) is recognized as revenue in the same period that it is received. Revenue from member assessments is not believed to change significantly from existing practice except for the consideration of collectability. Before an entity can recognize revenue under FASB ASC 606, the entity must deem collection of the consideration to be probable.

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).

Under FASB ASC 606, the association is required to recognize revenue from special assessments as the performance obligations, as indicated by the purpose or use of the special assessment funding, are satisfied. Revenue should be recognized from special assessments when the five steps to the revenue recognition process are met. Those five steps are discussed earlier in the lesson. Different types of the common special assessments may have revenue recognized differently. For example, revenue from special assessments to fund operating or replacement fund shortfalls may be recognized in the period in which it is billed since the performance obligation (funding shortfalls in funds or unexpected expenses) would generally be met around the same time the assessment is billed to the members. There is diversity in thought on how CIRAs will recognize revenue from special assessments to accumulate monies for specific future expenses or to repay loans. The differences in thought primarily relate to what is the performance obligation and how the performance obligation is met.

Some practitioners believe that if a special assessment is to be used for the replacement of the siding on a common area building (a special assessment to accumulate monies for specific future expenses), the association's performance obligation is the arrangement for the replacement of the siding. Therefore, revenue would be recognized when the arrangement for the replacement was made. The period in which the major repair occurs may be after the period in which the monthly fee is received, and a contract liability (deferred revenue) would be recorded when the special assessment is billed. Other practitioners believe the performance obligation is met much sooner and special assessment revenue is recognized as revenue when billed. The authors believe CIRAs need to clearly identify the performance obligation and assess when control is transferred when recognizing special assessment revenue for specific future expenses. Those two steps to the revenue recognition process appear to be critical in recognizing special assessment revenue. (Transfer of control is part of step five discussed earlier. Revenue is recognized when or as performance obligations are satisfied.) Before an association can recognize revenue under FASB ASC 606, the entity must deem collection of the consideration to be probable. Depending on the resolution of this issue, this may be a change in practice.

Repayment terms of special assessments may vary considerably among CIRAs. Some owners may pay off their portions at once while others may pay principal and interest for longer-term special assessments. Under the new revenue recognition guidance, practitioners should consider whether or not an adjustment to the transaction price is required to recognize the time value of money for special assessments with long-term payment terms.

Developer 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. Like member assessments, the performance obligation could be determined as the maintenance of the common area property, which is generally believed to be met on a periodic basis throughout the fiscal year.

Ancillary Operations. The term *ancillary operations* describes any association activities other than the ordinary maintenance, security, governance, and administrative activities common to most associations. 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.

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.

The association must recognize revenues for ancillary operations as the association's performance obligation is satisfied. Generally, this is to be expected when the services are provided. Under FASB ASC 606, management of the association must review the activities related to the ancillary operations in conjunction with the performance obligations of the association to determine when proper revenue recognition occurs.

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. 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.

24. Revenue can be recognized from a contract if which of the following occurs?

    a. The entity's cash flows are unlikely to change as a result of the contract.

    b. Both parties are committed to perform obligations under the contract.

    c. The transaction price is not fixed and cannot be estimated.

    d. At least one of the parties has approved the contract.

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)**

    a. 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.]

    b. 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.]

    c. 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.]

    d. 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. Which of the following can be treated as contributions of capital for tax purposes only for a CIRA? **(Page 265)**

    a. 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.]

    b. 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.]

24. Revenue can be recognized from a contract if which of the following occurs? **(Page 275)**

    a. The entity's cash flows are unlikely to change as a result of the contract. [This answer is incorrect. According to FASB ASC 606-10-25-1, to recognize revenue from a contract, the contract must have commercial substance. To have commercial substance, the risk, timing, or amount of an entity's cash flows must be likely to change as a result of the contract.]

    b. Both parties are committed to perform obligations under the contract. [This answer is correct. The revenue recognition guidance in FASB ASC 606-10-25-1 only applies to contracts with customers

that meet certain criteria. One of the conditions that must be met for revenue recognition is that each party is committed to perform its obligation(s) under the contract (such as an obligation to provide a good or service or an obligation to pay consideration).]

c. The transaction price is not fixed and cannot be estimated. [This answer is incorrect. To recognize revenue from a contract under FASB ASC 606-10-25-1, the payment terms must be able to be identified in the contract. However, the price does not have to be fixed or explicitly stated as long as the right to payment is enforceable and the transaction price can be estimated.]

d. At least one of the parties has approved the contract. [This answer is incorrect. Per FASB ASC 606-10-25-1, to recognize revenue the contract must have been approved by the parties to the contract. If only one party has approved the contract, revenue cannot be recognized yet.]

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 (HOATG182)

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.tr.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 $95 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 ($95 for email or fax; $105 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*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     HOATG182 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.

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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 (HOATG182)

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. CIRAs 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. 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.

38. 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.

39. 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.

40. A CIRA might levy a special assessment under what circumstances?

    a. To fund projects that were budgeted for the current year.

    b. To accumulate money for expenses anticipated in the current year.

    c. To replace shortfalls in the current year's funding.

    d. To make loans to CIRA members for home improvement 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.

Contract: An agreement between two or more parties that creates enforceable rights and obligations.

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.

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.

Performance obligation: A promise in a contract with a customer to transfer a good or service to the customer.

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.

Prepaid expenses: Advance payments for products or services that will be used in operations during the year.

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.

Revenue: Inflows or other enhancements of assets of an entity or settlements of its liabilities from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

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 (HOATG183)

OVERVIEW

COURSE DESCRIPTION: 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.

PUBLICATION/REVISION DATE: September 2018

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

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of homeowners' associations and the other interest realty associations

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** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

IRS Enrolled Agents (EA) and Non-Credentialed Return Preparers (NCRP): This course is designed to enhance professional knowledge for IRS EAs and IRS NCRPs. Checkpoint Learning is an IRS Continuing Education Provider that is approved to deliver continuing education to IRS Enrolled Agents and IRS Non-Credentialed Return Preparers.

CTEC CREDIT: 7 CTEC Federal Tax Law Hours

IRS EA CREDIT: 7 Federal Tax Law/Tax Related Matters Hours

IRS NCRP CREDIT: 7 Federal Tax Law Hours

FIELD OF STUDY: Accounting, 1 hour; Taxes, 7 hours

EXPIRATION DATE: Postmark by **September 30, 2019**

KNOWLEDGE LEVEL: 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.

TO COMPLETE THIS LEARNING PROCESS:

Log onto our Online Grading Center at **cl.tr.com/ogs.** Online grading allows you to get instant CPE credit for your exam.

Alternatively, you can submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

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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 inactive 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.A82, 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, GAAP 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 inactive AICPA guide illustrates financial statements that present interfund accounts as follows:

	20X2			20X1
	Operating Fund	Replacement Fund	Total	Total
ASSETS				
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
TOTAL ASSETS	$ 146,000	$ 384,000	$ 530,000	$ 331,000

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 Reality 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.

Exhibit 1-1

Types of Cash Flows

OPERATING	INVESTING	FINANCING	NONCASH INVESTING AND FINANCING TRANSACTIONS
CASH RECEIPTS FROM: • Member operating assessments • Member assessments for major repairs and replacements • Member assessments for amortization of mortgage principal (cooperatives only) • Developer assessments, guarantees, and subsidies • Special assessments • Interest from members • Investment income (interest and dividends) • Other income: —Program income —Special use fees —Facility rental —Laundry —Vending machine —Key fees —Forfeited deposits —Transfer fees —Commercial operations • Settlement of litigation • Refunds from suppliers	CASH RECEIPTS FROM: • Sale of property and equipment • Proceeds from certificates of deposit not classified as cash or cash equivalents • Sale of investments (Cash flows should be reported gross for each security classification.)	CASH RECEIPTS FROM: • Short-term borrowings • Long-term borrowings • Issuance of stock • Initial member contributions for working capital • Initial developer contributions • Interfund transfers • Receipts from interfund loans	• Assets contributed by the developer or converter • Assets purchased out of social or other funds and donated to the CIRA • Acquiring property and equipment by assuming liabilities or exchanging assets • Issuing stock in exchange for noncash consideration

OPERATING	INVESTING	FINANCING	NONCASH INVESTING AND FINANCING TRANSACTIONS
CASH PAYMENTS FOR: • Operating expenses: —Management fees —Wages and benefits —Utilities —Service and contracts —Repairs —Supplies —Insurance and licenses —Legal and accounting —Security — Administrative expenses • Replacement expenses (other than asset acquisitions) • Interest (excluding amounts capitalized) • Taxes	CASH PAYMENTS FOR: • Property and equipment (including capitalized interest) • Certificates of deposit not classified as cash or cash equivalents • Investment securities (Cash flows should be reported gross for each security classification.)	CASH PAYMENTS FOR: • Repayment of amounts borrowed (short-term debt, long-term debt, capital lease obligations) • Treasury stock • Patronage dividends • Interfund transfers • Repayment of interfund loans • Refunds of excess assessments or special assessments	

* * *

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:

	Operating Fund	Replacement Fund	Total
CASH FLOWS FROM FINANCING ACTIVITIES			
Interfund transfers	$ 50,000	$ (50,000)	$ —
Interfund borrowings	20,000	(20,000)	—
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.

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 inactive 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[a]

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[b]	20X7 Funding Requirement[c]	Components of Fund Balance at Dec. 31, 20X6[d]
Roofs	5 to 14	$ 1,620,000	$ 120,000	$ 154,000
Streets	5 to 14	96,000	40,000	57,000

Components	Estimated Remaining Useful Lives (Years)	Estimated Current Replacement Costs[b]	20X7 Funding Requirement[c]	Components of Fund Balance at Dec. 31, 20X6[d]
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 equipment	3 to 7	80,000	12,000	12,000
		$ 2,852,000	$ 302,000	$ 379,000

Notes:

[a] As illustrated in Exhibit A-8 of the AICPA guide.

[b] 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.)

[c] The funding requirement for the subsequent year, although illustrated in the AICPA guide, is not required to be disclosed.

[d] 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[a]

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[b]	20X7 Funding Requirement[c]	Components of Fund Balance at Dec. 31, 20X6[d]
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

Components	Estimated Remaining Useful Lives (Years)	Estimated Future Replacement Costs[b]	20X7 Funding Requirement[c]	Components of Fund Balance at Dec. 31, 20X6[d]
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	107,000	14,000	12,000
		$ 5,016,000	$ 374,000	$ 379,000

Notes:

[a] As illustrated in Exhibit A-8 of the (inactive) AICPA guide.

[b] 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.

[c] The funding requirement for the subsequent year, although illustrated in the (inactive) AICPA guide, is not required to be disclosed.

[d] 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 308)**

   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 309)**

   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 313)**

   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 meant 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 315)**

   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.

- 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 for 2017 tax returns, and a flat rate of 21% for 2018 and subsequent tax returns), 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:	Net Membership Income	Net Nonmembership Income
	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.
	Excess Membership Deductions	Net Nonmembership Loss
	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 Income	Net Nonexempt Function Income
	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 Loss	Net Nonexempt Function Loss
	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 Income	Net Nonpatronage Income
	Taxed at regular corporate rates, but may refund excess revenue as patronage dividends.	Taxed at regular corporate rates.
	Net Patronage Loss	Net Nonpatronage Loss
	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 Activities	Net Unrelated Business Income
	Exempt from tax.	Amount in excess of $1,000 is taxed at regular corporate rates.
	Net Loss from Exempt Activities	Net Unrelated Business Loss
	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**. 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.

On December 22, 2017, the president signed the Tax Cuts and Jobs Act (TCJA) into law. Generally, the changes are effective for tax years beginning in 2018 through 2025. Among the many significant changes affecting businesses, the TCJA reduces the corporate tax rate, including personal service corporations, to a flat 21% rate; increases the maximum amount a taxpayer may expense under Section 179 to $1 million and increases the phase-out threshold amount to $2.5 million; provides a temporary 100% first year deduction for the adjusted basis of qualifying business assets, modifies net operating loss deductions, reduces dividends-received deduction percentages, repeals the corporate alternative minimum tax, and limits fringe benefit expenses. For more information on this comprehensive tax overhaul, refer to Thomson Reuters Checkpoint's "Complete Analysis of the Tax Cuts and Jobs Act" and "Special Study-Highlights of the Tax Cuts and Jobs Act." Generally, the discussion in this lesson has not been updated for the TCJA.

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[a]

Reference	Summary	Factors Addressed[b]
IRC Sections		
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
Court Cases		
United Grocers v. U.S.A.	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[b]
Board of Trade of the City of Chicago and Subsidiaries v. Commissioner	Certain fees paid to the membership organization were nontaxable contributions to capital because there was an investment motive, as supported by the following factors: • The fee was earmarked for a capital acquisition or expenditure. •• The organization had a definite commitment to engage in capital activity. •• Both the organization and the members intended that funds collected were to be used for capital purposes. •• Funds were accounted for at the time of payment and were held for that purpose and no other purpose. • The payors were equity owners in the corporation, and there was an increase in equity capital as a result of the payment. • Members had an opportunity to profit from their investment in the corporation.	Purpose Accounted for as a capital contribution Held for that purpose Increase the capital account
Gibbons v. United States	The amount or proportion to be used for capital improvements must be stated at the time of the assessment and *earmarked* for that purpose at the time of receipt.	Advance notice
Maryland Country Club, Inc. v. United States	Three basic conditions are required for earmarking: • There must be a definite commitment to engage in some capital construction. • At the time of the initial payment, both the club and the member must be operating under the assumption that the funds so collected *will be used only for qualified capital purposes* to be completed within three years. • The funds must be accounted for at the time of payment and *held for that purpose and for no other purpose*. 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.	Purpose Advance notice Held for that purpose

Reference	Summary	Factors Addressed[b]
General Counsel Memorandum		
GCM 35929 (Memorandum issued regarding IRC Section 118)	Special assessments are capital contributions because: • They were paid voluntarily by the members.[c] • The equity of the members in the association increased. • The assessments were used to pay capital expenditures. • The everyday operating expenses were covered from other sources. Earmarking of funds, by itself, is not sufficient to create a contribution to capital.	Advance notice Accounted for as a capital contribution Increases the capital account
IRS Revenue Rulings		
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.	Purpose Separate bank accounts
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 *not* qualifying for capital treatment.	Purpose Advance notice Separate bank accounts
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 *not* qualifying for capital treatment.	Purpose Advance notice

Notes:

[a] *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**.

[b] See discussion later in this section.

[c] 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. Effective for tax years beginning after December 31, 2017, the corporate tax rate is a flat 21% rate. 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 greater than the 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

Citation	Applicable Quotation
IRC Section 263	"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*."
IRC Section 277	"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 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, *maintenance*, 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 . . . *However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered*."
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. *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*."
Treasury Regulations Section 1.277-1 (Proposed in 1972, withdrawn in 1986.)	*"Membership deductions are the expenses, depreciation, and similar items of deduction attributable to membership activities."*
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 *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*." 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	"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 United Grocers, Ltd. v. United States . . ., the Court said *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 . . .* Moreover, the availability of various types of personal property, including outdoor furniture, adds to the attractiveness or usefulness of the condominium project and, therefore, *enhances the value* 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."
General Counsel Memoranda 35929	"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 . . . *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* . . . 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."

* * *

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 (noncapital) 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).	The $50,000 is excluded from exempt function income in Year 1 under the provisions of Regulation 1.528-9. The $50,000 is included in exempt function income in Year 2 under the provisions of Regulation 1.528-9.	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 *entire* 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.

* * *

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**, 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.

   d. It is exempt from taxation under subchapter T.

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.

   d. Earnings on an investment of settlement proceeds.

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 330)**

   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 are not subject to the provisions of IRC Section 277.]

   d. It is exempt from taxation under subchapter T. [This answer is incorrect. In order for IRC Section 277 to apply, the entity cannot be exempt under another section of the Code. Therefore, since the CIRA is exempt under subchapter T it is not subject to the IRC 277 provisions.]

6. Which of the following statements best describes an aspect of tax law that applies to all CIRAs? **(Page 337)**

   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 343)**

   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 350)**

   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.]

d. Earnings on an investment of settlement proceeds. [This answer is incorrect. Earnings from the investment of the proceeds of a settlement or award can be significant. Unless the proceeds are invested in tax free securities, all earnings will be taxable income regardless of the nature of the underlying award.]

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 353)**

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.

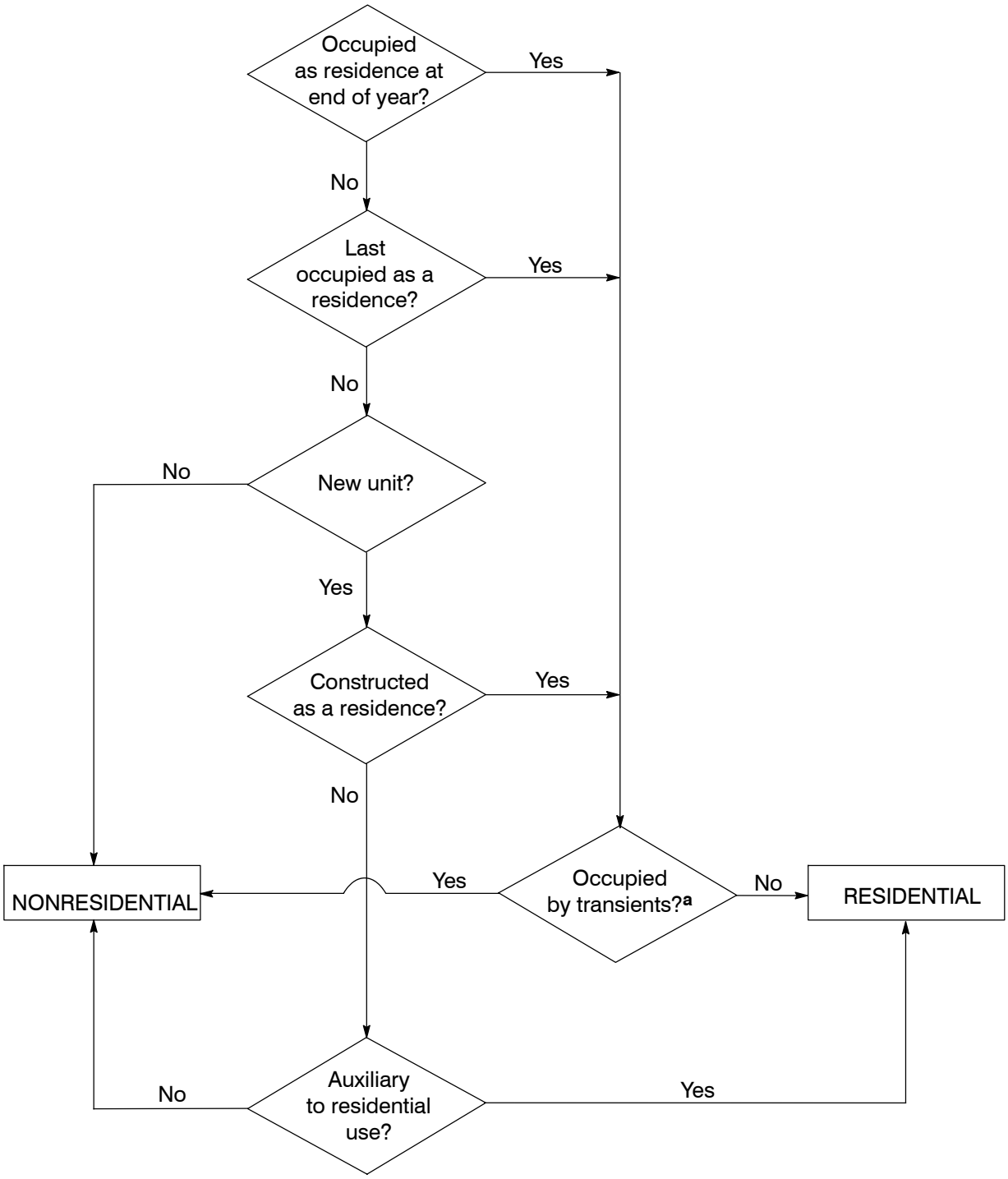
In making the 85% calculation, IRS regulations allow certain property to be considered as residential even though it is not occupied as dwelling units. For example, condominium associations may consider unoccupied units as residences if they were constructed for use as residences (in the case of new 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:

[a] 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 in 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	
Type of income:	**Exempt Function Income**	**Nonexempt Function Income**	**Membership Income**	**Non-membership Income**
Member operating assessments	X		X	
Member assessments for major repairs and replacements (noncapital in nature)[a]	X		X	
Interest on delinquent member assessments[b]	X		X	
Fees, fines, and penalties charged to members[b]	X		X	
Transfer and move in/move out fees[c]	X		X	
Investment income (other than tax-exempt income[d]) on both operating and replacement funds		X		X
Fees charged for services to members:[e]				
Laundry facilities		X	X	
Vending machine		X	X	
Community room rental		X	X	
Storage area rental		X	X	
Garage parking area[f]		X	X	
Key fees—nonrefundable[g]		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[h]	X	X	X	
Litigation proceeds:[i]				
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.

	INCOME CATEGORY				
	Interest	**Parking Garage**	**Vending/ Laundry**	**Community Room**	**Rentals**
EXPENDITURE CATEGORY[a]					
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:

[a] Those expenditures may cause condominium and homeowners' associations problems in meeting the 90% test if they exceed 10% of gross expenditures.

* * *

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	Disadvantages of Filing Form 1120-H
1. Form 1120-H is a one-page form. It is easier to complete than Form 1120.	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. Less risk is associated with filing Form 1120-H.	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	Disadvantages of Filing Form 1120-H
3. Exempt function income is not taxable.	3. Associations are not entitled to write off organizational costs.
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.)	4. Associations are not entitled to the deductions allowed under Part VIII of Subchapter B of the Code.
5. Some states exempt associations that file Form 1120-H from state income taxes.	

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. Effective for financial statements issued after December 31, 2017, the Form 1120 tax rate will be a flat 21% and could yield a lower tax than Form 1120-H. 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.
- For 2017, 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

Requests for Revocation		Requests for Extension	
Approved	**Denied**	**Approved**	**Denied**
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			

* * *

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 362)**

    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 365)**

    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 367)**

    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 rules, 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 373)**

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 375)**

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** 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 statues.)

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.

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	(23,743)
Corrected carryover to 20X6:	
Revenue Ruling 70-604 carryover	$ 5,917

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. (See Exhibit 2-12 for a graphic presentation of the treatment of 70-604 and 277 carryovers.)

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
	ACTION TAKEN							
1	70-604 election	(5) →	5					
	Subtotal		8					
2	70-604 election		(3) →	3				
	Subtotal			(2)				
3	277 loss carryover[a]			2 →	(2)			
	Subtotal				(3)			
4	277 loss carryover[a]				3 →	(3)		
	Subtotal					1		
5	70-604 election					(1) →	1	
	Subtotal						(2)	
6	277 loss carryover[a]						2 →	(2)
	TAXABLE NET MEMBERSHIP INCOME	$ 0	$ 5[b]	$ 0	$ 0	$ 0	$ 0	$ 0

Notes:

[a] This action is automatic; no election is required.

[b] 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). Effective for tax years beginning after December 31, 2017, the corporate tax rate is a flat 21% rate. 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	(50,000)
Corrected net operating loss carryover	$ -0-

Excess Membership Deductions

IRC Section 277 excess membership deductions carryover as previously reported	$ —
Adjustment to excess membership deductions	65,000
Corrected excess membership deductions carryover	$ 65,000

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. 2017 tax rates are as follows:

If Taxable Income Is	The Tax Is
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

Effective for tax years beginning after December 31, 2017, the corporate tax rate is a flat 21% rate.

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.

For tax years beginning after December 31, 2018, the AMT for C corporations is repealed.

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 for the 2017 tax year may be carried back or forward. For the 2018 tax year and future tax years, no carryback of the net operating loss is available, but the loss may be carried forward indefinitely. 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	Disadvantages of Filing Form 1120
1. Taxable income is taxed at the regular corporate rates (15% on the first $50,000 of taxable income for 2017; flat rate of 21% for 2018) versus the 30% (or 32%) tax rate required when filing Form 1120-H.	1. The risk of compliance is much higher for Form 1120 than for Form 1120-H.
2. Certain tax-planning opportunities may exist.	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 for Tax Years ending before December 31, 2017

Example 1: A condominium association has excess membership income.

	Form 1120		Form 1120-H
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	(195,000)		
Net taxable membership income		5,000	N/A
Specific deductions		N/A	(100)
Taxable income		$ 16,000	$ 10,900
Tax rate		15 %	30 %
Tax		$ 2,400	$ 3,270

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.

	Form 1120		Form 1120-H
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	(200,000)		
Net taxable membership income		0	N/A
Specific deductions		N/A	(100)
Taxable income		$ 11,000	$ 10,900
Tax rate		15 %	30 %
Tax		$ 1,650	$ 3,270

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 (for tax years ending before December 31, 2017), 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 the 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 2017 tax 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 for the 2017 tax year?

    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 382)**

    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 the 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 385)**

    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 391)**

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 2017 tax 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 392)**

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 for the 2017 tax year? **(Page 393)**

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. Beginning in 2018, Form 1024 has been replaced with Form 1024-A for organizations seeking exemption under IRC 501(c)(4) only. 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** 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 has since been combined into Revenue Procedure 2018-5, which is updated annually), 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 had not already received a determination letter from the IRS or had not filed a Form 990 (or 990 EZ) were required to file the notice by September 7, 2016.

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, most times, years later. 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.

The authors contacted the IRS attorney, who authored IRS Notice 2016-9 and was designated as the responsible contact for Section 506, regarding the inability of associations to comply with the timing requirements of Section 506 and the accompanying penalty, since the developer is still in control of the corporation at that point in time. The IRS attorney agreed that the penalty would most likely be waived when this information was disclosed to any examining agent. The authors have submitted multiple applications on Form 1024 (and Form 1024-A beginning in 2018) without the IRS issuing a penalty under Section 506.

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

Citation	Summary
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."

Citation	Summary
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."
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	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: 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. 2. It must not conduct activities directed to the exterior maintenance of private residences. 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.
Revenue Ruling 80-63	Revenue Ruling 80-63 was intended to specifically clarify Revenue Ruling 74-99 with respect to homeowners' associations. For example, it states the following: 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. 2. An association would not qualify for exemption if it restricts the use of its recreational facilities to members. 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.

Citation	Summary
	4. An association would not qualify for exemption if it owns and maintains parking facilities only for its members.
Rancho Santa Fe Association v. U.S.	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."
Flat Top Lake Association, Inc. v. U.S.	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.)
Ocean Pines Association, Inc. v. Commissioner	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.

* * *

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

PLR	Disposition	Summary
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.

PLR	Disposition	Summary
201234028	501(c)(4) application denied	This lake oriented community included parks maintained by the association that contained signs restricting use to members only.
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.

PLR	Disposition	Summary
201321039	501(c)(4) status revoked	Association's activities served only its members, not general public.
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.

PLR	Disposition	Summary
201801014	501(c)(4) status revoked	An internet corporation serving a single homeowner association was actually determined to be a for profit business.
21803010	501(c)(4) status revoked	Gated association determined to fail to promote social welfare through limited public access.
201810010	501(c)(4) status revoked	Condominium association did not promote social welfare and operated only for benefit of members.

* * *

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, 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 nonprofitable 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.
- 201732035—Denied; Not operated as a club and exceeded 15% test.
- 201745013—Denied; Association exercises architectural control.
- 201749011—Revoked; Not a club, open to public and exceeded 15% test.
- 201750021—Revoked; Not a club, open to public and exceeded 15% test.
- 201751022—Revoked; received oil royalties and exceeded 15% test, open to public.
- 201806012—Revoked; Not a club, association golf course open to public 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 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**.

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)	1,600
Total basis	$ 155,100

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 of 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$_T$ 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 407)**

    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 414)**

    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 420)**

    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 424)**

    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 427)**

    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 (HOATG183)

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.tr.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 $95 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 ($95 for email or fax; $105 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*
   - Fax to: **(888) 286-9070**
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     Thomson Reuters
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     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 ($95 for answer sheets sent by email or fax; $105 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

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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 (HOATG183)

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 in 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.
   ii. Cash flows from financing activities.
   iii. Cash flows from investing activities.
   iv. Interfund transactions.
   v. Net change in cash during the period.
   vi. Excess of revenues over expenses for the period.
   vii. Differences between the cash balance for future repairs/replacements and the fund balance for future repairs/replacements.
   viii. Supplemental disclosure of any noncash 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 largely all units 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 for 2017, 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 Gardenview 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 Gardenview's 2017 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 of 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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This index is a list of general topics discussed in this course. More specific key word searches can be performed using the search feature of this PDF.

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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—Pre-engagement Activities and Audit Planning (HOATG181)

Name: _____

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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.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Self-study Course Evaluation

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Course Title: Companion to PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations—Course 1—Pre-engagement Activities and Audit Planning

Course Acronym: HOATG181

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4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

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.
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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 (HOATG182)

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1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: September 30, 2019

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

Course Acronym: HOATG182

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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:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

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.
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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 (HOATG183)

CTEC Course No. 3039-CE-2167

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Firm Name: _____

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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.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: September 30, 2019

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: HOATG183

Your Name (optional): _____ Date: _____

CTEC Number: 3039-CE-2167 Email: _____

IRS Program Number(s): 0YC0C-T-01246-18-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:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

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:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. 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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